S. HRG. 112–498

CONCURRENT RESOLUTION ON THE BUDGET FISCAL YEAR 2012

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

ONE HUNDRED TWELTH CONGRESS

FIRST SESSION

January 7, 2011–THE U.S. ECONOMIC OUTLOOK: CHALLENGES FOR MONETARY AND FISCAL POLICY

January 27, 2011–THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2011–2021

February 1, 2011–THE U.S. ECONOMIC OUTLOOK

February 2, 2011–TAX REFORM: A NECESSARY COMPONENT FOR RESTORING FISCAL RESPONSIBILITY

February 3, 2011–CHALLENGES FOR THE U.S. ECONOMIC RECOVERY

February 15, 2011–THE PRESIDENT'S FISCAL YEAR 2012 BUDGET PROPOSAL

February 17, 2011–THE PRESIDENT'S FISCAL YEAR 2012 BUDGET AND REVENUE PROPOSALS

March 1, 2011 09THE PRESIDENT'S FISCAL YEAR 2012 EDUCATION BUDGET

March 2, 2011 09THE PRESIDENT'S FISCAL YEAR 2012 BUDGET REQUEST FOR THE DEPARTMENT OF ENERGY

March 3, 2011–THE PRESIDENT'S FISCAL YEAR 2012 BUDGET REQUEST FOR THE U.S. DEPARMENT OF TRANSPORTATION

March 8, 2011–THE REPORT OF THE NATIONAL COMMISSION ON FISCAL RESPONSIBILTY AND REFORM

March 9, 2011–DISTRIBUTION AND EFFICIENCY OF SPENDING IN THE TAX CODE

March 10, 2011–THE PRESIDENT'S FISCAL YEAR 2012 DEFENSE AND INTERNATIONAL AFFAIRS BUDGET

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FRIDAY, JANUARY 7, 2011

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The Committee met, pursuant to notice, at 9:31 a.m., in Room SH–216, Hart Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Wyden, Stabenow, Warner, Merkley, Manchin, Sessions, Enzi, and Cornyn.

Staff Present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The Committee will come to order.

I want to welcome everyone to the Budget Committee this morning. I especially want to welcome Senator Sessions.

Senator Sessions has not formally been recognized as Ranking Member of the Budget Committee, but that is just a formality. He will be as soon as the organizing resolution is adopted, and so I intend to treat Senator Sessions as the Ranking Member here today, and I think that is the appropriate thing to do.

I very much welcome Senator Sessions as my partner on this Committee. He has considerable knowledge of the budget and the budget process, and I very much look forward to working with him as we confront the significant challenges facing the country.

I also want to welcome Federal Reserve Chairman Ben Bernanke back to the Budget Committee. This is Chairman Bernanke's third appearance here, and we have always benefitted by his wise counsel. I believe that when the history of this period is written, you will be one of the heroes of the piece in averting what could have been a financial collapse.

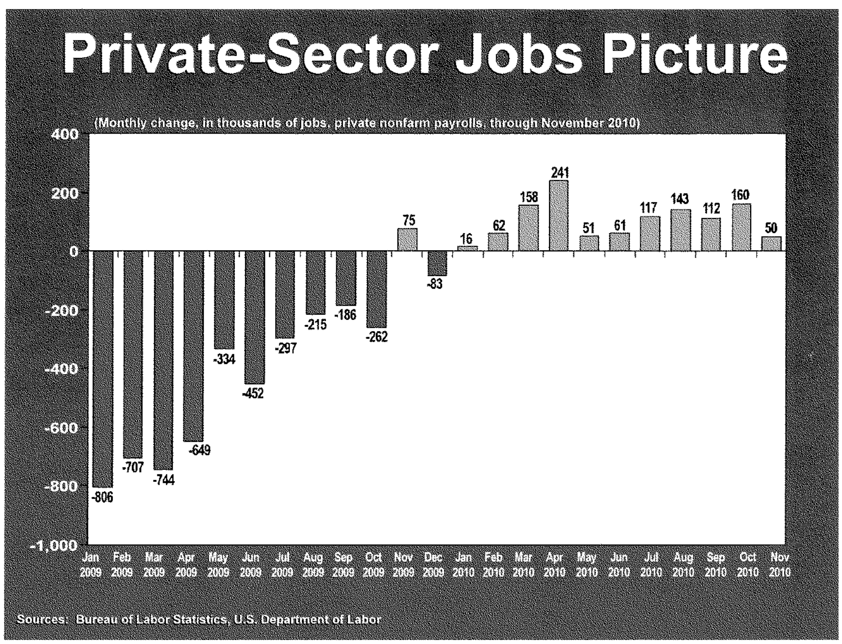
I was in the meetings with the former Secretary of the Treasury and with you when you warned us of how serious the financial circumstances were in late 2008. Those moments will be forever riveted in my memory, I am sure in yours as well. I personally believe you and then Secretary of the Treasury Hank Paulson, followed by this administration, have taken steps that were critically important to averting a financial collapse, not only here but globally as well.

Still, our Nation faces very serious challenges. We know we are on an unsustainable course with the budget, borrowing about 40 cents of every dollar that we spend. Clearly, that cannot continue for very long.

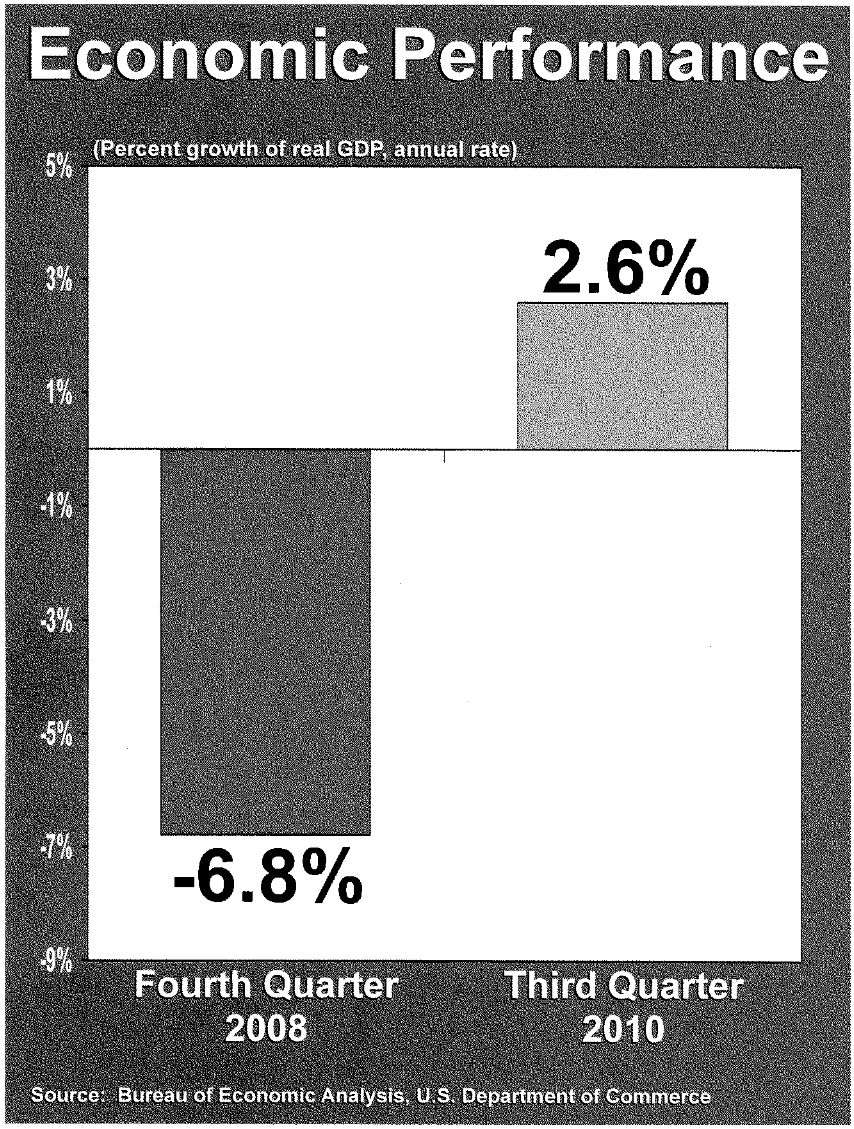
On the other hand, we also face a fragile economy. With one in every six workers in this country either unemployed or underemployed, that requires our immediate attention as well. My own belief is that we need to put in place a plan this year to get our fiscal house back in order, and that plan needs to be phased in over a period of time along the lines of what the Fiscal Commission proposed.

I think we also understand where we have come. This has been an extraordinary period in the country's economic history. I would like to just go over a brief history of what we have experienced.

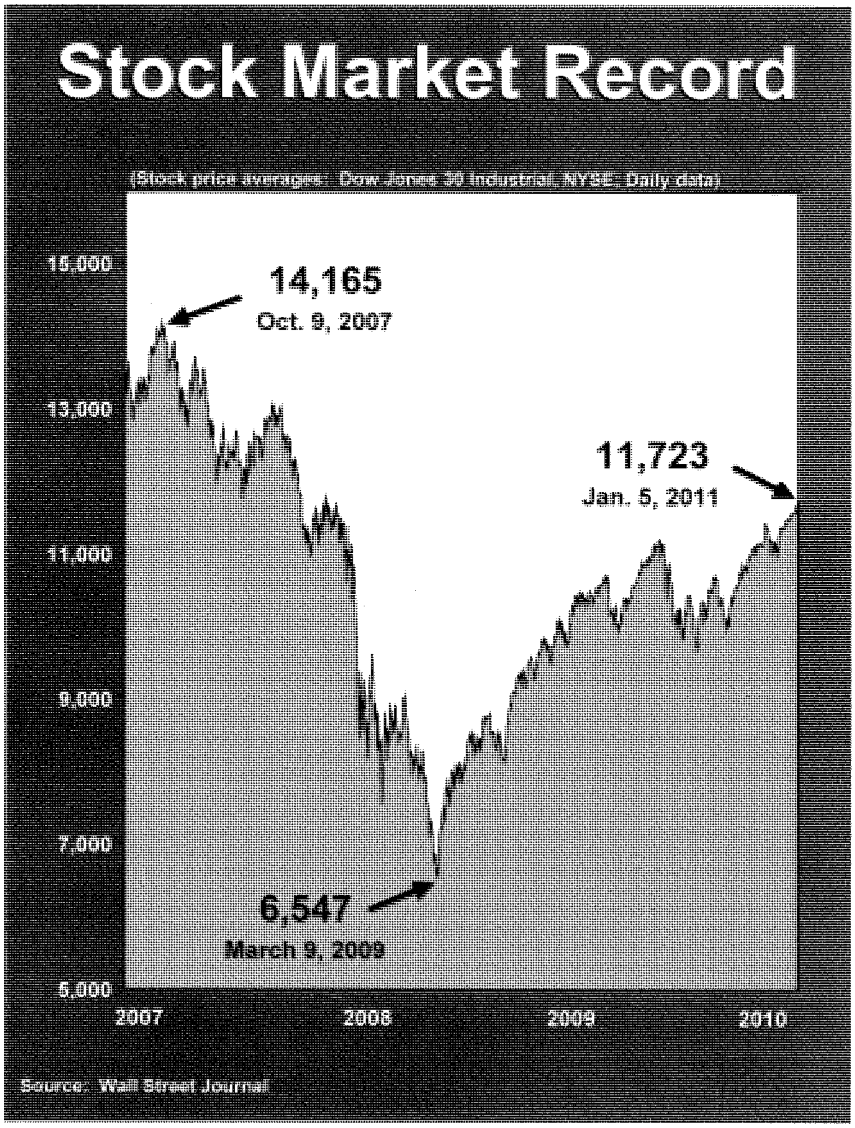
I personally believe the Federal response did avert what could have been a financial collapse. I believe it was that serious. In the meetings that I was in with then Secretary of the Treasury Hank Paulson and you, Mr. Chairman, the risks were very clear. We have seen some progress made—in fact, important progress made. Private sector job growth has returned, although not as much as we would have liked. We heard the numbers this morning, something over 100,000 jobs created in the private sector, a dramatic improvement of where we were back in January of 2009 when we were losing 800,000 private sector jobs a month. Now we have had 12 consecutive months of private sector job growth.

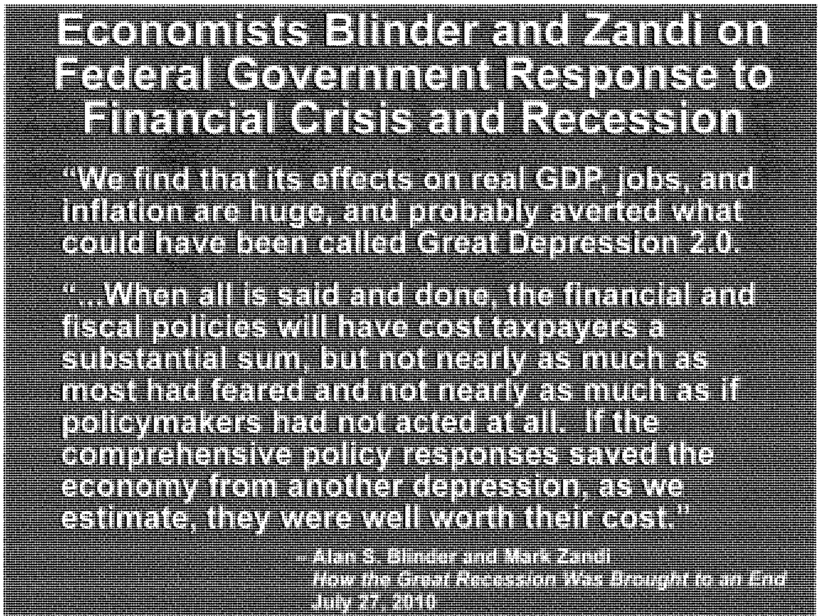


Now, in economic growth the pattern is the same, although actually somewhat better. In the fourth quarter of 2008, the economy actually contracted, actually shrunk by 6.8 percent. More recently, in the third quarter of 2010, we saw a positive growth of 2.6 percent—again, a dramatic improvement, while not as strong as we would hope. We have now had five consecutive quarters of growth.

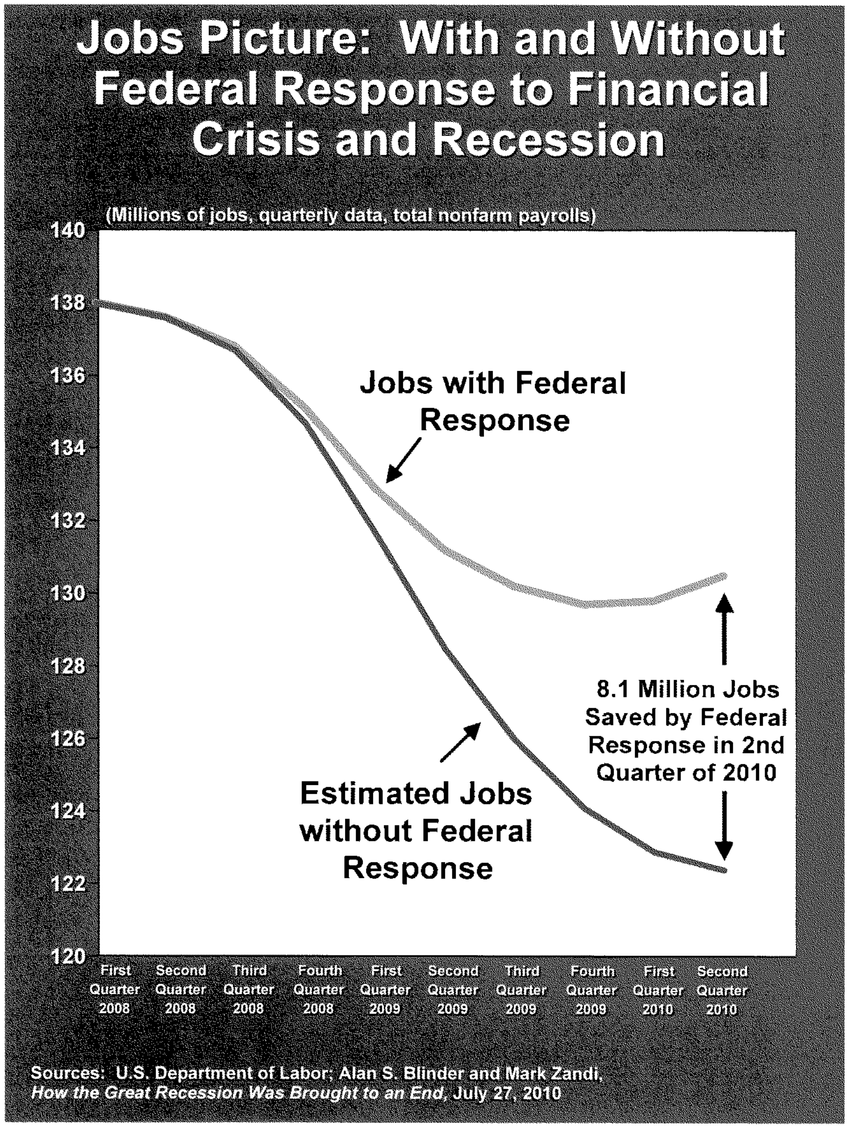


We have also seen a dramatic rebound in the stock market. After falling to a low of just about 6,500 in March of 2009, the Dow is now over 11,500. And two of the most respected economists in the country—Mark Zandi, who was a consultant to the McCain Campaign, and Alan Blinder, the former Deputy Chairman of the Federal Reserve—did an analysis that measured the impact of Federal actions—the TARP and stimulus—and also included the Fed's monetary policy actions, and they concluded as follows: "We find that its effects on real GDP, jobs, and inflation are huge and probably averted what could have been called 'Great Depression 2.0.' When all is said and done, the financial and fiscal policies will have cost taxpayers a substantial sum, but not nearly as much as most had feared and not nearly as much as if policymakers had not acted at all. If the comprehensive policy responses saved the economy from another depression, as we estimate, they were well worth the cost."

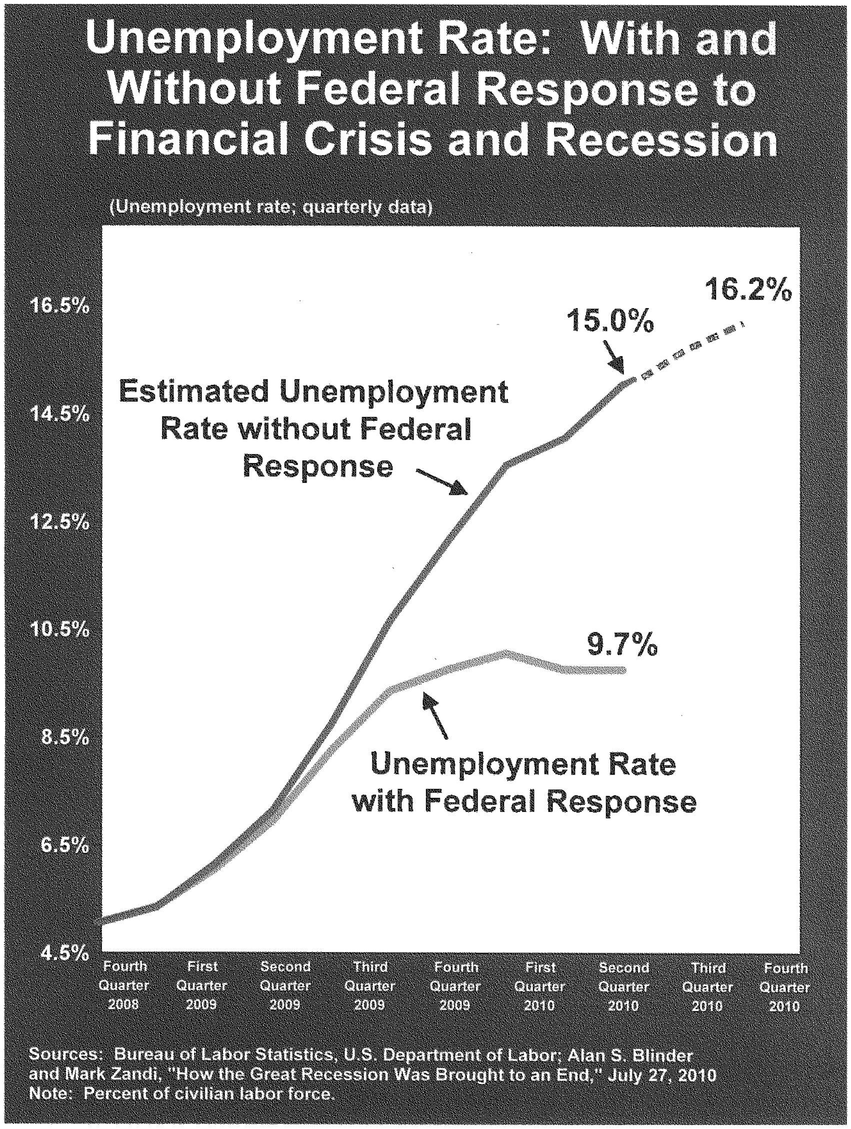




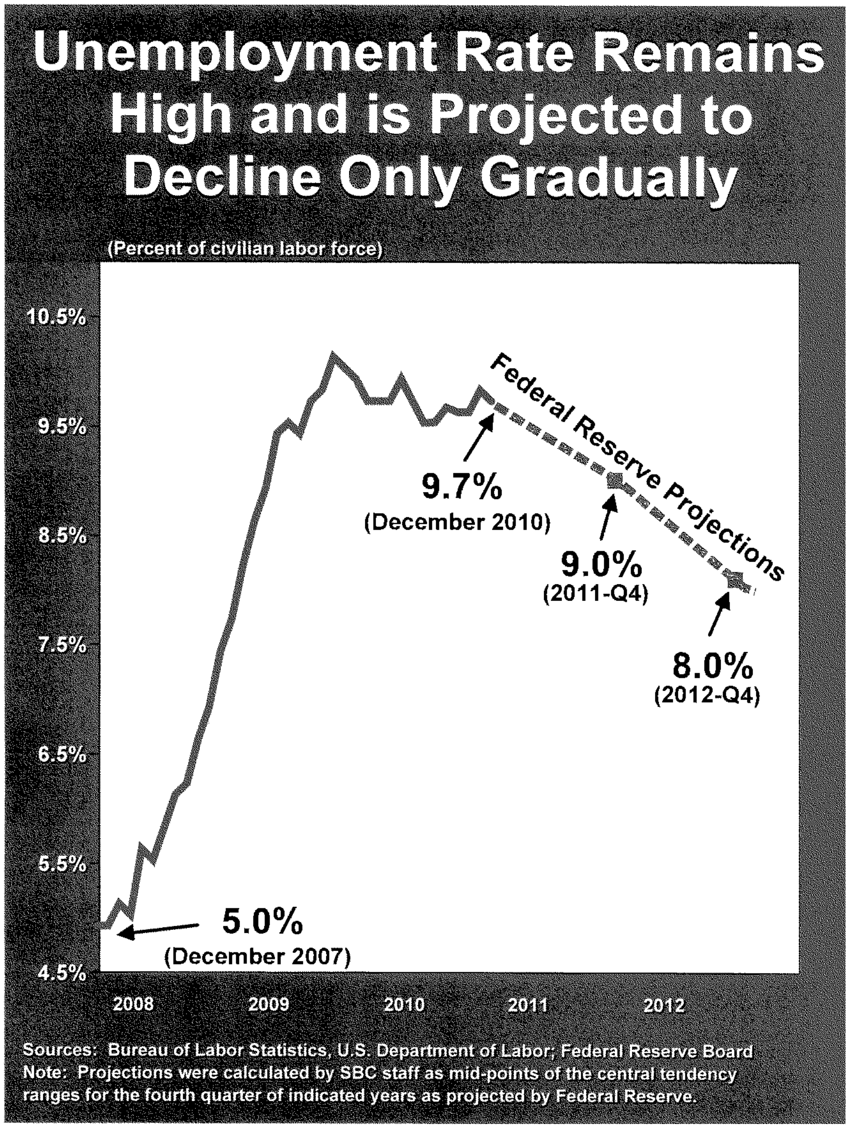
This next chart shows Dr. Blinder and Dr. Zandi's estimate of the number of jobs we would have without the Federal response. It shows we would have had 8 million fewer jobs in the second quarter of 2010 if we had not had the Federal response—the TARP and the stimulus.



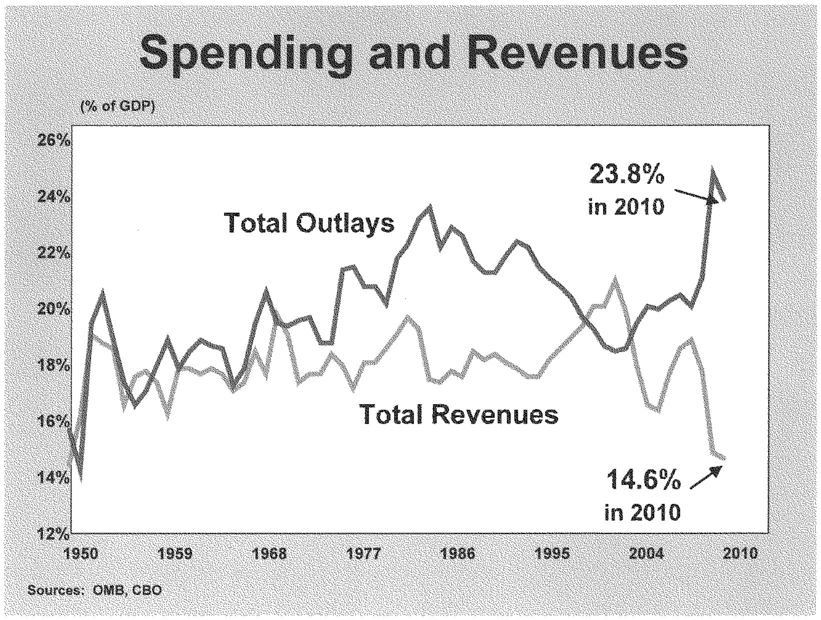
We see a similar picture with the unemployment rate. The unemployment rate averaged 9.7 percent in the second quarter. According to Dr. Blinder and Dr. Zandi, if we had not had the Federal response, the unemployment rate would have been 15 percent in the second quarter and would have continued rising to over 16 percent in the fourth quarter of 2010. So, clearly, the Federal response to the economic crisis has had and continues to have a significant positive impact on the economy, but we are not out of the woods.



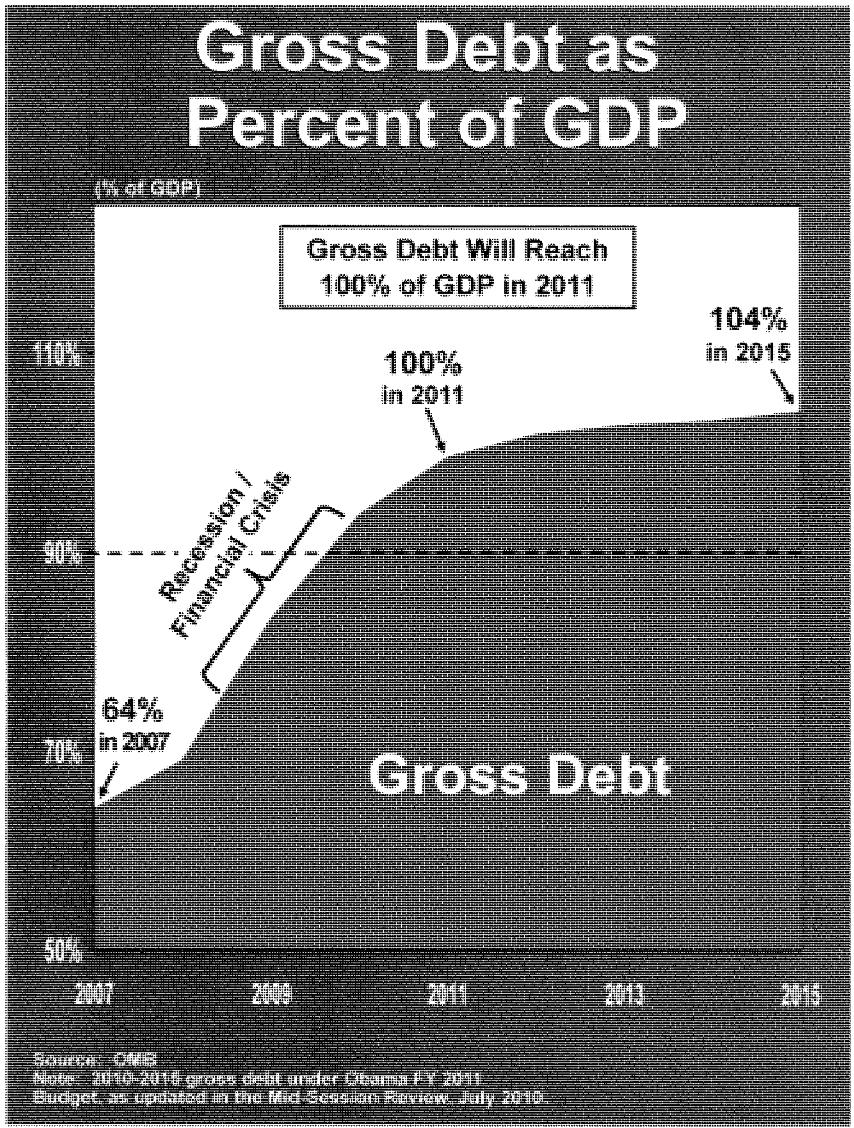
We cannot forget that, as I mentioned before, one in every six of our fellow citizens are either unemployed or underemployed. The unemployment rate in December, which was also announced this morning, was 9.4 percent. This is still far too high. And Federal Reserve projections show the rate is likely to come down only slowly, averaging still in the high 8-percentage-point range by the fourth quarter of 2012.



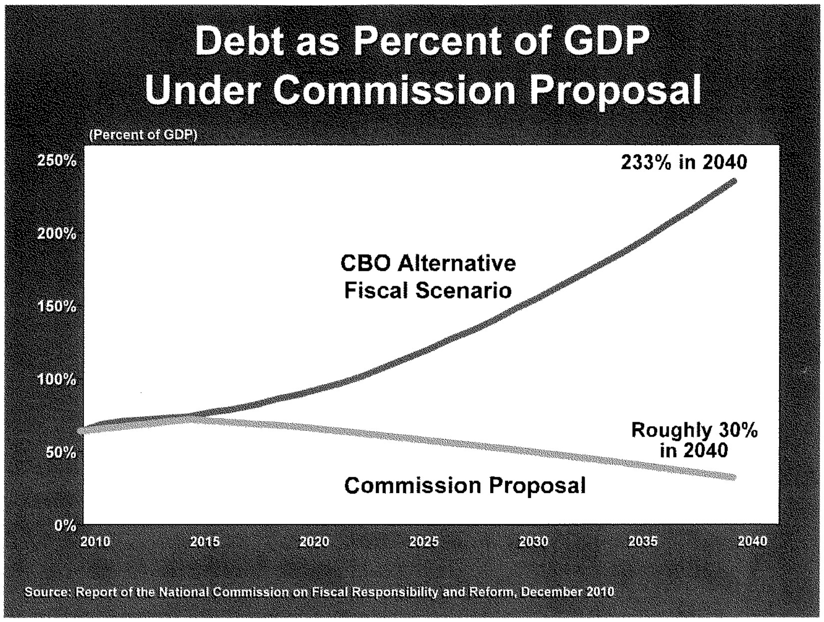
But as I noted, we must now also pivot to addressing the long-term fiscal imbalances that the country confronts. I believe we are at a critical juncture. We have been borrowing, as I mentioned earlier, 40 cents of every dollar that we spend. That cannot continue much longer. Spending is at the highest level as a share of our national income in 60 years; revenue is at its lowest level as a share of our national income in 60 years. I believe that indicates you have to work both sides of that equation if we are to make progress.



Gross Federal debt is already expected to reach 100 percent of GDP this year, well above the 90-percent threshold that many economists see as the danger zone. A leading economist came before our Commission and has come before this Committee, Dr. Carmen Reinhart, who has studied 200 years of fiscal crises around the world. She concluded that when government debt as a share of the economy exceeds 90 percent—and she is referring here to gross Federal debt—that economic growth tends to be about one percentage point lower than it would be if debt levels were not so high. If that association were applied to the United States today, it would translate into a potential economic loss of hundreds of billions of dollars and substantially fewer jobs for Americans.



So I believe the deficit and debt reduction plan assembled by the Fiscal Commission could provide a blueprint and a way forward. The plan would stabilize the publicly held debt by 2014 and then lower it to 60 percent of GDP by 2023 and roughly 30 percent by 2040. I emphasize that is the publicly held debt, not the gross debt.



The bipartisan Commission voted for the plan; 60 percent of us supported it—interestingly enough, five Republicans and five Democrats and one Independent. I think that demonstrates that we can reach across the aisle to do things that are critically important for the country. Facing up to the debt threat is something we must do, and we must do it together.

With that, we will turn to Senator Sessions for his opening remarks, and, again, I want to welcome him as Ranking Member of the Budget Committee.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Chairman Conrad. It is an honor to be here, to be with you. I respect you very much and value our friendship and enjoy being ribbed by you—effectively, I must add—and look forward to working with you to help make our country better. We have some real serious challenges ahead of us.

I also want to note how much I have admired our former Ranking Member, Judd Gregg. I know you and he had a great relationship. I think his leadership was particularly valuable. People listened to him, they trusted his judgment, and I hope that I can just come close to being as effective as he has been in this position.

I would like to share some thoughts and concerns. I know that when the mortgage crisis hit and the economy was whacked, a lot of people got together and tried to make some decisions. Mr. Chairman, it would have been better, I think, had we seen the mortgage crisis 2 years in advance and taken action to make the crisis less real. And I say that because we ought to be humble about where we are today.

I do not think anyone fully understands this magnificent world economy we are a part of. I do not think any one person, whether it is the Federal Reserve, the Secretary of Treasury, or even Congress, can have a little meeting and be sure that the actions we take are going to have certain impacts on this massive economy of which we are a part. When you are confused, in the end you need to return to the fundamentals of blocking and tackling, to the fundamentals of paying your bills on time, and create some confidence in the economy.

So today is our Committee's first hearing of the 112th Congress. We meet on the heels of a historic election. It is important, that election. The American people rebelled against wasteful Washington spending and a Government that has grown too large and too intrusive. The American people also rebelled against a political establishment that has placed our country on a path to fiscal decline. Solving our Nation's economic and debt crisis is about more than economics. It is about protecting our way of life at home and our standing abroad as a great Nation, and it is about honest and moral policy.

Our goal is not an era of austerity but an era of prosperity. Restoring fiscal discipline and strengthening the private sector is the only way to create growth and opportunity for every hard-working American, and it is the only way to protect our country's greatness and its vital role in the world.

To solve our problems, we must speak about them candidly. Our Nation's debt will soon be equal to the size of our entire economy. Forty percent of our budget relies on borrowed funds. In 2009, the interest on our debt alone cost $187 billion. And the Congressional Budget Office projects that under the President's budget these interest payments will climb to $916 billion in 2020. That exceeds any other part of our budget and is growing faster than any other part of our budget—vastly superior to the defense budget.

We are on a path that is unsustainable. The only real question is how much road is left between us and the edge of the cliff. The American people understand the situation. They understand that years of unchecked Federal spending has squandered our Nation's wealth and threatened our children's future. The American people understand what elites in Washington seem to forget, and that is, you can only live beyond your means for so long. Eventually the bill comes due. Fundamentally it is immoral to take from our children their wealth so we can spend unearned wealth today.

There are other problems, too. Considering the housing bubble, for years Congress delayed action to address the unfolding catastrophe at Freddie and Fannie. The Federal Reserve was asleep at the switch and failed to sound the alarm. And then one day the bubble burst, and the whole world changed. No one knows exactly what will happen if we continue our spending on the current course, but we must not find out.

James Baker wrote a recent piece in the Washington Times describing some of the worse potential consequences, saying we need to be more specific about what the consequences will be. He said, "One day the Treasury will hold an auction and there will not be buyers. The Federal Reserve will step in as a buyer of last resort, conjuring money from the ether to buy bonds. The injection of massive liquidity into the financial system will trigger fears of hyperinflation, causing the dollar to plunge and interest rates to rise. If the resources of the European Union and the International Monetary Fund are stretched to rescue the finances of tiny Greece and Ireland, the United States will not only be too big to fail but too big to bail out. Absent emergency action by the Government, the economy will plunge into a depression roughly 3 times more acute than the recession we just experienced."

I do not know if it would happen like that, but Barron's also had an editorial by an experienced Wall Streeter of 45 years warning of a hyperinflationary spiral. The writer explained that while the Federal Reserve can monetize the debt, historically a "break point occurs when a government borrows an amount equal to 40 percent of its expenditures for an extended period of time."

In a recent interview, Chairman Bernanke, you said you were 100 percent confident the Fed could prevent such inflation, but I am not sure the masters of the universe—you being maybe the master master how confident you can be about that. You have been wrong before. And while we can debate just how great and imminent the risk is, there is no debating what the American people have declared in poll after poll. We are on the wrong track.

But where is the leadership from our administration? Just last December, the President would only agree to maintain current tax rates if Congress agreed to new spending, all borrowed, that would add another $250 billion to the debt. Instead of slowing down, President Obama hit the accelerator. But simply easing off the pedal will not solve the problem. When you are driving toward a cliff at 90 miles an hour, you cannot just slow down to 60. You need to hit the brakes and steer on to the right road. For too long, Washington compromise has changed only the pace and not the direction that we are going.

Last November, the American people said, "Enough." That is precisely what they said, I believe. They sent Congress a new freshman class with a clear set of instructions. Those instructions include a budget that changes our trajectory and genuinely reduces the size, cost, and burden of Government. We can learn from those who are setting a strong example.

In New Jersey, Governor Chris Christie has a plan to close his State's funding gap without raising taxes.

In Britain, the new conservative government has taken strong action and has a plan to reduce their deficit from 10 to 4 percent of GDP in just 4 years. As Britain's Chancellor of the Exchequer George Osborne said, "It is a hard road, but it leads to a better future."

Yet some would argue that reducing Government spending even a small amount will reduce the quality of our life, but the surest way to lower the quality of life in America is to continue on our current course, spending without restraint, crushing private enterprise, and mortgaging the inheritance of our children.

The challenges ahead may be difficult, but the choices we face are not. We need to limit Government, control spending, and create an environment where the free market can thrive and flourish. It is a road map our Founders laid out more than two centuries ago. There is no doubt it will work again. America's progress is not a thing of the past. We can do this. But to achieve this progress, we can no longer compromise our Nation's founding principles. Instead we must fight for them and in so doing hope to find common ground in doing so.

Chairman Bernanke, I look forward to discussing these and other issues with you today, and I look forward to getting your thoughts on how you and the administration are working together with a plan for strengthening our future.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you so much, Senator Sessions, and I just want to say I welcome your analysis. We may not agree on every solution. I think the one thing we are agreed on is we are on an unsustainable course, and we have an obligation, we have a very serious and somber obligation to come up with a plan and to do it sooner rather than later, and I look very much forward to working with you on that.

Senator SESSIONS. Thank you. I value those comments.

Chairman CONRAD. Mr. Chairman, thank you so much for coming. I want to tell the Committee that Chairman Bernanke has also offered to come up here in a closed session with Committee members to discuss what he sees with respect to the economy, but we very much welcome your being here as our first witness as we embark on the challenge of putting together a budget for this year and succeeding years. Welcome.

STATEMENT OF THE HONORABLE BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Thank you. Thank you, Chairman Conrad, Senator Sessions, and other members of the Committee. I want to thank you for this opportunity to offer my views on current economic conditions, recent monetary policy actions, and issues related to the Federal budget.

The economic recovery that began a year and a half ago is continuing, although to date at a pace that has been insufficient to reduce the rate of unemployment significantly. The initial stages of the recovery in the second half of 2009 and in early 2010 were largely attributable to the stabilization of the financial system, the expansion of monetary and fiscal policies, and a powerful inventory cycle.

Growth slowed somewhat this past spring as the impetus from fiscal policy and inventory building waned and as European sovereign debt problems led to increased volatility in financial markets. More recently, however, we have seen increased evidence that a self-sustaining recovery in consumer and business spending may be taking hold. In particular, real consumer spending rose at an annual rate of 2.5 percent in the third quarter of 2010, and the available indicators suggest that it likely expanded at a somewhat faster pace in the fourth quarter.

Business investment in new equipment and software has grown robustly in recent quarters, albeit from a fairly low level, as firms replaced aging equipment and made investments that had been delayed during the downturn. However, the housing sector remains depressed as the overhand of vacant house continues to weigh heavily on both home prices and construction, and non-residential construction is also quite weak. Overall, the pace of economic recovery seems likely to be moderately stronger in 2011 than it was in 2010.

Although recent indicators of spending and production have generally been encouraging, conditions in the labor market have improved only modestly at best. After the loss of nearly 8.5 million jobs in 2008 and 2009, private payrolls expanded at an average of only about 100,000 per month in 2010—a pace barely enough to accommodate the normal increase in the labor force and, therefore, insufficient to materially reduce the unemployment rate.

On a more positive note, a number of indicators of job openings and hiring plans have looked stronger in recent months, and initial claims for unemployment insurance declined through November and December. Notwithstanding these hopeful signs, with output growth likely to be moderate in the next few quarters and employers reportedly still reluctant to add to payrolls, considerable time likely will be required before the unemployment rate has returned to a more normal level.

Persistently high unemployment by dampening household income and confidence could threaten the strength and sustainability of the recovery. Moreover, roughly 40 percent of the unemployed have been out of work for 6 months or more. Long-term unemployment not only imposes exceptional hardships on the jobless and their families, but it also erodes the skills of those workers and may inflict lasting damage on their employment and earnings prospects.

Recent data show consumer price inflation continuing to trend downward. For the 12 months ending in November, prices for personal consumption expenditures rose 1.0 percent, and inflation, excluding the relatively volatile food and energy components, which tends to be a better gauge of underlying inflation trends, was only 0.8 percent, down from 1.7 percent a year earlier and from about 2.5 percent in 2007, the year before the recession began.

The downward trend in inflation over the past few years is no surprise given the low rates of resource utilization that have prevailed over that time. Indeed, as a result of the weak job market, wage growth has slowed along with inflation. Over the 12 months ending in November, average hourly earnings have risen only 1.6 percent.

Despite the decline in inflation, long-run inflation expectations have remained stable. For example, the rate of inflation that households expect over the next 5 to 10 years, as measured by the Thompson Reuters/University of Michigan Surveys of Consumers, has remained in a narrow range over the past few years. With inflation expectations stable and with levels of resource utilization expected to remain low, inflation is likely to be subdued for some time.

Although it is likely that economic growth will pick up this year and that the unemployment rate will decline somewhat, progress toward the Federal Reserve statutory objectives of maximum employment and stable prices is expected to remain slow. The projections submitted by the Federal Open Market Committee, or FOMC, showed that, notwithstanding forecasts of increased growth in 2011 and 2012, most participants expected the unemployment rate to be close to 8 percent 2 years from now. At this rate of improvement, it could take 4 to 5 more years for the job market to normalize fully.

FOMC participants also predicted inflation to be at historically low levels for some time. Very low rates of inflation raise several concerns.

First, very low inflation increases the risk that new adverse shocks could push the economy into deflation; that is, a situation involving ongoing declines in prices. Experience shows that deflation induced by economic slack can lead to extended periods of poor economic performance. Indeed, even a significant perceived risk of deflation may lead firms to be more cautious about investment and hiring.

Second, with short-term nominal interest rates already close to zero, declines in actual and expected inflation increase, respectively, both the real cost of servicing existing debt and the expected real cost of new borrowing. By raising effective debt burdens and by inhibiting new household spending and business investment, higher real borrowing costs create a further drag on growth.

Finally, it is important to recognize that periods of very low inflation generally involve very slow growth in nominal wages and incomes as well as prices. I have already alluded to the recent deceleration in average hourly earnings. Thus, in circumstances like those we face now, very low inflation, or deflation, does not necessarily imply any increase in household purchasing power. Rather, because of the associated deterioration in economic performance, very low inflation, or deflation, arising from economic slack is generally linked with reductions rather than gains in living standards.

In a situation in which unemployment is high and expected to remain so and inflation is unusually low, the FOMC would normally respond by reducing its target for the Federal funds rate. However, the Federal Reserve's target for the Federal funds rate has been close to zero since December 2008, leaving essentially no scope for further reductions. Consequently for the past 2 years, the FOMC has been using alternative tools to provide additional monetary accommodation. Notably, between December 2008 and March 2010, the FOMC purchased about $1.7 trillion in longer-term Treasury and agency-backed securities in the open market. The proceeds of these purchases ultimately find their way into the banking system, with the result that depository institutions now hold a high level of reserve balances with the Federal Reserve.

Although longer-term securities purchases are a different tool for conducting monetary policy than the more familiar approach of managing the overnight interest rate, the goals and transmission mechanisms of the two approaches are similar. Conventional monetary policy works by changing market expectations for the future path of short-term interest rates, which in turn influences the current level of longer-term interest rates and other financial conditions. These changes in financial conditions then affect household and business spending. By contrast, securities purchases by the Federal Reserve put downward pressure directly on longer-term interest rates by reducing the stock of longer-term securities held by private investors. These actions affect private sector spending through the same channels as conventional monetary policy.

In particular, the Federal Reserve's earlier program of asset purchases appeared to be successful in influencing longer-term interest rates, raising the prices of equities and other assets, and improving credit conditions more broadly, thereby helping stabilize the economy and support the recovery.

In light of this experience and with the economic outlook still unsatisfactory, late last summer the FOMC began to signal to financial markets that it was considering providing additional monetary policy accommodation by conducting further asset purchases. At its meeting in early November, the FOMC formally announced its intention to purchase an additional $600 billion in Treasury securities by the end of the second quarter of 2011, or about one-third the value of securities purchased in earlier programs. The FOMC also maintained its policy, adopted at its August meeting, of reinvesting principal received on the Federal Reserve's holdings of securities. The FOMC stated that it will review its asset purchase program regularly in light of incoming information and will adjust the program as needed to meet its objectives.

Importantly, the committee remains unwaveringly committed to price stability and in particular to maintaining inflation at a level consistent with the Federal Reserve's mandate from the Congress. In that regards, it bears emphasizing that the Federal Reserve has all the tools it needs to ensure that it will be able to smoothly and effectively exit from this program at the appropriate time.

Importantly, the Federal Reserve's ability to pay interest on reserve balances held at Federal Reserve banks will allow it to put upward pressure on short-term market interest rates and thus to tighten monetary policy when needed, even if bank reserves remain high. Moreover, the Fed has invested considerable effort in developing methods to drain or immobilize bank reserves as needed to facilitate the smooth withdrawal of policy accommodation when conditions warrant. If necessary, the committee could also tighten policy by redeeming or selling securities on the open market.

As I am appearing before the Budget Committee, it is worth emphasizing that the Fed's purchases of longer-term securities are not comparable to ordinary Government spending. In executing these transactions, the Federal Reserve requires financial assets, not goods and services. Ultimately, at the appropriate time, the Federal Reserve will normalize its balance sheet by selling these assets back into the market or by allowing them to mature. In the interim, the interest that the Federal Reserve earns from its securities holdings adds to the Fed's remittances to the Treasury. In 2009 and 2010, those remittances totaled about $120 billion.

Fiscal policymakers also face a challenging environment. Our Nation's fiscal position has deteriorated appreciably since the onset of the financial crisis and the recession. To a significant extent, this deterioration is the result of the effects of the weak economy on revenues and outlays along with the actions that we are taking to ease the recession and steady financial markets. In their planning for the near term, fiscal policymakers will need to continue to take into account the low level of economic activity and the still fragile nature of the economic recovery.

However, an important part of the Federal budget deficit appears to be structural rather than cyclical; that is, the deficit is expected to remain unsustainably elevated even after economic conditions have returned to normal. For example, under the CBO's so-called alternative fiscal scenario, which assumes that most of the tax cuts enacted in 2001 and 2003 are made permanent and that discretionary spending rises at the same rate as the GDP, the deficit is projected to fall from its current level of about 9 percent of GDP to 5 percent of GDP by 2015, but then to rise to about 6.5 percent of GDP by the end of the decade.

In subsequent years, the budget outlook is projected to deteriorate even more rapidly as the aging of the population and continued growth in health spending boost Federal outlays on entitlement programs. Under this scenario, Federal debt held by the public is projected to reach 185 percent of the GDP by 2035, up from about 60 percent at the end of fiscal year 2010.

The CBO projections by design ignore the adverse effects that such high debt and deficits would likely have on our economy. But if Government debt and deficits were actually to grow at the pace envisioned in the scenario, the economic and financial effects would be severe. Diminishing confidence on the part of investors that deficits will be brought under control would likely lead to sharply rising interest rates on Government debt and potentially to broader financial turmoil. Moreover, high rates of Government borrowing would drain funds away from private capital formation and increase our foreign indebtedness with adverse long-run effects on U.S. output, incomes, and standards of living.

It is widely understood that the Federal Government is on an unsustainable fiscal path, yet as a Nation we have done little to address this critical threat to our economy. Doing nothing will not be an option indefinitely. The longer we wait to act, the greater the risks and the more wrenching the inevitable changes to the budget will be. By contrast, the prompt adoption of a credible program to reduce future deficits would not only enhance economic growth and stability in the long run, but could also yield substantial near-term benefits in terms of lower long-term interest rates and increased consumer and business confidence.

Plans recently put forward by the President's National Commission on Fiscal Responsibility and Reform and other prominent groups provide useful starting points for a much needed national conversation about our medium- and long-term fiscal situation. Although these various proposals differ on many details, each gives a sobering perspective on the size of the problem and offers some potential solutions.

Of course, economic growth is affected not only by the levels of taxes and spending but also by their composition and structure. I hope that in addressing our long-term fiscal challenges the Congress will seek reforms to the Government's tax policies and spending priorities that serve not only to reduce the deficit but also to enhance the long-term growth potential of our economy, for example, by encouraging investment in physical and human capital, by promoting research and development, by providing necessary public infrastructure, and by reducing disincentives to work and to save. We cannot grow out of our fiscal imbalances, but a more productive economy would ease the trade-offs that we face.

Thank you, Mr. Chairman, Senator Sessions. I would be pleased to take your questions.

[The prepared statement of Mr. Bernanke follows:]

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Statement by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

Washington, D.C.

January 7, 2011

Chairman Conrad, Senator Sessions, and other members of the Committee, thank you for this opportunity to offer my views on current economic conditions, recent monetary policy actions, and issues related to the federal budget.

The Economic Outlook

The economic recovery that began a year and a half ago is continuing, although, to date, at a pace that has been insufficient to reduce the rate of unemployment significantly.[1] The initial stages of the recovery, in the second half of 2009 and in early 2010, were largely attributable to the stabilization of the financial system, expansionary monetary and fiscal policies, and a powerful inventory cycle. Growth slowed somewhat this past spring as the impetus from fiscal policy and inventory building waned and as European sovereign debt problems led to increased volatility in financial markets.

More recently, however, we have seen increased evidence that a self-sustaining recovery in consumer and business spending may be taking hold. In particular, real consumer spending rose at an annual rate of 2-1/2 percent in the third quarter of 2010, and the available indicators suggest that it likely expanded at a somewhat faster pace in the fourth quarter. Business investment in new equipment and software has grown robustly in recent quarters, albeit from a fairly low level, as firms replaced aging equipment and made investments that had been delayed during the downturn. However, the housing sector remains depressed, as the overhang of vacant houses continues to weigh heavily on both home prices and construction, and nonresidential construction is also quite weak. Overall, the pace of economic recovery seems likely to be moderately stronger in 2011 than it was in 2010.

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[1] This testimony was submitted before this morning's employment report for December, which will provide an important update on the state of the labor market.

Although recent indicators of spending and production have generally been encouraging, conditions in the labor market have improved only modestly at best. After the loss of nearly 8-1/2 million jobs in 2008 and 2009, private payrolls expanded at an average of only about 100,000 per month in 2010--a pace barely enough to accommodate the normal increase in the labor force and, therefore, insufficient to materially reduce the unemployment rate.[2] On a more positive note, a number of indicators of job openings and hiring plans have looked stronger in recent months, and initial claims for unemployment insurance declined through November and December. Notwithstanding these hopeful signs, with output growth likely to be moderate in the next few quarters and employers reportedly still reluctant to add to payrolls, considerable time likely will be required before the unemployment rate has returned to a more normal level. Persistently high unemployment, by damping household income and confidence, could threaten the strength and sustainability of the recovery. Moreover, roughly 40 percent of the unemployed have been out of work for six months or more. Long-term unemployment not only imposes exceptional hardships on the jobless and their families, but it also erodes the skills of those workers and may inflict lasting damage on their employment and earnings prospects.

Recent data show consumer price inflation continuing to trend downward. For the 12 months ending in November, prices for personal consumption expenditures rose 1.0 percent, and inflation excluding the relatively volatile food and energy components--which tends to be a better gauge of underlying inflation trends--was only 0.8 percent, down from 1.7 percent a year earlier and from about 2-1/2 percent in 2007, the year before the recession began. The downward trend in inflation over the past few years is no surprise, given the low rates of resource utilization that have prevailed over that time. Indeed, as a result of the weak job market, wage growth has slowed along with inflation; over the 12 months ending in November,

[2] Average job gains for 2010 are through November.

average hourly earnings have risen only 1.6 percent. Despite the decline in inflation, long-run inflation expectations have remained stable; for example, the rate of inflation that households expect over the next 5 to 10 years, as measured by the Thompson Reuters/University of Michigan Surveys of Consumers, has remained in a narrow range over the past few years. With inflation expectations stable, and with levels of resource utilization expected to remain low, inflation is likely to be subdued for some time.

Monetary Policy

Although it is likely that economic growth will pick up this year and that the unemployment rate will decline somewhat, progress toward the Federal Reserve's statutory objectives of maximum employment and stable prices is expected to remain slow. The projections submitted by Federal Open Market Committee (FOMC) participants in November showed that, notwithstanding forecasts of increased growth in 2011 and 2012, most participants expected the unemployment rate to be close to 8 percent two years from now. At this rate of improvement, it could take four to five more years for the job market to normalize fully.

FOMC participants also projected inflation to be at historically low levels for some time. Very low rates of inflation raise several concerns: First, very low inflation increases the risk that new adverse shocks could push the economy into deflation, that is, a situation involving ongoing declines in prices. Experience shows that deflation induced by economic slack can lead to extended periods of poor economic performance; indeed, even a significant perceived risk of deflation may lead firms to be more cautious about investment and hiring. Second, with short-term nominal interest rates already close to zero, declines in actual and expected inflation increase, respectively, both the real cost of servicing existing debt and the expected real cost of new borrowing. By raising effective debt burdens and by inhibiting new household spending and business investment, higher real borrowing costs create a further drag on growth. Finally, it is important to recognize that periods of very low inflation generally involve very slow growth in nominal wages and incomes as well as in prices. (I have already alluded to the recent deceleration in average hourly earnings.) Thus, in circumstances like those we face now, very low inflation or deflation does not necessarily imply any increase in household purchasing power. Rather, because of the associated deterioration in economic performance, very low inflation or deflation arising from economic slack is generally linked with reductions rather than gains in living standards.

In a situation in which unemployment is high and expected to remain so and inflation is unusually low, the FOMC would normally respond by reducing its target for the federal funds rate. However, the Federal Reserve's target for the federal funds rate has been close to zero since December 2008, leaving essentially no scope for further reductions. Consequently, for the past two years the FOMC has been using alternative tools to provide additional monetary accommodation. Notably, between December 2008 and March 2010, the FOMC purchased about $1.7 trillion in longer-term Treasury and agency-backed securities in the open market. The proceeds of these purchases ultimately find their way into the banking system, with the result that depository institutions now hold a high level of reserve balances with the Federal Reserve.

Although longer-term securities purchases are a different tool for conducting monetary policy than the more familiar approach of managing the overnight interest rate, the goals and transmission mechanisms of the two approaches are similar. Conventional monetary policy works by changing market expectations for the future path of short-term interest rates, which, in turn, influences the current level of longer-term interest rates and other financial conditions. These changes in financial conditions then affect household and business spending. By contrast, securities purchases by the Federal Reserve put downward pressure directly on longer-term interest rates by reducing the stock of longer-term securities held by private investors.[3] These actions affect private-sector spending through the same channels as conventional monetary policy. In particular, the Federal Reserve's earlier program of asset purchases appeared to be successful in influencing longer-term interest rates, raising the prices of equities and other assets, and improving credit conditions more broadly, thereby helping stabilize the economy and support the recovery.

In light of this experience, and with the economic outlook still unsatisfactory, late last summer the FOMC began to signal to financial markets that it was considering providing additional monetary policy accommodation by conducting further asset purchases. At its meeting in early November, the FOMC formally announced its intention to purchase an additional $600 billion in Treasury securities by the end of the second quarter of 2011, about one-third of the value of securities purchased in its earlier programs. The FOMC also maintained its policy, adopted at its August meeting, of reinvesting principal received on the Federal Reserve's holdings of securities.

The FOMC stated that it will review its asset purchase program regularly in light of incoming information and will adjust the program as needed to meet its objectives. Importantly, the Committee remains unwaveringly committed to price stability and, in particular, to maintaining inflation at a level consistent with the Federal Reserve's mandate from the Congress.[4] In that regard, it bears emphasizing that the Federal Reserve has all the tools it needs

[3] More specifically, the Fed's purchases should tend to reduce term premiums, a component of the yield to longer-term securities. Longer-term interest rates are also influenced by market expectations of the future path for short-term interest rates, which in turn depend on the outlook for the economy and so for the target federal funds rate.
[4] Most Committee participants judge that, in the longer term, inflation in the range of 2 percent or a bit less appropriately balances the risk that adverse economic shocks could tip the economy into deflation against the benefits of low and stable inflation. An inflation rate modestly above zero also reduces the probability that monetary policymakers will be constrained from easing policy when necessary by the zero lower bound on nominal

to ensure that it will be able to smoothly and effectively exit from this program at the appropriate time. Importantly, the Federal Reserve's ability to pay interest on reserve balances held at the Federal Reserve Banks will allow it to put upward pressure on short-term market interest rates and thus to tighten monetary policy when needed, even if bank reserves remain high. Moreover, the Fed has invested considerable effort in developing methods to drain or immobilize bank reserves as needed to facilitate the smooth withdrawal of policy accommodation when conditions warrant. If necessary, the Committee could also tighten policy by redeeming or selling securities on the open market.

As I am appearing before the Budget Committee, it is worth emphasizing that the Fed's purchases of longer-term securities are not comparable to ordinary government spending. In executing these transactions, the Federal Reserve acquires financial assets, not goods and services. Ultimately, at the appropriate time, the Federal Reserve will normalize its balance sheet by selling these assets back into the market or by allowing them to mature. In the interim, the interest that the Federal Reserve earns from its securities holdings adds to the Fed's remittances to the Treasury; in 2009 and 2010, those remittances totaled about $120 billion.

Fiscal Policy

Fiscal policymakers also face a challenging policy environment. Our nation's fiscal position has deteriorated appreciably since the onset of the financial crisis and the recession. To a significant extent, this deterioration is the result of the effects of the weak economy on revenues and outlays, along with the actions that were taken to ease the recession and steady financial markets. In their planning for the near term, fiscal policymakers will need to continue

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interest rates. Many central banks around the world have come to similar quantitative judgments about the long-run level of inflation that best fosters growth and stability.

to take into account the low level of economic activity and the still-fragile nature of the economic recovery.

However, an important part of the federal budget deficit appears to be structural rather than cyclical; that is, the deficit is expected to remain unsustainably elevated even after economic conditions have returned to normal. For example, under the Congressional Budget Office's (CBO) so-called alternative fiscal scenario, which assumes that most of the tax cuts enacted in 2001 and 2003 are made permanent and that discretionary spending rises at the same rate as the gross domestic product (GDP), the deficit is projected to fall from its current level of about 9 percent of GDP to 5 percent of GDP by 2015, but then to rise to about 6-1/2 percent of GDP by the end of the decade. In subsequent years, the budget outlook is projected to deteriorate even more rapidly, as the aging of the population and continued growth in health spending boost federal outlays on entitlement programs. Under this scenario, federal debt held by the public is projected to reach 185 percent of the GDP by 2035, up from about 60 percent at the end of fiscal year 2010.

The CBO projections, by design, ignore the adverse effects that such high debt and deficits would likely have on our economy. But if government debt and deficits were actually to grow at the pace envisioned in this scenario, the economic and financial effects would be severe. Diminishing confidence on the part of investors that deficits will be brought under control would likely lead to sharply rising interest rates on government debt and, potentially, to broader financial turmoil. Moreover, high rates of government borrowing would both drain funds away from private capital formation and increase our foreign indebtedness, with adverse long-run effects on U.S. output, incomes, and standards of living.

It is widely understood that the federal government is on an unsustainable fiscal path. Yet, as a nation, we have done little to address this critical threat to our economy. Doing nothing will not be an option indefinitely; the longer we wait to act, the greater the risks and the more wrenching the inevitable changes to the budget will be. By contrast, the prompt adoption of a credible program to reduce future deficits would not only enhance economic growth and stability in the long run, but could also yield substantial near-term benefits in terms of lower long-term interest rates and increased consumer and business confidence. Plans recently put forward by the President's National Commission on Fiscal Responsibility and Reform and other prominent groups provide useful starting points for a much-needed national conversation about our medium- and long-term fiscal situation. Although these various proposals differ on many details, each gives a sobering perspective on the size of the problem and offers some potential solutions.

Of course, economic growth is affected not only by the levels of taxes and spending, but also by their composition and structure. I hope that, in addressing our long-term fiscal challenges, the Congress will seek reforms to the government's tax policies and spending priorities that serve not only to reduce the deficit but also to enhance the long-term growth potential of our economy--for example, by encouraging investment in physical and human capital, by promoting research and development, by providing necessary public infrastructure, and by reducing disincentives to work and to save. We cannot grow out of our fiscal imbalances, but a more productive economy would ease the tradeoffs that we face.

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

Chairman CONRAD. Thank you for your excellent testimony.

I want to go to your final point. This is the Budget Committee. We have a special responsibility to our colleagues and the country to propose a fiscal policy going forward. What I hear you saying is that it is critically important that we adopt a credible plan, longer-term plan, to deal with our deficits and debt. Is that an accurate understanding of what you are saying to us?

Mr. BERNANKE. That is correct, Mr. Chairman. Our fiscal issues are very long-term in nature. They increase— the difficulties increase over time. Merely addressing this year's spending is not going to solve the problem. We need to develop a plan, and a credible plan, one that markets will accept as plausible, to address the longer-term structural budget deficits that we face.

Chairman CONRAD. The Fiscal Commission proposed a plan that would reduce the debt over time by $4 trillion, which would stabilize the debt in the short term, but importantly, bring the debt down as a share of the economy to roughly, publicly-held debt, to 30 percent of GDP. That is over an extended period of time. Is that about the magnitude of the size of the plan that is necessary?

Mr. BERNANKE. Senator, no one knows exactly what the desirable debt-to-GDP ratio is in the long run. You mentioned the 90 percent number as an upper level of comfort. In the near term, I think we need to focus on stabilizing the debt-to-GDP ratio. Under the alternative scenario of the CBO, it just rises indefinitely and that is certainly not sustainable.

If we could achieve, say, in the next decade a two or three percentage point of GDP reduction in the deficit, that would be sufficient to bring the primary deficit close to zero and would stabilize the debt-to-GDP ratio over the next decade. We would need additional steps after that. So I think stability is the first step. Bringing it down is a bonus, if we can do that.

Chairman CONRAD. You know, that was really the conclusion of the Commission. The conclusion of the Commission was, first job, job one is to stabilize the debt. You know, we talk about these different measures of debt. Publicly-held debt is currently roughly 60 percent. The gross debt is currently about 90 percent. And most of the advice to the Commission was, you have to stabilize publicly-held debt at 60 percent, gross debt at 90 percent. But over time, you really need to bring it down. You should not stabilize it and consider that you have finished the job because you need to have a margin to deal with future shocks. Is that your judgment, as well?

Mr. BERNANKE. Yes, Mr. Chairman, but stabilizing it would be a very important first step.

Chairman CONRAD. Yes. Job one, stabilize.

Mr. BERNANKE. Right.

Chairman CONRAD. My second question is the timing of imposing the tough choices that need to be made here on both the spending side of the equation, and the Commission proposed roughly $2.2 trillion of spending cuts, proposed nearly a trillion dollars of new revenue. The rest of the savings was savings of interest. In terms of when you pivot, that is a critical question. The Commission's conclusion was you ought not to take the really tough steps that need to be taken for the next several years. You need to begin. You need to adopt the plan. But the real tough medicine needs to wait until the economy is on stronger ground. What would your recommendation be to us?

Mr. BERNANKE. Mr. Chairman, I think the issue is credibility. If we can—it is not really sufficient to say, well, we are not doing anything now because of the recession but we will do something later, but we are not specifying what that is. I think if we could adopt a credible plan that is specific enough and credible enough to address the long-run situation, that would be the most positive thing that we could do, and in doing so, we could get really all the benefits without having to take actions that would endanger the very near-term recovery, which is still somewhat fragile.

Chairman CONRAD. Yes, that was very much the conclusion of the Commission. It is not enough to say, yes, we are going to do something in the sweet bye-and-bye. You have actually got to adopt a plan. You have to put it in place. You have to put it in place legislatively so people know, yes, we are going to cut spending. We are going to improve the revenue base. We are going to have savings of interest costs. And it has to be credibly scored. It has to be real. But you should not have the bite occur too soon or you endanger this fragile recovery.

You made another set of comments that I thought was very important and that was the composition of the spending reductions, the composition of the revenue is also critically important to future economy growth. You are saying, look, you have to pay attention to human capital, education. You have to pay attention to infrastructure because that improves the economic competitive position of the United States. But when you are imposing these spending cuts, you have to go after things that are superfluous, and goodness knows as we look across Federal spending there are places we are not doing things that enhance economic growth. There are things that constitute waste, although the idea that just cutting waste, fraud, and abuse is going to solve this problem is—I wish it were the case, but it is necessary but not sufficient.

On the revenue side, the Commission concluded one of the best things we could do is broaden the tax base, eliminating some of the tax expenditures, but simultaneously reducing rates to make America more competitive. Is that what you had in mind when you talked about paying attention to the composition of the changes that are made?

Mr. BERNANKE. Yes, Mr. Chairman. On the first point, the National Income Accounts do not really distinguish between government consumption and investment very sharply. I mean, there is a technical distinction. But we need to think about making investments for the future as opposed to simply spending on current needs, and so thinking about government programs, we should ask the question, will this provide benefits in the future, provide a more productive, competitive economy in the future.

On the tax side, I do not think it is really very controversial among economists that rising rates combined with a multiplication of exemptions, deductions, credits, and so on leads to a tax code which is very complex and can distort economic decisions, and I think all of the major deficit reduction commissions have taken the opportunity to talk about the need to lower rates but to avoid—but to close loopholes so as not to lose revenue. So I think that is something, I hope, that the Congress will talk about. It is not at all inconsistent to both address the long-term deficit issues but also to think about making our tax code and our spending priorities more growth friendly.

Chairman CONRAD. I tell you, there is nobody that could have participated in this process that did not conclude this tax system that we have is just completely out of date. You know, it does not take account of the world that we live in today.

The other conclusion of the Commission was that you have to have everything on the table. Spending, revenue, and every part of Federal spending has to be dealt with, and, you know, even defense. One of the most startling, I would say to my colleague, one of the most startling pieces of information that came to the Commission was 51 percent of the Federal workforce is at the Department of Defense. That does not count the contractors. When we asked the defense analysts who came before the Commission, how many contractors does the Department of Defense have, they told us they could not tell us, not because it was secret but because they did not know. And when we asked them, what was the range, they said between one and nine million. That is a pretty broad range.

So we have issues throughout the Federal Government and we are going to have to address them. I very much appreciate the good advice that you have given us.

Mr. BERNANKE. Thank you.

Chairman CONRAD. Senator Sessions? By the way, we are going with eight-minute rounds, a little bit longer than usual because of the numbers who are here, and I have tried to respect that in my time and hope others will.

Senator SESSIONS. Thank you, Mr. Chairman.

First, Mr. Bernanke, let me pursue the question that revolves around your confidence about being able to prevent inflation. You note that you remain unwaveringly committed to price stability in your statement, and in particular, maintaining inflation at a level consistent with the Federal Reserve's mandate. In that regard, it bears emphasizing that the Federal Reserve has all the tools it needs to ensure that it will be smoothly and effectively exit from this program at the appropriate time.

Well, forgive me if I am less confident you can know precisely when and how to exit and that you can do so smoothly. And I notice that the bond market and the common seems almost consensus view now around Wall Street and investors is that bonds are a bad investment, presumably because they expect a realistic reality of an increase in interest rates in the future as a result of quantitative easing deficits and the like. Can you assure us? It looks to me like, would you not agree, that investors are getting nervous already?

Mr. BERNANKE. Well, Senator, first, on your earlier comment about the 100 percent certainty, what I was talking about there was not that we would know exactly with certainty the right moment. What I was trying to convey was I thought I was certain that we have the tools we need. Now, it is always the case that when you are reversing monetary policy in a period of growth, that as a matter of judgment, you can be too early, too late, but that is true for normal monetary policy as well as for unusual monetary policy. So I am not trying to claim omniscience, and, of course, it is always possible that we will be either a little too slow or a little too quick, and we will do our very, very best to move at the right time.

As far as inflation is concerned, though, I mean, again, the actual inflation rate is at essentially a post- war low and inflation expectations look very stable—

Senator SESSIONS. What about—is there a difference between interest rates on the Federal debt and inflation?

Mr. BERNANKE. The interest rates on the Federal also are quite low, of course, and in the indexed bond market, the break-even inflation rates are about where you think they want to be if people expect that over the next five to ten years the Fed will keep inflation at about two percent, which is about where we think we ought to be aiming. We are going to pay very close attention to the inflation situation and we take that very, very seriously.

Senator SESSIONS. But tell me, just trying to bring a little common sense and an honest question to you, it does seem that the bond market is nervous. It does seem to me that the quantitative easing plans continue and may continue again and that the deficits continue at an unsustainable rate. Why should people not be worried that eventually there could be a tipping point reached and a rather dramatic surge in our interest rates could occur?

Mr. BERNANKE. Well, on the monetary policy side, as I said, we are in a situation similar to where we always are, which is we need to find the right moment to begin tightening. You mentioned that the bond market is expecting short-term rates to rise in the future. That would, of course, be corresponding to the Fed tightening and reversing the easy money policies.

In terms of the fiscal side, there, I absolutely agree with you. I think that if the Congress and the administration do not find a credible plan for controlling the long-term structural deficits, there could be very serious problems in financial markets and in inflation. That is the history of many, many situations in the past.

So I do very much urge this committee to look for strong and credible actions to control the Federal debt. If that is done, then I do not think that inflation will be a long-term problem. What we are trying to do, I think, in the short term, is to create an appropriate balance between the risks of inflation and the risks of deflation, which are not yet gone.

Senator SESSIONS. With regard to unemployment, I think you made clear in your statement, but it is important for us to understand, even though the rate dropped three-tenths, four-tenths of a point to 9.4, the 103,000 jobs added is really sort of treading water about what you have to just maintain the current employment rate, is that not right, and that is not really a number that we can celebrate today?

Mr. BERNANKE. It is about what we expected, but as you say, it is not a number that is going to—if we continue at this pace, we are not going to see sustained declines in the unemployment rate.

Senator SESSIONS. But the predictions were as much as 275,000 jobs are being added.

Mr. BERNANKE. That was not—certainly not our prediction, and not most Wall Street predictions. There was a number that came out of—the so-called ADP number, which was very high—

Senator SESSIONS. Yes.

Mr. BERNANKE. —but that is only loosely connected with the actual number.

Senator SESSIONS. I think the American people are deeply concerned about where we are heading economically. Their jobs are at stake. I believe that that is a legitimate concern. To what extent do you have a plan and to what extent does the administration, the President have a plan that sees into the future and it says, we are going to do A, B, C, and D and those things will bring us out of this, and is it written? Can we see it?

Mr. BERNANKE. Senator, well, first of all, it was concern about the failure of unemployment to decline that motivated us back in August and September to adopt more monetary accommodation, and my view is that we have already had some benefits from that. We have seen some improvements in the outlook. We have seen some improvements in financial markets. So that is certainly part of what we are trying to do, is trying to keep this recovery going.

In addition, of course, we are working very hard in our role as a regulator to try to improve the availability of credit to small businesses and to other borrowers. Senator Warner, I know, has been very interested in that issue. So we are working very hard and that is our top priority.

Senator SESSIONS. Well, we have a change-over in the White House. Mr. Summers is gone. Ms. Romer is gone. Peter Orszag has left. Mr. Lew is there at OMB. We have a new Chief of Staff, I hear, today. But I do not sense anywhere in our government that we have the kind of clarity of leadership we had under Mr. Volcker when we had the crisis in the late 1970s and early 1980s. One of the Fed members said we knew we were doing the right thing. They were protesting Mr. Volcker. Some called for his resignation. But we had a plan and we were staying with it.

Can the American people have confidence that you and the administration are on the same page and we have a plan other than reacting every month or two to some new change in conditions?

Mr. BERNANKE. Well, Senator, the Federal Reserve is independent of the administration. I mean, we try to coordinate with the administration. We try to coordinate with Congress. But the Federal Reserve is independent. We make independent decisions.

Senator SESSIONS. I know you are independent.

Mr. BERNANKE. So the administration's plan, Congress's plan, I mean, those are not our province. That is for the administration and Congress to decide.

In our case, we do have a plan, and like—I have tremendous respect for Chairman Volcker, and one of the things that he did, as you say, was he did what he thought was right even though there was a lot of criticism, and I think that is what the importance of independent monetary policy is. At the Federal Reserve, we recognize that there are different views, but we are trying to do the best thing that we can for the American economy and that is the beauty of having an independent central bank.

Senator SESSIONS. Thank you very much. Mr. Volcker, history records, I think, was correct in his plan. I hope history will record the same for your leadership.

Chairman CONRAD. Thanks, Senator Sessions.

Let me just indicate that on our side, it is Senator Wyden, Senator Warner, Senator Manchin, Senator Stabenow, Senator Merkley. On the Republican side, it is Senator Enzi and Senator Cornyn.

Senator Wyden.

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

I, too, want to welcome Senator Sessions as our Ranking Minority Member. He is somebody I greatly enjoy working with and respect very much. I do want to note for the record that I do not believe the Auburn Tigers have a realistic chance of keeping up with the University of Oregon's fast-moving, innovative offense in the championship game, but we will save that for another discussion. I just want to welcome my good friend.

Senator SESSIONS. Well, if you are correct in that, I will be pleased to wear that tie you have on for a few days perhaps.

Senator WYDEN. We have an agreement, and I will reciprocate. [Laughter.]

Senator WYDEN. Senator Conrad, thank you very much, and Mr. Chairman, we are so glad to have you here, and I especially because you and I share a similar view that the big idea for economic growth in our country is fundamental tax reform, where you go in there and clean out this job-killing, thoroughly discredited mess, and you addressed that, I thought, very well in the "60 Minutes" discussion that you had back in December.

Here is my first question. It was clear at the end of the year that you had to take some steps with respect to the tax code in the short term so that people would not be clobbered at the beginning of the year, the middle-class folks and small businesses and others. But what I am concerned about is when you look at the overall structure of what was done in December, it has contributed once again to tax uncertainty, all of the two-year provisions, the one-year provisions, the phase-ins, the phase-outs. As you know, the tax code has tripled in just the number of words in the last decade and that has been fueled once again by what was done in December.

I want to make sure, for the record, it is clear that when you are talking about long-term economic growth, you want a different tax model than what the Congress passed in December. You do not want to see more provisions added and more exemptions and deductions. You think, by and large, we ought to be draining the swamp, cleaning out a lot of the clutter to hold down some rates, keep progressivity and provide some certainty. You want a different model than what was passed in December for the long term, is that correct?

Mr. BERNANKE. Yes, Senator. What was passed in December was understandable, given the exigencies of time and so on. But I hope that the Congress will think hard about what long-run tax structure will be most beneficial, and lowering rates and closing loopholes is, I think, the best approach.

Senator WYDEN. The second question, there has been considerable discussion in the last few days, really the last week or so, about the idea of instead of the kind of tax reform you and I want, comprehensive reform, just going out and changing the corporate tax rate. I think that would be a big mistake, and the reason why is that most businesses in America, probably in the vicinity of 80 percent, pay taxes essentially as individuals, some Chapter S, sole proprietors, partnerships, the whole host of firms that are not, in effect, C Corporations.

Is there not a real danger if you go in and just make changes on the corporate side to have further distortions, further complications, and end up with yet more uncertainty than you would have if you went in and made a comprehensive overhaul, recognizing the connections between the individual provisions in the code and the business provisions?

Mr. BERNANKE. Well, Senator, as you know better than me or anyone, there are many interactions between the two codes, including, for example, the double taxation of dividends and many other issues. So, yes, ideally, I hope that you would look at the tax system as a holistic single part of policy. I do not know what is feasible for politically and so on. That is really your call. But ideally, yes, of course, you would like to make sure that the entire Federal code is consistent and is supportive of efficient growth.

Senator WYDEN. I will keep you out of the politics, but colleagues, and we have several on the Finance Committee and Senator Sessions is very interested in it, the Chairman is making a very important point. There is today such a connection between the individual portions of the code and the corporate portions of the code, to just split one out as some have been discussing, I think, could once again create a whole set of additional distortions in the American economy and I appreciate what you are saying, Mr. Chairman.

One other point with respect to tax reform that I think you have touched on in the past but would be important to have on the record. Today, it is very clear that people loathe the Internal Revenue System. I mean, it is just up there at the top of all of the Federal agencies and functions of the Federal Government people are furious about.

It seems to me if you got to the point where you had a one-page 1040 Form—Senator Gregg and I have that in our bill, as you know, Chairman Volcker has all but proposed that, it was in the Bush proposal, for Pete's sakes, years and years ago—would not having a one-page 1040 Form, where most people could complete taxes themselves rather than spending their whole spring on TurboTax and the like, would that not in and of itself be a public good in terms of simplicity and understanding and making people feel more confident that the American economy and the underpinnings of the American economy were sound?

Mr. BERNANKE. Well, as a general matter, simplicity, besides being less likely to be distortionary, has benefits of lower compliance costs, which are quite significant, and less need for the IRS or for accountants to adjudicate complex provisions in the code. So certainly simplicity is to be desired and I think it would make people more comfortable with the tax code because it would be less of a burden and because they would feel more comfortable that there were not all kinds of loopholes they did not understand that people were taking advantage of.

Senator WYDEN. One last question, again, not from a political standpoint, from an economic standpoint. One judgment I have made, looking back over the last quarter century on this, is that a mistake in 1986 was to not have some provisions to make it tougher to unravel fundamental tax reform when you got it. In other words, over the last 25 years after it was enacted, pretty much a few weeks later, the ink on the bill was dry and everybody just went back to business as usual. From an economic standpoint, how useful would it be when the tax code is overhauled this time, so there is more fairness for the middle class and take these steps to be globally competitive, how important from an economic standpoint is it to make it tougher to unravel it as soon as you get the reform?

Mr. BERNANKE. Well, Senator, as you say, there are political and probably constitutional issues involved in all that, but everything else being equal, greater clarity and certainty is obviously beneficial, and to the extent that you can create more certainty about where the tax code is going to be over a number of years, that would be helpful.

Senator WYDEN. Mr. Chairman, thank you, and I look forward to following up with you on these matters, and the fact that you have been outspoken on this has really given a boost to reformers and we are very appreciative. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman.

To follow up on what the Senator from Oregon said, our Nation's fiscal policy is in tatters. Our projected level of Federal spending growth is unsustainable. Our Tax Code is a mess. The only constant is that the Federal budget deficit is large and likely to remain that way.

To what extent does the uncertainty that comes with these problems undermine economic growth?

Mr. BERNANKE. It is hard to make a quantitative judgment, Senator, but I am sure it is a negative. I do think that addressing our long-term structural budget deficits would not only reduce the risks we face in the future, but would probably have near-term benefits in terms of possibly of lower interest rates but also in terms of greater confidence and certainty. As you say, as it stands the one thing we know about our long-term tax and spending commitments is that they are not feasible, they cannot happen, they are not sustainable. So we do not know how things are going to change. So, yes, the more clarity we can achieve, the better we will be, the better off we will be.

Senator ENZI. Thank you. I was a cosponsor of the Conrad-Gregg deficit commission bill and was pleased that we got one, one way or another, and I think that that sheds some real light on what needs to be done by Congress. I am really concerned about the rapidly rising debt-to-GDP ratios and watching what is happening over in Europe. They have enacted some programs to rein in government spending. Some of them did not act quickly enough and had to be bailed out by their neighbors.

During a hearing before the House Budget Committee in June, Representative Hensarling asked you whether the United States was nearing a similar point given our comparable debt-to-GDP ratio, and you responded that you do not know exactly how much breathing space we have. Rather than enact austerity cuts as the Europeans did, we have seen our gross national debt increase by $1 trillion since June. Can you give us any kind of an indication of how much breathing room we do have if we continue on this course before we reach that tipping point? Anything more exact since June?

Mr. BERNANKE. You know, I just think it is inherently impossible to pinpoint the exact date or the exact level of debt that would create a crisis or a sharp increase in interest rates.

That being said, it would be the better part of valor to take action now to make sure that we do not get too close to that point. I do not know what the number is, but what I do know—and the CBO's projections show this very clearly— is that absent any action, the debt-to-GDP ratio is going to be not only rising but rising at an increasing pace. It is going to be heading straight to heaven, basically, and that is certainly not going to happen—that certainly cannot occur.

So I do not know at what point exactly, but that point will come if we do not take appropriate action.

Senator ENZI. I also appreciate your meeting with some other groups. Senators Warner and Chambliss started a group to review these things, and I appreciated your comments about the difference between our debt-to-GDP ratio and the Japanese one where they have a lot of savings and we do not. There are just so many things that need to be taken into consideration with all of these things.

I know that the Fed undertook quantitative easing because of a fear of deflation, yet other than housing prices, Americans are experiencing inflation in virtually every other major household outlay, particularly when it comes to groceries and gasoline. America's economy runs to a large degree on motor fuel. If as some analysts predict gasoline prices reach $4 a gallon this summer, will not this risk choking off the economic recovery?

Mr. BERNANKE. Well, first, just the facts are that inflation is 1 percent including food and fuel, so inflation overall, taking into account everything that people buy, is quite low.

Now, it is true that people are very sensitive to the price of gasoline, and we are watching that very carefully. I do not think that quantitative easing of monetary policy is the main reason that oil prices are up in the past few months. The dollar, after all, has been quite stable, and oil prices are up in essentially all currencies. I think the main reason oil prices are up is the strength of emerging markets, the demand for energy from China and other fast-growing emerging-market economies.

That being said, we are watching it very carefully because, as you point out, higher gas prices are like a tax on families; and if they get too high, then that will, in fact, be a negative for growth as well as for inflation. So we will pay very close attention to both energy prices and other commodity prices as well.

Senator ENZI. There is discussion among policymakers about removing the Federal Reserve's dual mandate of a stable monetary policy and full employment. Some have suggested that it would make sense to remove your mandate for full employment so that you can focus only on monetary policy. Do you have an opinion about this matter?

Mr. BERNANKE. Senator, we are not seeking any change. We think the current mandate is workable. That being said, I think it is entirely appropriate for the Senate and for the Congress to consider what mandate they want to set. There are, after all, central banks around the world that do focus primarily on price stability, and whatever decision the Congress makes, of course, we will honor that decision and pursue that mandate.

Senator ENZI. Thank you. I do not have any further questions.

Chairman CONRAD. Thank you so much, Senator Enzi.

Senator WARNER.

Senator WARNER. Thank you, Mr. Chairman, and thank you for holding this hearing this morning.

Chairman Bernanke, let me first of all acknowledge what my colleague Senator Enzi has already said and thank you for being willing to meet with a growing bipartisan group of Senators. Senator Chambliss and I have been working, along with Senator Wyden and others, on saying we need to move forward on a real plan. And compliments to Senator Conrad and Senator Gregg and others. And while imperfect—and I particularly appreciate your comments in your testimony about the President's National Commission on Fiscal Responsibility and Reform that we ought to go ahead and take that work product of the last year and use that as a starting point, because I think as both you and Senator Sessions have said in your testimonies, simply talking about deficit reduction does not get us anyplace. We have to have a real plan to work against. And it is the intention of Senator Chambliss and me to take that work and put it into legislative language and introduce it. I think, again, a point that both Senator Conrad and Senator Wyden have made, is that if we are going to take on this issue, it is going to require dramatic cuts in Government spending, but it is also going to require meaningful tax reform. And I think, again, a lot of the early attention to the Commission's work focused on the deficit reduction piece. It did not focus as much on the tax reform piece, which both lower corporate rates and individual rates, and actually I would add on the individual side, lent more progressivity to the Tax Code. So I think it is a good working document, and I look forward to working with colleagues on both sides of the aisle to see if we can get as many cosponsors as possible to at least move forward on this discussion. And it is my hope that we could actually see a plan put forward this year, working off of the President's Commission, as I am sure it would be amended, and actually get it voted on. Because the way I hear you saying—now, you would never be as impolite as to use these terms, so let me use these terms. But you are basically saying to us, the Congress and the policymakers, we have to walk and chew gum at the same time, so that we have to continue to do short-term stimulus—you at the Fed have done that through your quantitative easing policies, and we in certain tax policies that were taken in December, both in terms of short-term stimulus, but that short-term stimulus then has to be morphed into long-term deficit reduction.

Going back to some of Chairman Conrad's earlier questions, you know, what should we look at as the metrics or other indicators of when we should kind of ease off on the stimulus and ramp up the deficit reduction piece? Should that be based on a timeline? I think the President's Commission, Chairman Conrad, you had a lot of your actions starting to click in about 2012, 2013, 2014. Should it be on a kind of date line process? Should it be based on when growth hits at a certain level, unemployment falls to a certain level? What should be the indicators, even if we get a plan in place, that would trigger the kind of hard choices around deficit reduction that we are looking at?

Mr. BERNANKE. Senator, first let me say that I enjoyed meeting with your group, you and Senator Chambliss, and I commend you for the extra work you are doing on this issue.

I think there is an important trade-off. We need to—we, the American people, the Congress needs to demonstrate a credible commitment to solving the long-term fiscal problems. The stronger and more credible the plan that is put forward, the less need there will be to take sharp short-term cuts in order to show your seriousness. So a strong long-term plan that kicks in over a period of time will make it less necessary to take actions in the short term that would be counterproductive from the point of view of the recovery. So that is why it is so important to develop a strong plan.

So that is the trade-off: The stronger the plan, the less near-term downpayment you have to make.

Senator WARNER. And, Mr. Chairman, could I just interrupt for one second? Based upon your testimony today by referencing the National Commission on Fiscal Responsibility and Reform, by referencing that effort, is that an endorsement that that would be viewed in your mind as a strong plan?

Mr. BERNANKE. Yes. For example, it has the feature that I believe that by 2015 there is a stabilization of the debt-to-GDP ratio which requires, I think, about a two- to three-percentage-point-of-GDP cut in the deficit starting in a couple of years through the rest of the decade.

In terms of criteria, I think there is no magic number, but what we need to see is a sense of momentum, a sense that there is enough forward movement and strength in the recovery that we can feel confident that it will continue and will not be knocked off course by too precipitate fiscal retrenchment.

Senator WARNER. I know you do not want to give me a set indicator, but should those indicators be time, growth rate, unemployment rates, a combination of all of those? What should be our markers if we pass this plan—whether the Commission's plan or a like kind serious plan, there has to be some markers when we shift course from stimulative activities to serious deficit reduction and cost—

Mr. BERNANKE. Well, all of those factors matter, but I think a sustained growth rate above sort of the long-term average would be an indication that the recovery is proceeding and has some momentum. But, again, the stronger, more credible the forward-looking plan, the less need there will be to make sharp short-term adjustments that might risk the recovery.

Senator WARNER. Let me in my last moment follow up on Senator Enzi's comments, and I think he was looking for a percentage on when the markets will say "no mas" in terms of our debt-to-GDP ratio. I guess my feeling is it is not a question of if we are going to do deficit reduction. It is going to happen. It is really only a question of when, and whether we are going to do this on our timetable in a way that is not disruptive to the economy or whether it is going to be dictated by the markets in terms of their lack of faith in our ability to service our debt over the long term.

And so what I guess I would ask you—and I know my time has expired, Mr. Chairman, and this will be my last question. You know, we cannot predict that to a specific percentage or date certain. But what would be or what could be some of the warning signs that we are getting close to that precipice? Could it not be some external international, God forbid, terrorist incident that might put a shock wave across the economy? Could it not be another economy in Europe getting close to a failing point, an economy that would be larger than, say, Ireland or Greece? What are some of those warning signals? And would you also say that if we start going down this precipice it could happen very quickly once we get to that unforeseen point?

Mr. BERNANKE. So in terms of market signals, I think I would look at things like Government financing, interest rates, long-term bond yields, the dollar, indicators of confidence in the United States.

I think it is important to understand, if I may, that nobody doubts that the United States has the economic capacity to pay its bills. It is really a question of do we have the political will to do that, and demonstration of the political will, that is what the markets are watching. Are the Congress and the public and the administration able to demonstrate that they are serious and that they have enough willingness to work together to make progress? At the point where confidence is lost in that, you could see a relatively quick deterioration in financial positions, as we saw in some cases in Europe, where things change very quickly based on just the change in sentiment about the prospects for those economies.

Senator WARNER. Thank you, Mr. Chairman. I look forward to working with you and Senator Sessions and all our colleagues on making sure we do not get to that point.

Chairman CONRAD. Yes, we appreciate the effort that you have mounted, along with Senator Chambliss, our colleague.

I just for the record want to point out that the Commission proposal stabilized the debt by 2014 and then starts bringing it down on a sure path after that.

Senator MANCHIN.

Senator MANCHIN. Thank you, Mr. Chairman.

Chairman Bernanke, first of all, from the perspective of my home State of West Virginia, I am concerned about the finances of our State and all the States, being a former member of the NGA. What I would like to know is from your opinion as based on the future pension liabilities of both corporate and State governments, the recent reports of the financial crisis that many of our States are facing in the very near term future, have you all looked carefully at the possibility of a default on general obligation and municipal bonds by State and local governments and the budget strains that would present to the overall U.S. economy? We are concerned about that the stimulus runs out June of this year. What happens if there is no more stimulus to come or Federal bailout, if you will, and they have to work on a balanced budget amendment and they cannot meet these long-term obligations? Have you all looked into that or been spending any time on it?

Mr. BERNANKE. To some extent, Senator, yes. No question State and local governments are under a lot of pressure. They have been cutting spending and employment over the last couple years. The Federal assistance will continue in 2011, but after 2011, it is going to be pretty much zeroed out, I think. And so, on the one hand, the States are seeing some improvement in tax revenues as there has been some growth; but on the other hand, they could be losing some of the Federal assistance. So the pressures on State budgets and local municipal budgets are going to continue for a while, and that is going to be a head wind for the overall economy as well as for the individual States.

It is also true—this is more a long-run issue—that like the Federal Government, the State and local governments have some long-term fiscal issues relating primarily both to pensions of State employees but also to health care promises, which in most cases are almost entirely unfunded. So those are long-term obligations that could be collectively as much as $2 trillion for all the States together in the long run. Now, those, of course, are long-run obligations and do not come in the near term. So there are some very serious long-term fiscal pressures.

Now, in terms of the municipal bond market, it currently seems to be functioning reasonably well. Liquidity is fine. Issuance has actually been very high, including issuance for capital projects, so we are not seeing extraordinary stress in the municipal markets, which suggests that investors still are reasonably confident that there will not be any defaults among major borrowers. And one reason they might believe that is because most States have rules which put debt repayment and interest payments at a very high priority, above many other obligations of the State and localities.

So, bottom line, the municipal markets, bond markets, seem to be doing okay, but clearly there is a lot of both near-term and longer-term pressure on these governments, and it is going to be something that is not going to be going away in the near term.

Senator MANCHIN. Another question I have is that, you know, in West Virginia, when families have problems, whether they be families or single parents, they cannot really respond and kind of understand what we do here in Washington or what Government does. They do not sit down and think how much more money can they spend or how much can they borrow to get themselves out of trouble. They start looking at cutting expenses.

What expenses could the Federal Government cut that would have the longest—or have the most effect on long-term stability in your recommendation? What should we be cutting?

Mr. BERNANKE. Well, Senator, I should just say first, very strongly that these tough decisions about taxes versus spending and the mix of spending and so on are your decisions and not mine, and I do not want to inject myself too much. But I will say one thing which is just obvious from the arithmetic, which is that going forward the costs of health-related programs—Medicare and Medicaid—are rising prospectively very quickly, and on current trends, you know, would be at some point, between Medicare and Medicaid and Social Security, would essentially be what is now the entire budget of the United States.

So I do think that an important priority for us as a country and for the Congress from a fiscal point of view is to think about what we can do to achieve better cost efficiency in the health care area at the same time that we do what we can to maintain quality and access. So that is clearly an area we need to look at.

That being said, of course, we have military spending, other discretionary spending. We have the Tax Code. There are many other things that you will certainly want to look at.

Senator MANCHIN. And I know that there have been some Members of Congress who have long advocated for a Federal audit on the Federal Reserve System. Would you oppose an independent audit of the Federal Reserve System?

Mr. BERNANKE. The Dodd-Frank Act included an amendment, sponsored by Senator Sanders and others, that includes an exhaustive audit of all the financial aspects of the Federal Reserve. In fact, on December 1st, we released all the information about our—all the lending programs, financial programs, credit programs that we undertook during the crisis. So as far as our finances are concerned, we are an open book, and if there is any area where you or your colleagues are dissatisfied with the information, I would be happy to work with you to make sure you get what you need. So in terms of all aspects of our finances and operations, I think it is reasonable for Congress to want to have that information.

The one area where I have been concerned—and this goes back to my earlier comment to Senator Sessions—is that monetary policy independence is very important for the stability of our economy and our financial markets, and where "Fed audit" is really a code for congressional intervention in monetary policy decisions, that is where I would be much less comfortable.

Senator MANCHIN. And, finally, is the Federal Reserve considering any policy changes that would negatively impact the financial viability of local community banks around the country?

Mr. BERNANKE. To the contrary, we have a strong commitment to community banks, and we have, in fact, recently increased our schedule of direct meetings with the Board with representatives of community banks. There is obviously a lot of work to be done to implement Dodd-Frank and Basel III and other changes in financial regulation. It is our objective—I think the intent of both Basel III and the Dodd-Frank Act is to focus on the largest so-called too-big-to-fail banks and to make them not too big to fail. That is where our focus is as well, and we want to make sure that we do what we can not to increase the regulatory burden that small banks face. And small banks have been playing just an incredibly important role. Particularly as large banks have cut back on their lending to small businesses in other contexts, they have in many cases stepped up and proven their worth to the U.S. economy.

Senator MANCHIN. Thank you, sir.

Chairman CONRAD. Thank you, Senator.

Senator STABENOW.

Senator STABENOW. Well, thank you, Mr. Chairman, and welcome, Mr. Chairman.

Mr. Chairman, thank you for your thoughtfulness, and I think what you laid out to us both in terms of where we have come from, what we have done, and where we need to go I think is very, very important.

I feel as a member of this Committee now for many, many years, though, that I have a need to make sure that we do not have revisionist history whenever we are talking about how we got here. I think it is really important if we are not going to repeat mistakes that have been made before that got us here. I think it is important to just say once again for the record that when I had the opportunity to come in and serve with you, Mr. Chairman, Committee members in 2001, we had the biggest surpluses in the history of the country. And so we have not always been in this situation, and there were a number of decisions made on spending, frankly, without accountability that haveten us where we are. And I would argue that, unfortunately, the spending in the 8 years in the previous administration was not focused on those things that create innovation to create jobs, to compete in a global economy or focus on opportunity or security for middle-class families. Instead it was very much focused on the benefit to a privileged few. And at the time, in the last administration, we were told deficits did not matter when we were focusing on things that would benefit the privileged few. Now, after two very, very tough years—very tough years, very slow years—we are turning it around. We have not gotten things back on track. People in Michigan are still hurting, although it is better, but we have a long way to go.

My concern is that we are now hearing with the new majority in the House that, again, deficits only matter when it is things that affect middle-class families in terms of opportunity, education, innovation; but that when it comes to the policies that got us in this mess, focusing on tax cuts for the privileged few, supply-side economics, hoping it will trickle down, that that does not count. And so we saw this week over $1 trillion exempted from the budget rules that will add over $1 trillion in debt if we go forward with that, based on a way of looking at the economy that frankly did not work and then it got us in the last decade, in my judgment, into the hole that we are in.

So, Mr. Chairman, I want to ask you about how we get out of this hole, both short term and long term, and I agree we need a credible plan, and I very strongly share your view that we have to be very careful in the short run. It is a very fragile situation. And I do not, frankly, see how we get out of this with over 15 million people out of work. I do not know how—how do we get out of deficit if we do not first focus on jobs?

One of the things that I am proudest of is the fact that we did not give up on American manufacturing 2 years ago. We did not give up on the American automobile industry, and this year, for the first time since 1999 all three companies are making a profit. They are actually bringing jobs back to this country. And because of our investments in innovation, we are going to go from 2 percent of the world's battery manufacturing, advanced batteries, to 40 percent in the next 4 years.

But my question, Mr. Chairman, relates to the immediate situation for families that are not yet feeling this recovery and the fact that we have tens of millions of people who are out of work. And, frankly, when we talk about 2008 budget numbers, I would like to go back to 2008 jobs numbers and focus on that to get us out of deficit. But how would you focus on job creation in the short run, knowing that we have serious long-term issues that have to be addressed on the deficit? But at the same time, I guess I would like your reaction to the notion that we will not get out of debt if we have over 15 million Americans out of work.

Mr. BERNANKE. Senator, you are absolutely right that a large part of the deficit we currently have is what economists call a "cyclical deficit." It arises because unemployment is well above a normal level, and what we need to address is the structural component, the part that remains once the economy is back to a more normal level.

Again, I think that we need to think of fiscal policy as a piece; that is, we cannot think about short run and long run separately. You have to think about them together. And the more credible and effective our plans are for addressing the long-term structural issues, structural deficits, the more scope we will have and more flexibility we will have to allow continued support for the recovery now that we continue to need as the economy remains in a very still weak and fragile condition.

So my advice, for what it is worth, is, again, not to focus only on the short term but think also about the long term, that you need to combine those two things. You mentioned things like innovation. Again, as I talked about in my testimony, the composition and structure of Government spending and the Tax Code and so on is also very important. Are we doing enough for innovation? We spend quite a bit of money on that, but is it well directed? Is it sufficient to keep our leadership position going forward?

So those would be the themes I would note. Long-term structural deficits need to be addressed, and in doing so it would help the short term, would give us more flexibility in the short term. And we need to think hard about what we are doing to promote longer-term growth, longer-term innovation, longer-term human capital, training, education, and so on that makes people able to get better jobs and sustain higher incomes.

So it is a tough set of problems, and they are very much interconnected.

Senator STABENOW. Well, I very much appreciate your comments and share your feeling that it is about balance; it is putting in place the long-term plan; but also understanding that in a global economy—we are in transition now as a country—that it is very, very important that we be investing in those things, opportunity, education, innovation, that allow us to move forward in terms of growing the economy quickly.

Before my time runs out, just one quick question to follow up on small businesses. We passed the small business jobs bill. We talked about the importance of supporting community banks. I would just ask you—on the one hand, we are saying to banks, "Lend more."

Regulators are saying, "Don't lend," essentially, or "Tighten up things." It is critical, I think, that the Fed and other regulators help banks, community banks, take full advantage of the lending initiatives that we placed in the small business jobs bill. And I am wondering what actions the Federal Reserve is doing or can do to help small business.

Mr. BERNANKE. Senator, as it happens, I am going to be on a panel sponsored by the FDIC, I think it is next week, with Sheila Bair and with Senator Warner. We will be talking about small business credit and talking about all the initiatives and things that the Congress has done, the Federal Reserve has done, and the other banking agencies have done.

But just very briefly, we are very attuned to the need to have an appropriate balance. On the one hand, we do not want banks making bad loans. That is how we got in trouble in the first place. But on the other hand, creditworthy borrowers need to have access to credit so that they can hire and they can expand and help the economy recover. And so we have been working very hard with the banks and with our examiners to try to get a balanced approach and I think it is beginning to pay off. There is some improvement, in my view, in the availability of credit and I expect to see more lending this year. So there is—the terms and standards have begun to ease a bit. So I think there is some progress on that side.

We have also, and I will not take too much of your time, but we have also undertaken a series of meetings around the country, more than 40 meetings, where we have met with small businesses, lenders, examiners, local officials, trade associations, and the like, and tried to identify technical problems and other issues that have blocked access to credit and we have found some very useful things and we are working—we are moving forward on the things we learned.

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

Chairman CONRAD. Thank you very much, Senator Stabenow.

Senator Cornyn is recognized for 30 seconds. No, that is not—

Senator CORNYN. Mr. Chairman, I cannot clear my throat in 30 seconds.

[Laughter.]

Chairman CONRAD. Seriously, we are doing eight-minute rounds.

Senator CORNYN. Mr. Chairman, thank you very much for your service in what is, by all accounts, a very challenging job. But, of course, we are all volunteers here and no one is holding a gun to our head and making us do these jobs. We volunteer to do them because we think we can contribute to doing things that are in the best interest of the country and appreciate very much your service in admittedly a very challenging job.

It strikes me that there are three events coming up which will really provide an opportunity for Congress and the administration to demonstrate its seriousness at dealing with the runaway spending and the unsustainable debt problem that we have. One is the President's budget is going to be due the first Monday in February. That will be, I think, one of the first indications, perhaps, of the President's response to the report of the Fiscal Commission, and I want to congratulate all of our colleagues who participated in that on a bipartisan basis who I think demonstrated great courage in voting for a plan, albeit one that we all can find some differences with. But again, the time for talk is running out and now it is time for action.

So it strikes me as the first event that will provide the President an opportunity to respond to that in a meaningful way, to set out his budget for the next fiscal year, will be the first Monday in February, or I hear it may slip by a week or so.

The second, it strikes me, is the debt ceiling vote that is going to be coming up, and there has been a lot of talk and speculation about what might happen, whether there will be some additional conditions that would be imposed on voting to extend the debt ceiling, which is obviously a very sensitive and important issue.

And then it strikes me that the third sort of watershed that is coming up here that will demonstrate our collective seriousness of dealing with this, particularly from a fiscal policy standpoint, will be the expiration of the Continuing Resolution.

But I want to ask you specifically about something that Senator Manchin alluded to briefly in terms of not just the Federal Government's problems dealing with its debt, but the States and municipalities. Meredith Whitney, an analyst who correctly foresaw the mortgage crisis in 2008, now predicts that 50 to 100 sizeable U.S. cities could default in 2011. She said this could cause hundreds of billions of dollars of municipal bond defaults and warns that, next to housing, this is the single most important issue in the United States and certainly the biggest threat to the U.S. economy. And I would note, obviously, many States are in deep fiscal trouble, also, and there is the potential—at least the potential, maybe not the probability at least imminently, but at least the potential—that we could see some defaults at the State level.

I heard what you said about the municipal bond market not showing any imminent signs of crisis, but do you agree that this is a very serious issue that needs to be confronted?

Mr. BERNANKE. Well, I do not have a—I am sorry, Senator. I do not have a forecast about default risk. I think that sounds like a somewhat pessimistic view, but something we need to pay close attention to. Clearly, a lot of cities are under—certainly, no one can question they are under a lot of financial stress and it is something we need to pay attention to because it would have some spillover effects into other markets. But we do not at this point see anything of that magnitude happening.

That being said, I think cities and localities will need to take strong measures to avoid default. Default is only, at best, a short-term solution for local governments because what they find is that it will be very difficult to get back into the market, or if they do, they will have to pay a higher interest rate, so it would obviously be very much in their interest to take the difficult measures to avoid default.

So I, again, as I said earlier, while there is no question that there is a lot of stress at State and local governments, at this point, the municipal market seems to be operating fairly normally, but we will watch that very carefully.

Senator CORNYN. That is fair enough. Let me sort of drill down a little bit, because this is a point I want to get to, in particular. In 2002, you gave a speech before the National Economists Club in

Washington and you said, quote, and I think this is a fair quote, tell me if it is not, quote, "The Fed has the authority to buy foreign government debt as well as domestic government debt." And we know that under the QE2 plan that you are implementing at the Fed, you are buying U.S. Government bonds, but would that extend to State and local debt, that authority?

Mr. BERNANKE. Only in a very, very limited way. So first of all, we have no intention to buy foreign debt. That is really a provision to allow us to hold foreign exchange reserves, and we are not planning any policy in that direction.

Senator CORNYN. My interest, obviously, is really on the State—

Mr. BERNANKE. On the State and local, we have very limited authority there. We do have the authority to buy very short-term municipal debt that is within certain categories. So we have very limited ability to buy State, local, municipal debt. And moreover, the Dodd-Frank legislation restricts our ability additionally not to lend to any insolvent borrower and not to lend to an individual borrower, but only in terms of a broad program. So we have no expectation or intention to get involved in State and local finance. I think to the extent that there is anyone to look at that, it would have to be Congress to look at that.

Senator CORNYN. Well, I do not have to tell you how a request for a bailout or for a State or municipality would be received here in Washington. So let me ask you, under Chapter 9 of the Bankruptcy Code, a municipality could go through a bankruptcy proceeding. But right now, there is no provision in the Bankruptcy Code, as I understand, for a State to go through a bankruptcy-like proceeding, a Chapter 11 where, of course, the secured creditors, the bondholders and others would maintain the highest priority, but there would be a procedure by which the State could ultimately wind its way out of this crisis situation and get back onto a more sound fiscal basis.

There has been some suggestion among commentators and others that Congress ought to look at a procedure that would allow that to happen as one alternative. Would you think that that would be a wise or a good thing for Congress to do?

Mr. BERNANKE. I think it would be useful for Congress to look at the situation broadly and try to identify what potential problems that might be there and what lacunae there might be in the bankruptcy law, et cetera. I think it would be extraordinarily unusual for a State to default. It has not really happened seriously for 160 years or so and I think we ought to focus on States meeting their obligations, which they do have the tools to do. And again, as I mentioned before, in most States, the debt and interest payments are the top priority and they would come in front of provision of services and so on. So I think we should understand the situation, but I am very, very hopeful and expect that we will be able to avoid defaults at that level.

Senator CORNYN. And I share that hope, but if I may conclude on this question, what would be the consequence of a large State like California or Illinois defaulting on its debt?

Mr. BERNANKE. It is—

Senator CORNYN. In terms of the national economy.

Mr. BERNANKE. Well, it is difficult to know, frankly, because it has not happened for a long time. It would certainly be a—it would certainly create a lot of stress and volatility in the markets. There is no question about that. It also would mean that the State, when it came back into the market, would probably have to pay a much higher interest rate for a considerable period and therefore it would be, I think, very much a last resort for any State to do that.

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

Chairman CONRAD. I thank the Senator. I thank the Senator for asking the question, because I think this is something we need to be paying close attention to. The Senator has raised the question of a series of municipalities that may be under significant stress. We have also been told that there are a number of States, I have been told as many as 20. Governor Manchin, maybe you have more recent information—

Senator MANCHIN. I just cycled out of being Chair of the NGA and we were very much concerned about this, watching the fiscal viability of every one of the States, and everything is back to 2008 levels, is what we were based off, and that is what you all based off in Congress when you set up the help that was given as far as the aid to the States. That all goes away by June 30. Most of our fiscal budgets are done June 30, 2011.

Chairman CONRAD. And do you have a rough idea of how many States are—

Senator MANCHIN. I think upwards more of in the high 20s, low 30s, that could be in serious problems. We are concerned. We are very much concerned.

Chairman CONRAD. We have an analysis, by the way, underway on this question. This may be one of the things we would like to talk to you about if you have an opportunity to come up and meet with us in a session with all Senators. We do have an effort underway based on the conversation I had with Governor Manchin earlier.

Senator MANCHIN. If I could ask one question, Mr. Chairman, and to Mr. Bernanke, is I think what we were asking, and the Senator from Texas was asking the same, is there any plan—I know it has not happened for many, many years and maybe—but we are seeing indications and concerns that we have right now, and States have done everything humanly possible because they have to meet a balanced budget every year and they have cut to the bone, if you will, and if the cash flow is just not there to suffice with the amount of services they have to give, is there any bailout or any other proposal that you all have or have been looking at? I think that is what we are saying. Is there any plan available that could help a State, that would prevent this from happening, from falling into default, or could you do that?

Mr. BERNANKE. I do not think the Federal Reserve has the authority and I do not think it would be appropriate for us to do that. This is something that would take place over a period of time. It would not happen in a day or two and there would be plenty of time, I think, for Congress and for the State legislature to look at alternative solutions. So I think this is really a political fiscal issue. We will watch it very carefully because it has implications for the economy and for financial markets, but I do not think the Fed really has much that we can do about it.

Senator MANCHIN. Mr. Chairman, I would recommend that maybe as a committee what we should do is check with the NGA. They will give you a complete status of what they see in real crisis.

Chairman CONRAD. I think we had better think about how we get input on this. The more we look, and Senator Cornyn has brought to our attention here what we had heard earlier as a result of the information you shared with us, this is something that is out there on the horizon that we need to pay very close attention to.

Senator Merkley, we apologize to you because we interceded on your time. We will give you an additional minute and you are recognized.

Senator MERKLEY. Thank you very much, Mr. Chair, and I will use a few seconds of that to say that, Senator Sessions, I am happy to hear that you are willing to wear Senator Wyden's tie if Oregon wins. I have a pin right here that maybe you would be willing to wear this pin after Oregon wins for a couple of days.

Senator SESSIONS. I would be glad to, although I am not going to lose any sleep over that prospect.

[Laughter.]

Senator MERKLEY. Will you be out there on Saturday?

Senator SESSIONS. Having an Auburn team going to Tuscaloosa and come out victorious, I am a little confident. But actually, it is exciting. It is so much fun and people are so excited. I am sure they are in Oregon. It is just one of the great things about America, that people can pick out something other than politics—

Senator MERKLEY. Absolutely.

Senator SESSIONS. —and have some fun with.

Senator MERKLEY. A little bit of an antidote.

Well, let me turn to the business at hand, and thank you very much for your testimony, Mr. Chairman. I wanted to start by asking a little bit around the QE2 policy. As I understand it, you could summarize it by saying that in buying these bonds, you are injecting more money into the economy. Doing so reduces the interest that would be borne on those bonds, which encourages people to maybe hold less of those bonds and invest more in either corporate bonds or perhaps stocks, if there was a substitution effect, to invest in American business. So that is kind of one category.

Another category would be that in doing this, one also creates more pressure in terms of those economies such as China's which are using a pegged exchange rate with the United States to try to reduce the impact of China's currency manipulation on our ability to sell our products abroad.

Do you see both of those as key components of this policy, or is one more important than the other, or could you just help us get our hands around those two pieces?

Mr. BERNANKE. Senator, first, I want to say the Federal Reserve is neutral on the Auburn-Oregon issue.

[Laughter.]

Senator MERKLEY. I am disappointed to hear that, because there are two Senators from Oregon here and only one from Alabama, so—

[Laughter.]

Mr. BERNANKE. Senator, your first part of your description, I think, was very accurate. I mean, we are trying to ease financial conditions to stimulate more economic activity. You know, de facto, this policy has been in effect really since August, because we, in August, we began to reinvest our securities and I began to talk about this in public and the markets began to anticipate these actions. And we have seen since August significant improvements in stock prices, in spreads and volatility, in a variety of areas, and I think we are having some positive benefits on financial conditions and are contributing to a better outlook for the economy.

It is not our intention to do anything in particular on the international front. Our objectives are focused entirely on the U.S. economy, which is what our mandate tells us to do. It is true that to the extent that China or other countries undervalue their exchange rate or maintain a fixed exchange rate, that they import U.S. monetary policy. U.S. monetary policy, in my view, which is quite accommodative, is appropriate for the United States. It is not particularly appropriate for China, given how quickly they are growing. In fact, they are dealing with some inflation issues now. So, in fact, it is forcing them to take some actions. Letting their exchange rate appreciate somewhat would be helpful for them in this context because it would reduce the inflation pressures that they are otherwise going to experience. But that is not the key objective of the policy. The policy's objective is to try to meet our price stability and employment goals.

Senator MERKLEY. No, I understand that, but the employment goals also are impacted by the ability of us to sell our products overseas, so there is kind of a complete picture that comes to play in that.

And in that regard, let me turn then to manufacturing, because one of the challenges certainly for American products, making them here and selling them abroad, is the difference in labor rates. But there has also been the argument that in our trade agreements, we sometimes end up in a situation where foreign producers seem to have full access to the American economy while, both through currency manipulation and through non-tariff barriers, American products do not seem to be able to get into the foreign markets as easily, and that that differential has undermined manufacturing in America.

There has also been a related conversation that I just wanted to lay it out because I see it starting to appear here and there, and that is that one of the reasons we seem to be coming out on the short end of these trade agreements is because we also go into these negotiations with other goals that are not necessarily economic goals, that is, goals related to access, military access, finding a key ally to say, as we did within the markets in China when we were involved in the wrestling with the Soviet Union, that we take non-economic goals into these agreements.

So I thought I would just see if you would like to comment a little bit on these challenges in terms of our ability to maintain a manufacturing base and some of the interrelated issues regarding trade negotiations.

Mr. BERNANKE. Senator, of course, we remain an important manufacturing power. I think we still have the largest manufacturing sector in the world. Employment has been declining very sharply because of productivity gains. But you are also correct, I think, that trade and currency issues are an important factor.

On the currency side, I have been very clear that I believe that the policy of China and other emerging markets to undervalue their currencies is counterproductive both for those countries and also for international imbalances and for global trade flows and I hope that we can continue to work with China and those other countries to create a more flexible exchange rate regime. I think that is very important.

I am not deeply conversant with the details of trade negotiations. I think every country has multiple objectives when they engage in these negotiations, but I hope that we will be aggressive in pursuing WTO remedies, et cetera, as needed to eliminate trade barriers, both tariff and non- tariff barriers, and I am very supportive, like most economists, of free trade agreements which work both ways, that allow both exports as well as imports to flow freely.

Senator MERKLEY. Thank you. Let me turn to another issue, which is the ongoing impact of the high level of foreclosures on housing prices in America. We have had an ongoing rate, and I think it is projected through the balance of this year, of about 300,000 foreclosure filings a month. Not all of those will result in foreclosures, but many will. We still seem to be driving down the value of homes, which results in more families underwater, more families that are in a situation they certainly cannot borrow against the value of their house since the house is worth less than they owe.

How does this—and I will just note that our effort to intervene, which was highly debated two years ago when I first came here to the Senate, a decision to invest $50 to $100 billion to assist Oregon—not Oregon, but Oregon and the United States homeowners—as a result of an expenditure over these two years of less than a billion dollars—I think last I checked it was about $500 million. So our intervention has been modest, at most. This remains both a huge factor affecting the quality of life for families and their ability to look positively on the future. How does this play into our monetary policy or interrelate in ways that we should understand better?

Mr. BERNANKE. Well, you said it very well. Foreclosures continue to be very high. There have been sincere government efforts to try to address the problem, but they run into lots of bureaucratic and other difficulties, as well as the fact that in a weak economy with lots of unemployment, there are a lot of folks for whom there really is no solution or good alternative, given that income has been lost through job loss.

This is an important consequence—has important consequences for the macro situation, as I alluded to in my testimony. The high levels of vacancies, homes that are not only empty but are, in fact, reducing the value of the neighboring homes around them are driving down prices, which is affecting household wealth, which is affecting consumer spending and confidence. It is affecting the whole residential industry. Construction is very, very weak because with prices so low, new construction cannot recover its costs. It has some implications for the quality of mortgage assets and therefore for our financial system. In our reviews of bank capital positions, we are doing stress test scenarios and one of the main stressors is what happens if house prices were to fall five or ten or 15 percent more and how would that affect their mortgage portfolios and their capital.

So in a number of different directions over and above how it is affecting the individual families, at the community level and at the broad economic level, it is a very serious problem and it is one of the reasons that the recovery, along with the problems in credit markets, one of the reasons that the recovery is not as robust as it normally would be, given how deep the recession was.

Senator MERKLEY. My time has expired. I do have another question, if it is appropriate.

Chairman CONRAD. Given the fact we intruded on your time, go ahead.

Senator MERKLEY. Thank you. Well, one of the interesting developments is that families started saving a substantial amount, recognizing that they needed to prepare for the possibility of the loss of a job or the drop in value of their home and so on and so forth, which, of course, on the spending side that throws a wrench into the economy. But one thing that I have heard reference to, but I am not sure if it is right, is that the amount of consumer debt has decreased by more than the amount the national debt has increased. That is, if you take the family debt and the national debt together, our total indebtedness has dropped. Is that accurate, and how does that play into the macroeconomic picture in terms of the impact of our national debt?

Mr. BERNANKE. That is correct, and one way to see that is that our current account deficit, which is our foreign borrowing, has gone down, meaning that our total need for borrowing, public and private, is lower than it was before the crisis. That is the opposite side of saying that the aggregate demand, that total spending is insufficient to bring the economy to full employment. So what you say is exactly right and it, again, is consistent with the need for continued, at least speaking from the Federal Reserve's perspective, continued accommodative monetary policy to help support the economy's recovery.

Senator MERKLEY. Thank you.

Chairman CONRAD. I thank the Senator.

We will go to a second round, and I think maybe what we will do is reduce this to four minutes so we do not impose too much on the Chairman's time.

Let me just say, I haveten an initial report now on the States' situation and I have asked Senator Manchin, as former head of the National Governors Association, to get us the latest information that is available from that source. Here is what I have in an initial review since our conversation on the floor, I think it was last week, Governor Manchin, maybe a week ago or so.

In looking at what has happened since enacting their 2011 budgets, 15 States had new budget gaps open by late November totaling $27 billion. Nearly the entire gap is accounted for by five States: Illinois, half of it, roughly half; Arizona, about ten percent; Washington, seven percent; California, roughly seven percent; Texas, five percent. Those are the new gaps that opened up in 2011 after they collectively had closed $84 billion of gaps in working on their 2011 budgets.

What is, I think, a serious matter is looking at the

2012 budget gaps. NCSL's survey, the National Committee on State Legislatures, projected a gap of roughly $97 billion

in 2012. The Committee on Budget and Policy Priorities reports that gap currently stands at $113 billion and is expected to grow to $140 billion once all the States have updated forecasts. So we are talking about a significant problem here with some 35 States projecting gaps in 2012. Only 11 States reporting no budget gaps for 2012. I must say, proudly, my State has no budget gap. I think Governor Manchin left his State in very good shape. I do not think they face a budget gap.

But that—now, looking back in 2011, they closed $84 billion of budget gaps, so clearly there is capacity there to do significant budget gap closing looking at 2012. But, I mean, $140 billion is a big number, certainly for those individual States, and I think it is—you know, you look at Illinois, for example. They are talking about a 2012 budget gap of $15 billion, which represents 50 percent of their budget. That is a whopper.

And I do think we need to be prepared with a plan in case we are approached by one or more States, because clearly, the problem is concentrated in a handful of States. As I indicated, five States were the significant majority of the 2011 gaps—Illinois, Arizona, Washington, California, and Texas. We have to be ready with a plan if we are approached with respect to requests from any or all of those States, and I understand fully that is not in your domain, but I think we can reasonably anticipate that we may have requests made to us. I can tell you, I do not think Congress, the House or the Senate, are going to be very interested in bailouts to States.

Senator MANCHIN. Mr. Chairman?

Chairman CONRAD. Senator Manchin?

Senator MANCHIN. If I may, just in open discussion here, the States are going to be in a situation where they are going to have to have the flexibility to refinance to put their financial houses in order. Everybody bet on the come, if we will. They worked off of 2008 levels, the amount of stimulus that helped them get through a difficult time, and we thought the economy would pick up and it has not. They are still left short, if you will, and they are making some really draconian cuts and they are all making that effort.

But with that, our know, our ability—our bond ceilings that we have that we as States were able to go out to the market with, there might be some creative financing that is needed to be done here and we are going to need all the help we can get. Can they raise those ceilings to see if there is a market so they can refinance zero percent bonds, to go out and find out if they can create value within their States. I do not think the appetite is here in Congress to just say, okay, here is more money to help you. Can we help you help yourself? Can we give you some flexibility? Are there some restrictions and regulations that we can ease up on?

I think that is what would be most appreciative, and I think we should be looking at it now because it is not if it is going to happen, it is when they are going to need our assistance and help.

Chairman CONRAD. Well, I think you make a very good point, and I think since our previous conversation, I immediately asked people to go out and do this survey and I think it is something this committee is going to have to be prepared with an answer. And what you are saying, I think, makes eminent good sense. That is, maybe there are ways to help with creative financing. I do not think there is going to be much appetite here to send truckloads of money to States.

I have about used my time on this four-minute round. Others? Senator Sessions, would you like an additional round?

Senator SESSIONS. I would, Mr. Chairman, and there is so much to ask, Chairman Bernanke, I will submit written questions to you.

With regard to the State situation, the States are sovereign. They have issued their own debt, and the people who loan money to States need to know their likelihood of being repaid is based on the financial condition of that State. And there is a moral erosion of a significant nature when we undertake to start bailing out more. I just think this whole bailout mentality has far more ramifications than a lot of us think and a lot of people have indicated.

I understand what you are saying, Mr. Bernanke, and that States need to get their house in order. They should not expect low-interest loans from the Fed if they get in trouble. Is that correct?

Mr. BERNANKE. They should not expect loans from the Fed, and I think the numbers that the Chairman referred to are prospective gaps obviously. They are a measure of how much spending cuts or tax increases are going to be needed to achieve balance. It is going to be difficult, but on the other hand, there is some improvement in the economy, and tax revenues actually have picked up some. So it is a difficult situation, but I hope the States will be able to address it.

Senator SESSIONS. But I have just got to tell you, places like California have been living beyond their means for a very long time, even when the economy was in good shape. Our State is very frugal. We try to operate a good State, and I think I am not inclined to ask my constituents to rescue someone who has been improvident.

I will note what Mr. Christie is doing in New Jersey: the agriculture department, reduced 24 percent; banking, 12 percent; community affairs, reduced 35 percent; education, down to 8 percent; human services, 4 percent; law and public safety, 7 percent; roads, 3 percent.

Now, I suggest New Jersey is not going to sink into the ocean. It is still going to be there. And this idea that cuts—and even this deficit commission, bless your heart, I hope I would have been willing to support the Commission's recommendations. It is about as good as anything we have seen. But it does not call for anything like a reduction in Federal spending like this. It actually does not call for any, really, in discretionary accounts of a significant amount. So we can do better, and the American people are telling us this.

Mr. Bernanke, I have criticized some of you folks, including President Bush and Mr. Greenspan. I do not think you realize the political world we live in, the real world we live in. You think, well, we can—in 2001, when we needed to stimulate the economy and run a deficit, well, we have had a surplus for a few years, we can just ask the Congress to spend money, and then when they get to a certain point, we can tell Congress to stop. But those of us who committed and were elected to try to balance the budget and participated in tough votes to balance the budget really had our legs chopped off. We were not able then to warn against spending. Even the Republicans, some of them, and the Fed seemed to be saying deficits do not matter. And now, see how hard it is to turn off the spigot? I think the same thing—maybe you and the Fed can turn off the spigot just like that within your power. But for us politically it is not easy. So we have to get a consensus.

I think the American people have a sense right now— don't you, Mr. Chairman?—that they want us to do something now. And I want to ask you, are you telling us that you think it is premature to start reducing some of our spending levels and some of the Government accounts because it might hurt the economy? The Brits do not seem to think so. In a similar situation to our, they are cutting now.

Mr. BERNANKE. What I said, Senator, was that it is a long-run issue. It has to do with—you know, the problems are not just this year or next year. The problems go out decades. And I think it is not too soon to have a strong set of measures that will bring down deficits over time so that we have at some point a stabilizing and then declining debt-to-GDP ratio.

So I think action is needed, but I think you are not going to solve the problem by just making cuts for this year's budget. You need to think about the whole future path and all the obligations both implicit—I mean, the Chairman talked about the debt held by the public and the gross debt and so on. All those debt numbers do not include the unfunded obligations that we have for entitlements, for example. So the true debt is probably 3 or 4 times bigger than what the Chairman is talking about.

So we need to address that, but what I am saying is that we want to take—we should take a long-run perspective, and that is really what the markets are looking at, and that is what economic stability requires.

Senator SESSIONS. Fair enough. I do believe we have an opportunity to limit waste and spending right now, and it would not damage the economy, and in the long run we need to work together to try to figure out how to create confidence that our economy is under control and our spending is under control.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Chairman Bernanke, I want to ask about China in a different way. I also chair the Senate Finance Subcommittee on Trade and Competitiveness, and I want to take you through what I think is going on with China and get your reactions in the American economy and particularly the cause of creating more good-paying jobs.

A decade ago, when China was admitted to the World Trade Organization, in effect there was a commitment made to marketplace principles. That was essentially what their entry to the World Trade Organization was all about.

In the last 6 months—and, frankly, we have seen this over a considerable period of time—it seems to me we have seen considerable backsliding in China with respect to these marketplace principles, and two areas I have been especially concerned about most recently are rare earth minerals, which are so important for American manufacturing, green goods and others, where the Chinese in effect are saying, look, we are going to keep our rare earth minerals here; and if people in the United States want manufacturing, they got to come there. And we are also seeing it in what amounts to discrimination against American digital goods and services, which is another important area of good-paying jobs for our country.

My question to you is: What is your sense about the implications of China backsliding on these marketplace principles that they in effect committed to? And I will tell you, just in my view, they are violating World Trade Organization principles in those two areas, the question of rare earth minerals and digital goods. What are the implications of what they are doing there? And what is an appropriate role that our Government ought to be taking?

Mr. BERNANKE. Well, the WTO agreements have specific rules and procedures, and we have actually brought some actions under WTO, and I believe we won a couple of them. So within the rules that China has agreed to, the WTO process looks like it has been working. But I am not so sure that I would agree that China is backsliding. I mean, there have been issues all along with intellectual property and government procurement and a wide variety of—you know, access to—

Senator WYDEN. Well, those are two areas most recently, and they are very important to the American economy. Rare earth minerals and digital goods, this is a pretty new phenomenon. This is the last 6 months, and that is why I am talking about the implications for the economy.

Mr. BERNANKE. Well, on rare earth minerals, you know, I agree that that is a strategic input. I do not believe the United States has any current capacity or has very little capacity in that area, so we might want to consider some strategic investments in that area. But this is just a number—there are a number of areas, and the Chinese would raise issues with us as well about exports and so on, the technological exports and so on, where I think ongoing engagement is really going to be important. And, of course, the President of China is going to be here in a few days, and I hope that will be an opportunity for high-level discussions. But this is part of the ongoing process we have had with China for a while, which is to try to hold both sides to trade and investment obligations, and it has been a struggle in many cases. I am not disagreeing with you.

Senator WYDEN. Well, I thank you. I clearly come to these trade issues looking for ways to open markets. That is why I think that we are at such a critical time. And I have voted for every market-opening agreement since I have been in public life. But I also think it is important to adhere to principles that ensure that in a global marketplace everybody has an opportunity to make markets work. And I think we are seeing in a number of areas considerable backsliding from the Chinese, and I look forward to following up with you on this as well, because we cannot meet our target of doubling exports, as we have set out to do in this country, and substantially lowering the unemployment rate as our constituents are demanding unless we have an opportunity around the world to have fair access to markets. And I think in a growing number of areas, that has not been the case.

I look forward to working with you in the days ahead, and I thank you for your appearance today.

Mr. BERNANKE. Thank you, Senator.

Senator WYDEN. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator MANCHIN.

Senator MANCHIN. Just to follow up very quickly on that, in the State of West Virginia we have been blessed with some of the highest quality coking coal in the world, and I brought this to the attention of people in higher places, that we are concerned about most of our assets are being purchased by foreign countries. We still have the good fortune of our miners working and we are mining the coal and the severance tax the State receives. But as the Senator just mentioned, most of this product is leaving this country. That is the ingredients of making the steel that is needed that builds industry, if you will. And I do not know if we know the critical juncture we are at, but I can tell you, we can see it every day, the outside interests and the amount of money they are paying for these reserves.

With that being said—I know this has been talked about—I am the new kid, if you will, in town—the TARP, the whole bailout of the banking system. It is still in my area as far as in West Virginia, we are very much concerned that small businesses do not have access to capital, are having a hard time acquiring it. Individuals, if you will, commercial developers, the building industry. The thing that is really lacking and throwing us back right now is the access to capital. And we have heard it, you know, we bailed out Wall Street but not Main Street.

When do we see relief or what do you think needs to be done, sir, for us to opening up the banking industry so it can start taking, if you will, some calculated risk and putting money back in the market?

Mr. BERNANKE. Well, just on the narrow question of TARP, of course, capital went out to smaller firms as well as larger firms, and Congress just recently passed the small business plan that has non-TARP capital going to small banks that are willing to make loans to small businesses. So some of this money has gone to small firms as well as large firms.

It is a tough problem because you have small businesses who were used to somewhat easier conditions before the crisis. Terms and lending conditions have tightened up to some extent for understandable reasons given what happened during the crisis and given the losses that banks took.

It is also a situation where the economy has been weak and where the value of collateral, the value of stores or factories, et cetera, has come down, which makes it more difficult to borrow as well. So there are some fundamental reasons why credit is harder to come by.

That being said, I think there is a tendency to overreact. There is a tendency after a crisis or in a weak period to tighten too much, to swing too far, the pendulum to swing too far, and—

Senator MANCHIN. Do you think that has been done?

Mr. BERNANKE. I think in some cases that has been the case, and that as I have said, the Federal Reserve, we understand—we have a responsibility to keep banks safe and sound as best we can. On the other hand, we also have considerable interest in having the economy grow. And so we have been—and I would be happy to give you much more detail at a more convenient time and send you a letter or meet with you personally, however you would like to do it. But we have taken a lot of actions to try to create a better balance for banks to make sure that they can make good loans; that if they are following safe and sound procedures that we will not criticize them for making a loan to a small business or even a business where the collateral value has declined. So we are very sympathetic to what you are saying, and we have been working hard, and I do think that there is some progress. I think there is some improvement. And as the economy expands and as credit needs go up, I think we are going to see more lending take place.

But we are very much aware of this issue, and we are reaching out to small businesses, we are reaching out to banks. And if you have any suggestions or you have—if anyone would like—we have an ombudsman who will be happy to take any complaints or concerns. We do want to be responsive on this issue.

Senator MANCHIN. I will do that. I will bring specifics, if I may, and maybe you can give us some help.

Mr. BERNANKE. Of course.

Senator MANCHIN. Thank you.

Chairman CONRAD. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and I appreciated the reference, Mr. Chairman, to the Small Business Lending Fund, which was a proposal that I developed in response to a problem we saw in community banks in Oregon where they were noting that because of the FDIC requirements on leverage being firmly applied, healthy community banks were unable to lend. We do not yet know the results of that program, but it was one way to try to get funds into Main Street banks so that they could assist Main Street businesses. And in addition to banks that did no have the capitalization to make additional loans, we have banks that are not only healthy but do have funds but are kind of sitting on them waiting to see what happens with the economy. And so we look forward to continuing to brainstorm some of the ways we can get liquidity in the hands of small businesses, because if they cannot borrow money, they cannot seize business opportunities. And they are a job machine that we have to put fully to work, and finding the right way to do that is very important.

I wanted to turn back to housing. Oregon produces a lot of lumber, and many other States produce lots of products that are not being consumed when the housing market is down. There are a series of ideas that are still being talked about. Again, a $50 to $100 billion promise has turned into less than $1 billion of spending to assist homeowners. One of those concepts is to do a national short sale program in which families who have passed an economic distress test or filter, if their home is being sold at a far lower value after being foreclosed on or shortly before being foreclosed on, that the family itself might have a chance to buy it back using lending that is fully underwritten based on their ability to pay, but maybe not the complete traditional FICO score structure.

A second approach being talked about is downpayment grants to help first-time homebuyers. Of course, we have experimented with this program, but to help absorb that inventory of foreclosed homes, so that instead of having an empty home on the block, you have a family that is in that home, and to help arrest the downward direction of house pricing.

A third is another examination of bankruptcy reform as a way to kind of adjudicate the issues involved in homeownership where every other contract can be adjudicated by a bankruptcy judge, a home contract cannot be. And with appropriate protocols that we have been alerted to in terms of being backward-looking not forward-looking, great concern to the banking community.

So as we look at this national housing challenge, which I think you echoed the concern that it is a major factor in our economy getting back on track, if these are not the right ideas, what are the right ideas? What more can we do here in Congress to take on one of the really big domestic issues affecting the quality of life for families and the strength of our economy?

Mr. BERNANKE. Well, I am afraid there are no simple solutions, as you might imagine, and the ones you mention are all interesting ones, and let me just offer in general that we would be happy to work—staff would be happy to work with you on the details of any of these ideas. If you would like to take us up on that, we would be more than happy to work with you.

The short sale idea has been around. I think it is fairly similar to the idea of just having a principal reduction in the mortgage, which is something that is now— which the Federal Reserve actually advocated for a number of years, which I have talked about in speeches for some time as being a way of creating greater incentives for the homeowner to want to stay in the home. That is a program that is now currently in place, building on a program that was passed a couple years ago. I do not know how far along that hasten, but that is one approach.

Senator MERKLEY. Not very far.

Mr. BERNANKE. Not very fair. I think—

Senator MERKLEY. And there is an important—I will just interject here on this. The challenge on the principal reduction is that as long as the family looks anywhere near viable, financial institutions are very, very reluctant to write down the principal. The idea of the short sale is at the point that a bank or a mortgage holder has concluded that the family is going to go under and the home is going to have to be resold, at that point there is no longer kind of this competition between writing down an existing loan on the books because the loan is going to be—the house is going to be foreclosed on, the loan is going to be gone anyway. So that is why the conversation has migrated in that direction.

Mr. BERNANKE. Well, again, economists at the Board and around the Federal Reserve System have been working on various plans, schemes to try to address this problem, and I would be more than happy to work with you in more detail on these issues. But getting the principal down through some mechanism is obviously one approach.

On the downpayment assistance, I think you would want to design it in a way so that—one of the concerns that we had about the homeowners—the tax credit was that it created a temporary bump but did not seem to have a permanent impact on the housing sector. So you would want to do something that did not just shift purchases in time a little bit, but actually created a more sustainable demand for housing. And that is another difficult problem.

But, you know, I have been—I am a member of the committee that oversees the TARP, and so we have been getting regular presentations from the Treasury on the various programs, and to their credit, you know, they have gone beyond their initial HAMP program to look at a number of different experimental approaches, giving States money to apply to their own strategies. So there are a lot of ideas out there and a lot of things that are being experimented with, but clearly, particularly in a world where unemployment is 10 percent and long-term unemployment is 44 percent of that unemployment, there are situations where it is very difficult to find a solution.

Senator MERKLEY. My time has expired, but can I follow up on one piece of this?

Chairman CONRAD. If it is brief, because we have made a commitment here that the Chairman would get out of here by noon and we are little past that now.

Senator MERKLEY. Okay. The concept of a permanent downpayment grant at a lower level for first-time homebuyers addresses that issue you were talking about of just shifting demand forward, but it also addresses something more fundamental, which is our primary mechanism of reducing the cost of homes for families, is the home mortgage interest deduction. But that kicks in primarily when you buy a larger house and you are in a higher tax bracket. So the vast bulk of the subsidy goes to the families who need it the least in terms of actually becoming homeowners. And so the idea of a downpayment grant—and it should be in addition to. I am not taking anything away from the concept of interest deduction on your home. But the idea is that now you have a working family of modest means that is buying a very modest house, and we are helping them become homeowners, in which they would hardly benefit at all from the mortgage interest deduction. And so it serves as kind of a fairness factor because we should help working families buy homes as well as help successful families buy large homes, and yet also help absorb this inventory of empty homes. So that is kind of the broader, fuller picture of it.

Mr. BERNANKE. The Commission that the Chairman was on talked a lot about the interest deduction and lots of, I think, interesting ways to think about whether that could be made more productive, more constructive.

Senator MERKLEY. I will mention I am not addressing the interest—

Mr. BERNANKE. No, no. I understand. But it raises the point that some people it does not really help very much. If you do not itemize, for example, you do not get the interest deduction.

Senator MERKLEY. Thank you.

Chairman CONRAD. I thank the Senator.

One final question that we have been asked, and that is, with the substantial expansion of the balance sheet by the Federal Reserve to make sure the flow of credit continued during this downturn, can you anticipate now what percentage of that expansion would be realized as losses? I have been told that it is very small. Can you give us some sense of that?

Mr. BERNANKE. Well, first, as I mentioned in my testimony, this is not deficit spending. We are buying assets which we will either sell back to the market or allow to run off. Currently we are in a profit position. Our cost of funds is very low, so the interest that we are receiving we are remitting back to the Treasury. I got a new number this morning. For 2009 and 2010, we remitted back to the Treasury $125 billion from this program, which is much higher than our normal.

Should it be the case that short-term interest rates rise, which, of course, could happen if the economy recovers and we need to normalize monetary policy, then those remittances could go down. But currently we are in a—you know, this is at this point a profitable program from the perspective of the Federal deficit.

Chairman CONRAD. And is it your forecast at this point that you will then not experience losses on this extension of credit that was made during the downturn?

Mr. BERNANKE. As a practical matter, what matters is not losses, because those are paper losses. What matters is the amount of funds, remittances we send back to the Treasury. Under most scenarios, because our cost of funding is so low, we will continue to remit back to the Treasury significant amounts of money. Under a scenario in which short-term interest rates rise very significantly, it is possible that there might come a period where we do not remit anything to the Treasury for a couple of years. That would be, I think, the worst-case scenario. But even in that case, we would have offsetting that both the early payments, which are above normal, and the fact that to the extent that this is a successful policy, it will strengthen the economy and increase tax revenues.

So I think from a purely fiscal point of view, I think this is most likely to be beneficial, not harmful, to the Government's financial position.

Chairman CONRAD. The reason I asked the question and phrased it like I did is because in common parlance there has been a great concern that what the Federal Reserve did was going to result in large losses to taxpayers or there was the potential for that. And you do not see that.

Mr. BERNANKE. I do not see that as likely, and our record so far not only in this program but in all of the lending and other special credit programs we have done, you know, has been very positive from a perspective of returns to the Treasury.

Senator SESSIONS. With regard to quantitative easing on the Federal purchases, that money that you pay back is money that came from the Treasury. Is that right? It is the interest—

Mr. BERNANKE. Well, yes, but it is, of course—another way of looking at it is that it is interest that the Treasury did not have to pay to the Chinese.

Senator SESSIONS. I am aware of that, but it is a zero sum game I guess in that sense. And you believe it is helpful to the economy. I understand that.

Mr. BERNANKE. That is the main point.

Senator SESSIONS. That is the main point of it.

On "60 Minutes" a couple years ago, you made reference to this is the equivalent of printing money. Was that when the Fed buys—is quantitative easing the purchase of Treasury bills, is that what you meant when you said printing money?

Mr. BERNANKE. So I was actually talking about a somewhat different issue at that point. So let me try to explain what really happens. What happens is that when we buy securities, the money finds its way into the banking system and shows up as reserves that the banks hold with the Fed. So currently banks are holding a large amount of reserves with the Fed which will have to at some point be unwound as we exit from this program. However, I think there are some folks out there who think that we are literally printing money and putting it in circulation. That is absolutely not happening.

Senator SESSIONS. But it does have a tendency, does it not, to increase the circulation of dollars, which, like more apples in the marketplace, makes the apple less valuable? Or does it not?

Mr. BERNANKE. The amount of currency and money in circulation has not really been affected by this program. Very slightly. And, in fact, money growth over the last year or so, 2 years, has been below normal. So it is not a situation where the Fed is dumping money into the economy. That is not what is happening.

Senator SESSIONS. Thank you.

Chairman CONRAD. Thank you. Thank you very much for your appearance. Thank you for your forthright testimony here, and we look forward to having you up for a meeting with the members as we try to craft a fiscal policy to get us back on track.

Mr. BERNANKE. I look forward to it. Thank you, sir.

[Whereupon, at 12:09 p.m., the Committee was adjourned.]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

April 18, 2011

The Honorable Bill Nelson
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 7, 2011, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Nelson:

1. The Federal Reserve Board of Governors and the Federal Open Market Committee are mandated by the Congress to use their authority over monetary policy to promote the goals of maximum employment, stable prices, and moderate long-term interest rates. Some influential Members of Congress have recently indicated their desire to change the Federal Reserve's statutory objective to focus solely on maintaining stable prices. In your view, what is the appropriate mandate for the Federal Reserve?

Since 1978, the Federal Reserve's statutory mandate for monetary policy has been to promote maximum employment, stable prices, and moderate long-term interest rates. Achieving the first two of these objectives would be expected to lead to success on the third as well, so this mandate is often referred to as the "dual mandate." I believe that this mandate is appropriate, and the Federal Reserve is not seeking a change to its statutory mandate. Of course, we would honor any change that the Congress made. However, it is worth noting that a flexible inflation objective of the sort that is common around the world would not necessarily have led to policy decisions that differed appreciably from those that we made in recent quarters. For example, our decision last fall to provide additional accommodation through further purchases of longer-term Treasury securities reflected the Committee's judgment that unemployment was above and inflation somewhat below the levels that it thought were consistent with its dual mandate. A central bank that had only a price stability objective might well have looked at the low and declining level of inflation and judged that additional policy accommodation was appropriate to return inflation to target and to limit the risk of deflation. Moreover, with considerable slack in resource markets, such policymakers would likely have seen considerable scope for policy easing without running the risk of inflation rising above their objective.

2. Going forward, assuming Congress has the opportunity to revisit and amend the Dodd-Frank Wall Street Reform and Consumer Protection Act, what improvements, if any, would you like to see?

The Board has made considerable progress in carrying out its assigned responsibilities under the Act. As we continue to work through our rulemaking and other implementation projects, we will communicate challenges, including technical or substantive errors we encounter in the legislation, to you in response to this inquiry.

3. What are the key criteria you will use to determine whether the $600 billion asset purchase program announced in November has been a success? Alternatively, what indicators would suggest to you that the program has been a failure?

Although large-scale purchases of longer-term securities are a different monetary policy tool than the more familiar approach of targeting the federal funds rate, the two types of policies affect the economy in similar ways. Conventional monetary policy easing works by reducing short-term interest rates and also by lowering market expectations for the future path of short-term interest rates, which in turn reduces the current level of longer-term interest rates and contributes to an easing in broader financial conditions. These changes not only reduce businesses' and households' borrowing costs, they also lower the rates at which investors discount future cash flows and thus tend to raise asset prices. Lower borrowing costs and higher asset prices, in turn, bolster household and business spending and thus support an increase in economic activity. By comparison, the Federal Reserve's purchases of longer-term securities have not affected very short-term interest rates, which remain close to zero, but instead have put downward pressure directly on longer-term interest rates. By easing conditions in credit and financial markets, these actions encourage spending by households and businesses through essentially the same channels as conventional monetary policy, thereby bolstering the economic recovery.

A wide range of market indicators supports the view that the Federal Reserve's securities purchases have been effective at easing financial conditions. For example, since August, when we announced our policy of reinvesting maturing securities and signaled that we were considering more purchases, equity prices have risen significantly, volatility in the equity market has fallen, corporate bond spreads have narrowed, and inflation compensation as measured in the market for inflation-indexed securities has risen from low to more normal levels. Yields on 5- to 10-year Treasury securities initially declined markedly as markets priced in prospective Fed purchases; these yields subsequently rose as investors became more optimistic about economic growth and as traders scaled back their expectations of future securities purchases. All of these developments are what one would expect to see when monetary policy becomes more accommodative, whether through conventional or less conventional means. Moreover, these developments are remarkably similar to those that occurred during the earlier episode of asset purchases, notably in the months following our March 2009 announcement of a significant expansion in our securities holdings. The fact that financial markets responded in very similar ways to each of these policy actions supports the conclusion that these actions had the expected effects on markets and are thereby providing significant support to job creation and the economy.

Some have expressed concern that the Federal Reserve's asset purchase program would lead to a sizable increase in expected inflation rather than to a stronger recovery, or that it would set the stage for future financial instability by encouraging potential borrowers to employ excessive leverage to take advantage of low financing costs and by leading investors to demand too little compensation for bearing risks as they seek to enhance rates of return in an environment of very low yields. We take these concerns seriously. My colleagues and I have said that we will review the asset purchase program regularly in light of incoming information--including information on the economic outlook, the efficacy of the program, and any unintended consequences that might arise--and will adjust it as needed to promote maximum employment and stable prices. The Federal Reserve is carefully monitoring economic and financial indicators for signs that expected inflation is heating up and for potential threats to financial stability.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

May 20, 2011

The Honorable John Cornyn
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 7, 2011, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Cornyn:

Chairman Bernanke, I have a number of questions regarding the Federal Reserve's $600 billion bond-purchase program, known as quantitative easing, or QE2, announced this past November.

At the time QE2 was announced, some argued against it, saying it would only add to excess reserves in the banking system and those reserves already amounted to about $1 trillion. Supporters of QE2 said the policy would help the economy by reducing long-term interest rates. But now long-term Treasury yields are significantly higher than they were at the time QE2 was announced. Mortgage rates are also noticeably higher.

1. What I am wondering is what are the objective criteria by which we can judge the effectiveness of QE2 and whether the program is helping the economy, or whether the economy is improving on its own without any assistance from QE2?

From December 2008 through March 2010, the Federal Open Market Committee (FOMC) purchased about $1.7 trillion in longer-term Treasury, agency, and agency mortgage-backed securities. In August 2010, we began reinvesting the proceeds from all securities that matured or were redeemed in longer-term Treasury securities, so as to keep the size of our securities holdings roughly constant. Around the same time, we began to signal to financial markets that we were considering providing additional monetary policy accommodation by conducting further asset purchases. And in early November, we announced a plan to purchase an additional $600 billion in longer-term Treasury securities by the middle of this year.

Although large-scale purchases of longer-term securities are a different monetary policy tool than the more familiar approach of targeting the federal funds rate, the two types of policies affect the economy in similar ways. Conventional monetary policy easing works by reducing short-term interest rates and also by lowering market expectations for the future path of short-term interest rates, which, in turn, reduces the current level of longer-term interest rates and contributes to an easing in broader financial conditions. These changes not only reduce businesses' and households' borrowing costs, they also lower the rates at which investors discount future cash flows and thus tend to raise asset prices. Lower borrowing costs and higher asset prices, in turn, bolster household and business spending and thus support and increase in economic activity. By comparison, the Federal Reserve's purchases of longer-term securities have not affected very short-term interest rates, which remain close to zero, but instead have put downward pressure directly on longer-term interest rates. By easing conditions in credit and financial markets, these actions encourage spending by households and businesses through essentially the same channels as conventional monetary policy, thereby bolstering the economic recovery.

A wide range of market indicators supports the view that the Federal Reserve's securities purchases have been effective at easing financial conditions. For example, since August, when we announced our policy of reinvesting maturing securities and signaled that we were considering more purchases, equity prices have risen significantly, volatility in the equity market has fallen, corporate bond spreads have narrowed, and inflation compensation as measured in the market for inflation-indexed securities has risen from low to more normal levels. Yields on 5- to 10-year Treasury securities initially declined markedly as markets priced in prospective Fed purchases; these yields subsequently rose as investors became more optimistic about economic growth and as traders scaled back their expectations of future securities purchases. All of these developments are what one would expect to see when monetary policy becomes more accommodative, whether through conventional or less conventional means. Moreover, these developments are remarkably similar to those that occurred during the earlier episode of asset purchases, notably in the months following our March 2009 announcement of a significant expansion in our securities holdings. The fact that financial markets responded in very similar ways to each of these policy actions supports the conclusion that these actions had the expected effects on markets and are thereby providing needed support to job creation and the economy.

2. When will the Federal Reserve make a determination that QE2 is working?

As noted in my response to question 1, we believe that our asset purchases are having a positive effect on financial conditions, and so are providing support for the recovery and helping to move inflation, over time, back to levels consistent with our mandate of maximum employment and stable prices.

3. Is it your intention to make this an open-ended program?

My colleagues and I have said that we will complete purchases of $600 billion of longer-term Treasury securities by the end of the second quarter, consistent with the intended asset purchase program we announced in November of 2010. We have also said that we will regularly review the size and composition of the Federal Reserve's securities holdings in light of incoming information and that we are prepared to adjust those holdings as needed to best foster maximum employment and price stability.

4. Once the Federal Reserve decides to wind down QE2 and reduce its multi-billion dollar bond portfolio, how long will it take to do so?

Once the recovery is sufficiently strong, the FOMC will need to consider withdrawing policy accommodation in order to avoid the risk of a buildup of inflation pressures. The Federal Reserve has the necessary tools to smoothly and effectively exit from the current extraordinary degree of accommodation at the appropriate time. Our ability to pay interest on reserve balances held at the Federal Reserve Banks will allow us to put upward pressure on short-term market interest rates and thus to tighten monetary policy when required, even if bank reserves remain high. We have developed additional tools that will allow us to drain or immobilize bank reserves as needed to facilitate the smooth withdrawal of policy accommodation. If needed, we could also tighten policy by redeeming or selling securities.

The FOMC intends to normalize the size and composition of the Federal Reserve's balance sheet over time. However, this adjustment should be conducted in a manner that is consistent with the achievement of the FOMC's objectives of maximum employment and price stability. In order to minimize market disruptions, sales of securities from the portfolio should be implemented in accordance with a framework communicated in advance and be conducted at a gradual pace that potentially could be adjusted in response to changes in economic and financial conditions. The actual timing and pace of sales will, therefore, depend on economic developments and the FOMC's assessment of the outlook.

In a response to a question I asked during the hearing, you stated that the Federal Reserve has a "very limited authority" to purchase state and local municipal debt.

5. Could you please provide a reference point in the statute that provides the Federal Reserve authority to purchase state and local debt?

Section 14(b)(1) of the Federal Reserve Act (12 U.S.C. § 355) authorizes Federal Reserve Banks, upon the direction of the FOMC, to purchase bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any state, county, district, political subdivision, or municipality. The last purchases of municipal bonds by Federal Reserve Banks under the authority of Section 14(b)(1) occurred in 1933.

6. Could you please explain the limitations, aside from those you mentioned from the Dodd-Frank Wall Street [Reform and Consumer Protection] Act (P.L. 111-203), that are imposed on the Federal Reserve's authority to purchase state and local municipal debt?

As set forth in the Response to (5) above, the Federal Reserve may only purchase municipal obligations that (A) have a maturity from date of purchase not exceeding six months; and that (B) are issued in anticipation of the collection of taxes or receipt of assured revenues. It is estimated that a very small percentage of municipal bonds currently outstanding would fall within the statutory limitations of Section 14(b)(1).

7. Does the Federal Reserve's charter place any limits on the maturity or amount of state and local municipal bonds that may be purchased?

As set forth in the Response to (5) above, the Federal Reserve's authority to purchase municipal securities is limited to those with a maturity from date of purchase of not exceeding six months. There is no statutory limit upon the amount of state and local municipal bonds that may be purchased.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 1, 2011

The Honorable Debbie Stabenow
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 7, 2011, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Stabenow:

1. When derivatives legislation was initially implemented, Chairman Dodd and Lincoln clearly stated in a June 30, 2010 letter that the Act "does not authorize the regulators to impose margin on end users." Chairmen Peterson and Frank also unequivocally stated that their intentions were the same. Chairman Peterson noted, "[W]e have given the regulators no authority to impose margin on anyone who is not a swap dealer or a major swap participant," while Chairman Frank responded that, "[T]he gentleman is absolutely right. We do differentiate between end users and others." In response to questions offered at a recent hearing, you indicated that end-users do not contribute to systemic risk when you said, "The Board does not believe that end-users other than major swap participants pose the systemic risk that the legislation is intended to address."

- **In spite of these clear statements of Congressional intent, do you believe that legislation either requires or at a minimum gives regulators the authority to require swap dealers to collect margin from its non-major swap participant end-user counterparties?**

- **A number of organizations have estimated the economy-wide effects of collateral requirements could total hundreds of billions, or even in excess of a trillion dollars. Has the Board conducted its own analysis of the impact of collateral-intensive provisions of the Act?**

- **If the Board believes it is either required to or has authority to impose such a requirement, does the Board believe such a requirement is critical for the mitigation of systemic risk and that the risk-reducing benefits of such a requirement outweigh the economic costs?**

- **Since non-systemically significant end users have not been associated with systemic risk concerns, is the Board concerned that requiring entities that are not swap dealers or major swap participants to post margin could reduce prudent risk management, harm economic growth or create other unintended consequences?**

Although section 723 of the Act provides an explicit exemption for certain end users from the swaps clearing requirement, there is no exclusion in section 731 or section 764 of the Act from the margin requirements for a swap dealer or major swap participants (MSPs) swaps with end users. Sections 731 and 764 of the Act require the CFTC, SEC, Board, and other prudential regulators to adopt rules for swap dealers and MSPs imposing initial and variation margin requirements on all non-cleared swaps. The statute directs that these margin requirements be risk-based. Although development of a proposed rule is still underway, the Board and the other prudential regulators are giving serious consideration to how the relatively low risk posed by commercial end users engaged in hedging activities should be reflected in the amount of margin that dealers and MSPs need to collect from them. For example, we are considering whether it would be appropriate to allow a banking organization that is a swap dealer or MSP to establish a threshold, with respect to an end user counterparty, based on a credit exposure limit that is reviewed, monitored, and approved in accordance with the banking organization's standard credit approval processes, below which the end user would not have to post margin. The Board and the other prudential regulators are working to estimate the costs of margin requirements in order to inform the interagency rule-making process.

As you noted, the Board expressed its view in a prior hearing that end users, other than MSPs, do not pose systemic risk. The Board has long been of the view that derivatives are valuable tools for the management of risk, and it is committed to working with the Congress and other regulators to ensure that the benefits and costs from the use of these instruments are appropriately balanced, both for end users and for other market participants.

2. Does the Board believe that imposing margin on a swap dealer, when that dealer transacts with an end user that is not a major swap participant, is a critical policy tool for containing systemic risk or does it believe that other policy tools in the Act – including central clearing between financial entities, capital requirements applicable to swap dealers and major swap participants, and margin requirements applicable when swap dealers and major swap participants trade with each other – are sufficient for containing systemic risks?

The Act creates a comprehensive regulatory system governing the derivatives trading activities of swap dealers and major swap participants. Central clearing, which is required for certain swap transactions, provides another tool for mitigating counterparty credit risk. Another important tool is the creation of trade repositories which will support regulatory oversight and policymaking through provision of more comprehensive data on the derivatives market. These statutory requirements form the core of reform efforts designed to reduce the likelihood of OTC derivatives transmitting shocks through the financial system.

3. The CFTC will release its proposed rule on margin for trades with non-bank swap dealers in the next couple of weeks. Given the significant uncertainty that this issue creates for businesses, do you anticipate that the Federal Reserve and other prudential regulators will release its proposed rule on margin for trades with bank swap dealers soon? Can you provide any indication of timing?

The Board and other prudential regulators are jointly developing a rule on margin for swaps involving swap dealers and major swap participants that are banks. The timing is somewhat uncertain because of the need for all the prudential regulators to concur on the language, but we are striving to seek public comment in the near future and to adopt final rules by July of this year. The prudential regulators have begun a consultation process on these rules with the CFTC and the SEC and plan to continue that process as the rules are developed.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 11, 2011

The Honorable Chuck Grassley
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 7, 2011, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Grassley:

1. What evidence do we have that the Treasury securities purchase program is having the intended effect?

From December 2008 through March 2010, the FOMC purchased about $1.7 trillion in longer-term Treasury, agency debt, and agency mortgage-backed securities. In August 2010, we began reinvesting the proceeds from all securities that matured or were redeemed in longer-term Treasury securities, so as to keep the size of our securities holdings roughly constant. Around the same time, we began to signal to financial markets that we were considering providing additional monetary policy accommodation by conducting further asset purchases. And in early November, we announced a plan to purchase an additional $600 billion in longer-term Treasury securities by the middle of this year.

Although large-scale purchases of longer-term securities are a different monetary policy tool than the more familiar approach of targeting the federal funds rate, the two types of policies affect the economy in similar ways. Conventional monetary policy easing works by reducing short-term interest rates and also by lowering market expectations for the future path of short-term interest rates, which, in turn, reduces the current level of longer-term interest rates and contributes to an easing in broader financial conditions. These changes not only reduce businesses' and households' borrowing costs, they also lower the rates at which investors discount future cash flows and thus tend to raise asset prices. Lower borrowing costs and higher asset prices, in turn, bolster household and business spending and thus support an increase in economic activity. By comparison, the Federal Reserve's purchases of longer-term securities have not affected very short-term interest rates, which remain close to zero, but instead have put downward pressure directly on longer-term interest rates. By easing conditions in credit and financial markets, these actions encourage spending by households and businesses through essentially the same channels as conventional monetary policy, thereby bolstering the economic recovery.

A wide range of market indicators supports the view that the Federal Reserve's securities purchases have been effective at easing financial conditions. For example, since August, when we announced our policy of reinvesting maturing securities and signaled that we were considering more purchases, equity prices have risen significantly, volatility in the equity market has fallen, corporate bond spreads have narrowed, and inflation compensation as measured in the market for inflation-indexed securities has risen from low to more normal levels. Yields on 5- to 10-year Treasury securities initially declined markedly as markets priced in prospective Fed purchases; these yields subsequently rose as investors became more optimistic about economic growth and as traders scaled back their expectations of future securities purchases. All of these developments are what one would expect to see when monetary policy becomes more accommodative, whether through conventional or less conventional means. Moreover, these developments are remarkably similar to those that occurred during the earlier episode of asset purchases, notably in the months following our March 2009 announcement of a significant expansion in our securities holdings. The fact that financial markets responded in very similar ways to each of these policy actions supports the conclusion that these actions had the expected effects on markets and are thereby providing significant support to job creation and the economy.

2. The Treasury purchase program has led to some devaluation of the dollar and rise in commodity prices. How confident are you that Fed will act quickly enough to unwind asset purchases and prevent significant increases in inflation? If the economy is slowly gaining momentum, as recent data suggest, is the Fed considering ending or reversing Treasury purchases before June 2011?

We have seen significant increases in many commodity prices as well as some depreciation of the dollar in recent months. However, the increase in commodity prices has largely resulted from rapid growth in demand from fast-growing emerging market economies coupled, in some cases, with constraints on supply. The changes in the foreign exchange value of the dollar over this period appear to have reflected developments both in the United States and abroad.

Despite these recent moves in commodity prices and the dollar, overall inflation remains quite low in the United States: Over the 12 months ending in December, the price index for personal consumption expenditures (a measure of prices for all the goods and services purchased by households) increased by only 1.2 percent, down from 2.4 percent over the prior 12 months. To assess underlying trends in inflation, economists also follow several alternative measures of inflation; one such measure is core inflation, which excludes the more volatile food and energy components and therefore can be a better predictor of where overall inflation is headed. Core inflation was only 0.7 percent in 2010, compared with around 2-1/2 percent in 2007, the year before the recession began. The downward trend in price inflation is not surprising, given the substantial slack in the economy. Moreover, longer-run inflation expectations have remained stable; for example, the rate of inflation that households expect over the next 5 to 10 years, as measured by the Thompson Reuters/University of Michigan Surveys of Consumers, has remained in a narrow range over the past few years. With levels of resource utilization likely to increase only gradually, and with longer-run inflation expectations stable, FOMC participants project that inflation will remain subdued for some time.

Nonetheless, my colleagues and I recognize that the FOMC must withdraw monetary stimulus once the recovery has taken hold and the economy is improving at a healthy pace. As your question suggests, the timing of that step will depend in part on the contours of the economic recovery this year. Importantly, the Committee remains unwaveringly committed to price stability and does not seek inflation above the level of 2 percent or a bit less that most FOMC participants see as consistent with our mandate to promote maximum employment and stable prices.

My colleagues and I have said that we will review the asset purchase program regularly in light of incoming information--including information on the economic outlook, the efficacy of the program, and any unintended consequences that might arise--and will adjust it as needed to promote maximum employment and stable prices. In particular, it bears emphasizing that we have the necessary tools to smoothly and effectively exit from the current accommodative stance of monetary policy at the appropriate time. Our ability to pay interest on reserve balances held at the Federal Reserve Banks will allow us to put upward pressure on short-term market interest rates and thus to tighten monetary policy when required, even if bank reserves remain high. We have developed additional tools that will allow us to drain or immobilize bank reserves as needed to facilitate the smooth withdrawal of policy accommodation. If needed, we could also tighten policy by redeeming or selling securities.

3. The Treasury purchase program includes purchasing assets with long durations. If interest rates rise, the long-dated assets will have declined in value. How does the Federal Reserve plan to handle the interest rate risk associated with owning long-duration assets? How will the Federal Reserve manage the losses?

Currently, the Federal Reserve's System Open Market Account (SOMA) portfolio is in a modest overall unrealized gain position of about $70 billion. Through time however, if interest rates rise and the market value of the securities in the portfolio decline, the portfolio could have unrealized losses. The Federal Reserve does not realize losses on its portfolio unless a security is sold. As a result, even if the securities in the SOMA portfolio were to decline in value, there would be no implication for Federal Reserve earnings if the assets were not sold. Moreover, we currently expect that realized losses on any potential sales of securities will be far more than offset by the substantial interest income that the Federal Reserve earns, and is expected to continue to earn, on the SOMA portfolio.

Federal Reserve accounting rules call for net income to be remitted to Treasury, after setting aside funds to cover operations, to pay dividends to member banks, and to reserve funds to equate surplus capital to paid-in capital. Under most scenarios, given the Federal Reserve's low interest expense, we will continue to remit significant earnings to the Treasury. Indeed, over the past two years we have remitted to the Treasury about $125 billion.

However, if interest rates were to rise more than is implied by current market rates, or if the Federal Reserve were to sell assets relatively rapidly, realized losses would be higher than expected, reducing the Federal Reserve's net income. Under some particularly adverse scenarios, asset sales could lead to realized losses that exceed net interest income, and as a result, Federal Reserve remittances to the Treasury could fall to zero for a time. To appropriately assess the cost of the asset-purchase program, however, it is important to compare any potential losses in the future with the high level of remittances we have seen in the early years of the program. In addition, to the extent that the policy is successful in stimulating economic growth, the Treasury should receive increased tax revenues resulting from the stronger economy.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 11, 2011

The Honorable Mike Crapo
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 7, 2011, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Crapo:

1. Do you agree with the testimony from economists Carmen Reinhart and Ken Rogoff that, once our gross debt reaches 90 percent of GDP, that it creates a significant drag on our economic growth to the extent that we basically lose a full percentage point, so that, for example, if our economy otherwise would have grown at a 4 percent rate, we will actually only see 3 percent growth?

Persistently high and rising levels of government debt relative to GDP can have a number of negative effects on the economy. An elevated and growing ratio of federal debt to GDP will eventually put upward pressure on real interest rates and thus inhibit capital formation, productivity, and economic growth. Indeed, increased expectations of steadily expanding federal debt in the future could make households and businesses more cautious now about spending, capital investment, and hiring, thus slowing economic growth even before federal debt actually moves up to higher levels. Large government debts also can increase our reliance on foreign lenders, implying that the share of U.S. national income devoted to paying interest to foreign investors will increase over time and that a lesser share of U.S. national income would be available for domestic consumption. Moreover, an increasingly large cost of servicing a growing national debt could require significant fiscal actions to cover these costs, which would tend to slow economic growth by reducing incentives to work, save, hire, and invest. Finally, a large federal debt decreases the flexibility of policymakers to take actions needed to counteract adverse shocks to the economy, thus leaving the economy more vulnerable to the negative effects of recessions and financial crises.

It is difficult to identify an exact threshold at which federal debt would begin to pose more substantial costs and risks to the U.S. economy or to know precisely what the magnitude of those negative effects would be. What we do know, however, is that the costs and risks to the U.S. economy will grow if the ratio of federal debt to GDP is allowed to increase to progressively higher levels. Indeed, the historical experience of countries that have faced fiscal crises indicates that interest rates could rise suddenly and rapidly, imposing substantial costs on our economy, if global financial market participants were to lose confidence in the ability of the United States to manage its fiscal policy. In light of the uncertainty about when such a development might occur, the prudent course is for fiscal policymakers to move quickly to put in place a credible plan in order to stabilize, and potentially reduce, the ratio of federal debt to GDP over the medium and longer term. The sooner a credible fiscal plan is established, the more time affected individuals will have to prepare for the necessary changes, likely making the necessary adjustments less painful and more politically feasible. Moreover, acting now to develop a credible program to reduce future deficits would not only enhance economic growth in the long run, these actions could also yield substantial near-term benefits for the economy from lower long-term interest rates and increased consumer and business confidence.

2. The most expensive government bailouts will be those of Fannie Mae and Freddie Mac – the largest housing lenders that purchased home loans, packaged them into investments and then guaranteed them against default. According to a January 2010 CBO background paper titled "CBO's Budgetary Treatment of Fannie Mae and Freddie Mac," CBO

"believes that the federal government's current financial and operational relationship with Fannie Mae and Freddie Mac warrants their inclusion in the budget (p. 7)." Do you agree with the CBO report that the debt obligations of Fannie Mae and Freddie Mac should be included in the federal budget?

In September 2008, the Director of the Federal Housing Finance Agency placed the two mortgage-related government-sponsored enterprises (GSEs) – Fannie Mae and Freddie Mac – into conservatorship with the federal government, which took a major ownership interest in both of these GSEs. In the judgment of the Congressional Budget Office (CBO), those actions effectively made Fannie Mae and Freddie Mac part of the federal government and implied that all of their operations should be reflected in the federal budget. However, the Administration's Office of Management and Budget (OMB) has continued to treat Fannie Mae and Freddie Mac as non-government entities, though their financial transactions with the Treasury have been recorded in the federal budget. Ultimately, the OMB makes the final decision about the treatment of Fannie Mae and Freddie Mac in the federal budget. Neither the CBO nor the OMB incorporates the debt securities or the mortgage-backed securities issued by Fannie Mae and Freddie Mac in their estimates of federal debt held by the public, which is defined as including only debt issued directly by the Treasury.

3. Some analysts are warning about the potential for defaults in the $2.8 trillion municipal bond market while others say those predicting widespread defaults are exaggerating the connection between budget pressure and failure to meet payments on general-obligation bonds. This healthy debate has led some to speculate that rather than letting a state default on its bonds, the Federal Reserve would take the unprecedented action of buying state bonds. What is the state of the municipal bond market and is it accurate that you would oppose any pressure for a back-door bailout by having the Federal Reserve buy state bonds?

Conditions in the municipal market generally reflect the continued pressures on state and local budgets. The recession caused state and local tax revenues to decline substantially, and the weak labor market boosted their spending for Medicaid and other transfers as the rolls of these programs swelled. Although increased federal grants-in-aid have helped offset some of the decline in their tax revenues, state and local governments have reduced their hiring and spending for many programs in order to address their budget shortfalls. However, as the economy has recovered, state tax revenues have trended up over the last year. While a continued firming in the recovery should lead to further growth in state revenues, federal stimulus grants will be winding down this year and next year. As a result, state and local governments are likely to face tight budgets for some time. Moreover, in the longer run, state and local governments will have to confront issues relating to the funding of pensions and health-care benefits for retired state and local employees.

The municipal bond market has experienced some strains over recent months, although the market currently seems to be functioning reasonably well. Investor concerns about the fiscal situations of many governmental entities, including some very large states, led to an increase in spreads of yields on municipal securities over those on comparable-maturity Treasuries and wider credit default swap spreads on state debt around the turn of the year. However, these measures of risk in the municipal market have generally receded more recently, although the market continues to price in higher levels of default risk than before the recession. Some pullback by investors has also been evident in recent activity at tax exempt bond funds, which have recorded significant outflows since last November following large inflows over the previous year and a half, although preliminary data suggest some moderation of these outflows more recently. Gross municipal bond issuance slowed last month, but much of the drop-off seems to have been associated with the outsized amount of issuance in the fourth quarter of last year in anticipation of the expiration of the Build America Bonds program at the end of 2010. While it is unclear how the situation in the municipal bond market will develop, our best judgment at this point is that states will ultimately be able to take steps to shore up their budget situation; further defaults by some local municipalities are probable, but such defaults seem likely to remain relatively limited in size. The Federal Reserve monitors the municipal bond market carefully along with other markets in making its assessments of financial market conditions and the economic outlook.

Regarding potential purchases of state bonds, section 14 of the Federal Reserve Act (FRA) provides the Federal Reserve only very limited authority to purchase certain types of municipal obligations. In particular, the FRA authorizes the Federal Reserve Banks, subject to the rules and regulations of the Board of Governors and the instructions of the Federal Open Market Committee, to buy and sell bills, notes, revenue bonds, and warrants so long as they have a maturity from date of purchase of six months or less and have been issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by a State, county, district, political subdivision or municipality. The Federal Reserve has not purchased municipal obligations under this authority for many decades. More broadly, the Federal Reserve has long opposed suggestions that it should provide financial assistance to municipal governments. The Congress wisely established limitations on the ability of the Federal Reserve to purchase municipal securities, and these limitations help support fundamental principles such as the independence of the central bank and a strong federal system of government in which states and municipalities have powers and responsibilities that are not subject to review or oversight at the national level. Because decisions regarding the possible allocation of federal funds to state and municipal governments are inherently political, these matters should be discussed and ultimately determined by elected officials rather than appointed officials such as those at the Federal Reserve.

4. The commercial real estate (CRE) market continues to face significant challenges and community banks are expected to take large losses since many of the institutions hold large exposures. In order to jumpstart new lending in the small balance CRE sector and help clear the inventory of seriously delinquent CRE loans, some are suggesting a commercial real estate guarantee proposal that would have Treasury issue up to $25 billion of credit guarantees of individual small-balance commercial real estate loans. What do you think of this idea?

At the end of the third quarter of 2010, approximately $3.2 trillion of outstanding debt was associated with CRE, including loans for multifamily properties. Of this amount, about one-half, or $1.6 trillion, was held on the balance sheets of commercial banks and thrifts. An additional $700 billion represented collateral for CMBS, and the remaining balance of $900 billion was held by a variety of investors, including pension funds, mutual funds, and life insurance companies.

During 2010, delinquency rates on construction and development loans began to improve slightly, falling 1 percent in the first three quarters of 2010. Additionally, delinquency rates on loans backed by existing nonfarm, nonresidential properties leveled off in 2010. Still, even if CRE delinquency metrics continue improving, there remains a sufficiently large overhang of distressed CRE at commercial banks such that loss rates for this portfolio will likely stay high for some time.

At this time, it is difficult to assess whether or not a program to provide up to $25 billion of credit guarantees for small-balance CRE loans would generate new lending activity. Moreover, a program of this size would likely not have a material impact on the overall condition and performance of CRE related markets.

Continued progress on working through the overhang of distressed CRE will take time and will depend on banks taking strong steps to ensure that losses are recognized in a timely manner, that loan loss reserves and capital appropriately reflect risk, that loans are modified in a safe and sound manner, and that loans continue to be made available to creditworthy borrowers. Nonetheless, I can assure you that the Federal Reserve will continue to work with lenders to ensure that bank management and supervisors take a balanced approach to ensuring safety and soundness and serving the credit needs of the community.

THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2011–2021

THURSDAY, JANUARY 27, 2011

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, Wyden, Nelson, Cardin, Whitehouse, Begich, Manchin, Sessions, Crapo, Ensign, Cornyn, Thune, Portman, Toomey, and Johnson.

Staff present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

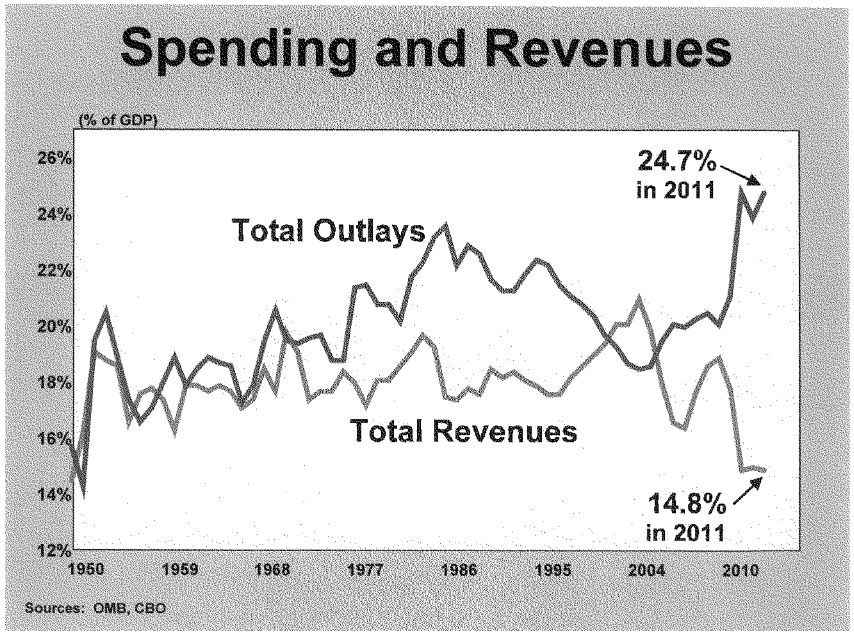
I want to welcome everyone to the Budget Committee this morning. I know there are other members who are on their way, but they had other business. As you know, this is the day that Committee assignments are determined, and so there are members who will be here who are involved in that process.

Today's hearing will focus on CBO's new budget and economic outlook. Our witness today is the CBO Director, Doug Elmendorf.

Director Elmendorf, welcome back to the Committee. I want to take a moment to congratulate you on your reappointment that was formally made yesterday as CBO Director. That is a well-deserved recognition for your extraordinarily professional work. I just want to say the confidence that you enjoy on both sides of the aisle is a testimony to you and to the entire team at CBO. Over and over, you have demonstrated your independence. I might add that even when I had a proposal that was very important to me, you did not give it very good marks, and I think that demonstrates pretty clearly your independence. But that is healthy. That is what we need here. We need an independent scorekeeper who is going to give us their best assessment of the effect of the policies that are enacted by Congress.

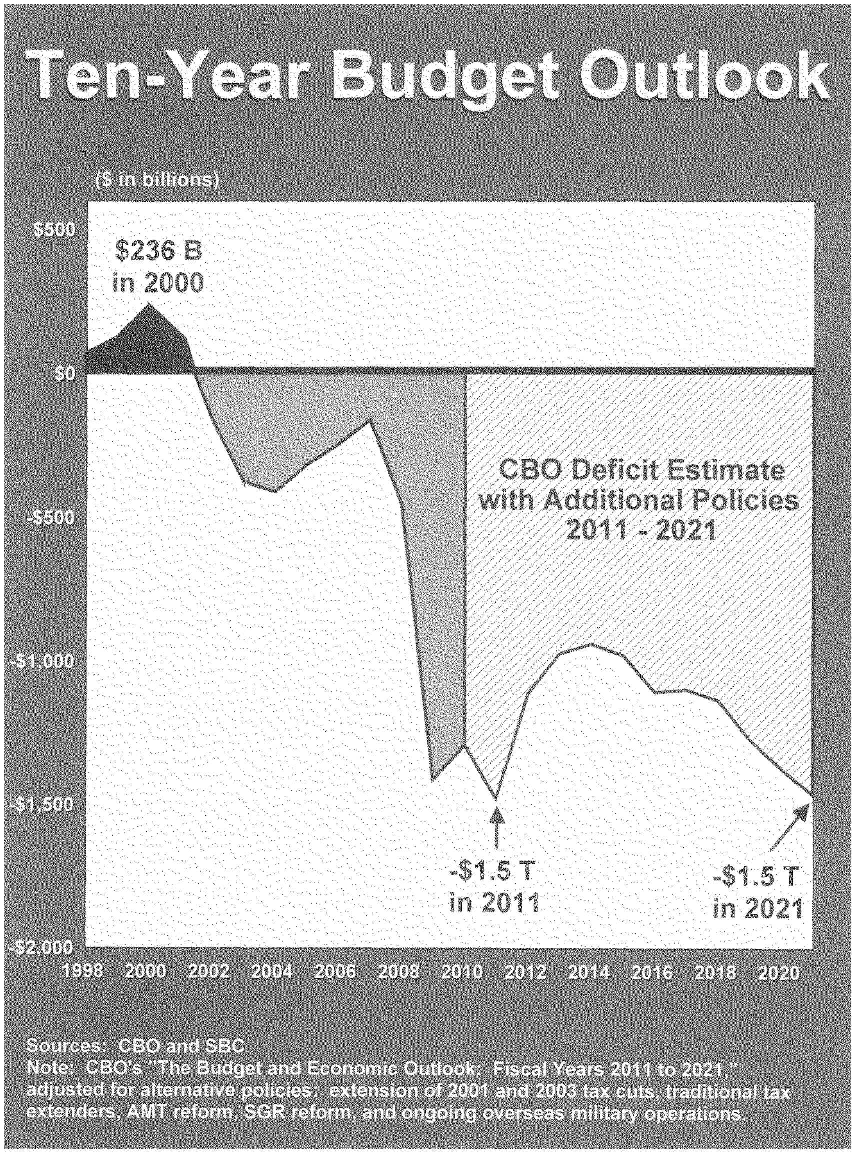
You have demonstrated, I believe, a very high degree of professionalism, as has your entire team at the Congressional Budget Office. You have been unbiased and a fair umpire, calling it like you see it. Your reappointment by a Democratically controlled Senate and a Republican-controlled House speaks volumes of the trust and respect that you and your team have earned on both sides of the aisle. We look forward to your testimony here today.

CBO's report should be a red light flashing to the Nation. Our fiscal situation is serious and becoming more so. We are at a critical juncture. We are borrowing 40 cents of every dollar that we spend. Spending, as this chart indicates, is at its highest level as a share of the economy in more than 60 years; and revenue is at its lowest level as a share of the economy in more than 60 years.

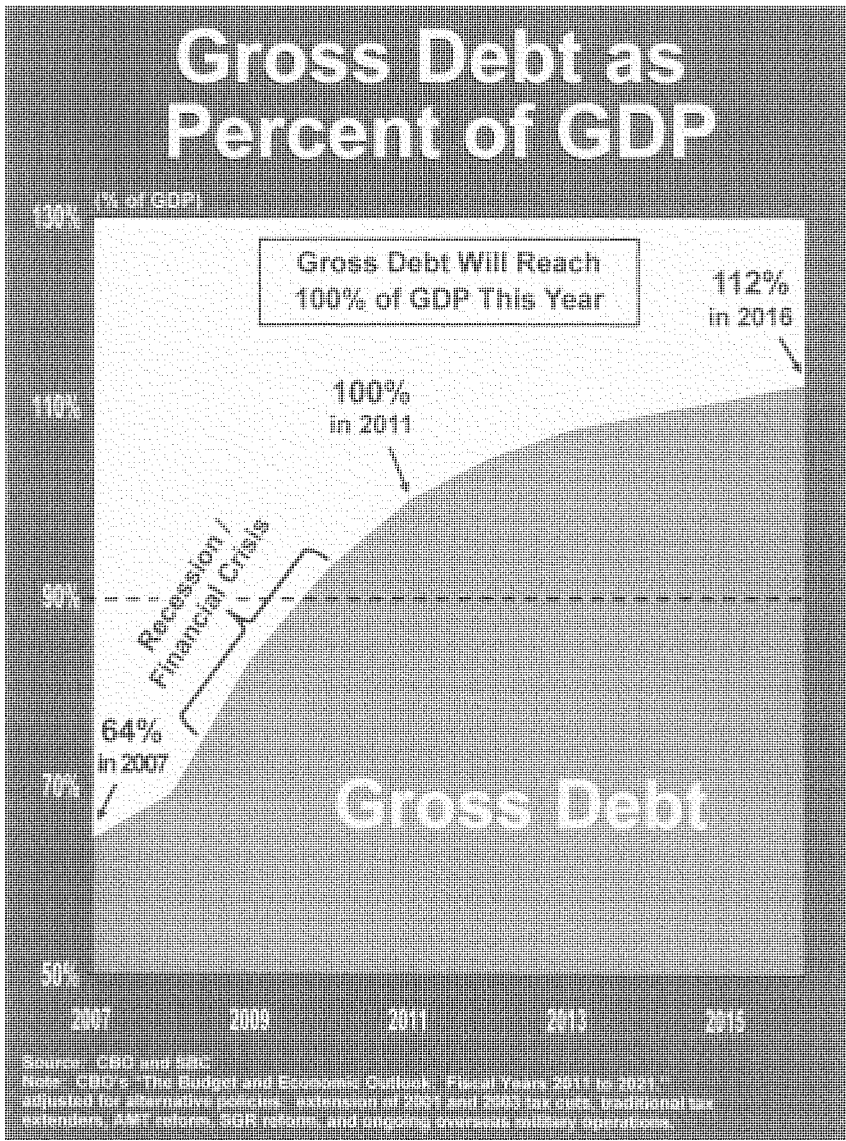


Let me just repeat that. Spending as a share of our national income is at the highest level in 60 years; revenue as a share of our national income is at its lowest level in 60 years. No wonder that we are headed for the largest deficit ever. This is utterly unsustainable, and the sooner we address it, the sooner we come to grips with it, the better.

This next chart depicts CBO's new 10-year baseline projections with additional policies added in. It shows that, due to passage of the tax extension package and the slow pace of the economic recovery, CBO is now expecting to see deficits of more than $1 trillion a year continuing through at least 2012. It shows that deficits will then briefly fall before rising again as the bulk of the baby-boom generation begins to retire and health care costs continue to climb.



Under the same scenario, gross Federal debt is expected to reach 100 percent of gross domestic product this year and continue rising. It is important to remember that many economists regard anything above the 90-percent threshold as a danger zone. And as disturbing as those near-term deficits and debt are, the long-term outlook is even more dire. It is the deteriorating long-term outlook that is the biggest threat to the country's long-term economic security. The warning signs are as clear as they can be.



Earlier this month, two of the world's leading credit rating agencies, Moody's and S&P, warned again that rising U.S. debt could lead to America losing its AAA credit rating. If such a thing were to happen, it would be a very serious blow and could set off continuing tensions in the global financial markets.

DOWJONES Newswires

01/13/2011

S&P, Moody's Warn On U.S. Credit Rating Due To Rising Debt

By Mark Brown and Nathalie Boschat

LONDON (Dow Jones)—Two leading credit rating agencies Thursday warned the U.S. on its credit rating, expressing concern over a deteriorating fiscal situation that needs correcting.

Moody's Investors Service Inc. said in a report Thursday that the U.S. will need to reverse an upward trajectory in its debt ratios to support its Aaa rating.

"We have become increasingly clear about the fact that if there are not offsetting measures to reverse the deterioration in negative fundamentals in the U.S., the likelihood of a negative outlook over the next two years will increase," Sarah Carlson, senior analyst at Moody's , told Dow Jones Newswires.

Standard & Poor's Corp. Thursday also didn't rule out changing the outlook for its U.S. sovereign debt rating because of the recent deterioration of the country's fiscal situation.

The U.S. currently has a triple A rating with a stable outlook at both agencies.

"The view of markets is that the U.S. will continue to benefit from the exorbitant privilege linked to the U.S. dollar" to fund its deficits, Carol Sirou, head of S&P France, said at a Paris conference Thursday.

"But that may change. We can't rule out changing the outlook" on the U.S. sovereign debt rating in the future, she warned.

She added the jobless nature of the U.S. recovery was one of the biggest threats to the U.S. economy. "No triple-A rating is forever," she said.

Moody's said the U.S., Germany, France and the U.K. still have debt metrics, including debt affordability—the ratio of interest payments to revenue—compatible with their Aaa ratings at the agency.

But all four countries must bring the future costs arising from pension and healthcare subsidies under control if they "are to maintain long-term stability in their debt burden credit metrics," Moody's said in its regular Aaa Sovereign Monitor report.

Moody's noted that measures were recommended by the U.S. National Commission on Fiscal Responsibility and Reform, appointed by President Obama, to achieve a balanced primary budget by 2015, but that there was insufficient support to trigger consideration of those recommendations by the full Congress.

They included a wide variety of measures, including Social Security reform, cutbacks in the growth of Medicare outlays, elimination or modification of the mortgage interest tax deduction, a gasoline tax and other measures, Moody's said.

"In Moody's view, a plan that would result in a reversal of the upward trajectory in the debt ratios would indeed be supportive of the country's Aaa rating," the ratings agency said in its report. "However, it is unlikely that the Commission's recommendations will be adopted."

The most recent official figures show the ratio of federal debt to revenue averaging 397% of gross domestic product in the period to 2020, while the ratio of interest to revenue will rise to 17.6% by 2020, from 8.6% in the last fiscal year.

These figures are "quite high for an Aaa-rated country," Moody's said. Debt affordability is "very important to the rating process," Carlson said.

U.S. general government debt affordability, including states and municipalities, is "rising over time to a high level for an Aaa-rated country," the report said.

In his recent testimony before the Senate Budget Committee, Federal Reserve Chairman Bernanke called for a demonstration of political will to address the long-term fiscal imbalances. He stated, and I quote: "Nobody doubts the United States has the economic capacity to pay its bills. It is really a question of do we have the political will to do that. And demonstration of political will, that is what the markets are watching. Is the Congress and the public and the administration, are they able to demonstrate that they are serious and that they have enough willingness to work together to make progress? At the point where confidence is lost, you could see a relatively quick deterioration in financial conditions."

Fed Chairman Bernanke on Need for Demonstration of Political Will to Address Long-Term Debt

"...[N]obody doubts the United States has the economic capacity to pay its bills. It's really a question [of] do we have the political will to do that. And demonstration of political will, that's what the markets are watching. Is the Congress and the public and the Administration – are they able to demonstrate that they are serious and that they have enough willingness to work together to make progress? At the point where confidence is lost ... that [is where] you could see a relatively quick deterioration in financial conditions..."

– Federal Reserve Chairman Ben S. Bernanke
Testimony before Senate Budget Committee
January 7, 2011

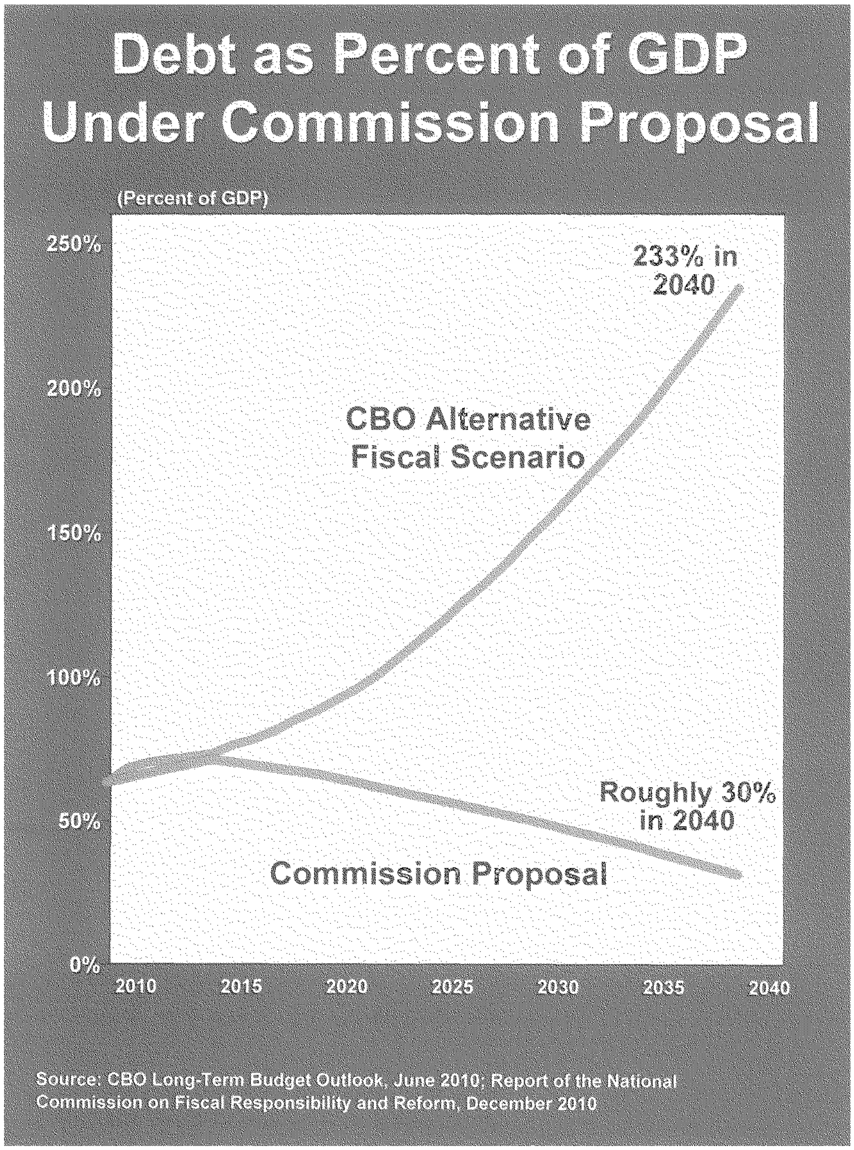
That, again, all from the Chairman of the Federal Reserve.

I hope people are listening. We cannot afford to wait until the markets lose confidence in the conduct of our financial affairs. We need to act, and we need to act this year. That does not mean we need to make steep cuts immediately. All of the bipartisan commissions have come back with recommendations and have recommended that we begin modestly because of the continuing economic weakness, but that we put in place a credible plan that convinces markets that we are going to get the result that is required. Enacting such a plan now, according to the Chairman of the Federal Reserve and others, would reassure the markets and help boost our near-term economy.

I believe the deficit and debt reduction plan assembled by the President's Fiscal Commission provides one way forward, and I want to emphasize I supported the Commission report. I did so proudly. There are things in it I do not like, but that is really not the point. The Fiscal Commission came back with a plan that 11 of the 18 Commissioners supported, five Democrats, five Republicans, one Independent. And I can tell you it is not very popular, certainly by the phone calls I have received and the letters I have received. We understand that. But it is necessary. It would reduce the debt by some $4 trillion over the next 10 years, and it would get us on a path that would take us back from the brink and do so in a very important way.

The Commission plan was also important because it showed how to reduce the deficit and debt in a balanced way. It included substantial cuts in discretionary spending. It included entitlement reform. It included tax reform—tax reform that broadened the base and lowered rates to help America be more competitive. If you focus only on non-defense discretionary spending, the cuts will have to be so Draconian that they will simply not be sustainable. That is my judgment. Tax reform that raises revenue also, I believe, must be part of the plan.

The result of this balanced approach was to get the deficit and the debt first stabilized and then over time to bring it down quite sharply. To solve the long-term challenge, it will require real compromise and a great deal of political will. We need everyone at the table, and that includes the President of the United States. And we need to have both sides, Democrats and Republicans, willing to move off their fixed positions and find common ground. We cannot continue to put this off. We need to reach an agreement this year. It is time for the administration and members on both sides in Congress to come together to get this done.



With that, we will turn to Senator Crapo, who is going to do the opening statement for the Republican side. I want to welcome Senator Crapo. He served on the Fiscal Commission as well. He was one of the 11 that supported its conclusions, as did I. Thank you, Senator Crapo, for that, and please make whatever statement you choose, and then we will go to our witness and then open it for questions.

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

Chairman CONRAD. If you would withhold——

Senator CRAPO. Yes.

Chairman CONRAD. I want to welcome—we have not formally recognized the new members to the Committee. That will happen in a process a little later today, but we now know who the new members are going to be, and we want to welcome them here this morning. Senator Portman, Senator Toomey, Senator Johnson, I know later today you will be formally added to the Committee, but we want to include you this morning, and we will extend the courtesy of giving you the chance to ask questions as well.

With that, again, thank you, Senator Crapo.

OPENING STATEMENT OF SENATOR CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman, and we also welcome our new members. We look forward to working with them, and as you can see, knowing who they are, they bring a high level of new talent to this Committee, and we appreciate their willingness to support us.

I also wanted to give Senator Sessions' apologies. He had a conflict that was unavoidable. He asked that I sit in until he could get here. He will be the Ranking Member on our side this year, and we look forward to his solid leadership as well.

I agree very strongly with the concerns that you have raised as we move forward to deal with America's fiscal dilemma. And, Dr. Elmendorf, I have appreciated working with you in the past and look forward to working with you very closely as Congress moves forward to develop a proposal that is credible and that will get us out of this difficult problem.

I just want to highlight a couple of points, most of which, Senator Conrad, you have already made.

First, the time for delay, the time for gridlock, the time for debate is over, and we must take action. One of the strongest messages that the economists and experts who testified to the President's Fiscal Commission gave was that the single act of the United States Government—Congress and the President coming together—and developing a credible plan that had a realistic expectation of being followed would be one of the most significant things we could do to strengthen our economy, to give confidence to investors, and to help rebuild the revenue side of the equation that we are dealing with as we try to build a solution to this problem. We must act, and we must act now.

We must demonstrate the political will that will require us to make a lot of tough decisions. The Chairman was correct. Those of us who voted in favor of this plan, I do not think a single one of us liked everything in the plan. But I do believe that every one of us faced very, very serious criticism because of the ability to pick apart a proposal to get out of this difficult fiscal situation that we find ourselves in, and the fact that there are going to be plenty who will pick it apart, whatever we choose to do. And we must be prepared to move forward aggressively, and I give my commitment. I know that on our side and your side there is the will to engage in this issue, and we have to move it forward now.

I also believe that the President must be heavily engaged in this process. To his credit, he established a Fiscal Commission to deal with the issue. That Fiscal Commission has now issued a report. The President has an opportunity to either accept or modify that report or propose some other approach and give us a detailed plan to move forward on. It will not necessarily be the plan that Congress adopts, but the President needs to engage. We need to engage. And we must get past the politics of the past and deal with this issue, making the hard decisions that have to be made.

As we move forward in that context, I personally very strongly believe that all aspects of the spending and revenue side of the equation must be on the table. They were in the President's Fiscal Commission's approach. I thought some were too lightly treated and some were too heavily treated, but they were all on the table. And as a part of that, I strongly believe that we must have tax reform.

One of, I believe, the most beneficial developments of the President's Commission's activities was the elevation of the understanding that our Tax Code today is so complicated, so unfair, so expensive to comply with, and puts America as a Nation in such an anticompetitive position with the rest of the world that we have a tremendous difficulty on the revenue side of the equation achieving a solution. We must eliminate those problems and create a Tax Code in which Americans can thrive in powerful economic activity.

And I know, Dr. Elmendorf, that your side of that may be more focused on the budget numbers, but ultimately I believe as a Committee that we need, Mr. Chairman, to guide as we engage and put our approach together, we need to guide this Nation in a comprehensive path toward a solution, a credible plan that can be put into place and implemented today. I mean literally this year we have to act.

The last thing I will say is this: Any plan for us to get out of this difficult fiscal hole in which we have put ourselves as a Nation must be a plan that will be implemented over a period of time, a period of years. And that will require that more than just this Congress participate and more than just this President participate in implementing this plan. Because of that, I believe that process reforms are as critical as the substance reforms dealing with spending and tax policy. And process reforms are going to have to be strong. What I mean by that is we need to not only create the plan we have been talking about and pass the plan and make it law, but also make it law that Congress must follow that plan and that super majorities of votes must be achieved in order to change it so that we can send the strong message to our people and to the world that we not only have put a plan on the table, but that we will implement it.

So there are a lot of tough parts of the task that we have before us, and, Dr. Elmendorf, we are going to be relying on you for the numbers and the analysis. We have done that on difficult issues before. I look forward to doing it as we move forward in this process. But nothing could be more important. This is the most critical threat to our Nation, in my opinion, and I include the threats that we receive from external sources. In fact, the head of the Joint Chiefs of Staff has said that the greatest threat to our security is our debt. And I believe that we have to get it right. We have to get the numbers right, we have to get the policy right, and we have to get the process right. And I hope that we will be able to build a strong, bipartisan solution to move forward and achieve that promptly.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you so much, Senator Crapo, and thank you for your strong statement here this morning, and thank you for your service on the Fiscal Commission. Thanks, too, to the other members from the Senate who supported that effort: Senator Coburn, Senator Gregg, who is now retired but was the Ranking Member of this Committee, and Senator Durbin. Along with my vote, that made five of the six from the Senate who supported the Commission report, even though we, I think all of us, believe that if we would have done it, we would have done a different job and perhaps a better job; but at the end of the day, we have to get a result. At the end of the day, we have to find a way to get a result, and——

Senator CRAPO. Could I just interject one quick point there?

Chairman CONRAD. Certainly.

Senator CRAPO. I think everyone in America knows that the Commission's report failed to get the necessary 14 votes that would have been required to force a vote in Congress on it. But I think it is important to just note that it did get more than 60 percent of the votes, which is what is sufficient in the Senate to pass legislation.

Chairman CONRAD. That is a very important point. Eleven of 18—again, five Democrats, five Republicans, one Independent—supported the recommendations of the report.

With that, we will turn to Dr. Elmendorf. Again, welcome back to the Committee, and please proceed with your testimony.

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

Mr. ELMENDORF. Thank you, Mr. Chairman, Senator Crapo. I appreciate very much your confidence in me and, much more importantly, your confidence in the analysis that my colleagues and I at CBO have been doing and will continue to do for you.

Among my colleagues I want to recognize for one moment Bob Dennis, who is sitting behind me and who has led our Macroeconomic Division for many years. He has been one of our most important people for many years, and he is retiring from CBO at the end of next month.

Chairman CONRAD. If we could ask Bob to stand and be recognized.

[Applause.]

Mr. ELMENDORF. Mr. Chairman, I also want to pass on, on behalf of my and my colleagues, our unhappiness at hearing about your plans to retire at the end of this session, as we were unhappy at Senator Gregg's plan to retire at the end of the previous Congress. But we look forward to working with you very intensively for the next 2 years, and we look forward to working with Senator Sessions and Senator Crapo and the other members of the Committee throughout this Congress.

Chairman CONRAD. Let me just say that I am not going to retire, but I am just not going to run again.

[Laughter.]

Mr. ELMENDORF. I understand.

The United States faces daunting economic and budgetary challenges. The economy has struggled to recover from the recent recession. The pace of growth in output has been anemic compared with that during most other recoveries, and the unemployment rate has remained quite high.

Federal budget deficits and debt have surged in the past 2 years, owing to a combination of a severe drop in economic activity, the costs of policies implemented in response to the financial and economic problems, and an imbalance between spending and revenues that pre-dates the recession.

Unfortunately, it is likely that a return to normal economic conditions will take years, and even after the economy has fully recovered, a return to sustainable budget conditions will require significant changes in tax and spending policies.

Let me discuss the economic outlook first and then turn to the budget outlook.

CBO expects that production and employment will expand in the coming years, but at only a moderate pace, leaving the economy well below its potential for some time. We project that real GDP will increase by about 3 percent this year and again next year, reflecting continued strong growth in business investment, improvements in both residential investment and net exports, and modest increases in consumer spending. But we have a long way to go on the employment front.

Move to the next slide, please. The next one after that, please. Keep going. I am sorry. And again. So let us focus on this.

Payroll employment, which declined by 7.3 million during the recent recession, rose by only 70,000 jobs on net between June 2009 and December 2010. The recovery in employment has been slowed not only by the slow growth in output but also by structural changes in the labor market, such as a mismatch between the requirements of available jobs and the skills of job seekers.

We estimate that the economy will add roughly 2.5 million jobs per year for the next 6 years, similar to the average pace during the late 1990s. Even so, we expect that the unemployment rate will fall only to 9.2 percent in the fourth quarter of this year and 8.2 percent in the fourth quarter of 2012. Only by 2016 in our forecast does the unemployment rate reach 5.3 percent, close to our estimate of the natural or sustainable rate.

CBO projects that inflation will remain very low in 2011 and 2012, reflecting the large amount of unused resources in the economy, and will average no more than 2 percent a year between 2013 and 2016.

Economic developments and the Government's responses to them have, of course, had a big impact on the budget. We estimate that if current laws remain unchanged, the budget deficit this year will be close to $1.5 trillion, or 9.8 percent of GDP. That would follow deficits of 10 percent and 8.9 percent of GDP in the past 2 years, representing the three largest deficits relative to the size of the economy since 1945. As a result, debt held by the public will probably jump from 40 percent of GDP at the end of fiscal year 2008 to nearly 70 percent at the end of fiscal year 2011.

If current laws remain unchanged, as we assume for CBO's baseline projections, budget deficits would drop markedly over the next few years as a share of output. If we can go back, I think, two slides, the darker line shows the deficit under our baseline projections reflecting current law. Deficits would average 3.6 percent of GDP from 2012 through 2021, totaling nearly $7 trillion during that decade. As a result, the debt held by the public would keep rising, reaching 77 percent of GDP.

However, that projection is based on the assumption that tax and spending policies unfold as specified in current law. Consequently, it understates the budget deficits that would occur if many policies currently in place were continued rather than allowed to expire as under current law.

For example, suppose instead that three major aspects of current policy were continued during the coming decade: first, that the higher 2011 exemption amount for the alternative minimum tax is extended and, along with the AMT tax brackets, is indexed for inflation; second, that the other major provisions in the recently enacted tax legislation that affected individual income taxes and estate and gift taxes were extended rather than allowed to expire in January 2013; and, third, that Medicare's payment rates for physician services were held constant rather than dropping sharply as scheduled under current law. All of those policies have recently been extended by the Congress for 1 or 2 years. If they were extended permanently, deficits from 2012 through 2021 would average about 6 percent of GDP rather than 3.6 percent—that is the lower dashed line in that picture—and cumulative deficits over the coming decade would total nearly $12 trillion. Go to the next slide, please. Debt held by the public in 2021 would rise to almost 100 percent of GDP, the highest level since 1946.

Beyond the 10-year projection period, further increases in Federal debt relative to the Nation's output almost certainly lie ahead if current policies remain in place. Spending on Social Security and the Government's major mandatory health care programs—Medicare, Medicaid, the Children's Health Insurance Program, and insurance subsidies to be provided through exchanges—will increase from roughly 10 percent of GDP to about 16 percent over the next 25 years.

To prevent debt from becoming unsupportable, the Congress will have to substantially restrain the growth of spending, raise revenues significantly above their historical share of GDP, or pursue some combination of those approaches. The longer the necessary adjustments are delayed, the greater will be the negative consequences of the mounting debt, the more uncertain individuals and businesses will be about future Government policies, and the more drastic the ultimate policy changes will need to be. However, changes of the magnitude that will ultimately be required could be disruptive. Therefore, Congress may wish to implement them gradually so as to avoid a sudden negative impact on the economy, particularly as it recovers from the severe recession and so as to give families, businesses, and State and local governments time to plan and adjust.

Allowing for such graduate implementation would mean that remedying the Nation's fiscal imbalance would take longer and, therefore, that major policy changes would need to be enacted soon in order to limit a further increase in Federal debt.

Thank you very much.

[The prepared statement of Mr. Elmendorf follows:]

Congressional Budget Office

Testimony

Statement of
Douglas W. Elmendorf
Director

The Budget and Economic Outlook: Fiscal Years 2011 to 2021

before the
Committee on the Budget
United States Senate

January 27, 2011

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Thursday, January 27, 2011. 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 Sessions, 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 2011 through 2021. Those estimates were released yesterday in the report titled *The Budget and Economic Outlook: Fiscal Years 2011 to 2021*.

The United States faces daunting economic and budgetary challenges. The economy has struggled to recover from the recent recession, which was triggered by a large decline in house prices and a financial crisis—events unlike anything this country has seen since the Great Depression. During the recovery, the pace of growth in the nation's output has been anemic compared with that during most other recoveries since World War II, and the unemployment rate has remained quite high.

For the federal government, the sharply lower revenues and elevated spending deriving from the financial turmoil and severe drop in economic activity—combined with the costs of various policies implemented in response to those conditions and an imbalance between revenues and spending that predated the recession—have caused budget deficits to surge in the past two years. The deficits of $1.4 trillion in 2009 and $1.3 trillion in 2010 are, when measured as a share of gross domestic product (GDP), the largest since 1945—representing 10.0 percent and 8.9 percent of the nation's output, respectively.

For 2011, the Congressional Budget Office projects that if current laws remain unchanged, the federal budget will show a deficit of close to $1.5 trillion, or 9.8 percent of GDP (see Table 1). The deficits in CBO's baseline projections drop markedly over the next few years as a share of output and average 3.1 percent of GDP from 2014 to 2021. Those projections, however, are based on the assumption that tax and spending policies unfold as specified in current law. Consequently, they understate the budget deficits that would occur if many policies currently in place were continued, rather than allowed to expire as scheduled under current law.

The Economic Outlook

Although recent actions by U.S. policymakers should help support further gains in real (inflation-adjusted) GDP in 2011, production and employment are likely to stay well below the economy's potential for a number of years. CBO expects that economic growth will remain moderate this year and next. As measured by the change from the fourth quarter of the previous year, real GDP is projected to increase by 3.1 percent this year and by 2.8 percent next year (see Table 2). That forecast reflects CBO's expectation of continued strong growth in business investment, improvements in both residential investment and net exports, and modest increases in consumer spending. It also includes the impact of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (referred to in this report as the 2010 tax act), enacted in December, which provides a short-term boost to the economy by reducing some taxes, extending unemployment benefits, and delaying an increase in taxes that would otherwise have occurred in 2011. CBO projects that inflation will remain very low in 2011 and 2012, reflecting the large amount of unused resources in the economy, and will average no more than 2.0 percent a year between 2013 and 2016.

The recovery in employment has been slowed not only by the moderate growth in output in the past year and a half but also by structural changes in the labor market, such as a mismatch between the requirements of available jobs and the skills of job seekers, that have hindered the reemployment of workers who have lost their job. Payroll employment, which declined by 7.3 million during the recent recession, gained a mere 70,000 jobs (or 0.06 percent), on net, between June 2009 and December 2010. (By contrast, in the first 18 months of past recoveries, employment rose by an average of 4.4 percent.) Consequently, the rate of unemployment has fallen by only a small amount: After climbing to 10.1 percent of the labor force during 2009, the unemployment rate declined only to 9.4 percent by December 2010. Other measures of labor market conditions suggest even more slack than does the unemployment rate. For example, almost 9 million workers who have wanted full-time work in the past two years have been employed only part time.

As the recovery continues, the economy will add roughly 2.5 million jobs per year over the 2011–2016 period,

Table 1.

CBO's Baseline Budget Outlook

	Actual, 2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
							In Billions of Dollars							
Total Revenues	2,162	2,228	2,555	3,090	3,442	3,651	3,832	4,075	4,275	4,489	4,712	4,963	16,570	39,084
Total Outlays	3,456	3,708	3,655	3,794	3,975	4,202	4,491	4,691	4,885	5,185	5,451	5,726	20,117	46,055
Total Deficit (-) or Surplus	**-1,294**	**-1,480**	**-1,100**	**-704**	**-533**	**-551**	**-659**	**-617**	**-610**	**-696**	**-739**	**-763**	**-3,547**	**-6,971**
On-Budget	-1,371	-1,548	-1,186	-792	-621	-641	-752	-706	-693	-768	-798	-808	-3,992	-7,765
Off-Budget[a]	77	68	86	88	87	90	94	90	82	73	59	45	445	794
Debt Held by the Public at the End of the Year	9,018	10,430	11,598	12,386	12,996	13,625	14,358	15,064	15,767	16,557	17,392	18,253	n.a.	n.a.
							As a Percentage of GDP							
Total Revenues	14.9	14.8	16.3	18.8	19.9	20.1	20.0	20.3	20.4	20.5	20.7	20.8	19.1	19.9
Total Outlays	23.8	24.7	23.3	23.1	23.0	23.1	23.5	23.4	23.3	23.7	23.9	24.0	23.2	23.5
Total Deficit	**-8.9**	**-9.8**	**-7.0**	**-4.3**	**-3.1**	**-3.0**	**-3.4**	**-3.1**	**-2.9**	**-3.2**	**-3.2**	**-3.2**	**-4.1**	**-3.6**
Debt Held by the Public at the End of the Year	62.1	69.4	73.9	75.5	75.3	74.9	75.0	75.2	75.3	75.8	76.2	76.7	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

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

CBO estimates. However, even with significant increases in the number of jobs, a substantial reduction in the unemployment rate will take some time. CBO projects that the unemployment rate will gradually fall in the near term, to 9.2 percent in the fourth quarter of 2011, 8.2 percent in the fourth quarter of 2012, and 7.4 percent at the end of 2013. Only by 2016, in CBO's forecast, does it reach 5.3 percent, close to the agency's estimate of the natural rate of unemployment (the rate of unemployment arising from all sources except fluctuations in aggregate demand, which CBO now estimates to be 5.2 percent).

For the period beyond 2016, CBO's economic projections are based on trends in the factors that underlie potential output, including the labor force, capital accumulation, and productivity. The projections therefore do not explicitly incorporate fluctuations resulting from the business cycle. In CBO's projections, growth of real GDP averages 2.4 percent annually from 2017 to 2021, a pace that matches the growth of potential GDP over those years. The unemployment rate averages 5.2 percent in that same period.

The Budget Outlook

The recovery now under way might be expected to lessen the budget imbalance in 2011 by increasing tax revenues and decreasing spending for certain income-support programs, such as unemployment compensation. However, revenue growth will be restrained by the slow and tentative pace of the recovery and by the 2010 tax act.

Moreover, outlays for many programs are projected to continue to grow and more than offset the decreases in spending (for unemployment compensation, for example) yielded by improving economic conditions.

The resulting federal budget deficit of nearly $1.5 trillion projected for this year will equal 9.8 percent of GDP, a share that is nearly 1 percentage point higher than the shortfall recorded last year and almost equal to the deficit posted in 2009, which at 10.0 percent of GDP was the highest in nearly 65 years.

By CBO's estimates, federal revenues in 2011 will be $123 billion (or 6 percent) more than the total revenues recorded two years ago, in 2009. The continued slow

Table 2.

CBO's Economic Projections for Calendar Years 2010 to 2021

	Estimated, 2010	Forecast 2011	Forecast 2012	Projected Annual Average 2013–2016	Projected Annual Average 2017–2021
	Fourth Quarter to Fourth Quarter (Percentage change)				
Real GDP	2.5	3.1	2.8	3.4	2.4
PCE Price Index	1.4	1.2	1.3	1.7	2.0
Core PCE Price Index[a]	1.0	1.0	1.2	1.6	2.0
Consumer Price Index[b]	1.2 [c]	1.3	1.3	2.0	2.3
Core Consumer Price Index[a]	0.6 [c]	0.9	1.2	1.9	2.2
	Fourth Quarter Level (Percent)				
Unemployment Rate	9.6 [c]	9.2	8.2	5.3 [d]	5.2 [e]
	Calendar Year Average				
Interest Rates (Percent)					
Three-month Treasury bill rate	0.1 [c]	0.3	1.1	3.6	4.4
Ten-year Treasury note rate	3.2 [c]	3.4	3.8	4.7	5.4
Unemployment Rate (Percent)	9.6 [c]	9.4	8.4	6.4	5.2
Nominal GDP (Percentage change)	3.8	3.7	4.4	5.1	4.4

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

Notes: Data for the fourth quarter of 2010 were not available when CBO's forecast was completed in early December. Numbers for gross domestic product (GDP) in the table for 2010 are therefore based on CBO's estimates made in early December. More recent estimates from other forecasters, based on additional data, suggest that growth of nominal and real (inflation-adjusted) GDP in the fourth quarter was higher than CBO estimated.

PCE = personal consumption expenditures.

a. Excludes prices for food and energy.

b. The consumer price index for all urban consumers.

c. Actual value for 2010.

d. Value for 2016.

e. Value for 2021.

improvement in economic conditions is anticipated to boost revenues from individual income taxes, corporate taxes, and other sources by nearly $200 billion between those two years; however, revenues from social insurance taxes are projected to decline by more than $70 billion relative to their level two years ago, mostly as a result of a one-year reduction in payroll taxes included in the 2010 tax act.

Spending, for the most part, has been growing faster than revenues. Programs related to the federal government's response to the problems in the housing and financial markets are an exception; outlays recorded for the Troubled Asset Relief Program (TARP), for example, will decrease by $176 billion from 2009 to 2011, CBO projects.[1] But if current laws remain unchanged, federal outlays other than those for the TARP are projected to be $366 billion (or 11 percent) higher in 2011 than they were in 2009.

1. The Administration recorded outlays of $151 billion for the TARP in 2009, which reflected its estimate of the cost of the actions that had been undertaken by the Treasury. Because the financial system stabilized and many institutions repaid the assistance provided by the TARP earlier than expected, the Administration—following the standard procedures for federal credit programs—reduced the previously recorded cost by posting a large *negative* outlay (that is, a reduction in spending) in 2010. The program will again reduce the deficit in 2011, CBO estimates—showing negative outlays of $25 billion, mostly reflecting a further adjustment to the estimated cost recorded in 2009.

According to CBO's projections, mandatory spending excluding outlays for the TARP will increase by $191 billion (or 10 percent) between 2009 and 2011.[2] Significant growth in many areas—in particular, for Social Security, Medicare, and Medicaid—is expected to be offset only partially by reductions in outlays for other programs, primarily for Fannie Mae, Freddie Mac, and deposit insurance. Discretionary spending will increase by an estimated $137 billion over the two-year period; about one-third of that increase stems from funding provided by the American Recovery and Reinvestment Act of 2009 (ARRA). In addition, outlays for net interest will rise by an estimated $38 billion from 2009 to 2011, mostly because of substantial increases in borrowing.

Under current law, CBO projects, budget deficits will drop markedly over the next few years—to $1.1 trillion in 2012, $704 billion in 2013, and $533 billion in 2014. Relative to the size of the economy, those deficits represent 7.0 percent of GDP in 2012, 4.3 percent in 2013, and 3.1 percent in 2014. From 2015 through 2021, the deficits in the baseline projections range from 2.9 percent to 3.4 percent of GDP.

The deficits that will accumulate under current law will push federal debt held by the public to significantly higher levels. Just two years ago, debt held by the public was less than $6 trillion, or about 40 percent of GDP; at the end of fiscal year 2010, such debt was roughly $9 trillion, or 62 percent of GDP, and by the end of 2021, it is projected to climb to $18 trillion, or 77 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 over the next decade. CBO projects that the government's annual spending on net interest will more than double between 2011 and 2021 as a share of GDP, increasing from 1.5 percent to 3.3 percent.

CBO's baseline projections are not intended to be a forecast of future budgetary outcomes; rather, they serve as a neutral benchmark that legislators and others can use to assess the potential effects of policy decisions. Consequently, they incorporate the assumption that current laws governing taxes and spending will remain unchanged. In particular, the baseline projections in this report are based on the following assumptions:

- Sharp reductions in Medicare's payment rates for physicians' services take effect as scheduled at the end of 2011;
- Extensions of unemployment compensation, the one-year reduction in the payroll tax, and the two-year extension of provisions designed to limit the reach of the alternative minimum tax all expire as scheduled at the end of 2011;
- Other provisions of the 2010 tax act, including extensions of lower tax rates and expanded credits and deductions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and ARRA, expire as scheduled at the end of 2012; and
- Funding for discretionary spending increases with inflation rather than at the considerably faster pace seen over the dozen years leading up to the recent recession.

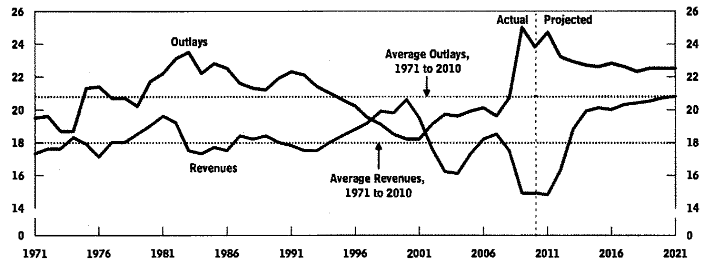
The projected deficits over the latter part of the coming decade are much smaller relative to GDP than is the current deficit, mostly because, under those assumptions and with a continuing economic expansion, revenues as a share of GDP are projected to rise steadily—from about 15 percent of GDP in 2011 to 21 percent by 2021 (see Figure 1).

As a result, the baseline projections understate the budget deficits that would arise if many policies currently in place were extended, rather than allowed to expire as scheduled under current law. For example, if most of the provisions in the 2010 tax act that were originally enacted in 2001, 2003, and 2009 or that modified estate and gift taxation were extended (rather than allowed to expire on December 31, 2012), and the alternative minimum tax was indexed for inflation, annual revenues would average about 18 percent of GDP through 2021 (which is equal to their 40-year average), rather than the 19.9 percent shown in CBO's baseline projections. If Medicare's payment rates for physicians' services were held constant as well, then deficits from 2012 through 2021 would average about 6 percent of GDP, compared with 3.6 percent in the baseline. By 2021, the budget deficit would be about double the baseline projection, and with cumulative deficits totaling nearly $12 trillion over the

2. Mandatory spending is governed by permanent law; in contrast, discretionary spending is controlled by annual appropriation acts.

Figure 1.
Total Revenues and Outlays

(Percentage of gross domestic product)



Source: Congressional Budget Office.

2012–2021 period, debt held by the public would reach 97 percent of GDP, the highest level since 1946.

Beyond the 10-year projection period, further increases in federal debt relative to the nation's output almost certainly lie ahead if current policies remain in place. The aging of the population and rising costs for health care will push federal spending as a percentage of GDP well above that in recent decades. Specifically, spending on the government's major mandatory health care programs—Medicare, Medicaid, the Children's Health Insurance Program, and health insurance subsidies to be provided through insurance exchanges—along with Social Security will increase from roughly 10 percent of GDP in 2011 to about 16 percent over the next 25 years.[3] If revenues stay close to their average share of GDP for the past 40 years, that rise in spending will lead to rapidly growing budget deficits and surging federal debt. To prevent debt from becoming unsupportable, policymakers will have to substantially restrain the growth of spending, raise revenues significantly above their historical share of GDP, or pursue some combination of those two approaches.

3. See Congressional Budget Office, *The Long-Term Budget Outlook* (June 2010, revised August 2010).

Chairman CONRAD. Thank you, Director Elmendorf.

You know, one of the things we say a lot on this Committee is the current trajectory, projected trajectory on our deficits and debt is unsustainable. You have used that language as well. What do you mean by that?

Mr. ELMENDORF. As the debt rises relative to the size of the economy, so does the burden on the economy, on American citizens, of making the payments on that debt, of making the interest payments. And as that burden rises, it becomes more difficult to prevent a further increase in debt because the rising interest payments are tending to squeeze out the other forms of Government spending or push up tax revenue in ways that are difficult for the country to absorb.

So the rising debt payments can start to snowball in a way that can make the debt rise faster and faster, and one sees that in our longer-term projections as one goes out beyond the coming decade where the path of debt to GDP can rise quite sharply.

In order to continue the borrowing implicit in those kinds of pictures, the Government needs to find investors willing to purchase Government securities, both to roll over the existing debt as it matures and to acquire the new debt necessary to finance the ongoing budget deficits.

At some point investors are likely to become increasingly nervous about whether the Government can, in fact, manage its budget. That is what we and others have called a fiscal crisis, and we have seen very recently other countries encounter a crisis of that sort in which it becomes impossible for the Government to finance the trajectory of debt that it has in mind at affordable interest rates.

Now, we have been very clear that we do not have an analytic capability of predicting what a tipping point might be and when it might happen. But as the debt rises relative to GDP and as the trajectory continues to be steeply upward, the risk of that sort of crisis increases.

Chairman CONRAD. So part of your analysis and reason for the trajectory of our debt being unsustainable is that puts upward pressure on interest rates in order to satisfy those who loan us money to take on greater risk, and that has the effect of slowing the economy. Is that part of your analysis?

Mr. ELMENDORF. Yes, that is right. So as the Government needs to work harder to find buyers for its debt, it has to pay higher interest rates over time. And more importantly, from an economic point of view, the Government's borrowing is crowding out the borrowing that private firms or households might do to support investment in plant and equipment or to support new housing. And it is the crowding out of that private investment that makes future incomes lower than they would otherwise be.

Chairman CONRAD. Well, I think that analysis is very much in line with what every economist has told this Committee and what the Chairman of the Federal Reserve has told this Committee.

Let me go a little bit further because part of your analysis of the trajectory of future deficits and debt is tied to the question of interest rate levels. And you have a projection of what interest rates are likely to be during the term of this forecast. What would happen if the interest rates were, for example, 1 percent higher than you project? I think you did a sensitivity analysis to determine what would happen to our debt if interest rates were just 1 percent higher than what you project currently. Could you tell us what you found?

Mr. ELMENDORF. Yes, Mr. Chairman, and for others, this is in Appendix B of our outlook where we illustrate the sensitivity of those budget projections to a variety of pieces of the economic forecast.

If interest rates are 1 percentage point higher than we project throughout the entire decade for both short-term and long-term rates, we estimate that the budget deficit would be $1.25 trillion larger over the coming decade than in our baseline projection.

Chairman CONRAD. So you would add another $1.25 trillion—"trillion," that is with a "T," not billion, not million, trillion—if interest rates were just 1 percentage rate higher than in your forecast?

Mr. ELMENDORF. Yes, that is right.

Chairman CONRAD. Let me ask you this: As you evaluate where we are headed, the Chairman of the Federal Reserve testified before this Committee in recent days, and basically his advice to us on deficit and debt reduction was start modestly but then grow the effort in a very determined way once the economy is on stronger ground. His argument to the Committee was that this recovery is still fragile. One in every six Americans is either underemployed or unemployed. And so what he was saying to this Committee was you ought to begin the process, but begin fiscal discipline in a modest way, but put in place a plan that goes way beyond modest to get the debt first stabilized and then to bring it down to more manageable levels.

Is that your advice to this Committee as well? Or what is your advice?

Mr. ELMENDORF. Well, as you know, Mr. Chairman, I will not make policy recommendations to you and your colleagues. I think in judging the speed of policy changes that you are considering, you and your colleagues face a difficult trade-off. On the one hand, as I said, the longer that you wait to make those policy changes, the more the debt will mount, the greater the negative consequences of that will be, including the crowding out other investment, increased loss of flexibility to respond to future emergencies that we cannot foresee now; the greater will be the burden of interest payments and crowding out other forms of spending or pushing up tax receipts to keep the debt from growing yet faster; and the greater the risk of a fiscal crisis.

At the same time, the faster that you make policy changes, especially those of the magnitude required to fix a fiscal imbalance of this size that I have shown and you have talked about, those changes can be disruptive to the households that are planning for certain sorts of benefits, to the businesses that are planning around certain features of the Tax Code, to State and local governments that are depending on the Federal Government to continue its relationship with them as it has been in the past. And the faster you move, the harder it is for them to adjust.

Chairman CONRAD. Let me ask you this question: I think that analysis that you have given is very much in line with what other economists have told this Committee of a broad range of philosophical backgrounds. Because when we have witnesses before this Committee, we try to provide a broad range of philosophical input. Some are telling us that tax cuts are so beneficial that if we enact tax cuts, they really will not lead to additional deficits because the cost is offset by the economic growth that they encourage.

What is your analysis with respect to the effect of tax cuts on the budget?

Mr. ELMENDORF. So the answer, of course, depends to some extent on the specific tax cuts that one has in mind. As a general matter, reductions in marginal tax rates, which affect the incentives faced by households and businesses, reductions in those rates can encourage work and savings and, thus, boost the economy, and through that provide some offset to the direct loss in tax revenue from the reductions in rates.

For broad-based reductions in taxes, I think the consensus in the economics profession is that the offset provided through the extra work and saving is significantly smaller than the direct revenue loss, and thus that the net effect on the budget is a reduction in revenues. As I said, one might reach different conclusions for particular changes in tax rates, but for broad-based changes, I think that is the professional consensus.

Chairman CONRAD. So give us an understanding—and, look, I supported extending the tax cuts. I supported extending all of them because I believed the economy was in such weak condition that we needed some certainty and we needed the additional lift that those tax cuts can give in the short term. Isn't the CBO analysis that tax cuts have a differential effect short term and long term?

Mr. ELMENDORF. Yes, that is right. Again, I do not think that is unique to us either. In the results that we presented to you in testimony at the end of September about the effects of different ways of extending the expiring tax provisions that you and your colleagues were considering, we looked at both the effects in the next few years and the effects at the end of the decade and beyond in future decades.

In the short term, we think that reductions in tax receipts that put more money into the hands of taxpayers that they can then spend can stimulate economic activity, the demand for goods and, thus, production and employment. And that is especially true, I should emphasize, under current economic conditions where there is so much unused labor, so much unused industrial capacity, and where the Federal Reserve has already pushed the interest rates that it controls most directly down essentially to their lower bound.

But over the longer term, as we showed in these results in September, reductions in tax revenue that are not matched by reductions in Government spending and, thus, lead to wider budget deficits tend to reduce the level of economic activity, and there are different forces at work there. The lower tax rates do spur work and saving, as I said, and we incorporate that in our estimates. At the same time, the larger deficits—again, on the assumption that spending is not cut commensurately, the larger deficits crowd out private capital formation. And for most of the different parameter values, most of the models that we use—and we us a variety to illustrate the uncertainties. For most of those approaches that we have taken, the loss of future output and income from the extra deficits outweigh the boost from the lower tax rates.

Chairman CONRAD. And isn't it your analysis that the tax cuts we just enacted in fact do add to the deficit and the debt?

Mr. ELMENDORF. Yes, that is correct. The legislation, as we report in our outlook, that legislation increased budget deficits this year and next and over the entire decade by around $800 billion, I believe.

Chairman CONRAD. All right. Let me go to Senator Crapo, and then we will go to members for questions in order of arrival. We use the early bird rule here, and we will follow that as well. I think given the number of Senators, we better do 7-minute rounds. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

I want to followup briefly on the last line of questioning. In your analysis—and I describe what the Chairman and you were talking about as "dynamic scoring of tax policy." I do not know if that is the accurate description of it, but do you take into consideration the dynamic impacts of tax policy as you provide us your numbers? In other words, when you do your analysis and come up with that $800 billion number for a deficit impact, are you calculating into that the dynamic impact of tax policy on the economy and on revenues?

Mr. ELMENDORF. People use these words in different ways. Let me distinguish two sets of words and tell you what I mean by them.

Dynamic scoring I think of as incorporating in a revenue estimate or a cost estimate a full range of microeconomic and macroeconomic behavioral responses.

The revenue estimates that you get, like all the revenue estimates have done for decades in the Congress, are done by the staff of the Joint Committee of Taxation, not by CBO. Those estimates incorporate a vast array of microeconomic behavioral responses. They do not incorporate effects of changing economic aggregates like GDP.

Separately, we and our colleagues on the staff of the Joint Tax Committee do dynamic analyses of various sorts, analyses in which we do allow the macroeconomic aggregates to change through these behavioral changes along with the various sorts of microeconomic behavioral effects. And we reported to you that sort of dynamic analysis in the testimony I did in September about the effects of tax policy. We do this every year in an analysis of the President's budget. We have done this for the American Recovery and Reinvestment Act. We do this in a whole variety of circumstances. It is a great deal of work to do. We tend to do it only for particularly significant pieces of legislation for which we have weeks or months of lead time in terms of your interest. And the staff of the Joint Tax Committee does similar sorts of analyses as well.

Senator CRAPO. All right. Let me ask you, what kind of revenue growth estimates are you using throughout the decade in your projections?

Mr. ELMENDORF. So revenue grows slowly for the next—certainly for this year, because we have the economy growing slowly.

Senator CRAPO. You are at 3.8 for this year, right? That is your——

Mr. ELMENDORF. I believe——

Mr. BOOTH. 3.1.

Mr. ELMENDORF. So for this year—yes, OK. So for this year we have total revenue growing by 3.1 percent.

Senator CRAPO. 3.1, OK.

Mr. ELMENDORF. And then much faster on average for the remainder of the decade, but much of that is from the expiration of a whole set of these tax provisions at the end of this year or the end of next year. So over the next few years between now and 2014, tax revenue rises by about 5 percentage points of GDP, and three-quarters of that is from the expiration of expiring tax provisions, and the other quarter is a variety of other effects, including economic growth.

Senator CRAPO. Do you use projections as to what rate of inflation you expect in the economy?

Mr. ELMENDORF. Yes. So obviously the nominal growth rates of revenues and of spending depend on our projection of inflation. As I mentioned earlier and as we describe at greater length in the report, we expect inflation to remain low in the next few years, then to move up toward the Federal Reserve's implicit target, which, according to Chairman Bernanke and others, is at 2 percent or a little under. If there were faster inflation, that would lead to more revenues. It would also lead to more spending, and in particular it would lead to higher interest payments on the debt. And in this Appendix C that was referenced before, one of the experiments that we did was to look at what happens if inflation is higher—I am sorry, Appendix B—is higher than it would otherwise be. Higher inflation of 1 percentage point a year would add about $900 billion to deficits over the next decade.

The important part of that is that with higher inflation there tend to be higher interest rates, so this already large and growing burden of interest payments would grow even faster.

Senator CRAPO. And are you familiar—I am shifting gears here a little bit, but are you familiar with the studies done by Rogoff and Reinhart comparing debt to GDP of different nations and so forth?

Mr. ELMENDORF. Yes, I am actually. Carmen Reinhart is a member of our panel of economic advisers.

Senator CRAPO. You are aware then that they use gross debt in their analysis. You have indicated that debt owed to the public, which is significantly lower than that, is going to be approaching the 90 to 100 percent mark by the end of the decade. Could you comment, given the context of their analysis and the fact that using literally debt owed to the public as opposed to gross debt, we are rapidly approaching those markers, on what you expect to be the consequences of our failure to change that dynamic, that growth in debt?

Mr. ELMENDORF. U.S. debt, publicly held debt, is already in unfamiliar territory for our country, and over the course of the next decade, if current policies are continued and debt pushes up toward 100 percent of our GDP, we will be entering unfamiliar territory for all developed countries over the past several decades. Not completely unknown territory. Some countries have gone there. Their experiences have usually been poor.

The U.S. is different from other countries in a variety of ways that might affect how far we can push up debt before we encounter larger negative consequences. People do view the U.S. economy as a vibrant one and the U.S. financial system, notwithstanding the events of the past few years, as a reliable one. That gives us a little more room perhaps.

On the other hand, we have low private saving rates compared with other countries, so our Government debt cannot be absorbed as much in U.S. saving. It has to rely on the saving and investment of others. That may give us less room than other countries.

Senator CRAPO. I want to interrupt because I have one more question I am going to ask, and so I would just—well, let me just interrupt and move to the next question——

Mr. ELMENDORF. Yes.

Senator CRAPO [continuing]. Because time is so short. I do want to followup on that in a future round.

Quickly, there are four major housing and banking activities that are reflected in the Federal budget to various degrees: TARP finance programs, the Federal Government's obligations to Fannie and Freddie, the premiums paid by and loss share payments to banks through the Deposit Insurance Fund, and the Federal Reserve's remissions of interest income to the Treasury earned on their open market operations and other portfolio investments.

Could you explain to me what the budget numbers associated with each of these entities actually reflects? For instance, do the numbers for these programs in the budget reflect cash, credit scoring, or actuarial costs? And are we treating these different aspects differently in our budget analysis?

Mr. ELMENDORF. So the answer to the last part of the question is yes, they are treated differently. The Federal budget is primarily a cash-flow accounting, money coming in and money going out. About 20 years ago, in the Federal Credit Reform Act, there were some changes made to try to better reflect the true cost of some of the Government's financial activities, the credit programs. In fact, that methodology, which we apply to credit programs under the law today, does not reflect the full cost of the Federal Government, the full cost in particular of the risk that the Government takes on in credit programs.

Beyond that, some of these other particular parts of the Government's activities that you mention have been put in place with different budgetary treatment. The TARP was set in place with instructions to us to treat it not exactly under the credit reform basis, but under a credit reform basis with an adjustment for the extra risk the Government is taking on, and we have done that.

Fannie Mae and Freddie Mac were brought into the Government in our assessment through the conservatorship, and the ownership and control of the Government has demonstrated. There is nothing in law that specifies how they should be treated in the budget. We are treating them, after discussion with the Budget Committees, on the same risk-adjusted basis that we are treating the TARP.

The administration, however, still views them as being outside of the budget. When they record the history of transactions, they record cash payments to those entities as if they were outside entities.

Unfortunately, in contrast, our projections, which view them as part of the Government, which we think is appropriate, treats them more on—does not record the cash transactions but imputes to the Federal Government the transactions those entities are engaged in.

So it is a very complicated business, and we are in ongoing discussions with the Budget Committee, both sides—here and also in the House—to try to think through if there are better ways for us to communicate to you and your colleagues what is really going on.

Chairman CONRAD. Can I just intercede on this point, Senator Crapo? Because I think it is important for members of the Committee to know that CBO, when they have a question about how to do these things, consults the Chairman and the Ranking Member of both the House and the Senate Budget Committees. They did consult us on the question of treating Fannie and Freddie off the books or on the books. We insisted that they be included because we think that is the most accurate reflection of the effect on the Federal books. And we were unanimous in that view. Senator Gregg was the Raking member here at that time. Congressman Ryan was Ranking in the House. And former Chairman Spratt, the four of us were consulted. The four of us agreed unanimously——

Senator CRAPO. And I agreed with——

Chairman CONRAD [continuing]. That they ought to be included.

Senator CRAPO. Thank you.

Chairman CONRAD. And I still believe that was the correct decision and that CBO wanted to do it that way, and we thought that was the appropriate way, so that we are not having things off the books here.

Senator CRAPO. Hopefully OMB will follow that lead.

Chairman CONRAD. I thank you.

Next, Senator Cardin.

Senator CARDIN. Mr. Chairman, thank you very much. Mr. Elmendorf, I very much appreciate your service.

Mr. ELMENDORF. Thank you.

Senator CARDIN. I agree with the comments of our Chairman and Senator Crapo that we need a credible plan, we need a credible plan now. The support and our enactment of a credible plan would have an incredible impact, I think, on our economy, and that all factors need to be part of the solution.

The difficulty is that Congress will normally take up issues on a specific matter, and then the discipline seems to break down. We will have a true emergency—a natural disaster, a Katrina. We will have a national security issue that we obviously have to respond to. And then we sort of say, well, we will take care of that, and we do it in a different manner. Well, we understand that. But then other matters get categorized as emergencies or urgent issues, and we make separate exceptions.

I agree that we need to do this in a balanced way, but it seems like domestic discretionary spending is always the one that is in the focal point and usually takes the brunt of this type of discussion.

So I was pleased that the President mentioned discretionary domestic spending first, and I want to try to get the relative impact of what the President said. In your CBO baseline, what projections are you making in regards to discretionary domestic spending?

Mr. ELMENDORF. So the procedure that we follow and have followed for years is to take the latest level of appropriations that the Congress has approved and then to increase that over the remainder of the decade with our estimate of inflation so as to maintain the same inflation- adjusted or real level of appropriations for those programs.

Senator CARDIN. And the President mentioned the freeze for 5 years. Would that be different than what you had in your baseline?

Mr. ELMENDORF. Yes, that would.

Senator CARDIN. Could you tell us what additional savings would be brought in by the President's recommendation if we, in fact, did a freeze on discretionary domestic spending over the next 5 years?

Mr. ELMENDORF. So we did a calculation that I think is relevant. I do not know precisely what the President is proposing, and, of course, he has not released his budget. But we did a calculation that involved freezing all non-defense discretionary spending except that that was directed by the Subcommittee on Homeland Security of the Appropriations Committee. And if one freezes that for 5 years and then at the end of the 5 years increases with inflation, but at a level that remains below the level that would otherwise have been in place, the savings over the decade are about $400 billion.

Senator CARDIN. Thank you. Now, you mentioned three policy issues that are not in your baseline but are actively being considered by Congress for extension: the alternative minimum tax, the extension of the tax issues that were passed in December, and the physician reimbursement under Medicare. Let me take them, if I could, separately.

Could you give me a comparable number as to what negative impact each of those three policies would have on your projections?

Mr. ELMENDORF. Yes, I think I can. For other people, there is a table in our outlook, Table 1–7 on page 22, that gives the budgetary effects of a variety of policy alternatives from which these numbers are drawn.

The effect of extending the income tax and estate and gift tax provisions, scheduled to expire at the end of next year, is about $2.5 trillion over the decade.

The effect of indexing the AMT for inflation is about $700 billion over the decade.

In fact, there is an interaction between those two policies. The money collected under the AMT depends on the level of regular tax rates. So if one both does the extension and indexes the AMT for inflation, there is another almost $700 billion of revenue.

So the extension of those tax provisions and indexing the AMT together add $3.8 trillion to deficits over 10 years, and then additionally there would be extra interest costs as well.

The effect of maintaining Medicare's payment rates to physicians is about $250 billion over the decade.

Senator CARDIN. Thank you. The reason I mention that is that, you know, we spend a lot of time on the spending bills here, and there is a lot of pain as we talk about bringing down Federal participation in programs that our local governments need or we need for our roads or we need for those who are the most vulnerable. And we have to do that. I think we all understand that. Part of bringing the budget into balance is that we are going to have to make those types of sacrifices. If we do that, we will bring about savings in the budget.

But then if we talk about the tax issues and just say, OK, well, you know, taxes are different, it pales in comparison, the extra deficits, what we are doing on the tax side based on all the good work we do on the spending side.

Now, I have not gotten to the military yet. Your baseline assumes what for military spending?

Mr. ELMENDORF. Well, as for non-defense spending, we take the latest level of appropriations provided by the Congress and increase that with inflation. Under the current circumstances where a good deal of money is being spent in Afghanistan and Iraq, that level may not be a good representation of what you or your colleagues would think of as the sort of base level of defense spending you would like to provide. And we also provide in the same table in the outlook some alternatives that involve different paths for defense spending.

Senator CARDIN. So you are taking a lower projection for the future than using the current——

Mr. ELMENDORF. No. We are taking the current. That is what I am trying——

Senator CARDIN. But you believe there will be some savings in the next 10 years as far as the spending in Afghanistan, or you——

Mr. ELMENDORF. Well, I am just saying that you and your colleagues have often asked us the question about, well, we think—you think this is higher than what you anticipate to provide in the future, so——

Senator CARDIN. So your baseline starts with the current level of military action that we are participating in.

Mr. ELMENDORF. Yes.

Senator CARDIN. So if, in fact, we bring down the military action and do not have to spend as much on our soldiers overseas, we can bring some back, that in and of itself would give us some savings that are not in your baseline.

Mr. ELMENDORF. Yes. In and of itself—let me just add——

Senator CARDIN. I understand there are going to be tradeoffs.

Mr. ELMENDORF. Let me just add quickly, when Secretary Gates has talked about savings that he would like to implement in the base defense budget, not counting those operations, the savings that he is discussing is from a higher level than our baseline. He is discussing savings relative to the budget plan that the Defense Department has put out. So those savings bring down that budget plan in the direction of but not all the way to our baseline.

Senator CARDIN. Of course, if the recent years are any indication, the numbers are going to probably be higher, because they have been higher than, I think, your—if we go back 3 or 4 or 5 years ago, what CBO's baseline was on military spending as to what we are spending today, we are spending more, if I am——

Mr. ELMENDORF. Well, so part of the problem is that depending on where in the year we have done the projections, whether the Congress has at that point enacted the sort of supplemental appropriations that have gone for overseas contingency operations, we tend to be extrapolating first the higher number, then a lower number, then a higher number. There has been an odd sort of ping-ponging that I think has been hard to follow.

Senator CARDIN. My time is up. I wanted to do the same thing with the entitlement spending. I did not have a chance to go through the analysis. But I guess my point is this: All of the major areas need to be on the table, and that was, I think, the credibility of the Debt Commission, Mr. Chairman. I must tell you, I think all of us were proud that the recommendation was balanced. Again, you know, we do have problems with provisions, but you have to have all at the table. Let us not just pick on discretionary domestic spending.

Chairman CONRAD. Thanks, Senator.

Senator CORNYNis next. I want to welcome Senator Thune to the Committee. He was not here when we welcomed new members. I want to extend our welcome to Senator Thune as well to the Committee. We look forward to working with you.

Let me just indicate to members, I try not to interrupt Senators when they are questioning, even though they may be at the end of their time. If you will kind of look, when I hold up the gavel, I prefer not to tap it on members, but if you will try to stick close to the time, in fairness to others.

Senator Cornyn.

Senator CORNYN. Thank you, Mr. Chairman.

Dr. Elmendorf, welcome, and let me start out by saying how much I, and I know other members of the committee and Members of Congress, appreciate the professionalism and integrity of your office. I know the numbers that you report are often batted around and spun in different ways, which must be a source of tremendous frustration to you, but you have always seemed to keep your cool despite that, and it is important that we get good numbers and thank you for that.

Mr. ELMENDORF. Thank you, Senator. That means a lot.

Senator CORNYN. You know, unfortunately, when we talk about the budget and the economic outlook, though, I feel like Mark Twain when he said, “Everyone talks about the weather but nobody ever does anything about it.” I think Congress is guilty of that, and that is why I was pleasantly surprised, Mr. Chairman, when you and other members of the President’s Fiscal Commission came out with what I thought was a bold and dramatic and sobering report. And so I hope, and I still hope, that we will take the opportunity to deal with this crisis, and I do believe it is approaching a crisis. We do not know when the tipping point will come, but we are almost there. And so we cannot just talk about the economic outlook and the budget. We have to do something about it. I do think that there is an opportunity, a window for us to do it.

Now, I heard you say we have to be careful about the pace of some of the austerity measures because it could further depress the economy, and I hear you loud and clear on that. But I think the political reality is we have a short time to do this, and if we do not do it within this six to 9 months, then the opportunity will be lost.

So I am anxiously awaiting the President’s budget, which will come the week of February 13, to see whether the President himself is serious about the crisis that was so well documented and explained by his own Fiscal Commission, and I hope that opportunity is not squandered by the same old, same old sort of thing that seems to happen time and time again.

But just to—I know we have talked a lot about the need to cut, but you alluded to the crowding out effect of more Federal Government borrowing on private access to private credit and I would like to just talk to you briefly about the importance of not just cutting, but growing the economy. I know when Senator Portman was over as OMB Director at the beginning of 2007, the budget deficit was 1.2 percent—1.2 percent. Now, it is around 10 percent. One reason why it was low is not because we were not spending money, because we were, but because the economy was booming. Jobs were being created. The coffers, the Federal Treasury was getting a lot of money. But now, for the reasons the Chairman mentioned, not only are we continuing our bad habits in terms of spending, indeed growing spending, the amount of money coming in because the economy is hurting, because people are out of work, losing their homes, it is a double whammy.

So let me ask you, on page 51 of the Budget and Economic Outlook, you have some economic projections in terms of growth of our Gross Domestic Product, and I believe I heard you say, and this appears to say on page 51, that in 2011, you are projecting the Gross Domestic Product to grow at 3.1 percent, is that correct?

Mr. ELMENDORF. Yes, that is right.

Senator CORNYN. Can you tell us at what point, how much growth of the Gross Domestic Product is required to see a net increase in employment? In other words, I assume with new people entering the work force that there is a level—I have heard it before, but I cannot recall the specific number—is there a range of growth that we need to see before we are going to start to see the unemployment rate coming down?

Mr. ELMENDORF. Well, at that pace that we project, Senator, we think the unemployment rate will begin to come down, but slowly. We think that the potential growth rate of the economy—I should explain what I mean by that, that apart from the cyclical issues, if the labor force were almost fully employed, if productive capital were almost fully in use, that the economic output would grow by maybe up to 2.5 percent a year. So if economic growth exceeds that rate, then we are in the process, we think, of closing the gap a little bit between the potential level of output and the actual level of output. That means putting people back to work again and putting equipment and plants back to work again.

Senator CORNYN. Chairman Bernanke testified a couple of weeks ago that he thought by 2012, we would still see unemployment stubbornly high, in the 8 percent range. Do you agree with that, or what is your view?

Mr. ELMENDORF. Yes, I do. So we think that the unemployment rate will be down to about 8.25 percent by the end of 2012. That is better than it is today, but obviously still well above the level that we have seen in strong economic conditions in the past.

Senator CORNYN. Since time is so short, let me just conclude on some matters that are of grave concern to me, and that has to do with energy costs and some of our policies emanating here from Washington having to do with our domestic energy supply.

First of all, I do not think it is any secret that the moratorium that was imposed on drilling for oil in the Gulf of Mexico, and now that the formal moratorium is lifted, what is sometimes called the "permitorium," the failure of the bureaucracy to issue permits to responsible producers to develop domestic energy, that it is having a dramatic negative impact on employment, particularly in the Gulf Coast States, but the ripple effect throughout the economy.

Likewise, we have discovered in the last couple of years as a result of modern technology a huge amount of natural gas here in America that is available from shale formations. I guess as I heard the President talk about green jobs, which sounds very good, and certainly we are all for conservation, looking for ways to protect the environment as we develop energy sources, I was concerned that there was not a whole lot of talk about what I would call red, white, and blue jobs, and those are jobs created from our domestic energy sources.

Let me just conclude on this, and I know the Chairman has held up his gavel, but let me conclude on this and say, what do you see in terms of energy costs, rising energy costs, particularly gasoline costs? We see $4 a gallon gasoline by summer. What are the rising costs of energy going to do to our economy?

Mr. ELMENDORF. I do not know offhand what our projection is. Normally for oil prices, which are an important economic factor, of course, we look to the futures markets as our starting point and follow the path that people buying and selling the right to have oil in the future, look at the price that they are putting on the oil. I do not think that calls for further large increases at this point in the price of oil. I am not sure about gasoline prices.

Mr. DENNIS. Oil prices are here.

[Document handed to Mr. Elmendorf.]

Mr. ELMENDORF. OK. So oil prices, we have rising. They are now about $90 a barrel. We have them rising to about $100 a barrel by 2017 and $110 a barrel by 2020. Of course, as we have seen historically, the price of oil can easily shoot up well beyond that and can fall well short of that for periods of time. So I think this is an aspect of the forecast that you could picture having a very large confidence range around these numbers. But we think this is consistent with what is in futures markets and with the historical experience.

Senator CORNYN. Certainly, if a conflict broke out in the Middle East and people became concerned about it, those numbers could skyrocket almost immediately, could they not?

Mr. ELMENDORF. Yes. That is right, Senator.

Senator CONRAD. Thank you.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman, and Dr. Elmendorf, thank you for all your good work.

In the middle 1980s, Democrats and Ronald Reagan got together. They got together on taxes, cut taxes, kept progressivity, and grew the economy. And we found a startling number a few days ago. In the 2-years that followed that bipartisan work, the economy created 6.3 million non-farm jobs. That is twice as many jobs as were created between 2001 and 2008, when tax policy was partisan.

Now, in your analysis, you, of course, just assume that between now and 2012, there will be no changes, and then after 2012, we will see what happens. What could you tell us—and this, of course, would just be a very rough analysis—would your fiscal outlook be if, say, in the next 2 years, Democrats and Republicans picked up on the kind of work that was done in the 1980s and grew the economy? Can you give us any sense of how your fiscal outlook would change? Obviously, it would change because you are not making any calculations based on anything else being done. But just what roughly would you suggest might be part of the changed fiscal outlook if a tax reform along the lines of what was done in the 1980s was enacted?

Mr. ELMENDORF. As you know, Senator, my capacity for analysis usually falls well short of your questions. As a very general matter, it is a widely held view among experts that a tax code that had a broader base, with fewer special exemptions, deductions, credits, so on, and thereby could have lower tax rates to raise the same amount of revenue, would be a more effective tax code in terms of raising revenue while producing less distortion to private economic behavior.

So all else equal, and there is a lot being swept into that phrase from your question, a tax code with a broader base and lower rates is one that we would expect to be more conducive to economic growth. But, of course, we would have to look at——

Senator WYDEN. Which would mean that the fiscal picture you have painted today would not be quite the bleak one that you have offered.

Mr. ELMENDORF. Not quite as bleak. As you understand, the gap between spending and revenues under extension of these policies that have been extended in the past is very large. That is not a gap that the economy can grow its way out of even with——

Senator WYDEN. Understood.

Mr. ELMENDORF [continuing]. The world's best tax system.

Senator WYDEN. Let us talk about the international implications of tax law for a minute, if we can. I am very interested in seeing the corporate rate cut considerably and have proposed cutting it from 35 to 24 in order to encourage manufacturing in the United States. In effect, that would provide us an opportunity to repatriate some of the money that is parked overseas back here in the United States again to grow the economy.

Have you all done any analysis with respect to an approach that, in effect, would promote that kind of repatriation through a tax code that incented job growth in the country?

Mr. ELMENDORF. I do not think we have studied that in particular, Senator. We actually are doing some work right now on different approaches to taxing international corporations in work that we hope to present to the Congress in a few months. I do not think we have studied that particular proposal, at least as of yet.

Senator WYDEN. I hope you will, and I will followup with your staff on it because I think it is important. I think we know that billions and billions of dollars are parked offshore right now and we ought to make it more attractive to repatriate that money through tax law and incent private sector job growth in our country.

I am going to ask you the same question I asked Dr. Bernanke with respect to tax law, and that is the effect of doing just corporate tax law changes rather than individual tax law changes at the same time, because my sense is, because most businesses pay taxes as individuals, not as C Corporations, you really have many interactions. And Dr. Bernanke said that he thought tax reform needed to be done in a holistic way, corporate changes and individual changes concurrently. Do you generally share that view?

Mr. ELMENDORF. Well, I think from the perspective of an analyst, tackling all the aspects of a general problem at once seems most effective. Of course, it is up to you and your colleagues to judge how many changes you can think through and agree upon in a finite period of time. I mean, as you understand, both the corporate tax reform and individual tax reform agendas are incredibly long and complicated. But yes, I think from an analytic perspective, trying to think about all the pieces of the tax code together would be most effective and most appropriately.

Senator WYDEN. I simply think the interactions between what individuals pay and what businesses pay is now so intertwined with sole proprietorships, LLCs, partnerships, and others that to just say you are going to split off one piece of the tax code and touch on reform there is to vastly oversimplify this and create a lot of distortions.

One other question. What are the growth implications of doing taxes on a temporary basis? Let me just read you a sentence from the Wall Street Journal toward the end of the year, and I will quote it. "The United States now has no single permanent tax regime for levies on salaries, capital gains and dividends, a Social Security tax, or a slew of targeted breaks for families, students, and others." So in effect, what America has done is to put the tax system on a permanently temporary basis. We are phasing things in. We are taking things out. We have a permanently temporary tax code.

What are the growth implications of having something that is now a gerry-built, temporary system rather than to look, as I tried to do at those 1986 numbers, which to me are just eye-popping. To think that when Ronald Reagan and Democrats got together, in 2 years, they created more jobs than you saw in 8 years of partisan tax policy, what would be the benefits of looking beyond a temporary approach?

Mr. ELMENDORF. I think the temporary nature of our current tax system, if you will, is damaging to the economy. We hope and expect that businesses and families are planning ahead, that they are making decisions now, making investments for the future, and it is very difficult for them to make those sorts of decisions in an informed and thoughtful way if the tax rates that will apply to them a year or two or three or four down the road are so uncertain. And I think that resolving that uncertainty would encourage and support household decisions, business decisions, investment, and hiring, probably.

Senator WYDEN. Mr. Chairman, my time has expired, but because we are all going to be working closely under your leadership over the next 2 years, I want to touch on this last point that Dr. Elmendorf made about the nature of a temporary set of tax policies. If we have, Mr. Chairman and colleagues, the same debate in the lame duck session of 2012, where we are once again talking about extending the tax law today for two more years, Dr. Elmendorf has told us that will be damaging for the economy and the country. So with your leadership and Senator Sessions, my hope is that this time, over the next 2 years, we can make permanent pro-growth changes to tax law, get it done in this Congress, and not just re-litigate another set of temporary tax law changes in the lame duck session of the 2012 Congress which Dr. Elmendorf has just told us would be very damaging.

Mr. Chairman, thank you for that extra time, but I think the point Dr. Elmendorf made is especially important there at the end.

Chairman CONRAD. Thank you for that.

Senator Sessions is now back. He was at another hearing that required his presence. I think it is probably most appropriate that we go to him for any opening statement he would want to make and then we will resume questions.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Mr. Chairman. It was a critical hearing that I had to be at involving my State——

Senator WYDEN. Your microphone is not working.

Senator SESSIONS. Maybe I can just move over here.

Chairman CONRAD. It is working now.

Senator SESSIONS. OK. That is better. Senator Wyden, fundamentally, you are absolutely correct. I mean, a permanent tax policy is better than an uncertainty, and we have too much uncertainty in our economy and we do need more stability. You have come forward with some proposals and ideas that I think are worth serious consideration and I look forward to working with you on it. I truly believe that you are attempting to accomplish something in an effective way.

I congratulate you, Mr. Elmendorf, for your reappointment at CBO. You have carried out your duties, I believe, with honesty and integrity and I look forward to working with you again. You have some rather specific controls on how you score and evaluate matters. It is not your fault. They have been established and you follow them, I think, objectively, whether we like the outcome or not. The rules are set up mostly by Congress.

So we got the new baseline from CBO yesterday. The news was not good. Our deficit is expected to reach nearly $1.5 trillion this fiscal year as of September 30. That is well above what we were projecting not long ago. Our gross debt is expected to reach 100 percent of GDP, meaning the amount of all the money our nation owes will soon be equal to the value of everything our nation produces. That is above the level, the 90 percent level that Rogoff and Reinhart can calculate in their fine, valuable book and analysis of nations who have defaulted on their debts. The 90 percent rate is significant. They find it is a significant number, and we are above that.

Forty cents of every dollar we spend is borrowed. By the end of the decade, the interest on our debt is expected to rise to nearly

$750 billion in 1 year. That crowds out spending. People would like to spend more on a host of projects, and I would like to do that, too, but we are going to have $750 billion less because, first, we have to pay interest on the surging debt that we have.

Former Federal Reserve Chairman Alan Greenspan said recently that we have almost a 50–50 chance of a bond market crisis in the next 2 years. That is the quote up there. It was apparently at the Wall Street Journal interview, and I thought that was something that we should hear. I mean, this is a man of wisdom. He has been around a long time and he said the only question is will this debt bond crisis be before—excuse me, that the kind of budget numbers that we need be passed before or after the crisis. It would be a lot better, I think we would all agree, critical, actually, that we do it before the crisis.

So the path we are in unsustainable, yet I have to say that President Obama in his State of the Union Address announced fundamentally we would just continue as we are. To hear the President's remarks, one would think his speech had been written 10 years ago. They were disconnected from the reality of the debt crisis that we face.

Earlier this week, I said his State of the Union Address would be a defining moment for his Presidency and I do not think he rose to the occasion. It was a timid speech. It squandered a historic opportunity to rally the American people behind true spending reform. He had the opportunity to look them in the eye, say what the real dangers we are facing are, and call on us to meet the challenge as Americans will, if properly called. It was far short of the standards set by Governor Chris Christie in New York and Prime Minister David Cameron in the U.K., in Britain, who are making tough choices.

No one forced Mr. Obama to be President. As my wife says, do not blame me. You asked for the job. He asked for this job and he has a real tough job now, and I think he did not lead effectively. He proposed instead that we continue a 5-year plan, and this so-called freeze on domestic spending is not a plan to reduce deficits. It is a plan to preserve the deficits, really locking in place the very spending levels that had been dramatically increased by President Obama in the past 2 years.

The plan is remarkable not for its strength, but for its weakness. In defense of his proposal, the President argued that the government spending is the engine of the economy, that the government is the engine of the economy, basically, and he had this airplane metaphor backward. The engine of our economy is the private sector, not the public sector. When the private sector grows, it creates jobs, new industries, new ideas, and more tax revenue. But when the public sector grows, it simply consumes more of what the private sector produces and big government waste is funded on the back on small business thrift.

The American people deserve candor and directness from the elected officials. The money to sustain the President's big government vision, the more investments he called for, is simply not there. We do not have the money. Meaningful spending reductions are not a choice, they are an obligation. There is no serious alternative. We need to take the tougher road, but the road that leads to prosperity. Reducing the size and cost of government may not be easy, but it is the only responsible course, the only one that will lead us to a better future.

So, Mr. Elmendorf, I look forward to discussing the issues with you now and as we go forward through the next years. Together, I believe we can make some progress.

Mr. Chairman, there is nobody that has seen this and studied it more carefully than you, and I look forward to seeking your advice as we go forward, also.

Chairman CONRAD. Thanks, Senator Sessions. You know, it may turn out it just falls to us on this committee to put forward a plan. It may be that since the Commission did not get 14 of 18, it may just be that we have to go back to a process that worked on this committee when I first came here, which is to have a real markup and for this committee to lead.

Frankly, I have never thought that on a problem of the dimensions of this one, where we typically do 5-year budgets, almost always do, in this circumstance, which really requires a plan that extends way beyond 5 years, that this was not the forum to sort it out. But I am not sure anymore. I am not certain that it is not going to fall to us to put a plan out there for our colleagues on the floor. I am going to be having discussions with members of the committee on both sides to see what the feeling would be about our taking this on and laying a plan before our colleagues, because this is the Budget Committee. Even though we have typically been limited to 5-year plans, maybe we are the only ones who are going to have the opportunity to lay out a comprehensive plan absent some kind of summit.

I prefer, I think the thing that makes the most sense is there is a summit between the White House leaders and the House and the Senate, because at the end of the day, the White House has to be at the table, and unfortunately, in the congressional budget process, the President is left out. The President sends us a budget, but then Congress passes a budget and it never goes to the President. It never goes to the President for his signature or his veto.

But if there is not going to be a summit, there is not going to be some kind of negotiation, maybe it is going to fall to us on this committee to put forward a plan.

Senator MANCHIN is next.

Senator MANCHIN. First of all, let me congratulate you on your reappointment.

Mr. ELMENDORF. Thank you, Senator.

Senator MANCHIN. We are glad too that we all agree on something. With that being said, sir, a couple questions very quickly.

On health care, as you know, you scored health care, and you see where we are right now with the bill being sent over in a repeal, and I have heard of the $200 billion score on that that it would cost us. Can you elaborate on that and a little bit about the mandates, what the mandates would do if they were eliminated? And also from a State's perspective, the 133 percent, Medicaid. And I am not sure if anyone really understood where we were—as States at that time, where we were coming from, the Governors were coming from. Most States do not cover 50 percent of the people that qualify, and we jumped from, let us say, the 50 percent all the way to

133, which we had a hard time swallowing. If you could talk about that, and then I have one final question, sir.

Mr. ELMENDORF. OK. You raise a lot of complicated issues there, Senator.

The original legislation as enacted last March, both the Patient Protection and Affordable Care Act and the health care parts of the reconciliation act, set in place substantial expansion of Federal entitlements for health care and paid for that expansion by setting in place new tax revenues and by trimming money from existing health program, in particular Medicare, and by trimming the money from Medicare in a way in which the gains to the Government budget would increase over time because the trimming was of a sort of reducing the rate of increase of payments to providers. And in our analysis, the combination of the extra tax revenue and the reductions in spending laid out in the legislation exceeded the cost of the new entitlement, so the legislation had in our assessment last March a small positive effect on the Federal budget.

Therefore, in the preliminary analysis that we prepared in time for the House vote, we concluded that repealing that legislation would have a small negative effect on the Federal budget. We are in the process of constructing a full cost estimate of the repeal legislation and which we make available, of course, as soon as we have completed it.

One of the many questions we were asked along the way of the health debate of the past 2 years, in addition to the Federal budgetary effects, was the effect on State government budgets. And as you said, the expansion of Medicaid in that legislation put additional burden on States. The expansion was set in place in a way where the Federal Government would pay a larger share of the cost of the new people made eligible for Medicaid than it does under the current Medicaid program but, nonetheless, would not pay all of that bill. And, in fact, the share the Federal Government will pay of those newly eligible people actually declines a little bit over time.

Our latest estimate is that the State's share of the costs associated with that Medicaid coverage expansion will be a little over $60 billion during the 2011–2021 period, the period covered by this latest outlook.

Senator MANCHIN. But 2014, that is when the States—it basically goes into effect, the expansion of Medicaid?

Mr. ELMENDORF. Yes, that is right. We tend to report 10-year numbers—11 years counting now, but, yes, it is principally 2014 and beyond. It is not our place to judge, of course, how States can deal with that or whether it is appropriate to do that. I will say that estimate incorporates our expectation of changes in State behavior in response to the higher burden that they will face. So our estimates cannot incorporate changes in law that you and your colleagues might implement at the Federal level——

Senator MANCHIN. Yes.

Mr. ELMENDORF [continuing]. But our estimates do incorporate responses by families and businesses, in this case it is doctors, and in this case by State government.

Senator MANCHIN. If you would do me a favor, because I want to move on to another question, if you would just give me—and if you could score the reduction from 133 to 100.

Mr. ELMENDORF. I would have to talk to you about——

Senator MANCHIN. 133 to 100, and also if the mandates were removed and if there is an offset there. If we could talk about that after.

Mr. ELMENDORF. Yes, we will talk with you, Senator.

Senator MANCHIN. The other thing, the Debt Commission, I was very proud of the Debt Commission. I will tell the Chairman that, and everybody that worked so hard and the courageous stance you all took, and I appreciate that very much. But, you know, in West Virginia every family sits down and works through their budgets, and they set a budget and stick with it. Most States have a budget balance amendment, and I want to know what your thoughts would be for this Federal Government, because it does not seem to me that we are ever going to have the will to tackle the problems that we have to and the votes that are going to have to be made unless there is a balanced budget amendment that forces us. And it would do it over a period of time because ratification would take some time to do it, and it would give us a chance to get our financial house in order. But it sets a firm grip, and you know the States are going through some very, very challenging, difficult times and making some difficult cuts, and they are looking at the Federal Government and saying, "Why can't you all do it? We are doing it. We are taking these severe cuts. We are making these tough votes. But we do not see anything coming from Washington."

If I could hear your response on a balanced budget amendment on constitutional change of how we do business in Washington.

Mr. ELMENDORF. So, Senator, I do not think it is appropriate for me to make a recommendation for or against that sort of change, but——

Senator MANCHIN. Can you tell me if it would be——

Mr. ELMENDORF. I would make a few observations.

Senator MANCHIN. Yes.

Mr. ELMENDORF. I think one is that the set of budget rules set in place in 1990 regarding caps on discretionary spending and a pay-as-you-go system for mandatory spending and taxes seemed to analysts to have been effective at helping to guide decisions of the Congress, as long as there was the focus in the Congress on the deficit reduction. Once the budget improved and that focus dissipated, then those restrictions were no longer effective. It was the——

Senator MANCHIN. But wouldn't a balanced budget amendment——

Mr. ELMENDORF [continuing]. Combination of rules——

Senator MANCHIN [continuing]. Hold this check in balance?

Mr. ELMENDORF [continuing]. And the focus in the Congress. Amending the Constitution to require this sort of balance raises risks that you are aware of. The automatic stabilizers that the Government has, the Federal Government has, the fact that taxes fall when the economy weakens and that spending and benefit programs increase when the economy weakens in an automatic way under existing law is an important stabilizing force for the aggregate economy. The fact that State governments need to work, as you said, against those effects in their own budget, need to take action to raise taxes or cut spending in recessions undoes the automatic stabilizers essentially at the State level. Taking those away at the Federal level risks making the economy less stable, risks exacerbating the swings in business cycles.

Senator MANCHIN. But you would agree that we are very unstable right now?

Mr. ELMENDORF. Yes, the automatic stabilizers are not perfectly stabilizing, but taking them away would have costs that you and your colleagues would have to weigh.

The other thing to say, of course, is that that amendment does not suggest—it does not by itself say how you or your colleagues would change taxes or spending——

Senator MANCHIN. Would you be asked to score a balanced budget amendment?

Mr. ELMENDORF. No, I do not believe that we score amendments to the Constitution. We estimate the effects of legislation that you and your colleagues are considering.

Senator MANCHIN. That would be good. I would like to talk to you further about that, but the balanced budget amendment is very, very important to me and to every Governor, to every State, to every household, especially in West Virginia. And if they can do it, they think we can do it also.

Senator SESSIONS. Mr. Chairman, I did not ask any questions on my first comment. Could I have just 2 minutes to ask a question?

Chairman CONRAD. Senator Ensign, is that OK with you?

Senator SESSIONS. Without Senator Ensign losing his place.

Chairman CONRAD. OK. We sort of have an unusual situation. It is a little unfair to do that, but you are the Ranking Member, so we will make an exception.

Senator SESSIONS. You are a great Chairman, and I thank you. [Laughter.]

Senator SESSIONS. Magnanimous.

Governor Manchin, with regard to the score of the health care bill, Mr. Elmendorf, the money that you have referred to that came in through the bill was Medicare trims or Medicare cuts and tax increases, most of which were Medicare tax increases, I believe, and that money was used to fund the new program.

But two things are important. First, Mr. Elmendorf has made crystal clear you cannot count that money twice. It cannot increase Medicare and fund the new program. This is a very serious matter that we are talking about. Very serious. And so isn't it true that the Treasury—the new health care program is not given new money to fund the new health care program, but the money they got from the Medicare tax increases and the Medicare cuts is borrowed by the Treasury and that the Treasury owes that money back when Medicare continues in default or goes into default and claims its money back?

Mr. ELMENDORF. So let me try to—so Senator Sessions is referring to a set of letters that we sent at his request in December of 2009 and January of 2010, and the way I would describe this is that the analysis that CBO does of legislation is done on a unified budget basis, taking into account all the pieces of spending and revenues. And we report the net effect of legislation on spending and revenues and the deficit as a whole.

The cutbacks in Medicare spending, which were large in that legislation, as I have said, together with revenue increases, more than offset in our judgment the extra spending on the new health entitlements and expanded health entitlements.

It is also the case, as you are saying, Senator, that the savings in Medicare, and particularly the savings in the Hospital Insurance part of Medicare, HI or Part A of Medicare, then lead to a greater accumulation of bonds in the HI trust fund. As we wrote in the letter to you, those bonds have important legal meaning. They are real U.S. debt backed by the full faith and credit of the U.S. Government like the debt sold to the public.

They do not have independent economic meaning in the sense that the fact that the trust fund has an accumulation of bonds does not give the trust fund some separate way to pay Medicare benefits, except, as you say, Senator, by coming back to the Treasury, redeeming those bonds, and getting that cash in the future.

Another way to say that is just that paying Medicare benefits in the future relies on tax revenue that will be raised in the future or borrowing that will be done in the future, cannot depend directly on the bonds in the trust fund.

Senator SESSIONS. I think that is fair. I think all of us need to understand that. But I would go a little bit further. It increased the internal debt of the U.S. Treasury because the money expended for the health care program is borrowed from Medicare, at least a substantial portion of it. And when Medicare, since we know it is going into default, inevitably will call those bonds, the United States Treasury will either have to raise taxes or borrow it on the economy or deflate the currency, which are the three choices governments have. Isn't that basically correct?

Mr. ELMENDORF. I mean, you are right. The money is being borrowed from the Medicare Trust Fund, and that——

Senator SESSIONS. It increases the internal debt, the gross debt of the United States.

Mr. ELMENDORF. And it increases the gross debt of the United States, yes, absolutely.

Chairman CONRAD. I thank the Senator, and I thank him actually for making the point because we have that same issue with Social Security. You know, the hard reality is—I hear it all the time. Social Security has trillions of dollars of assets. That is true. There are trillions of dollars of assets. They are special purpose bonds backed by the full faith and credit of the United States. Those are real assets. The problem is the only way those bonds are redeemed is out of current income, and Social Security is going to go permanently cash negative in 5 years.

So I have to say, those who have—and I have received the lash from those who say, well, you should not have to touch Social Security because there are trillions of dollars of assets. It is true there are trillions of dollars of assets. It is true that they are backed by the full faith and credit of the United States. It is also true that the only way those bonds get redeemed is out of the current income of the United States. And we are about to see a dramatic shift in the budget circumstance when we go to having hundreds of billions of dollars a year of surplus in Social Security that the general fund could borrow to having a circumstance in which there are hundreds of billions of dollars of debt that has to be serviced out of current income.

Senator Ensign, I apologize to you because you kind of got delayed here.

Senator ENSIGN. It is OK, Mr. Chairman. The important thing is getting some of these issues out on the table. What you just talked about I think is of absolute critical importance. You talked about the full faith and credit of the United States. That is really what we are dealing with here.

The Chairman held up, at the beginning of your talk, about Moody's and Standard & Poor's, talking about the AAA rating of the United States. Japan was just downgraded to AA. What would a downgrade from AAA to AA of the United States credit rating do to the interest rates and do to your budget projections? Because, by the way, your budget projections, in my opinion—I know you all try to be conservative, but just as we have seen last year, I think this year you projected a $1.1 trillion deficit last year, the year before for this year, right? And it turned out to be 1.5. And some of that was because of the tax policy that was passed at the end of the year. I realize that. I am going to ask a question on that. But the bottom line is these things can change radically very quickly, and this full faith and credit idea, this idea of if the bond raters downgrade our bonds, if the Fed is successful—and a lot of people think they are going to be successful in raising inflation, because that is what they are trying to do right now with their monetary supply. Those all lead to higher interest rates, higher than what you are projecting. And so that is basically the question. If it goes to AA, what does that do to your projections for this deficit?

Mr. ELMENDORF. So if the Federal Government's credit rating were lowered, that would certainly push up the interest rates the Government would pay, and thus the interest payments we would have to make. We have not attempted to quantify how much a given reduction in rating would affect interest rates, but it certainly would be an adverse effect for the budget.

Senator ENSIGN. And it would not be insignificant. it would be very significant. Would you agree with that statement?

Mr. ELMENDORF. I think it would be significant, Senator, absolutely.

Senator ENSIGN. Yes. And so the point is here we do not—I think that you talked about this. The sooner we make these changes, maybe the—they are going to be painful. But the sooner we make them, maybe a little less painful. As Alan Greenspan talked about, we are going to have to make these changes. It is just a question of do we do them in the middle of a crisis or do we do them to avoid the crisis. And that I think is the significant part of this.

Senator Cornyn mentioned, and, actually, I think Senator Sessions mentioned, we need Presidential leadership right now, and the Chairman has talked about this, talked about this Committee doing its job. I could not agree more. The President needs to lead right now. These issues that we are talking about—and you have been around. You have seen this, Dr. Elmendorf. These cuts—it is much easier to get reelected by giving money away, OK? None of us want to make these tough political votes. But we have a Democrat President, a Republican House, and a Democrat Senate right now. In my opinion, if the President would lead, join the two parties together, we could do actually what is right for the American people. But it is up to him to lead. He is the President. He is the only one with the bully pulpit. Our little microphones here do not echo through the country. He had it on the State of the Union. I think he failed on the State of the Union, personally, but he still have plenty of opportunity. We have the CR coming up. We have the debt ceiling coming up. There are other opportunities. He has his budget coming up. We have plenty of opportunities for the President to lead. And forget our party labels. This is about the future of our country. The debt that you are talking about, the interest on the debt, you have said that is unsustainable. It is. It is unsustainable.

Dr. Elmendorf, the reason you got reappointed by Republicans and Democrats is because you do try to call, you know, the fair shots. We do not always agree. You know, there is always—because what you do is unbelievably difficult to predict. But you play within the rules that you are given, and some of the rules are not necessarily the best rules for making the most accurate predictions as well. But the bottom line is I think all economists agree that our country is in serious trouble if we do not deal with this debt and deficit problem.

Four hundred billion dollars that the President talked about the other night, what percentage of that is of the debt that we are going to accumulate over the next 10 years based on your projections?

Mr. ELMENDORF. Well, under the baseline projections in which these various tax provisions expire and so on, we expect the Government will accumulate about $7 trillion in debt over the next decade, so $400 billion is a little over 5 percent of that.

Senator ENSIGN. It is a drop in the bucket, and actually it will probably—we all think it will probably be lower, especially if you talk about spending projections, if you talk about the alternative minimum tax, if you talk about the doc fix, if you talk about all those things that we know are going to happen.

Mr. ELMENDORF. So if we extend all of those expiring provisions in the way that I talked about at the beginning, we look for a debt of $12 trillion under that view of current policy over the next decade. And $400 billion is a few percent of that.

Senator ENSIGN. Yes, and as far as total spending during that time, projected spending during that time, what percentage of it? My back-of-the-napkin calculations are it is less than 1 percent.

Mr. ELMENDORF. Yes, that is right.

Senator ENSIGN. So the President has basically said, OK, we are going to reduce spending by less than a penny out of every dollar, OK? When this country—all economists say it is unsustainable. This country is literally headed for a financial crisis that we maybe have never seen. And for us to sit here—that is why it is so important for us, in my opinion, to join together as Republicans and Democrats with the President to tackle this problem.

You know, Mr. Chairman, what you said with the budget, I am willing to join whoever it is, but we have to make such difficult—

these are going to be painful—politically painful is what I mean by painful—politically painful choices to make.

I agree with Senator Wyden. We have to have the kind of tax policy because you cannot just cut your way out of this. You have to actually cut and grow. You have to do those at the same time. It is the only way you are going to solve this crisis, this financial crisis that could be looming on our country.

So I know there was a lot in there. The only last thing I have is State pensions now, Moody's is talking about requiring the States to put their pension obligations on their books. OK? Now, you talked about these stabilizing factors. What does that do potentially to, you know, the whole economic projections going off into the future?

Mr. ELMENDORF. So we are actually in the process of completing an issue brief on State pensions, which we will release very shortly, Senator. I think that is an important topic. The issue about the stabilization was mostly in the context of sort of year-to-year behavior of State budgets during a recession, an economic downturn and a recovery. But as you say, a very important long-term financial issue for States and local governments is the commitments they have made to pay certain benefits to retired government workers and whether they have or have not put aside sufficient money to meet those.

Senator ENSIGN. Right. Mr. Chairman, I realize my time has expired. Just a last comment. It is not in the future. You are seeing this. My State is dealing with it right now. My cities are dealing with this right now. Cities and States across the country are actually dealing with this problem right now. They know most of it is in the future, but it is actually affecting their State budgets currently.

Mr. ELMENDORF. Yes, that is right.

Senator ENSIGN. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, and thank you for your courtesy, Senator Ensign.

Senator WHITEHOUSE. Thank you, Chairman. And with respect to your comment about this Committee becoming a forum for doing some of the significant debt and deficit work that we may need to do, I can assure you that I am prepared for that work, and I think every member of this Committee would be prepared for that work. So if it is your judgment to proceed in that way, I think you will find that you have both interested and hard-working Senators who are prepared to engage in that discussion.

Chairman CONRAD. I thank the Senator for that. You know, I have thrown this out as an idea. I think it is going to take discussion among all the members of this Committee. Again, I personally would prefer that we have a summit that involves the President and the leadership of the House and the Senate. But if that is not to occur, it has to start somewhere.

Senator WHITEHOUSE. Director Elmendorf, if you have an insurance company and it collects premium in order to make payments in the insurance program, it builds up reserves that the insurance company holds. And there are times when fires take place, Katrinas take place, lives that are insured expire, and you have to draw on those reserves. And in those periods, the insurance program may go cash negative but remain fully actuarially sound.

As I understand it, our problem with Social Security is that it is and has been actuarially sound, will be actuarially sound through 2037; but that reserve fund of the incoming premium that was set aside was not left alone. Congress took it, borrowed it, left an IOU in its place, and spent it on other stuff. But I think—I see you nodding. I think it is important to point out that Social Security as a program is not actuarially at fault for the need that we will have to fund the cash needs. The problem that caused the need to fund the cash needs is not that there is an actuarial problem with Social Security, at least not for a quarter century. And I suspect with the President's recommendation that you raise the payroll tax cap, that even goes away and it becomes fully solvent indefinitely. What has happened is that management went into the reserves and took them out and spent them on something else. And if this were a private company and I were still an Attorney General, I would probably be prosecuting that management. But this is Congress, and it is all done in the light of day, and everybody was in on it, and it is part of the way in which we have done business.

Is that a fair description of our Social Security problem?

Mr. ELMENDORF. So let me just say, back to the parts that I think I understand and that I think I agree with. Social Security has sufficient resources, meaning the bonds held by the trust fund, that together with the expected inflow of payroll taxes it can meet benefits under current law for decades to come.

As you are saying and as Senator Sessions said, and Senator Conrad as well, the rest of the Government in a sense used the cash, left the trust fund with bonds, which are valuable assets. If you were running a private insurance company and had U.S. Treasury securities in its vault, you would view that as a pretty safe investment for that insurance company. The problem is that the rest of the Government used that cash. If, in fact, the Government had run surpluses equal to the saving of the trust fund over all of those years, then the Government as a whole would be in better financial shape due to the surpluses. It would be in much better shape to meet those commitments in the future. But, in fact, the Government has not run surpluses commensurate with the increasing balances in the trust fund, and thus, the Government has not improved its financial condition using that money. It has mostly used that money for other purposes. As Senator Sessions notes, the health legislation enacted last March essentially does with the extra money building up in the HI trust fund.

Senator WHITEHOUSE. But it is not an actuarial flaw in the Social Security program that causes the need to fund the reserves. It is the fact that the reserves were removed and spent on other things and now need to be replaced.

Mr. ELMENDORF. I think that is fair, Senator, but I would just say again CBO tends to look at the budget in a unified budget sense.

Senator WHITEHOUSE. No, I understand.

Mr. ELMENDORF. In some ways, the underlying problem here is to have a trust fund which is building up assets——

Senator WHITEHOUSE. That has no funds and nobody——

Mr. ELMENDORF [continuing]. Inside a budget that is essentially a cash-flow budget. And that is true for the Social Security trust funds, and it is true for the Hospital Insurance trust fund in Medicare as well. And once one has a trust fund building up assets inside a budget that is essentially viewed on an annual cash-flow basis, there is intrinsically in that a disconnect——

Senator WHITEHOUSE. It is similar to the——

Mr. ELMENDORF [continuing]. And the risk of the double counting that Senator Sessions refers to, just to emphasize, not that we cannot keep the numbers straight, but that one has to be careful in thinking and talking about——

Senator WHITEHOUSE. My time is running out. I am sorry to interrupt. But is it not similar to the difference between a liquidity shortfall and an insolvency problem? You still need——

Mr. ELMENDORF. The Federal Government as a whole, there is a problem that the total revenues that are expected to come in are not up to the total spending expected to go out. And it is really at the level of the overall Government that I prefer to focus, and I think that budgeteers have focused for a number of decades.

Senator WHITEHOUSE. Let me go on to one other point. I do not have a lot of time remaining, but it has been recently said that our debt is the product of acts by many Presidents and many Congresses over many years. I do want to single out one President, and that was President Clinton. As I recall, under President Clinton the Nation saw its first budget surpluses in decades. And if my recollection is correct, in January of 2001, immediately after President Clinton left office and when the Bush administration assumed office, it was the finding of the nonpartisan Congressional Budget Office, your operation, that the Clinton era trends, if they had been continued forward, would have led to a debt-free United States of America by the end of the last decade. Is that correct? Do I recall correctly?

Mr. ELMENDORF. I believe that is correct, Senator.

Senator WHITEHOUSE. So I think it is fair in terms of that to at least exempt President Clinton from responsibility for our deficit. He left us on track to being an actual debt-free Nation.

Mr. ELMENDORF. So as you know, Senator, I do not take sides on Presidents or Members of Congress. It is worth emphasizing that a number of things happened in 2001 that the CBO baseline projections in January of that year did not anticipate. One was very important changes in tax policy, which our baseline is not designed to anticipate. The other was——

Senator WHITEHOUSE. But those were not——

Mr. ELMENDORF [continuing]. A recession——

Senator WHITEHOUSE. But those were not the fault of President Clinton. He was out of office by then, correct?

Mr. ELMENDORF. Again, I am not—I do not talk in President terms. I am talking about——

Senator WHITEHOUSE. They took place after the President had left office.

Mr. ELMENDORF. That is correct, Senator.

Senator WHITEHOUSE. It is a matter of calendar.

Mr. ELMENDORF. The other thing that happened was that the economy fell into a recession, suffered a very large decline in the value of stock prices, and then——

Senator WHITEHOUSE. Again, after President Clinton left office.

Mr. ELMENDORF [continuing]. Revenues fell very—well, in fact, at the time there was some dispute about exactly when the recession had started. The——

Senator WHITEHOUSE. But as of January 2001, you were predicting a debt-free Nation. Your organization was predicting a debt-free Nation.

Mr. ELMENDORF. Yes, but the point I am trying to make is that there were economic developments and changes in the amount of tax revenue collected for a given economy that were also adverse to the budget outcomes. And I do not remember offhand—I think CBO has looked at this, but I do not remember offhand how much of the deterioration in the budget that occurred after that was due to legislation and how much was due to revisions to the economic and technical projections based on——

Senator WHITEHOUSE. I understand, and I am not trying to fault your predictive capabilities, and I am not trying to fault the January 2001 report. I am just trying to point out that at least one President really did the best that he could. And that is not something you need to react to, because I know you do not speak in those terms, but for the sake of my colleagues.

Thank you. My time has expired.

Chairman CONRAD. Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman. I would like to just comment on your earlier comments in terms of I believe this country hungers for leadership, and I certainly would be one willing to step up to the plate, also, and take the lead on this budget, trying to restore some fiscal sanity to this nation.

Chairman CONRAD. Well, I thank the Senator for that.

Senator JOHNSON. Thank you.

Dr. Elmendorf, just a couple of quick questions. Getting back to dynamic versus static scoring, does the CBO ever go back and study what estimates it had done from the standpoint of revenue and figure out what the actual results were and just compare what your estimates were?

Mr. ELMENDORF. We certainly do go back and look at our performance as best as we can evaluate it. We do not do the revenue estimates. We do the revenue baseline projections in this report, but the estimates of the effects of particular pieces of revenue legislation are done by the staff of the Joint Committee on Taxation, so we do not go back and reevaluate those.

We do look at our economic forecasts and report once a year, I think, on how accurate they have been. Every outlook or update reports on the revisions from the previous outlook, so one can see where—you can see as well as we can see where we have gone wrong.

We also look back when we can at how different pieces of legislation have unfolded relative to our estimates on the spending side. That can be harder to do than one might expect, because many forces are impinging on the outcomes, and the fact that the outcome looks different than we thought it would at the point the legislation was passed might be that we had the wrong estimate of the legislation, or it might be we had the wrong estimate of everything else that was going on.

Senator JOHNSON. Sure.

Mr. ELMENDORF. So it is harder to tell, but we do try.

Senator JOHNSON. I guess I am really trying to zero in on revenues, in particular, and I am thinking in reaction to if taxes are going to increase, do we really get this tax revenue that we were expecting, to do those types of studies. So if you know of anybody who has done that, I would be interested in seeing that in my office.

In terms of scoring the health care bill, did you estimate how many businesses would probably drop coverage, and as a result, how many individuals would be put into the exchanges and then what the cost of that effect would be?

Mr. ELMENDORF. Yes, Senator. So our estimate of the effects of the legislation on the number of people with employer-sponsored insurance, which was a small net decline, represented the net of a larger gross decline with some offset of additional insurance coverage by some employers. And that estimate accounted for the new subsidies being created through the insurance exchanges and the expansion of Medicaid. It also accounted for the existing subsidy provided through the tax exclusion for employer-sponsored health insurance. It accounted for the penalties that were imposed on individuals and businesses and the small business tax credit and so on.

And we thought that the overall effect of that set of provisions would be that some number of people would not receive insurance through their employers who otherwise would have. Some others would get insurance through their employers who would not have otherwise. And the net of those was fewer people getting health insurance coverage from their employer than would have been the case under prior law.

Senator JOHNSON. Do you have some estimated numbers? Is it a million people——

Mr. ELMENDORF. We do, actually. So we estimated that in 2019, that three million fewer people would have employer-sponsored health insurance, and that reflects the net of eight to nine million who would have had an offer of employer coverage under prior law and would not under the legislation that was enacted, six to seven million who would not have been covered under prior law but would have had the coverage under the legislation, and another one to two million people who would have an offer of employer-based coverage but would get covered in exchanges instead either by having an exemption to some of the rules or by sneaking around the rules.

Senator JOHNSON. Can you give my office the details of that?

Mr. ELMENDORF. Yes, of course.

Senator JOHNSON. OK. I would like to talk a little bit about—you were talking about the automatic stabilizers of a balanced budget amendment. Would an amendment that would just limit spending to 20 percent of GDP, or 18 or 19 percent of GDP, would that kind of circumvent that problem? Would that allow us to have those automatic stabilizers still be effective?

Mr. ELMENDORF. Well, it would allow the stabilizers on the revenue side of the budget to still be effective, but it might impinge on the stabilizers on the spending side of the budget. The fact that even apart from an extension or expansion of unemployment insurance benefits, if more people lose their jobs, more people can collect benefits. Under a given set of rules for what used to be called Food Stamps and is now called the Supplemental Nutrition Assistance Program, more people get benefits. So you would still be impinging on that.

I also, again, do not know what changes in policy you and your colleagues would choose to make to bring outlays down from the share of GDP they are now to the sort of levels that you are talking about. And as we discussed a few minutes ago with a number of members of the committee, the discretionary spending, and particularly the non-defense part of discretionary spending, is only one piece of the budget and not as large a piece as I think many people believe. As you understand, most of the spending the government does goes to Social Security or Medicare or Medicaid, that the defense spending—everything apart from those large health programs and Social Security and defense and the net interest payments on the debt, everything else is about a fifth of government spending at the end of the decade, by our projections. So the sort of reduction that you are talking about would, as you understand, require changes across a large swath of government spending programs.

Senator JOHNSON. I guess the point I am getting at, if you had a preference to choose between a constitutional amendment to balance the budget versus one to just limit spending to a certain percentage of GDP, do you have a preference?

Mr. ELMENDORF. I have not thought about that question, Senator, and even if I did, we are not—I do not come here to discuss my preferences but the analysis that CBO has done, and we can look more carefully into that question.

Senator JOHNSON. OK. Just one final question. It might actually be kind of a long answer, but maybe not. Can you, in layman's terms, describe to a family what a debt crisis would look like. What is going to be the effect on individuals?

Mr. ELMENDORF. So if—I will try. If the people we are relying upon to lend the Federal Government money became skeptical that the government would manage its budget in a way that they would get repaid and thus would start to demand higher interest rates to compensate them for that extra risk, that could push up interest rates throughout the economy that would make it harder for households to borrow money. It could make it harder for the businesses for which they work to borrow money to invest and expand.

It could—and on the Federal side, if the government were unable to borrow the money that it was needing to borrow given the paths of spending and revenue, it could require drastic changes, sudden large changes in the taxes people are paying to the government and in the benefits they are receiving from the government of the sort that we are seeing in some European nations that have hit a fiscal crisis. And the magnitude and suddenness of the changes and what the government would have to do under those circumstances, combined with the effects on the rest of the economy of that rise in interest rates, would clearly be damaging to people.

Senator JOHNSON. Thank you.

Chairman CONRAD. I thank the Senator.

Senator Begich is recognized.

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

A couple quick things. First, Mr. Chairman, I think the idea of a summit is fine, but I really believe that the role of the Budget Committee should—as a former mayor, what we used to do, we would present our budget to the Budget Committee. We would have to spend the time to explain. Departments would come in and go through it. I know there are jurisdictional issues, but it is a Budget Committee, and in my view, I think that is a role, and rather than wait to find out what the role is, we should seize it and do it and I think this is a great year to do it. I am a strong believer in that.

I am happy to sit here and go through departments and try to figure out what the heck they are up to and give our version, hopefully in a collective way, of how to move this budget forward, or future budgets, because the process of a CR is damaging and is irresponsible. Those that continue to move that forward on 1-month increments, and I think you would agree, I am hopefully not speaking for you here, but CRs are bad. They are not healthy for any type of government to do. So I think it is in our role and ability to do it, so I would——

Chairman CONRAD. If I could just intercede for one moment, because I think this point——

Senator BEGICH. Do not take too much of my time——

Chairman CONRAD. No, I will not take any of your time.

Senator BEGICH. OK.

Chairman CONRAD. I will not take any of your time.

Senator BEGICH. I did that so the staff would take note.

Chairman CONRAD. It is the Chairman's time. Here are things people on this committee need to appreciate, especially new members. No. 1, we typically only do a 5-year budget. Almost all of the budgets that have been done by Congress have been 5 years. And the problem is, the plan that the country needs goes well beyond 5 years.

The second big problem we have is we do not determine the specific policies that are adopted by the committees of jurisdiction. We give them numerical targets. We tell the appropriators how much they can spend. We do not tell them how to spend it. We do not have that authority. We tell the Finance Committee how much money to raise. We do not tell them how to raise it. And one of the difficulties of the Budget Committee being the lead on taking on this task is a lot of the compromises that need to occur go to the details, and unfortunately, we do not control the details.

So we tell the Finance Committee how much money to raise. We cannot impose on them our views of the policy that ought to be attached to that. That is, we cannot tell them, OK, broaden the base to raise this money and simultaneously lower the rates. We might make that assumption, and in anything we pass, we can state what our assumptions are. But this committee does not have the authority to determine those specifics.

So it really puts the Budget Committee in a very difficult position to reach agreement on a multi-year plan that has many dimensions to it because the specifics become critical. You know, what do those revenue numbers really represent in terms of policy?

Again, that will not come out of the Senator's time.

Senator SESSIONS. But it also is a little bit easier, too. So we do not have to tell exactly what to cut. Maybe we do have an opportunity to provide a little leadership.

Chairman CONRAD. Well stated. Senator Begich.

Senator BEGICH. Mr. Chairman, I agree with both of you on that. You know, if we have those discussions, we may have assumptions that we can lay down, but then we at least can know what those numbers will be, so I would encourage that.

The second thing, I think, and before I ask you a question, I want to echo what Senator Wyden said on a broader sweep, and that is if I was to pick two items, if we were limited to two items that this committee would focus on, one would be the larger budget and the second would be tax reform. The discussion of tax reform in the broader sense, not these temporary fixes which I think you said earlier, and I know this as a small business person, there is no certainty with these 2-year fixes. Businesses are not going to invest hundreds of millions of dollars, let alone billions of dollars, when they have no clue what the tax policies of this country are. They are going to go to countries that are more stabilized in this element and invest there. And so the certainty of what our tax policies are, I think, are going to be very critical long-term, and these 2-year fixes, again, I do not think are responsible. We need to look at the longer term. So I would echo what Senator Wyden said in regards to tax reform.

A couple quick questions, and it may be information you can just provide to my office. One is we hear on a regular basis, and I do not know if it would be out of your office or maybe it is out of Joint Tax, I am not sure which one would be the right one, but I want to get a good, clear picture. I think I know this answer, but the picture on who really owns our debt, because every time you hear it, you hear all these foreign countries, which they do own a portion of it. But the biggest holders are retirement funds, Social Security, trust funds, is that a fair statement?

Mr. ELMENDORF. Yes, and we actually released a report in December on Federal debt and interest costs——

Senator BEGICH. And who owns it?

Mr. ELMENDORF [continuing]. And it is owned largely by people in this country, but also importantly by people overseas.

Senator BEGICH. Right.

Mr. ELMENDORF. So it is a combination of both domestic and foreign——

Senator BEGICH. Do you know the percentage ratio, just roughly? Is it about 70–30? Sixty-forty?

Mr. ELMENDORF. It is about half-and-half.

Senator BEGICH. Fifty-fifty?

Mr. ELMENDORF. Yes.

Senator BEGICH. If you could provide that—we may have it, but just if you can provide that segment, that would be great——

Mr. ELMENDORF. Yes. Of course, we will do that.

Senator BEGICH [continuing]. Because every time you hear it, it is the foreign countries own ours, and actually, the big chunk of our retirement funds—I can tell you, as a former mayor, we invested in U.S. securities all the time because it is the safest and the right place to put the money.

The second, and I know Senator Johnson asked this question, is it also fair to say to families' impact, it would be on a local level, that it would impact direct services and potential services that local governments could provide because their ability to borrow would diminish if there is a debt crisis. Is that a fair-I just want to make sure that is on the record, too.

Mr. ELMENDORF. Yes, I think that is right, Senator. I mean, it is very difficult to predict what will happen if there is a sudden shift of sentiment against buying U.S. Treasury debt. We have not seen that in this country. We have not seen it in the world's most important financial market. We do not know——

Senator BEGICH. But it is a multi-layer effect. It is not just the Federal Government——

Mr. ELMENDORF [continuing]. But the effects, I expect, would ripple through the financial system in this country and would make it harder for borrowing for local and State governments as well as families and businesses.

Senator BEGICH. Very good. Let me ask you, and it was an interesting question that Senator Johnson asked—and I have actually, when we have had some meetings, this is a question I always have—in these reports, which are great reports, what I would love to get, and if it is possible, and some of the baseline information, maybe the GDP, maybe unemployment, whatever those items are that you kind of utilize as some of your base data in projecting, what I want to see is when I see a chart like this, I actually—not that I want to question necessarily your track record. It helps me get a sense.

If I look at 2010, it is a flash point. What I want to see is projections that were projected and what happened actually, and the reason that helps, at least me, have a better discussion of—an analysis of it. So, for example, the questions you had from Senator Whitehouse, here are some of the things that changed. Why is that important for me? Then I know policy that we impact has some impact of what you projected originally. Is that available? If we said to you, here are four or five areas that you project on into the future, can you go back 5 years and tell us, when you sat here, or whoever sat here, projected, and then what those deviations and what happened, is that something that——

Mr. ELMENDORF. Yes. I think we can do that, Senator. We are willing to talk with you about exactly which——

Senator BEGICH. Sure——

Mr. ELMENDORF [continuing]. Of the thousands of variables you are most interested in, but we certainly keep the records and look at them ourselves about how these projections have turned out.

Senator BEGICH. Great.

Mr. ELMENDORF. So we can put together, I think——

Senator BEGICH. We will have our staff work with your staff.

Mr. ELMENDORF. Yes.

Senator BEGICH. And the goal there is, I believe if you get information like that, you can kind of look back and then we know if we are the cause which has an effect, or is it something else, and that helps, I think, form policy or future discussions we might have here.

The last thing, just as I sit on the Armed Services Committee and we are going through, and we are going to go through a process here from Secretary Gates and all the reductions that will be occurring or are projected, do you participate in that at any level in the sense of this. As we know, 95 percent, approximately, of every Defense Department dollar has a U.S. impact, because they are very focused. Have you done any cross-analysis of, OK, if that cut occurs as projected, this is the kind of job impact it would be, because they are one of the highest in every department we have that puts money into this economy. Have you done anything like that?

Mr. ELMENDORF. Umm——

Senator BEGICH. Or are you equipped? Two parts. Have you done it? Are you equipped to do it if you have not?

Mr. ELMENDORF. I think we have not done it. I think we could do it.

Senator BEGICH. OK.

Mr. ELMENDORF. So we have looked at the economic effects of a variety of policies being considered by you and your colleagues, including about a year ago we did an analysis of a whole collection of policies that were being discussed as possible ways of increasing output and employment, boosting the pace of the recovery, and we looked at a number of changes on the tax side, a number of possible changes on the spending side.

Senator BEGICH. OK.

Mr. ELMENDORF. We did not look at defense spending separately. We looked at infrastructure spending and we looked at changes in grants to State and local governments.

Senator BEGICH. My time has expired, so maybe we will work with you on it, because Defense Department spending, as you know, is a huge part of our budget and the cuts that he is recommending are fairly significant, probably the most significant of any department that will be reviewed. But because they have such a high percentage of job impact of any department in U.S. jobs, we will talk to you about, maybe through the Armed Services Committee or—I just think it is an analysis that should be done.

Mr. ELMENDORF. Yes, Senator. We will be happy to talk with you.

Senator BEGICH. Thank you very much.

Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

Senator Portman.

Senator PORTMAN. Thank you, Mr. Chairman.

It is good to be here to hear from you, Dr. Elmendorf. I appreciated working with the Congressional Budget Office when I was on the House Budget Committee, and, of course, at OMB. We did not get a chance to work together since you came after that, but I appreciate your testimony today.

We find ourselves here at a very difficult time, do we not, a day after you have told us that we are facing the biggest deficit in the history of our country, in fact, in the history of the world this year. By the way, these projections are notoriously wrong.

Mr. ELMENDORF. Yes.

Senator PORTMAN. Unfortunately, this one looks like it is more accurate than some. I think Senator Whitehouse, perhaps inadvertently, just explained to us how wrong CBO projections can be sometimes, as they were in 2000, but the fact remains, we face a fiscal crisis. I am delighted to be on this committee. I just found out last night I was going to be joining Senator Conrad, Senator Sessions, and others, and I was really encouraged as much as I was discouraged by your projections, encouraged by what I heard today from my colleagues, including you, Mr. Chairman, and you, Mr. Sessions.

I think what you said earlier, Chairman Conrad, is very significant in terms of looking perhaps beyond the 5-year, maybe a 10-year budget and also trying in a bipartisan way to do what all of us, I think, acknowledge needs to be done, which is to find common ground and solve this crisis before we have the kind of economic repercussions you talked about earlier.

I had a couple of questions that I wanted to focus on and that really kind of just go to me understanding more how you feel about this crisis in your gut. If you were to say what is the single largest fiscal crisis or fiscal problem, fiscal issue facing our country today, what would you say it is, if you had to identify one thing?

Mr. ELMENDORF. Well, Senator, again, I appreciate your confidence in my gut, but I rely on the analysis that we do at CBO. The risk of fiscal crisis, in our view, comes from the imbalance between spending and revenues. That imbalance comes in the projections because spending rises to a share of GDP that we have not seen before in this country——

Senator PORTMAN. OK, but what is——

Mr. ELMENDORF [continuing]. And revenues rise above their historical average, but not as far as spending, in these baseline projections.

Senator PORTMAN. But what is it in the spending and in the revenue side that troubles you most? What is the single thing?

Mr. ELMENDORF. Again, it is not a matter of troubling. It has to be your choice and your colleagues' choice what parts of the budget you want to address. As an arithmetic matter, of course, the part of the spending that is growing very rapidly and growing much faster than GDP is spending on the government's large health care programs, both because of the aging of the population, and much of that money goes to older Americans, and because of rising health spending.

Senator PORTMAN. All right. I am encouraged by your answer, because I think it is health care, and I think it is not just health care as it relates to Medicare and Medicaid, which obviously drives the growth of those programs, and your projections here of 7 percent growth is, in the Chairman's words, unsustainable. But it also, of course, affects the private sector job growth, which leads to lower revenues than we would otherwise have. So I am going to take your answer to be health care, which I think is the right answer.

What do you think the most significant risk is in your baseline projections?

Mr. ELMENDORF. I have a long list of worries, Senator. You know, I think in terms of the budget projection, as you said, these projections are notoriously wrong because it is a very difficult business. But the crucial underlying factor here, as we were just discussing, is the rising number of older Americans relative to working Americans and the rising cost of health care relative to other things in the economy. And those fundamental forces have been foreseen for decades and, I think, are inexorable under current policies. So although the specifics will undoubtedly not turn out this way, I think there is a reason that for many, many reports now, CBO and many outside analysts, of course, have been looking at a deteriorating fiscal picture. But I do not view that as——

Senator PORTMAN [continuing]. Your projection, do you feel the biggest risk is in the area of government expenditures on health care?

Mr. ELMENDORF. So I think that is one very large uncertainty.

Senator PORTMAN. How about interest rates? We talked about it earlier, but one of the concerns I have in looking at your analysis is, and correct me if I am wrong, but I think the risk premium that the private sector is looking at, and this is why the Blue Chip estimate, I think, is above yours, I do not see embodied in your analysis. Do you feel you take into account the risk premium of these higher debts?

Mr. ELMENDORF. Well, in fact, our projection of long-term interest rates over this coming decade is actually above the interest rates that you can deduce from the current prices of Treasury securities in the financial markets. Our projection here reflects a combination of what we see in financial markets and our own modeling. Our own modeling actually points to interest rates being a little higher than the financial markets have built in, particularly in the latter half of the decade for the longer-term securities. So we have constructed a projection that puts some weight on our modeling and some weight on the financial markets.

But I think the point, as we have made a number of times, is that the swings in sentiment that drive fiscal crises are not usually telegraphed very well ahead of time. They often occur very suddenly.

Senator PORTMAN. Well, I would love some more information on the interest rate calculation because I think that is going to be, obviously, a big part of the uncertainty going forward, and I think it relates directly to the point that has been made many times here today, that we need to focus, all of us, our constituents, the American people, on this issue, and part of it is what is going to happen with rates, because that will affect everybody's everyday life as well as our business climate.

Obviously, three issues here. The discretionary side, we have talked about today. The entitlement side, which we have not talked about enough today. I wish I had more time. The third one is growing the economy, and we have talked some about that and I applaud Senator Wyden, who has now left, for his comments on tax reform.

I would just ask you one simple question with regard to the corporate rate. There is some recent research, and you have probably seen it—I think it is Hassett and Brill—that says there is a maximization point in the corporate rate of about 26 percent, and I guess that is somewhat obvious. That is lower than or about at the average of the OECD or the developed country rates. Have you all looked at that, and do you think we are leaving revenue on the table now? In other words, by having a relatively high corporate rate, are we getting less revenue than we would otherwise get? And do you think we have a misalignment here because of the competitive nature of the global economy? What is your view on what the right corporate rate ought to be?

Mr. ELMENDORF. Senator, I am sorry. I am aware of that paper, but we have not studied that analysis carefully, so I can't directly answer your question. If you are interested in our—I am interested, of course, myself. But more importantly, if you are interested, we can take a closer look at that report.

Senator PORTMAN. Since we are both interested, let us get some views from CBO on that, because I think it is a very interesting analysis, and although, as you said earlier, whether tax relief pays for itself or not depends on the tax relief, that this is one area where we might be able to find a consensus.

Thank you, Mr. Chairman.

Mr. ELMENDORF. We will be in touch, Senator. Thank you.

Chairman CONRAD. Senator Nelson.

Senator NELSON. A big part of the discretionary outlays that grew during 2010 was the stimulus bill, and a big portion of the stimulus bill was the money going to the States, the State fiscal stabilization. What do you expect would have happened if a lot of that money, for example, such as Medicaid money going to the States for 2 years, if that had not gone to the States, what do you think would have happened?

Mr. ELMENDORF. We think that States would have had to make larger changes to boost revenues or decrease other sorts of spending, and that would have had a negative effect on their economies, and that is why in our analysis of the Recovery Act we think those provisions and others provided an important boost to output and employment relative to what would have occurred in the absence of that legislation.

Senator NELSON. In my State, Florida received about $4.5 billion just for Medicaid over that particular period of time, another $2.2 billion for education. So it was huge. But we are coming to the end of the 2-year period and we are not going to be able to continue that. So what do you think is going to happen?

Mr. ELMENDORF. Well, the waning of the effects of the Recovery Act on the economy is one of the reasons that the economy is not growing more rapidly over the next few years in our projection.

Senator NELSON. So we see less of a robust recovery as a result of all this Federal money not going to the States for things that are hard to see because they are not roads and bridges that are being built. It is Medicaid and education assistance from the Federal Government to the States, and as a result of that going away, it is going to lessen the acceleration of the economic recovery.

Mr. ELMENDORF. I think that is right, Senator. That is analogous to what happens with the automatic stabilizers, the parts that you did not directly change but that occur automatically in downturns. Picture the economy running into a hole. The hole is shallower, but on the way out, then the recovery is also a little more shallow than it would otherwise be. And, of course, the tradeoff that you and your colleagues confront is that the large accumulation of debt to pay for the Recovery Act and for the automatic stabilizers and other things in the past few years has pushed debt to GDP up in a way that creates damage and risks itself.

Senator NELSON. OK. So that is one consequence, that by us not being able to send more money to the States, it is going to slow the economic recovery.

All right. Now, let us look on the other side. We passed the health care bill, and if you would state this for the record, as you have already publicly many times, the health care bill as it is passed right now and as it is law is roughly going to save the Federal Government in the next 10 years about a quarter of a trillion dollars, and your projections for the second 10-year period, that the Federal Government spending will be saved about a trillion dollars. Is that correct?

Mr. ELMENDORF. So, Senator, you are right that over the next decade, pending our actual full cost estimate of repeal which is underway, we think that over the next decade, the repeal of the health legislation would increase budget deficits by something on the order of $230 billion.

Over the longer horizon, we think that repeal of the legislation, assuming that it would be implemented as enacted without any future changes, the repeal would widen future budget deficits. That is an estimate that we have not offered in dollar terms because we think that it is difficult to get a good sense of dollars figures over such a long horizon in an economy with rising prices and that is growing. We have said instead that repeal of the legislation would reduce—rather, would increase Federal deficits in that second decade, in a broad range around one- half percent of gross domestic product. If you want to convert that yourself to dollars, as some members of the Committee have, you can do so. But for our purposes, we think it is more constructive for us to report the number in that sense.

Senator NELSON. OK. But the average American does not understand that percentage of the GDP, and so in our calculations, has it not been, Mr. Chairman, widely accepted that we are somewhere in the range of $1 trillion?

Chairman CONRAD. Yes, $1.3 trillion. One-half of 1 percent of GDP over the second 10-year period. The projected GDP during that period is forecast to be about $260 billion, so one-half of 1 percent would translate to $1.3 trillion.

Senator NELSON. OK. Well, then I think it is pretty clear, as we are going forward, we are going to have a slowed economic recovery because we helped out the States for 2 years with a massive infusion of money into the States that people do not ordinarily see, such as Medicaid spending as well as education. We enact a health care bill that does from a fiscal standpoint help the economy by saving the U.S. Government from spending close to a quarter of a trillion dollars in the next 10 years. So let me conclude by asking you now if you would help—let us put a fine point on this, on Social Security. We went through a long discussion of that with one of the other Senators earlier. But what is it that is happening in or about the year 2037 with Social Security that we need to underscore?

Mr. ELMENDORF. Well, in some year out there—and we have not updated those estimates since our last long-term budget outlook last summer—the Social Security trust fund will have redeemed all of the bonds that it holds and will have incoming payroll tax receipts that are not sufficient to pay the benefits that we project under current law. At that point the full benefits could not be paid without some action by the Congress to increase the money going into the trust fund or reduce the benefits being paid out.

Senator NELSON. OK, that is 26 years down the road. What is going to happen 10 years down the road with Social Security?

Mr. ELMENDORF. Well, as the baby-boom generation retired, of course, there will be increasing numbers of beneficiaries. We think at the end of the decade there will be about a third again as many Social Security beneficiaries as there are today. That will increase the benefit payments. But there will be enough money coming in and money in the trust fund—actually there is a picture at the back of the outlook that shows the path of the Social Security trust funds, but the OASI fund and the Disability Insurance fund. For those who want to check, it is on page 123. And in our estimate, the trust funds together will be running a surplus at the end of the decade, including the interest payments they receive from the Treasury on the bonds in the trust funds.

I should mention perhaps the disability—as you know, the Social Security trust funds—there are actually two of them. They are legally separate. The Disability Insurance trust fund we think will actually be exhausted in 2017 and would need some further action to pay benefits after that point.

Senator NELSON. At the end of this 10-year period——

Chairman CONRAD. Can I just say to the Senator, he has gone beyond his time.

Senator NELSON. I have. As you have been very generous and liberal with other Members of Congress, may I conclude with this one question?

Chairman CONRAD. Go ahead.

Senator NELSON. At the end of this 10-year decade, what is the effect of the trust fund of Social Security on the operating budget deficit of the U.S. Government?

Mr. ELMENDORF. I am not sure what you mean by "operating," I am afraid, Senator.

Senator NELSON. The budget deficit that we are working on.

Mr. ELMENDORF. Well, so the Social Security—there will be a surplus, as I said, in the Social Security trust funds reflecting the direct flows from payroll taxes and benefits, but also interest payments in the rest of the Government. Excluding those interest payments, Social Security will be in deficit, which is to say that the benefit payments will exceed the collections through payroll tax receipts and some other sources of revenue.

So apart from the interest payments from the rest of the Government to the Social Security trust funds, Social Security will be in a deficit situation. The dedicated revenues will fall short of the benefit payments that are promised.

Chairman CONRAD. I thank the Senator.

We are now past the hour of 12:30, and we had promised to get the Director out by that time, so that would mean Senator Thune would have no time to ask questions. But because he is from South Dakota and I am from North Dakota, that seems fair, at least to this Senator. But I am sure it does not sound fair to the Senator from South Dakota.

The Senator from South Dakota is recognized.

Senator THUNE. Thank you, Mr. Chairman, and to you and Senator Sessions, I welcome the opportunity to serve on this Committee. There will be some big issues debated here, and I look forward to engaging in that debate.

I want to thank you, Dr. Elmendorf, for your service and willingness to take on another stint here in what is under the best of circumstances a very difficult job, but under these circumstances an even more difficult and painful job.

You have kind of, I think, touched on this a little bit in response to some questions already, but Chairman Greenspan recently said the odds of a debt crisis in the next few years is nearly 50/50. And I know you would probably have trouble quantifying that, but what do you view those odds are?

Mr. ELMENDORF. As you said, Senator, I would have trouble quantifying that. I think it is very difficult to make an assessment of that sort, all respect, of course, to Chairman Greenspan. A crisis depends not just on the existing level of debt; it depends on, I think, the projections of debt. In the cases of some countries, it is dependent on how much debt they have had to roll over in a very short period. It depends importantly on the willingness of foreign investors to hold the assets of this country. And it depends I think most crucially on investors' perception of the sorts of policies that Congress and the President are inclined to enact.

So it is a very difficult business, and I think we have seen in other countries that have had very high debt-to-GDP ratios that things generally turn out badly unless they correct course. But exactly what the tipping point might be is just beyond our analytic capacity.

Senator THUNE. But the odds worsen the longer we wait, correct?

Mr. ELMENDORF. Yes, I think the higher the debt gets relative to the size of the economy, in particular the higher it gets and still looks to be pointed upward in projections like the ones that we show you, the greater the risk of a fiscal crisis.

Senator THUNE. You talked, I think, in response to some questions about the impact of—I think you were asked about energy costs. And if you talk about $100 a barrel for oil, which is what we are approximating now, that is one thing. If it were to go up to $150 a barrel, have you done some sensitivity analysis about how that impacts inflation and how much of the inflationary assumptions that you make are based upon the cost of energy?

Mr. ELMENDORF. So the energy is certainly important for our projections of overall consumer prices. It is not as important for core consumer prices, prices excluding food and energy. It matters a little bit because some amount of an increase in oil prices or the price of energy more generally will end up being passed through to the cost of other goods and services in a way that might get built into the underlying inflation process of the economy. But the evidence is that that passthrough is actually pretty small, so that means on a year-to-year basis, of course, changes in the price of energy affect household budgets, but that those movements tend not to become ingrained in the inflation process over the past few decades, based on what we have observed.

A similar point I should say about food prices. It is very, very important to households, but they do not seem to get built into the underlying inflation process. They rise and they fall in a way that seems more or less separate. So we do our best to try to project changes in those prices, but I think it is not as large a risk for inflation over the longer run as one might worry.

Senator THUNE. And it strikes me that what probably the biggest factor impacting interest rates—many factors, but inflation being one. If inflation starts to pick up, then I think the markets are just going to start demanding a premium for that, and that impacts our borrowing costs and everything else.

How confident are you in your inflation assumptions? Based upon what you are seeing globally right now, a lot of European countries and Asian countries are experiencing upticks. We have seen a little bit in December, probably not as much as other places in the world. But if we have to where we started having an issue with inflation, I suspect that the correlation between inflation and interest rates is really going to drive borrowing costs. What is your level of confidence in your assumptions with regard to inflation?

Mr. ELMENDORF. You are certainly right, Senator, that if inflation goes up, interest rates we expect would go up, too, and that would create further damage to the Federal budget. We do not think inflation will get high. It is currently below the rate that the Federal Reserve seems to view as consistent with their mandate for price stability. It has fallen a good deal in the past few years. It has fallen in a way that is broadly consistent with a lot of evidence that when tremendous numbers of people are unemployed and a tremendous amount of plant and equipment is not being used, that firms restrain price increases and inflation comes down.

Now, as the economy recovers, we think that inflation will move back up, but we see no reason why it will move above the range that the Federal Reserve is aiming for. The Fed balance sheet, as everybody understands, is very large, and they will need to withdrawn that liquidity to prevent inflation from going up. But we see no obstacle to their doing that, and certainly the statements of Chairman Bernanke and others show that they are very focused on the need to do that when the time arises.

So, of course, all these projections are uncertain, but we do not view a large increase in inflation beyond the level we have seen over the past decade or two as a significant risk in the forecast. It is a possibility, but it is not one of the risks that I am more worried about.

Senator THUNE. You said a 1-percent increase in interest rates would generate about $1.25 trillion in additional deficits over the decade. What does a 1-percent increase in interest rates add to the borrowing costs that we have today? Which the number I have seen, at least in the 2012 estimate, is interest will be at or exceed the amount that we spend on national security. So if we are assuming that number or thereabouts and you saw a 1-percent increase in interest rates, what does that do to the annual finance charges, borrowing costs for the Federal Government?

Mr. ELMENDORF. Well, an increase that occurred right now would not raise interest costs that much in the near term because much of the debt is outstanding, and we have a fixed rate. So when one looks at the pattern, we show for a rise in interest rates, it rises over time. It gets, for example, in 2015 to be about $100 billion in that year of higher interest payments.

Senator THUNE. At 1 percent——

Mr. ELMENDORF. The 1 percentage point increase.

Senator THUNE. Annually?

Mr. ELMENDORF. Annually. And by the end of the decade, 1 percentage point higher interest rates is worth about $200 billion a year. And it is growing so much because the debt is growing very rapidly.

Senator THUNE. Right.

Mr. ELMENDORF. In addition to the redemption of maturing securities and the issuance of new ones.

Senator THUNE. All right. Mr. Chairman, my time has expired.

Chairman CONRAD. I thank the Senator.

Senator THUNE. In deference to the Director, thank you.

Chairman CONRAD. I would like to just for a moment followup on this point that Senator Thune is raising, and I talked about it in my questioning period, too, because I think it is very, very important for people to understand. In a forecast you are trying to give us the best assessment on critical variables. You are trying to give us an assessment on economic growth, on interest rates, on rates of inflation, how all that comes together to affect Federal expenditures and Federal revenues, to give us an assessment of what is happening to the deficit and debt.

Many economists have told us they do not believe the economic world is perfectly predictable with respect to especially at the breaks. That is, when something turns, it can turn rapidly, and no forecast tends to capture that accurately.

How would you assess the risk of the basic underlying assumptions in the forecast that you provided to us yesterday on economic growth, inflation, and interest rates? Of those three, which are you most concerned about in terms of your underlying forecast not coming true or being at some significant variance?

Mr. ELMENDORF. Well, Mr. Chairman, I worry about all of them. Interest rates are the ones that can move around most dramatically in short periods of time. The inflation rate can spike. Economic growth, of course, can slow very sharply in recessions. But the variable that is most volatile on an average day or a month is interest rates, and all three are very important, of course, to the Federal budget. And that is why we look—in our appendix that illustrates the effects of changes in economic projections, those are three of the four experiments that we examined, precisely those three variables that you mentioned.

So I would hate to convey a sense that I am not worried about any of them, but I think the interest rates are the ones that are intrinsically most volatile and also, I think, given the Government's fiscal position and the fiscal trajectory, are the ones that are the greatest risk.

Chairman CONRAD. All right. I thank you for that. I think it is just important that we have that on the record for the benefit of the Committee.

Senator Sessions.

Senator SESSIONS. Isn't it a fact the Fed is artificially keeping the interest rates low through their quantitative easing and there is a limit at some point on how much that can be utilized?

Mr. ELMENDORF. The Fed is keeping interest rates low. I would not describe the current situation as any more artificial than what they normally do. They move interest rates up and down, as you know, to affect inflation and the path of the economy. And it is certainly right that they have pushed interest rates down. Both the Federal funds rate that they directly control, but also interest rates at longer maturities, they have pushed down through a variety of measures, including the latest quantitative easing. And we do not expect that to continue.

Senator SESSIONS. There is a limit to how much that can be—I just hate to press this health care cost. Someone could interpret your testimony as saying that the health care bill, if eliminated, would raise the deficit, and under one method of accounting, perhaps that is so. But under these circumstances, I have to say in my view it is not accurate, because we know that Medicare will be going into deficit, and they will call their bonds. It is not as if we do not know outside this 10-year window what is going to happen.

So when the United States Treasury spends money on a new program and that money is borrowed from Medicare, and Medicare we know is heading into default, it really increases the debt of the United States. It absolutely increases the internal debt, and I think any fair reading would suggest it increases the overall debt exposure of the United States.

Mr. ELMENDORF. So, Senator, you are correct that it increases the internal debt. I certainly agree that Medicare will redeem those bonds at some time in the future. And as we have discussed, that obligation can only be met by revenues that are available in the future.

When I refer to deficit effects, I refer, as my many predecessors as CBO Director have, to effects on the unified budget deficit. But you are correct, there are other ways of toting up what is happening in the Government's accounts. I will try to be more specific about that when I mean unified budget deficit.

Let me go back one more time to the internal debt, the gross debt, and I have agreed with you about the effects on gross debt. The way that CBO—again, this is not idiosyncratic to my leadership of CBO. The way that we look at budgets is to focus on the unified budget, the debt held outside of the Government, the debt held by the public. And then we show you projections of spending for Medicare and Social Security and Medicaid and so on going forward. And we think that the best way to assess the sort of current financial state of the Government in terms of the immediate obligations is debt held by the public or perhaps debt net of financial assets, as we show in our report; and that the best way to look at what the Government is going to encounter financially in the future is to look at our projections of spending and revenues and the effect that those paths have on future debt held by the public relative to GDP.

So we are consistent in our treatment of that. The future Medicare obligations are not lost in the approach that we take. They appear in the projections of spending and revenues that I have shown and that lead to that path of debt that most of this hearing has been about. But I understand, Senator, that there are different ways of looking at the pieces of the budget that may be useful to you and others for some purposes.

Senator SESSIONS. And is it your policy decision to use a unified score? Is that statutory or congressionally mandated that you produce first a unified budget score?

Mr. ELMENDORF. The focus on the unified budget began in the late 1960s. There was a Commission on Budget Concepts, and part of what that Commission did was to realize that at the time there were lots of different pieces of the Government where the money was being kept track of, observed, followed separately. And the judgment of that Commission, and I think of most budget experts in the subsequent 40-some years, has been that it is most effective to look at the budget of the Government as a whole in assessing the demands on credit markets and, thus, the crowding out of private borrowing and in assessing the Government's fiscal trajectory. It does not mean that all those people have been right, but I think that has been the standard in place for a number of decades.

Senator SESSIONS. It clearly has been the standard, and you have always made clear how you account for it, so I am not criticizing you.

Chairman CONRAD. Can I just followup on what Senator Sessions is raising? Because, you know, we have a budget responsibility in this Committee, and we understand that economists look at this, and they prefer looking at it on a unified basis. I think the problem that it leads to is when you look at this from a budget perspective, that alters your view, because the hard reality is all this debt has to be serviced, and it has to be serviced out of current income. And the frustration that some of us have had is that the press tends to focus on the unified concept. We understand that is because that is what affects the overall borrowing by the Government. On a unified basis—when you look at everything coming in, everything going out, that is a unified basis.

The problem that we run into in a budget context is those bonds that Social Security holds that are real assets, the redemption of those bonds can only occur out of current income. And what has been happening from a budget perspective is the general fund has been borrowing from Social Security, and we have borrowed well over $2 trillion. That money has to be paid back. How is it going to be paid back? It is going to be paid back by the other general expenditures of the Federal Government having to be reduced to make way for the payments that we are going to have to make on those bonds. And so it has a very specific and, we are going to see, dramatic impact on budgets because we have been enjoying in effect a subsidy from the Social Security trust fund of several hundred billion dollars a year. And that is about to change—in fact, has changed.

I want to correct one thing I said earlier, because I was working off the old forecast that Social Security is going to go permanently cash negative in 5 years. My staff informs me, under the new report, Social Security has gone permanently cash negative now. Is that the case?

Mr. ELMENDORF. Yes, that is right. As you are viewing cash, not counting interest payments from the rest of the Government.

Chairman CONRAD. Yes.

Mr. ELMENDORF. Yes.

Chairman CONRAD. So the budget problem that presents us with, instead of having several hundred billion dollars a year coming in from Social Security that we could send somewhere else, those days are over. Those days are over.

Mr. ELMENDORF. Yes, that is right, Senator. I would just emphasize one more aspect of this. The bonds that are held in the Social Security trust fund and those held in the Hospital Insurance trust fund are much less than the total future obligations. That is what we mean by saying the trust funds will exhaust their resources at some point. So the projections that we do of the spending for Social Security and Medicare under current law capture all of the benefits that would be paid under current law.

So in that sense, the gross debt that you are talking about is only capturing a subset of the future obligations. If you look at our projections of total spending and total budget deficits over a decade and beyond, they capture all of the benefits that we pay under current law, not just those for which there are bonds tucked away.

Chairman CONRAD. Yes.

Mr. ELMENDORF. It is also true there are some things in gross debt that may not reflect future obligations. It is not just the Social Security trust fund, although that is a big part of it. There is right now almost $2 trillion held by other Government—bonds held by other Government accounts. Not all of that does represent future obligations. So that is why we have focused, again, for many years on the overall budget situation, but we do report projections of gross debt. We report the Social Security surplus and the surplus in—which is almost all the off-budget surplus, and the surplus or deficit in the rest of the Government for you to use as you think about the budget.

Chairman CONRAD. Well, look, again, we recognize the professional job that CBO does, and we respect—there has to be an independent scorekeeper, and you are it. We also know that these things——

Senator SESSIONS. You are all we have.

Chairman CONRAD. Yes. We know that these are based on assumptions, and you have to make assumptions about growth, about inflation, about interest rates. And we all know they are going to be wrong. We all know they are going to be wrong because we look back in history and see that they have been wrong in the past, and they are very likely to be wrong going forward. But they are the best, most professional estimates that can be had at the time, and that really has to be what governs our decisions.

Let me just conclude by saying I think we are going to need at some point to maybe focus a little more directly on the entitlements and on their budgetary effects longer term. We do not have that scheduled at this point, but I do think—and I will talk to Senator Sessions about this. There is so much misunderstanding, I find, in the general public and in the news media with respect to the liabilities of the United States that I think we may need a hearing just on that. We have a lot of new members who may not understand quite how these funds flow and what their budgetary impacts are as well as their economic impacts.

With that, thank you very much, Dr. Elmendorf.

Mr. ELMENDORF. Thank you.

Chairman CONRAD. We stand adjourned.

[Whereupon, at 12:57 p.m., the Committee was adjourned.]

Questions for the Record
Submitted by the Honorable John Cornyn
Senate Committee on the Budget
January 27, 2011, Committee Hearing:
The Budget and Economic Outlook: Fiscal Years 2011 to 2021

Question 1. From a unified budget perspective, since PPACA created new federal spending obligations outside of Medicare, does PPACA's extending the life of the Trust Fund by 12 years actually indicate that the federal government is in a better fiscal position to pay future Medicare benefits for another 12 years?

Medicare's Hospital Insurance (HI) trust fund, like other federal trust funds, is essentially an accounting mechanism. In a given year, the sum of specified HI receipts and the interest that is credited on the previous trust fund balance, minus spending for Medicare Part A benefits, represents the surplus (or deficit, if the latter is greater) of the trust fund for that year. Any cash generated when there is an excess of receipts over spending is turned over to the Treasury, which provides government bonds to the trust fund in exchange and uses the cash to finance the government's ongoing activities. The HI trust fund is part of the federal government, so transactions between the trust fund and the Treasury are intragovernmental and have no net impact on the unified budget or on federal borrowing from the public.

Thus, any increase in revenues or decrease in outlays of the HI trust fund represents cash that can be used to finance other government activities without requiring new government borrowing from the public. Similarly, any increase in outlays or decrease in revenues in the HI trust fund in some future year represents a draw on the government's cash in that year. Thus, the resources to redeem government bonds in the HI trust fund and thereby pay for Medicare benefits in some future year will have to be generated from taxes, other government income, or government borrowing in that year. The HI trust fund and other trust funds have important legal meaning but little economic or budgetary meaning.

The reductions in Part A outlays and increases in HI revenues resulting from the Patient Protection and Affordable Care Act (PPACA) will significantly raise balances in the HI trust fund and might suggest that significant additional resources have been set aside to pay for future Medicare benefits. However, only the additional savings by the government as a whole truly increase the government's ability to pay for future Medicare benefits or other programs, and those will be much smaller. Unified budget accounting shows that the majority of the HI trust fund savings under the legislation will be used to pay for other spending and therefore will not enhance the ability of the government to pay for future Medicare benefits.

Question 2. Before health reform was enacted, CBO's January baseline report noted that outlays for [for health care entitlement programs] would "increase at an average annual rate of about 7 percent a year between 2011 and 2020". In this year's January baseline report, after enactment of the new health care law, CBO told a similar story when it projected outlays for these programs would still "increase at an average annual rate of about 7 percent a year between 2012 and 2021." Doesn't this indicate that PPACA failed to bend the cost curve of the federal budgetary commitment to health care?

The Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act (Public Laws 111-148 and 111-152) contained provisions that increased spending for federal health programs and other provisions that reduced spending in those programs. In its March 20, 2010, estimate of the budgetary impact of PPACA and the Reconciliation Act, CBO estimated that the effect of that legislation on the "federal budgetary commitment to health care" (a term CBO uses to describe the sum of net federal outlays for health programs and tax preferences for health care) would be to *increase* that commitment by about $390 billion over the 2010-2019 period. In subsequent years (after 2019), CBO expects that the effects of the provisions in PPACA and the Reconciliation Act that would tend to *decrease* the federal budgetary commitment to health care would grow faster than the provisions that would tend to increase it, leading to an expected reduction in the overall budgetary commitment to health care for the 10-year period following 2019.

Question 3. Could you comment on the exact dollar effect of the new health care law on the "federal budgetary commitment to health care"?

CBO estimates that, as a result of the new health care law, the federal budgetary commitment to health care between 2012 and 2021 will be $464 billion greater than it would have been under prior law. (That estimate reflects the baseline projections CBO issued in January 2011.)

Question 4. What, if any assumption is made in the CBO baseline regarding the amount of discretionary spending that will be spent to carry out the provisions of PPACA, including the Reconciliation Act of 2010?

CBO's baseline projections of discretionary spending for 2012 through 2021do not incorporate any explicit estimate of, or assumption about, how much will be spent to carry out the provisions of PPACA. CBO constructs its baseline in accordance with the provisions set forth in the (now expired) Balanced Budget and Deficit Control Act of 1985 and the Congressional Budget and Impoundment Act of 1974. Following those specifications, CBO's baseline projections for discretionary spending reflect the assumption that the most recent year's budget authority, including any supplemental appropriations, is provided in each future year, with adjustments for projected inflation.

Under the rules that govern its baseline, CBO assumes full-year funding for 2011 based on amounts provided under the continuing resolution in effect when the baseline is prepared. Those amounts hold most funding at 2010 levels.

In general, CBO assumes that the Administration will carry out its statutory responsibilities with the funds made available through appropriations; however, CBO has not estimated the amount of discretionary spending that will be spent from such funding to carry out PPACA and the Reconciliation Act.

In its 2010 cost estimates for PPACA and the Reconciliation Act, CBO noted that it would probably cost between $5 billion and $10 billion over the 2010-2019 period for the Department of Health and Human Services to implement the legislation, and that it would probably cost the Internal Revenue Service similar amounts for its implementation (and enforcement) activities under the new law. To date, since both agencies have been operating under continuing resolutions that provide funding at 2010 appropriation levels, there are no specific discretionary appropriations identified in law or in CBO's baseline for such implementation purposes.

Question 5. Do you agree with OACT that the CLASS program's system of premium collection and paying benefits could become fiscally unsustainable?

The legislation that created the Community Living Assistance Services and Support (CLASS) program provides the Secretary of Health and Human Services (HHS) with the authority to set premiums for both current and future enrollees as well as future benefits, but requires that they be set so that the program is in actuarial balance over 75 years. (Actuarial balance means that expected insurance premiums, plus the interest earned on such premium income, equal or exceeds the expected cash payments for future benefits and the administrative costs of operating the program.) Under that assumption, CBO estimated that establishing the CLASS program would reduce federal budget deficits by about $70 billion over the 2010-2019 period.[1] The cash flows under the new program were estimated to generate budgetary savings for both the 2010-2019 period and for the 10 years following 2019, followed by net budgetary costs in subsequent decades.

In its analysis of the budgetary effects of the CLASS program, CBO sought to produce estimates that were in the middle of the distribution of possible outcomes. Those estimates, as well as the future financial status of the CLASS program, are subject to considerable uncertainty, however, because they both depend importantly on the number

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[1] See Congressional Budget Office, letter to the Honorable Nancy Pelosi about the budgetary effects of H.R. 4872, the Reconciliation Act of 2010 (March 20, 2010).

of people who enroll in the program and the health status of those enrollees later in life.[2] Certain features of the CLASS program will help attract a relatively healthy group of enrollees and other features will make attracting such enrollees more challenging. The Secretary of HHS has a great deal of flexibility in administering the program; the challenge will be to attract a balance of people in terms of health risk to the program. If premiums can be kept sufficiently low, the CLASS program will be able to attract enough relatively healthy enrollees to ensure its viability. The challenge will occur if the CLASS program attracts an excessive number of enrollees who are in poor health—people who may not be able to obtain coverage from a private insurer. In that case, premiums may have to be high in order to maintain actuarial balance, but those high premiums could depress enrollment. High premiums and low enrollment could contribute to more adverse selection and future financial instability.

Question 6. The CBO baseline assumes that taxpayers will pay higher tax rates after 2012, to a great extent, because of the temporary nature of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). On the other hand, CBO's baseline assumes the extension of certain mandatory programs that are scheduled to expire in the future. What is the total amount assumed in the CBO baseline that will be spent on these expiring programs over the next five and ten years? What explains the difference in the treatment of between expiring tax relief and expiring mandatory programs for purposes of the CBO baseline?

The Congressional Budget Office constructs its baseline in accordance with the provisions set forth in the (now expired) Balanced Budget and Emergency Deficit Control Act of 1985 and the Congressional Budget and Impoundment Control Act of 1974. Under the Deficit Control Act, projections for most mandatory programs are made under the assumption that current laws continue unchanged. Thus, for those programs, CBO's baseline projections reflect expected changes in the economy, demographics, and other factors that affect the budgetary consequences of current laws that govern those programs.

In preparing its revenue baseline, CBO also assumes that current laws remain in effect—specifically, that scheduled changes in provisions of the tax code take effect and that no additional changes in those provisions are enacted.

The Deficit Control Act provided some exceptions to the assumption that current laws continue unchanged. For example, spending programs whose authorizations are set to expire are assumed to continue if they have outlays of more than $50 million in the current year and were established on or before the enactment of the Balanced Budget Act

[2] For a more detailed analysis of prior versions of the CLASS Act, see Congressional Budget Office, letter to the Honorable Tom Harkin about the budgetary effects of proposals to establish a Community Living Assistance Services and Support program (November 25, 2009).

of 1997. Programs established after that law was enacted are not automatically assumed to continue but are assessed program by program in consultation with the House and Senate Budget Committees. The Deficit Control Act also required CBO to assume that expired excise taxes dedicated to trust funds would be extended at their current rates. The law did not provide for the extension of other expiring tax provisions, even if they have been extended routinely in the past.

CBO's baseline projections therefore incorporate the assumption that the following programs whose authorization expires within the current projection period will continue: the Supplemental Nutrition Assistance Program (SNAP, formerly known as the Food Stamps program), Temporary Assistance for Needy Families, assistance to farmers through the Commodity Credit Corporation, the Children's Health Insurance Program, rehabilitation services, child care entitlement grants to states, trade adjustment assistance for workers, child nutrition, and family preservation and support. In addition, the Deficit Control Act directed CBO to assume that a cost-of-living adjustment for veterans' compensation would be granted each year.

In CBO's projections, the assumption that expiring programs will continue has little effect on mandatory spending totals in 2011; however, that assumption increases projected mandatory outlays by $447 billion over the 2012-2016 period, and by about $1.0 trillion between 2012 and 2021 (see attached table). Projected spending on SNAP (Food Stamps) accounts for approximately 60 percent of those outlays.

Estimates of the budgetary impact of proposed legislation reflect the differences in how spending and revenue provisions are treated in the baseline projections. Tax provisions that are assumed to expire in the baseline are also assumed to expire when legislation affecting them is being considered. And for spending programs that are assumed to continue in the baseline, even though their authorizations have expired, legislation modifying those programs or extending their authorizations is assumed to be in effect indefinitely, even if it would expire during the projection period.

Question 7. Good paying jobs and needed government revenue have been put at risk by the Administration's moratorium imposed last year and resulting permitting delays for deepwater and shallow water exploration. In December, the Administration also reversed scheduled plans for new lease sales off the Outer Continental Shelf. In your statement to the Committee, you note that "By CBO's estimates, federal revenues in 2011 will be $123 billion (6 percent) more than the total revenues recorded two years ago, in 2009.

How does CBO factor in permitting delays and cancelled lease sales for offshore oil and gas exploration?

Does the budget outlook reflect the expected loss in cumulative government revenue from lost production in the form of royalties, severance taxes, property taxes, income taxes, and lease bonuses?

If not, what assumptions were made for the new regulatory measures that have been imposed?

The proceeds from federal leases of oil and gas resources on the Outer Continental Shelf (OCS) are recorded as offsetting receipts (a credit against direct spending). Payments from lessees generally take three forms: A bonus payment when a company acquires a lease, an annual rental payment on the leased acreage prior to production, and annual royalties based on the value of any production. The federal government does not levy severance taxes or property taxes on OCS leases.

In most years, royalties from oil and gas production dominate total federal receipts from OCS leasing. In each of past two years, receipts from OCS leases totaled about $5 billion, of which roughly $4 billion was derived from royalty payments. The bulk of such royalties were earned on leases entered into during the 1980s and 1990s. The amounts collected depend on the price and quantity of oil and gas produced on the OCS, excluding production from certain deepwater leases that are statutorily exempt from paying royalties.

CBO's projections for the 2011-2021 period reflect the agency's best estimates of the budgetary impact of policies adopted in the wake of BP's Macando oil spill in 2010. Based on the information that was available from industry and government sources when CBO prepared its projections, the agency expects that most of those effects will be temporary. Although the Department of the Interior has suspended auctions of new OCS leases, analysts expect that such sales will resume later this year or in 2012. As a result, CBO did not include any offsetting receipts from bonus bids in baseline estimates for 2011 but projected a resumption of offsetting receipts from bidding on new leases in subsequent years.

Although total OCS production is likely to decrease slightly from 2010 to 2011 as a result of the Macando spill, CBO expects that the dollar amounts collected from royalties will increase in 2011. The projected growth in royalty receipts reflects the impact of higher oil prices and the effects on 2010 receipts of litigation regarding royalty relief for deepwater leases; net receipts in 2010 were reduced by about $2 billion because the department was required to refund the royalties that had been paid on most deepwater leases issued between 1996 and 2000. Although the number of firms drilling in the Gulf of Mexico declined in 2010 because of the department's temporary suspension of new drilling permits, many experts anticipate that production levels will rebound by the middle of the decade.

Costs for Mandatory Programs That Are Assumed to Continue Beyond Their Current Expiration Dates

(Billions of dollars)

												Total	
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2016	2012-2021
Supplemental Nutrition Assistance Program													
Budget authority	0	0	80	70	69	68	67	65	64	64	63	288	610
Outlays	0	0	76	71	69	68	67	65	64	64	63	285	608
Temporary Assistance for Needy Families													
Budget authority	0	17	17	17	17	17	17	17	17	17	17	87	173
Outlays	0	13	16	17	17	17	17	17	17	17	17	81	168
Commodity Credit Corporation[a]													
Budget authority	0	0	2	10	11	11	11	12	12	13	13	34	95
Outlays	0	0	1	9	10	11	11	11	12	13	13	30	90
Children's Health Insurance Program													
Budget authority	0	0	0	0	0	6	6	6	6	6	6	6	34
Outlays	0	0	0	0	0	3	6	6	6	6	6	3	32
Veterans' Compensation COLAs													
Budget authority	0	1	1	2	3	4	5	6	8	9	10	11	49
Outlays	0	*	1	2	3	4	5	6	8	9	10	11	48
Rehabilitation Services and Disability Research													
Budget authority	0	3	3	3	3	3	3	3	4	4	4	16	34
Outlays	0	2	3	3	3	3	3	3	4	4	4	14	32
Child Care Entitlements to States													
Budget authority	0	3	3	3	3	3	3	3	3	3	3	15	29
Outlays	0	2	3	3	3	3	3	3	3	3	3	14	29
Trade Adjustment Assistance for Workers													
Budget authority	0	*	1	1	1	1	1	1	1	1	1	4	10
Outlays	0	*	1	1	1	1	1	1	1	1	1	4	9
Child Nutrition[b]													
Budget authority	0	0	0	0	0	1	1	1	1	1	1	1	5
Outlays	0	0	0	0	0	1	1	1	1	1	1	1	5

Continued

Costs for Mandatory Programs That Are Assumed to Continue Beyond Their Current Expiration Dates (Continued)

(Billions of dollars)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
Ground Transportation Programs Not Subject to Annual Obligation Limitations													
Budget authority	*	1	1	1	1	1	1	1	1	1	1	3	6
Outlays	*	*	1	1	1	1	1	1	1	1	*	3	6
Family Preservation and Support													
Budget authority	0	*	*	*	*	*	*	*	*	*	*	2	3
Outlays	0	*	*	*	*	*	*	*	*	*	*	1	3
Ground Transportation Programs Controlled by Obligation Limitations[c]													
Budget authority	30	52	52	52	52	52	52	52	52	52	52	260	519
Outlays	0	0	0	0	0	0	0	0	0	0	0	0	0
Air Transportation Programs Controlled by Obligation Limitations[c]													
Budget authority	2	4	4	4	4	4	4	4	4	4	4	19	37
Outlays	0	0	0	0	0	0	0	0	0	0	0	0	0
Natural Resources													
Budget authority	*	*	*	*	*	*	*	*	*	*	*	*	*
Outlays	*	*	*	*	*	*	*	*	*	*	*	*	*
Total													
Budget authority	**32**	**81**	**164**	**164**	**164**	**171**	**171**	**171**	**172**	**173**	**174**	**744**	**1,605**
Outlays	*	**19**	**101**	**107**	**107**	**113**	**115**	**115**	**116**	**118**	**118**	**447**	**1,029**

Source: Congressional Budget Office.

Note: COLAs = cost-of-living adjustments; * = between -$500 million and $500 million.

a. Agricultural commodity price and income supports under the Farm Security and Rural Investment Act of 2002 (FSRIA) generally expire after 2012. Although permanent price support authority under the Agricultural Adjustment Act of 1938 and the Agricultural Act of 1949 would then become effective, CBO continues to adhere to the rule in section 257(b)(2)(iii) of the Deficit Control Act (now expired) that indicates that the baseline should assume that FSRIA's provisions remain in effect.

b. Includes the Summer Food Service program and states' administrative expenses.

c. Authorizing legislation provides contract authority, which is counted as mandatory budget authority. However, because spending is subject to obligation limitations specified in annual appropriation acts, outlays are considered discretionary.

CBO responses to questions submitted for the record from the Senate Budget Committee for the hearing held on CBO's January 2011 Budget and Economic Outlook report, held January 27, 2010.

Question for Director Elemendorf from Senator Sessions:

During his confirmation process, OMB Director Lew indicated he would review how both the CBO and OMB baselines are constructed and make suggestions on how they may be changed. Has Director Lew contacted you about any proposed changes to the baseline?

Answer: Director Lew has not contacted me to discuss how baselines are constructed. However, CBO and OMB staff frequently discuss how various programs are projected in our respective baselines and we work hard to ensure that we understand any differences the two agencies have in baseline treatment as well as to try resolving some of those differences when we recognize an error in interpretation of current law or long-standing baseline construction rules as specified in the Balanced Budget and Emergency Deficit Control Act.

In addition, CBO attempts to clearly highlight the important distinctions between its baseline projections and those prepared by the Administration. For example, the two agencies differ on the treatment of Fannie Mae and Freddie Mac in baseline projections, and CBO has taken steps to document and explain that difference in its semi-annual *Budget Outlook* reports.

Finally, CBO and OMB meet at least once each year (often more than once) along with staff of both sides of both budget committees to discuss scorekeeping issues including concerns over baseline construction. The most recent such meeting of that group, known as the "Scorekeepers," took place in December 2010, and an additional follow-up meeting to discuss alternative treatment of credit programs in the baseline is planned for later this spring.

THE U.S. ECONOMIC OUTLOOK

TUESDAY, FEBRUARY 1, 2011

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The Committee met, pursuant to notice, at 10:00 a.m., in Room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Wyden, Warner, Begich, Sessions, Thune, Toomey, and Johnson.

Staff Present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, 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 today. Today we will focus on the U.S. economic outlook. This is one of a series of hearings on the economy. We are taking a close look at how the economy is performing and where it is headed. Later this week, we will examine specific challenges the economy faces, such as housing, unemployment, and the State fiscal crises that are occurring around the Nation.

Today we are fortunate to have three really outstanding witnesses, economists who all have a long history of providing valuable testimony to this Committee and others. We look forward to hearing from Dr. Richard Berner, a Managing Director and Co-head of Global Economics, Chief U.S. Economist at Morgan Stanley. Good to have you back, Dick. Dr. Simon Johnson, Senior Fellow, the Peterson Institute for International Economics and a professor of entrepreneurship at MIT's Sloan School of Management. Good to have you back, Simon. And Dr. David Malpass, president of Encima Global. Am I pronouncing that correctly?

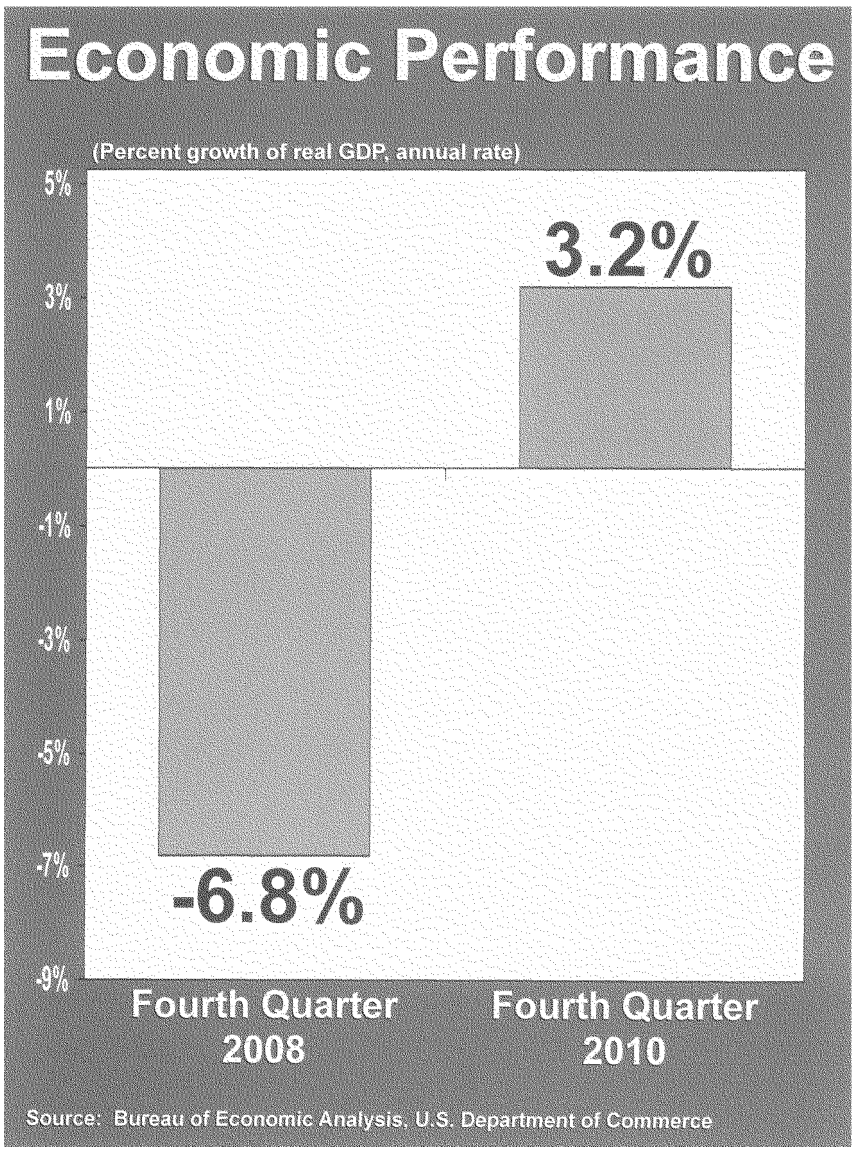
Mr. MALPASS. That is right.

Chairman CONRAD. Thank you, sir. We thank all three of you for making yourselves available to the Committee. We deeply appreciate that.

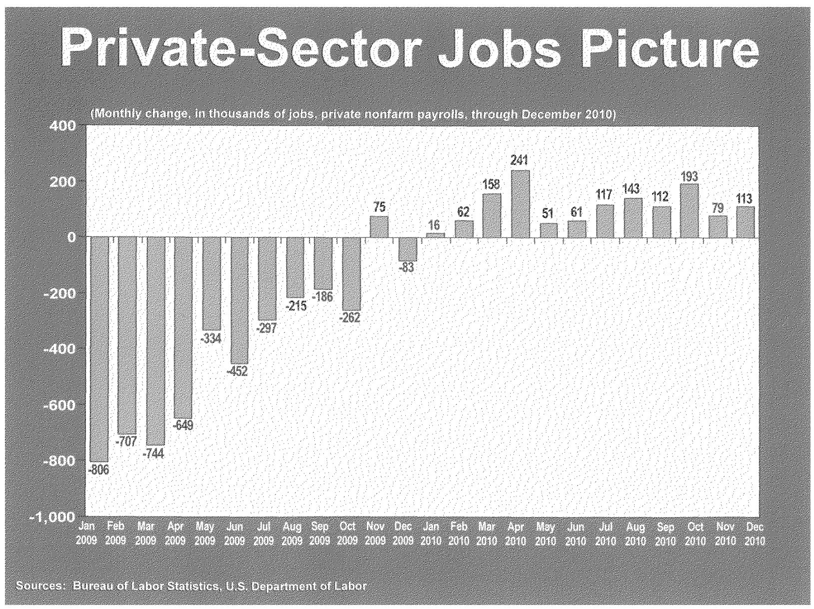
Let me begin by having a brief review of where we have been, my own analysis of what has brought us here and where we are headed. Let me just start by saying I believe TARP and stimulus were critically important to averting a global financial collapse. I was in the room when the Secretary of the Treasury in the Bush administration and the Chairman of the Federal Reserve told us that if we did not act on TARP, there could be a global financial collapse in days. Those are the words they used to us. They minced no words with us. They were as clear and compelling as they could have been.

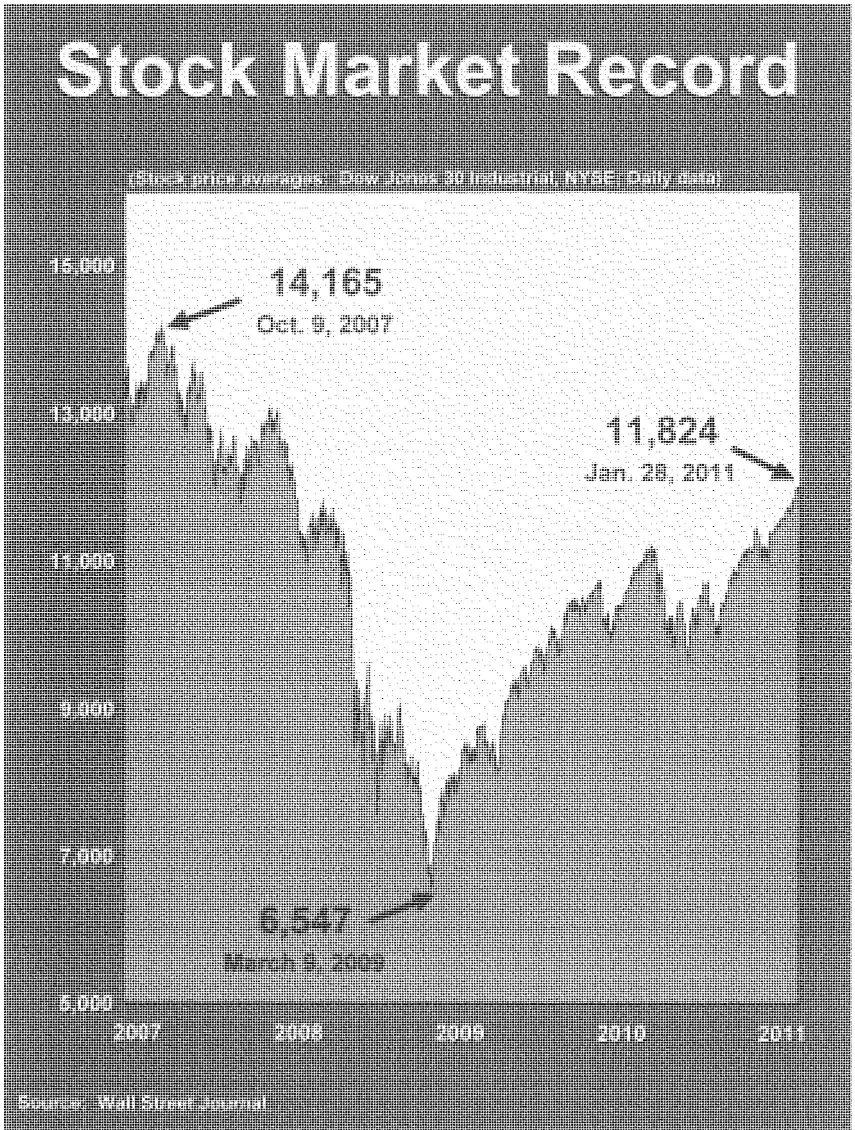
So TARP was put in place—and let me just put up the first chart that shows what I think is the very clear evidence that TARP was effective. This chart shows the TED spread, the difference between what the Government can borrow for and what the private sector can borrow for. And during the height of the crisis, the TED spread was 9 times normal. You can see it at the peak. When TARP was put in place, it came back very markedly to more normal levels and only now has really gotten back to its historic relationship.

Again, the TED spread is the difference between what the private sector can borrow for and what the public sector can borrow for, and we have seen a normalization in the TED spread. In fact, one of the tipoffs that we had that we were headed for trouble in 2008 was we saw erratic behavior in the TED spread in the year before.



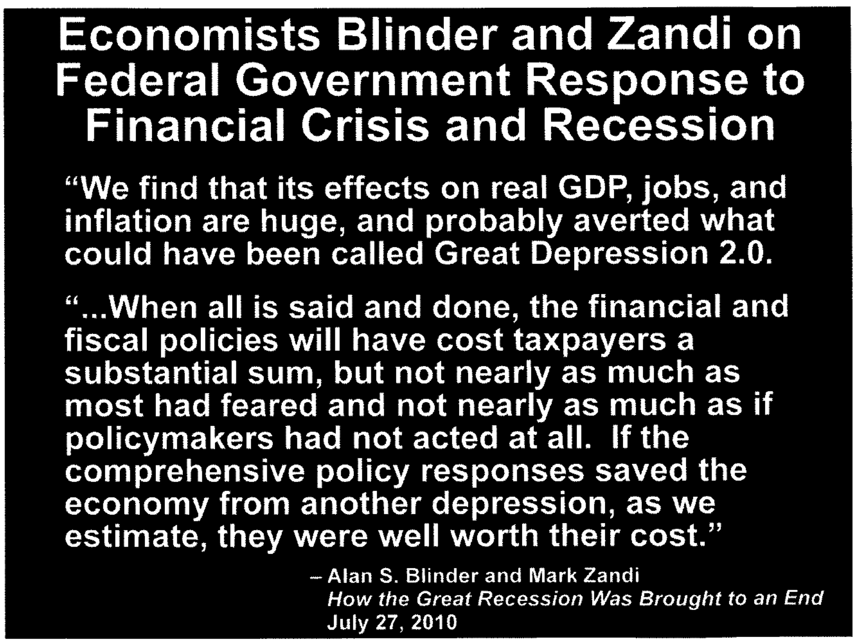
Let me go to the next chart, if we can. Economic growth, we had a negative 6.8 percent in 2008, the fourth quarter. We now see that economic growth has resumed. In the fourth quarter of 2010, we saw positive growth of 3.2 percent, and we have now had six consecutive quarters of growth. And we see the same evidence, evidentiary pattern in the private sector job growth. I think we all recall in January of 2009 the economy was losing more than 800,000 private sector jobs a month. In December 2010, the last month we have data for, the economy gained 113,000 private sector jobs. We have now had 12 consecutive months of private sector job growth.




Stock Market Record
(Stock price averages: Dow Jones 30 Industrial, NYSE; Daily data)
15,000
13,000
11,000
9,000
7,000
5,000
14,165
Oct. 9, 2007
11,824
Jan. 28, 2011
6,547
March 9, 2009
2007
2008
2009
2010
2011
Source: Wall Street Journal

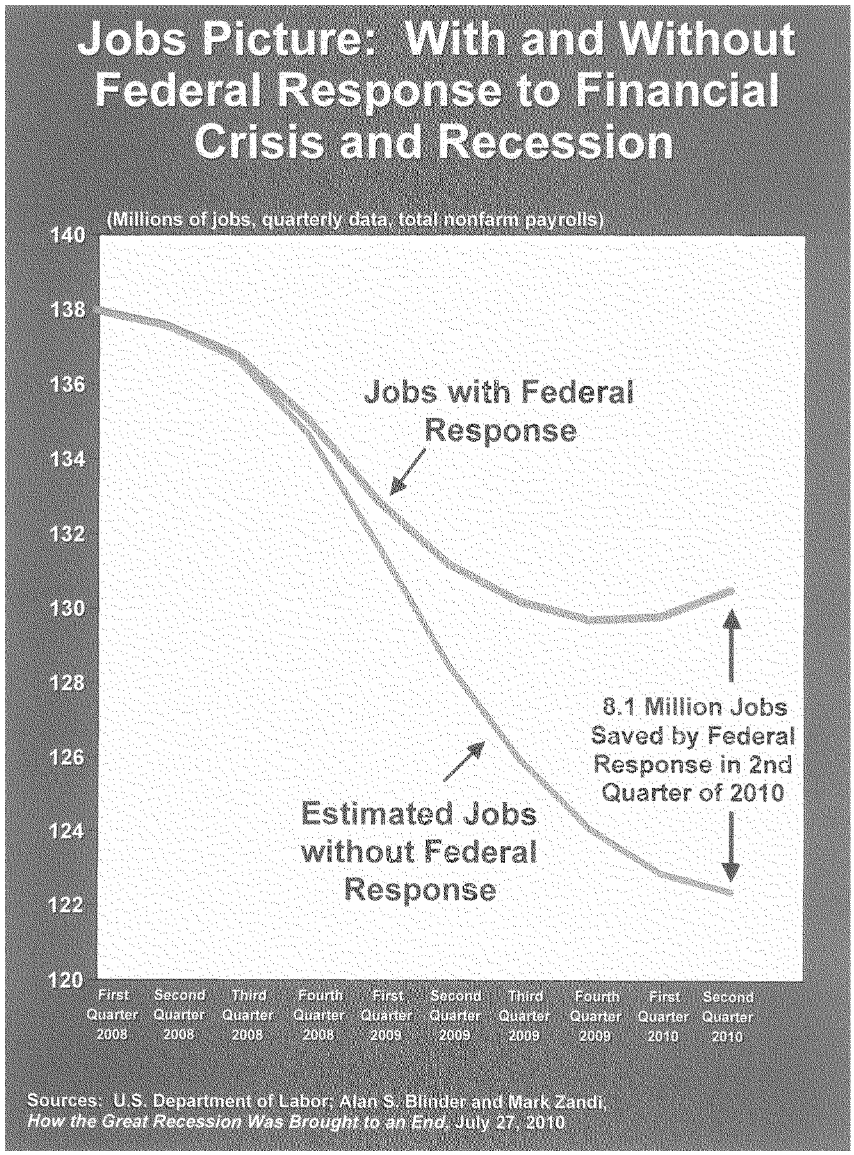
Third, we have also seen a dramatic rebound in the stock market. After falling to a low of 6,500 in March of 2009, the Dow has now risen back up well above 11,000—in fact, approaching 12,000.

Two highly respected economists—Dr. Alan Blinder, the former Vice Chairman of the Federal Reserve, and Mark Zandi, who was an adviser to the McCain campaign—completed a study last summer that measured the impact of Federal action, including TARP and stimulus, including both the Fed's monetary policy actions and the fiscal policy actions by Congress and the administration. Here is a quote from their report:

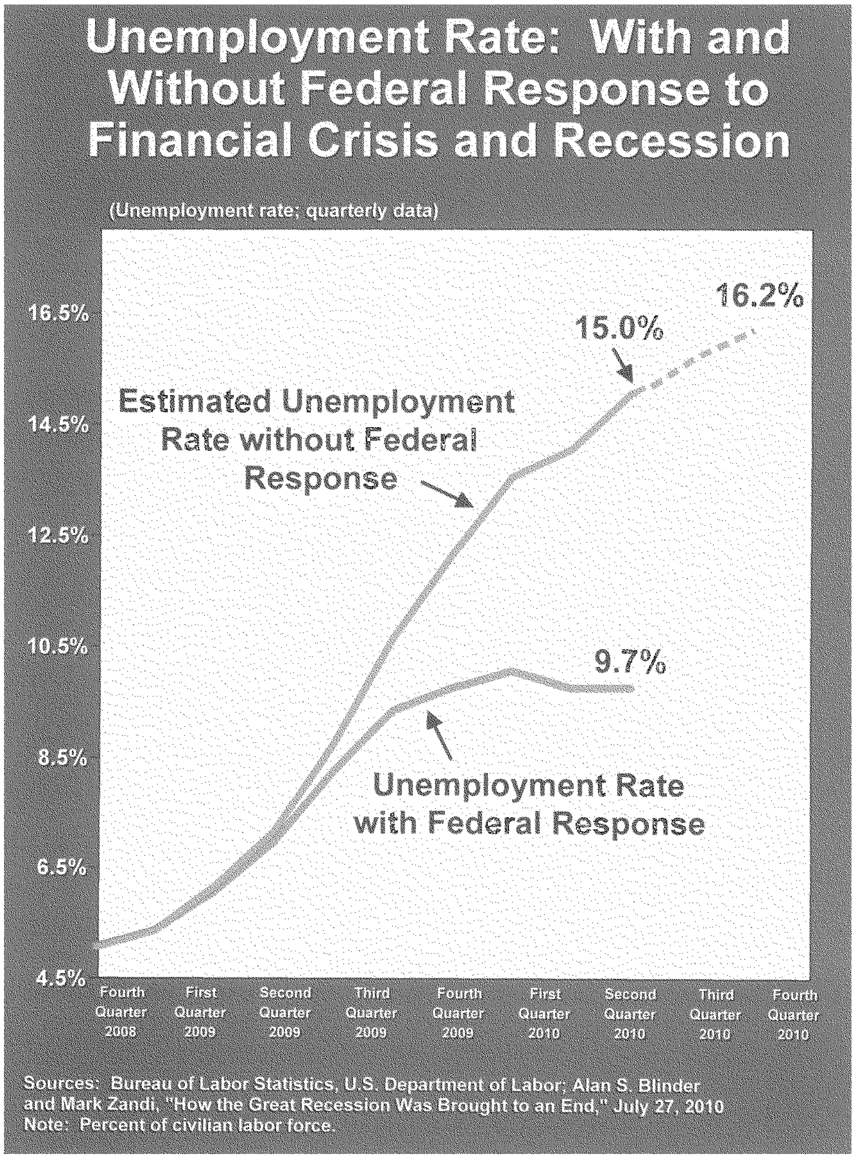


"We find that its effects on real GDP, jobs, and inflation are huge and probably averted what could have been called 'Great Depression 2.0.' When all is said and done, the financial and fiscal policies will have cost taxpayers a substantial sum, but not nearly as much as most had feared and not nearly as much as if policymakers had not acted at all. If the comprehensive policy responses saved the economy from another depression, as we estimate, they were well worth their cost."

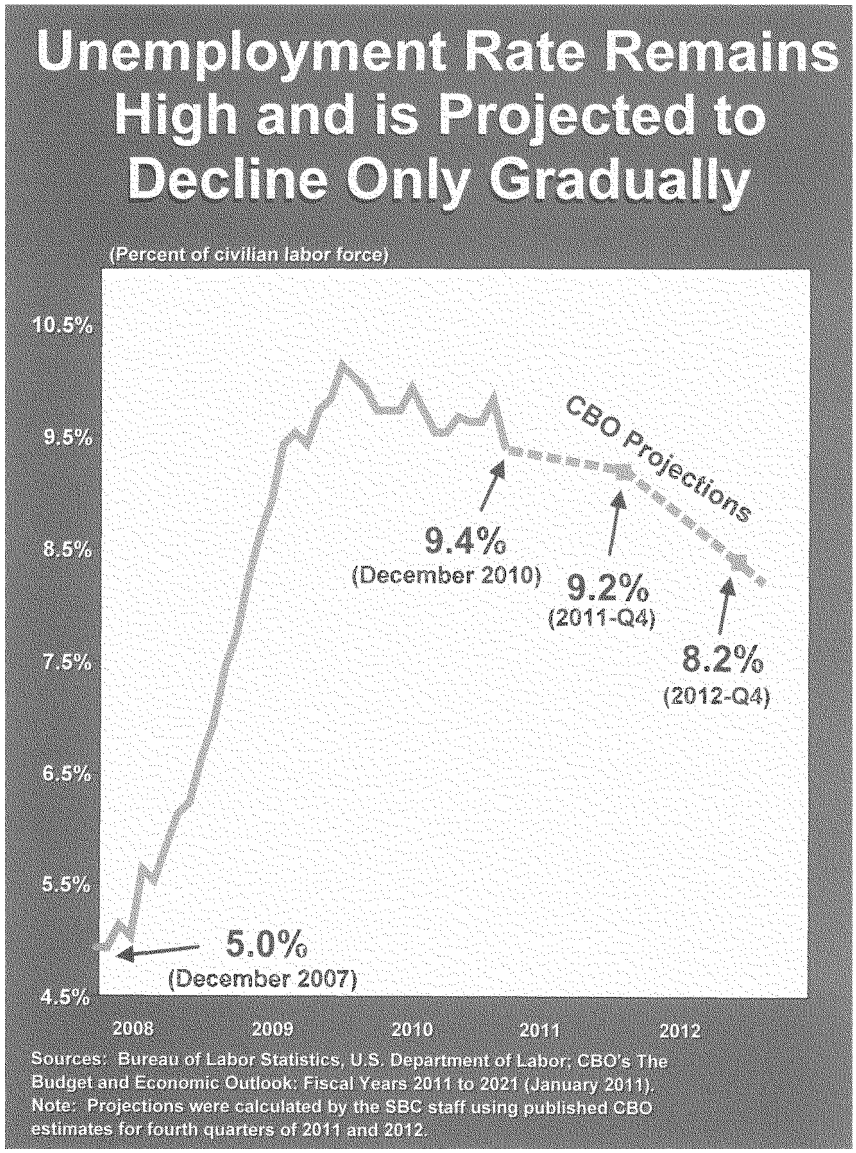
The next chart shows Dr. Blinder and Dr. Zandi's estimate of the number of jobs we would have had without the Federal response. It shows we would have 8.1 million fewer jobs in the second quarter of 2010 if we had not had the Federal response, specifically the TARP and the stimulus.



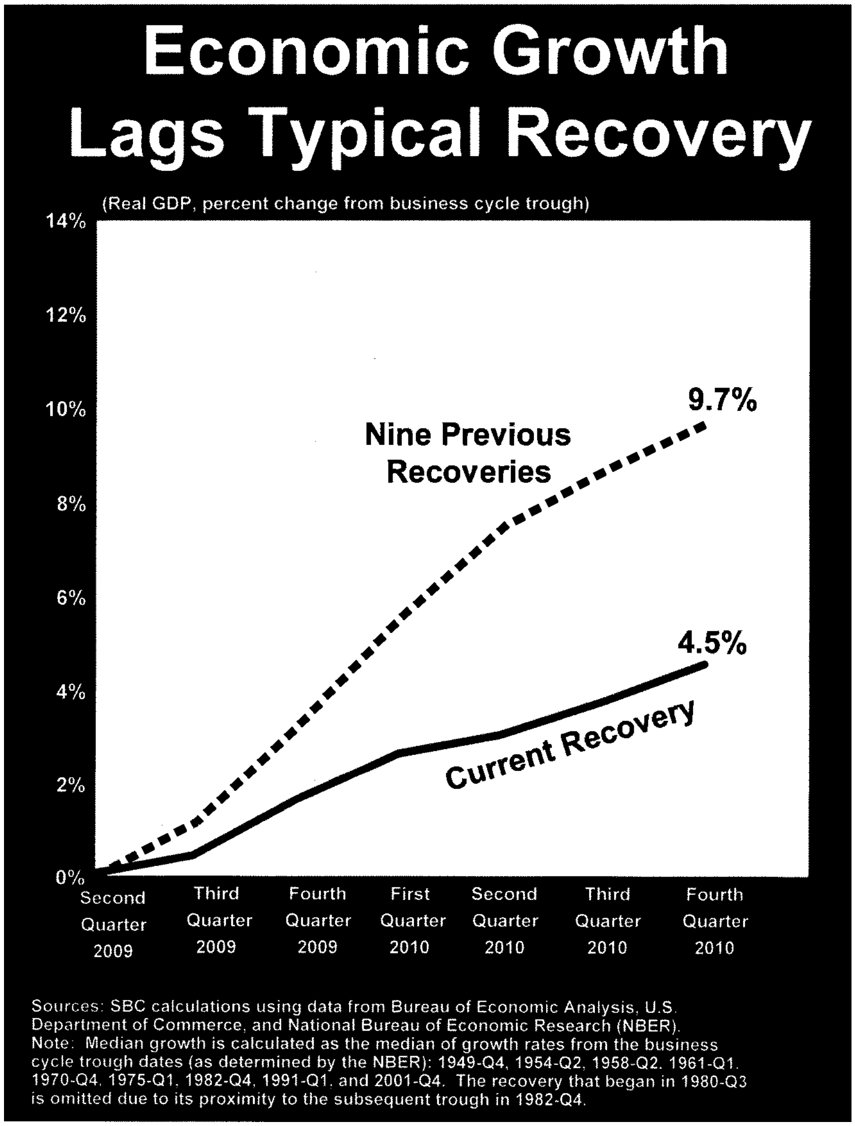
A similar story can be told by studying the unemployment rate. The unemployment rate averaged 9.7 percent in the second quarter of last year. According to Dr. Blinder and Dr. Zandi, if we had not had the Federal response, the unemployment rate would have been 15 percent in the second quarter and would have continued rising to 16 percent in the fourth quarter of 2010. There is no question that the unemployment rate has remained stubbornly high. Just a little over 3 years ago, it stood at 5 percent. It nearly doubled within a year's time and has fluctuated in the 9-percent-plus range ever since.



Last week, the nonpartisan Congressional Budget Office issued its budget and economic outlook projecting the unemployment rate will fall only slightly, to 9.2 percent by the fourth quarter of this year, and fall farther, to 8.2 percent by the fourth quarter of 2012.



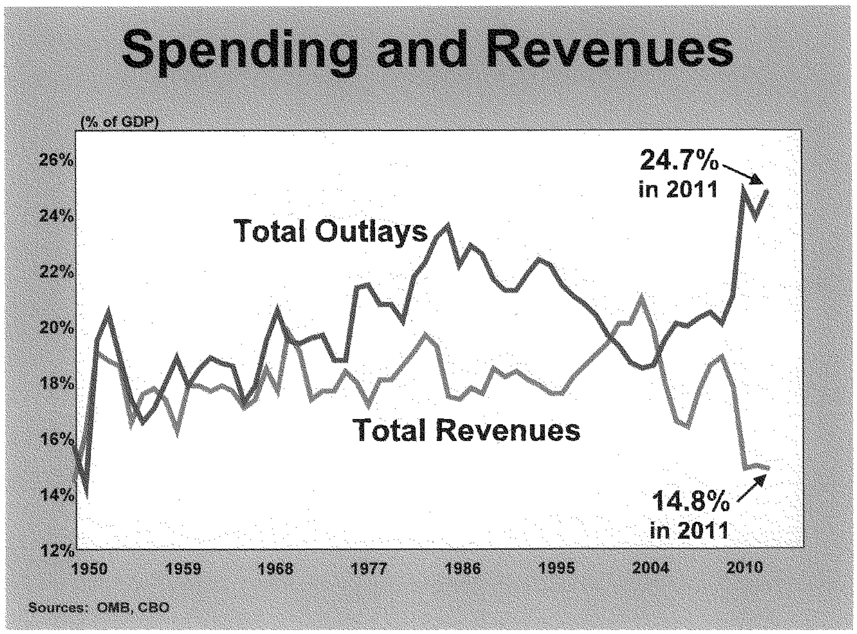
And the economy is growing at a much slower pace when compared to past recoveries. When measured against the nine previous recoveries over the past 60 years, we see the current recovery lags considerably the nine previous recoveries. Why is that? I believe it is because so much damage was done to the fiscal and financial system in this downturn.



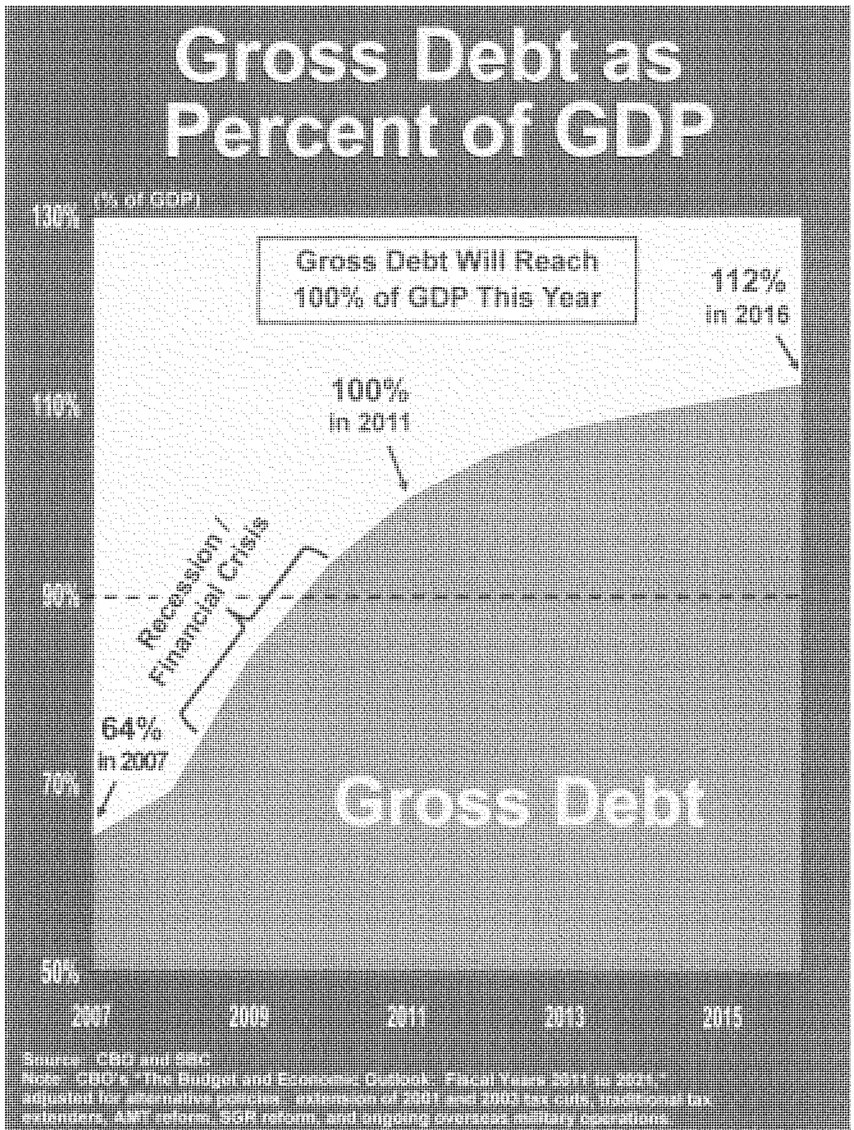
If you look at the previous recoveries since World War II, some of them have been relatively sharp, but none have seen the damage to the financial system done in this downturn. And so that dramatically affected the credit markets, and that dramatically affected business. That obviously affected economic growth and economic activity.

You know, I will never forget when Ms. Romer put out her forecast that we would see 8 percent unemployment, and I told the White House at the time and told anybody listening that they could throw that forecast right out the window, because that forecast was based on the last nine recoveries since World War II. And there was no basis for comparison because there was not the damage to the financial system in the previous recoveries as we experienced in this one. And so I thought it was a forecast that had no merit.

But we are now at a critical juncture. We have been borrowing about 40 cents of every dollar that we spend. That is clearly not sustainable. Spending is at its highest level as a share of the economy in 60 years. Revenue is at its lowest level as a share of the economy in 60 years. It seems to me readily apparent we have to work on both sides of the equation.

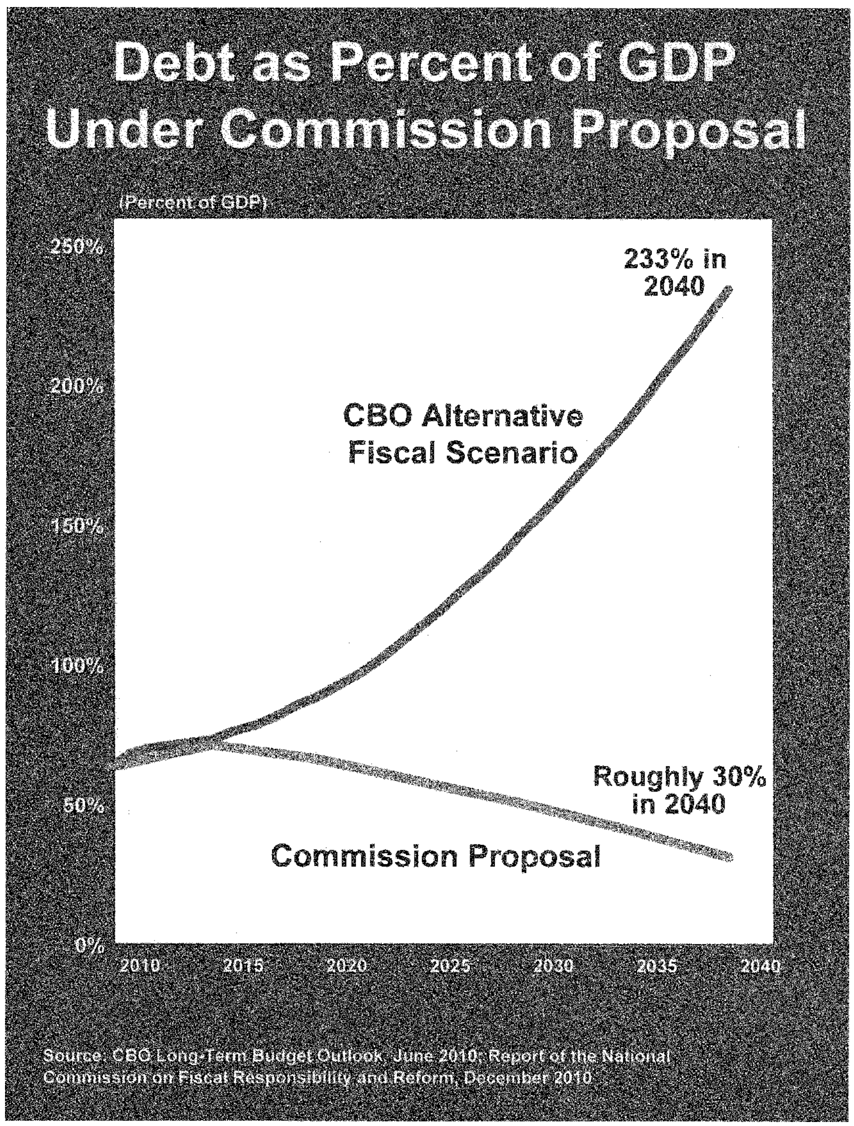


Gross Federal debt is already expected to reach 100 percent of gross domestic product this year, well above the 90-percent threshold that many economists see as the danger zone. Let me just recommend to my colleagues the work that has been done by two of our most distinguished economists. Carmen Reinhart was the lead author of the book reviewing 800 years of financial crisis. In her work and the work of Professor Rogoff at Harvard, they concluded that when countries reach a gross debt of 90 percent of GDP, they see future economic growth reduced substantially. And we are at 90 percent gross debt to GDP.



Now, one thing I want to be clear on is in the press typically you do not read about gross debt. You read about the publicly held debt. Publicly held debt is about 30 percentage points lower than the gross debt. So our publicly held debt today is in the 60 percentile range, but the gross debt is over 90 and will be at 100 by the end of this year. And, again, the work that was done by Carmen Reinhart at the University of Maryland and Dr. Rogoff at Harvard concluded that when your gross debt reaches 90 percent, you see future economic growth impaired, and impaired in such a way that it translates into a million fewer jobs. That at the end of the day, I think, is what we must keep in mind.

I believe that the deficit and debt reduction plan assembled by the President's Fiscal Commission on which I served got it about right. The plan would stabilize the debt by 2014, lower it to 60 percent of GDP—let me emphasize that is on a publicly held debt measure—by 2023, and roughly 30 percent by 2040. So publicly held debt would first be stabilized, then be brought back from the brink, and over time worked down to what most economists say is a far more sustainable level.



There were 18 members on the Commission. Eleven supported the report—five Democrats, five Republicans, one Independent. That is, 60 percent of the Commissioners supported the conclusions of the report that would reduce the debt by $4 trillion over the next 10 years. I believe that proved that Democrats and Republicans can join forces when we face an imminent threat to this country, and I believe this debt threat is an imminent threat to the Nation. We can put together a credible, responsible, realistic bipartisan budget plan, and this year we need to finish the job. It will require Presidential leadership, and it will require a Congress that is willing on both sides to come together to do things both of us would prefer not to have to do.

I hope very much we face up to this because a failure to do so would mean very serious consequences for the country in the future.

We will now turn to Senator Sessions for his opening remarks, and I want to thank members for their attendance here today, and, again, I thank the witnesses for their participation. Senator Sessions, welcome.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Senator Conrad. You have raised the challenge that is facing us very well and I know have made a case that a lot of what we have done has been successful. I understand that, but there are others who have concerns about what we have done and how well it has worked and how much we have accomplished.

I would like to get into a good discussion with our excellent panel, and I am sure we will learn a lot from them. It does appear we have been kicking the can down the road, and I thought that the roundtable discussion in Barron's with some of the world's biggest financial investors earlier this year raised some of the same problems and questions that you have raised and maybe some others also that lead us to a conclusion we are facing a very, very serious national challenge that I believe this Committee, as you indicated at our last meeting, will have to provide leadership for. And I would be glad to be with you in that effort.

I had the honor to meet with Mr. McTeague, former Prime Minister of New Zealand, who took over a country that was running systemic deficits for quite a number of years, and he participated in leading that country to sustained surpluses and unprecedented economic growth, growth in sound currencies, and he told me recently that he believed we need to have a goal of a balanced budget. I think that is a psychological, political question for us to ask. It is not easy to get there. I am convinced we can get there, but the American people are goal oriented, and if we can articulate for them a real substantial reduction in this debt and show them how there may be some short-term pain but long-term gain, I believe politically we are in a better situation to accomplish that than we have been in some time.

I just would quote from that Barron's roundtable interview some interesting questions. Mr. Zulauf out of Switzerland said, "There are two worlds: the industrialized world and the emerging world. The industrialized world continues to live in a fiction that it can afford its current lifestyle by going further into debt. At some point the bond markets will rot against that. The private household sector, not only in the U.S. but several industrialized countries, remains stretched financially and will continue to deleverage, reduce their debt, but the public sector is leveraging up, and there is the threat," he suggests.

Bill Gross, who I guess handles more money than any man in the world, at PIMCO Bond Fund said, "Printing your way out of this or kicking the can is possible for some countries, but the solution is not to create paper. It is to create goods and services the rest of the world wants to have."

They asked, "What are the prospects for that?" And he said, "The Obama administration has failed miserably in that regard. It has focused on consumption and fiscal stimulation that will give us 4-percent growth in 2011″—his estimate. The estimates of these experts were from 2.5 to 4. He had the highest growth projection for this year. But then he adds, "But it gives us nothing more than that. It is a sugar high that quickly disappears in 2012."

So we are facing some serious, grim prospects. Unemployment has not come back well, as we would like to see it. Indeed, at the end of the year, the Government survey indicates that the hours worked had not increased, which is an indicator that unemployment will go down if weekly hours are going up. That is not a good factor. The wage increases were slight, very slight this year, and below inflation, so that puts our net wage income not in a very good position. The amount of jobs added looked better than they are because we have to add 150,000 a month to stay level, and so we have seen job increases, but not much above the level you have to have to really reduce unemployment. And if wages are not increasing, the net money circulating is not where it needs to be. So I am worried about that.

And what I think—what I would like to be in a position where we were with Mr. Volcker. One of his associates just retired from the Fed. Brookings said that Mr. Volcker said, "Enough is enough. We have to get off this road. And he stood firm. They protested. They asked for his resignation. Tractors circled his building, probably some from North Dakota, and Alabama, too, probably. But he said, "We knew we were right." "We knew we were right." And I just do not sense we have that kind of leadership today.

I was disappointed that the new chief of staff, Mr. Daley, taunted the Republicans on his show Sunday, saying, "Where is the beef? You tell me where you are going to cut."

What did that mean? I say that means that the administration is not prepared to lead. They are not prepared to discuss the seriousness of the challenge we face and suggests that if somebody else steps up and makes suggestions about how to reduce this deficit, they may well even be attacked by the President and his administration. So I hope that is not true, but that is what it seemed to suggest for me. And I did not see the kind of leadership I hoped for in the State of the Union.

So, Mr. Chairman, you said a few things political, I said a few things political, but the truth is our country is in serious trouble. You and I both agree with that, and we are going to have to work together to do better. And thank you for calling this hearing.

Chairman CONRAD. Thank you, and let me just say to members of the Committee, what I said at the last hearing, I think even more strongly today, it has to start somewhere. And in the congressional process, we are it. I do not know what other Committee is going to take this on. The Appropriations Committee, they are not in a position to do it. The Finance Committee is not in a position to do it. So I think very clearly it is going to fall to us.

Look, I would much prefer that there would be a summit with the White House, the congressional leaders, Republican and Democrat, House and Senate, sit down and craft a long-term plan to get us back on track. I think that would be the best way to proceed because I think it is very important this be done before we get into a debate on the debt limit extension, because if the debt limit extension has to be the way of getting a result to get a plan, that in itself has serious risks attached to it. We could lose credibility in the bond markets globally if that is the leverage that has to be used. So we are much better off as a country if a plan is put in place prior to getting to the debt limit debate.

But if there is not going to be that kind of summit, then I do not know of an alternative to this Committee and the Committee in the House trying to craft a long-term plan and begin sort of bottom-up. So, again, I issue again a call for a summit involving the leaders of the House and the Senate and the President or his designees to come up with a credible long-term plan before we get to the debt limit crunch, which I think will come probably in May.

But I do not think we can wait for that. I think we have to prepare ourselves to begin crafting a plan here. And, look, it is not going to be easy. But we have a good beginning. We have had an excellent hearing with the head of the Congressional Budget Office. We have an excellent hearing today, and we will turn now to our witnesses.

Dr. Berner, welcome back to the Budget Committee, and please proceed. I understand that you are going to be retiring soon from this position, not retiring but leaving this position. You have always been somebody who has been an important resource for this Committee. Thank you.

STATEMENT OF RICHARD BERNER, PH.D., MANAGING DIRECTOR, CO–HEAD OF GLOBAL ECONOMICS, AND CHIEF U.S. ECONOMIST, MORGAN STANLEY

Mr. BERNER. Thank you, Senator. Thank you, Chairman Conrad, Ranking Member Sessions, and other members of the Committee for inviting me to this hearing to discuss the outlook for the economy, to outline some things that you can do to improve it, and briefly to discuss some of our budget challenges.

And, Senator Sessions, let me tell you that your anecdote reminded me of when I was back at the Fed, because I was in the building when the tractors were circling the building.

In the 6 months since I last appeared before this Committee, the economy has improved. Aggressive and unconventional monetary policy and fiscal stimulus helped. While the recovery remains subpar, recent additional monetary and fiscal stimulus will promote faster growth this year.

But the legacy of the crisis endures. Lenders are still hesitant to lend. Home prices are still declining. State and local budgets are strained, and we need much faster job gains to lower the unemployment rate.

Now, we expect the economy to grow by 4 percent after inflation over 2011 and about 3.25 percent over 2012. Two policy-related factors assure at least moderate growth and raise the odds of a somewhat better outcome: first, the one-two punch from new fiscal stimulus and a Fed committed to achieve its dual mandate; and, second, a dramatic reduction in political uncertainty after this summer.

Three key temporary elements in the stimulus package—a 1-year payroll tax holiday, a 13-month extension of emergency unemployment benefits, and expensing of business investment outlays—will boost growth this year, as you can see in the slide here that I am putting on the screen, but partly at the expense of 2012.

Now, there are four other factors that are already promoting more sustainable growth. First, ongoing balance sheet healing is easing financial conditions, except in mortgage credit. Second, the handoff from rising output to increased hours, employment, and income is slowly underway. Third, stronger global growth is finally boosting U.S. output. And, finally, pent-up demand for capital spending is healthy.

Thus, however, we have a two-tier economy. Strong leadership from exports and capital spending are offsetting the drag from weak housing activity and home prices and from cuts in State and local government budgets. Low inflation has promoted low bond yields. In turn, this has helped restrain Federal interest costs. We believe that that will be changing as inflation bottoms and begins to move higher. Significant economic slack will depress inflation. But rising inflation expectations and global pressure on food and energy quotes will push it higher.

Let me talk about six risks that still lurk for the economy. Two of those are domestic. Home prices could decline by more than the 6 to 11 percent in our baseline forecast, and State and local budget cuts could be more intense than we expect.

Four risks are global. There could be more spillover from Europe's sovereign credit crisis; more intense policy tightening in China and other emerging market economies. Crude quotes could surge past $120. That would be a risk. And politics could interfere with appropriate policy responses, as you alluded to.

That last risk has a new domestic dimension: The battle over budget priorities here does seem likely to crystallize in a showdown over increasing the Federal debt ceiling, which could disrupt financial markets.

So the outlook is improving, but we certainly cannot be complacent. Congress might consider other policies to improve the outlook for housing and employment, and thus the economy. Two years ago in testimony before this Committee I argued that tax cuts and stepped-up infrastructure outlays really do not get to the causes of this downturn. They mainly tackle its symptoms and can only cushion the blow.

Likewise, the recent fiscal stimulus package will boost near-term growth, but I will not put our economy on a strong, sustainable path. It will boost deficits and debt, netting to a negative for the economy over a longer time frame, unless we adopt policies aimed directly at the cause of our problems.

So what are some of those policies? America's housing and mortgage markets remain dysfunctional, thwarting recovery. Reducing principal is the right remedy. Only when some cushion of owners' equity returns and there is less risk of declining home prices will lenders readily offer credit.

Policy options to reduce principal take two forms: those encouraging writedowns to avoid default and those encouraging short sales, which allow underwater borrowers to sell their house at market value without writing a check to the current lender.

Adding incentives for both borrowers and lenders could energize such policies. Earned principal forgiveness is one such. Streamlining short-sale programs would help the writedown process for those borrowers facing foreclosure.

The recent discussion about fixing housing finance has involved the right role for Government and how to reform the GSEs. This debate is entirely appropriate, but it does create uncertainty for lenders, and it overlooks the critical need to sequence policy choices correctly. First, focus on repairing the legacy of bad loans. Only then can policymakers implement reform.

What about policies to improve employment? Private payrolls have risen by about $1.2 million over the past year, but over the past 18 months have been essentially flat. Much of that weakness is cyclical. However, there are four structural culprits involved: labor immobility from housing lock-in, mismatches between skills needed and those available, rising benefit costs, and uncertainty around policies in Washington. Briefly, fixing housing will improve labor mobility and help employment, and better training will improve worker skills. I will discuss remedies for benefit costs and uncertainty in a moment.

The economic outlook has clear cyclical implications for the Federal budget, and addressing our structural budget problems will improve long-term economic prospects. I would like to conclude with a couple remarks on each.

A healthier economy would directly improve the cyclical budget outlook, as we all know. More indirectly, fixing our housing and employment problems with targeted remedies would sustainably boost the economy and narrow the budget gap. Then we could safely unwind the fiscal stimulus now in place, further reducing deficits. But addressing structural budget challenges by reducing entitlement outlays will free up resources and capital for productive investment.

In the long run, the structural budget deficit is almost entirely about Federal health care spending, directly through Medicare and Medicaid and indirectly through the tax treatment of employer-provided health care benefits.

In addition, addressing health care costs would improve employment and the budget. High and rising health care benefits provided through the workplace drive up labor costs, reduce employment, and hurt growth. The cost of employee health care benefits is fixed because benefits are paid on a per worker basis. In my view, that helps explain why American employers cut payrolls relative to GDP more aggressively than other countries.

The plunge in employment also increased Medicaid eligibility, pressuring State budgets. FMAP grants plugged the States' budget holes but added to Federal red ink. The upshot is that high fixed costs of health care benefits have enlarged both our job deficit and our budget deficits at every level of Government.

Reducing health care costs is the next logical step in health care reform. The Affordable Care Act includes reforms aimed at Medicare cost savings, but more is needed to reduce the costs of health care for employers and employees alike. Changing the tax treatment of health care benefits would be a good place to start.

We are only starting to debate solutions for our long-term budget challenges. We need your bipartisan leadership to tackle them and steps that are fair and call for shared sacrifice and benefits. Proposals to freeze or cut non-defense discretionary spending do not address these challenges. In contrast, the Commission that you mentioned, Senator, the Commission's report offers sound principles and a balanced menu for action.

In the heat of those debates, let us remember that uncertainty about coming policy changes, including the size of prospective tax hikes, may weigh on decisions to hire, to expand, to buy homes, and to spend. You can reduce that uncertainty by crafting a credible plan to restore fiscal sustainability.

Mr. Chairman and members of the Committee, we have many challenges ahead. Our short-term challenge is to enhance the odds for a more vigorous, sustainable recovery. Our long-term challenges are to promote a sustainable fiscal policy and to preserve our important safety nets. Thanks for your attention and for the opportunity to offer advice. I would be happy to answer any of your questions.

[The prepared statement of Mr. Berner follows:]

The Economic Outlook, Policies to Improve It, and Implications for the Budget
Testimony of Richard Berner, Morgan Stanley
Senate Budget Committee
February 1, 2011

Chairman Conrad, Ranking Member Sessions, and other members of the Committee, my name is Richard Berner. I have until recently been Co-Head of Global Economics at Morgan Stanley in New York. Thank you for inviting me to this hearing to discuss the outlook for the US economy, to outline what policymakers can do to improve it, and briefly to discuss our budget challenges.

The Economy: Further Progress
In the six months since I last appeared before this Committee, the economy has improved. The financial crisis and the credit crunch that followed have receded further and most financial markets are functioning well. Aggressive and unconventional monetary policy and fiscal stimulus were instrumental.

Likewise, the deepest recession since the Great Depression is over, and while the recovery remains subpar, growth has improved. In the last quarter of 2010, the economy grew at a 3.2% annual rate. Gains in jobs and hours have been encouraging and appear poised to generate the household income and confidence needed to sustain recovery. Recent additional monetary and fiscal stimulus will promote faster growth this year.

But the legacy of the crisis endures and economic headwinds linger. One in four homeowners with a mortgage is still under water; lenders are still hesitant to lend to or refinance many borrowers. The process of cleaning up lenders' and household balance sheets is well advanced, but imbalances in housing mean home prices are still declining. State and local budgets are strained, limiting growth in their outlays.

The job deficit has left substantial slack in labor markets. Much faster job gains are needed to bring down the unemployment rate from 9.4% and to recover the remaining 7.3 million jobs lost in the recession. Other measures of slack, while narrowing, remain wide: Housing vacancy rates are high and industrial operating rates are still low. While the 'tail risk' of deflation is thus not zero, the Fed has greatly reduced it by boosting inflation expectations.

The Outlook: Still Moderate Growth
We expect the economy to grow by 4% excluding inflation over the four quarters of 2011 and 3.2% over 2012. Two policy-related factors assure at least moderate growth for now and raise the odds of a more bullish outcome this year and next: (a) the one-two punch from new fiscal stimulus and a Fed committed to achieve its dual mandate, and (b) a dramatic reduction in political uncertainty.

New stimulus impact. We estimate that the provisions of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 will add about 1 percentage point to growth in 2011 relative to our earlier baseline, pushing it to 4% over the four quarters of this year. Three key temporary elements — a one-year payroll tax holiday for employees, a 13-month extension of emergency unemployment benefits, and full expensing of business investment outlays for 2011 — will boost growth in 2011 partly at the expense of 2012. We estimate that their expiration at the end of 2011 will net to an offsetting drag of about half a percentage point in 2012.[1]

Exhibit 1 shows our estimates of the calendar year budget impact of all provisions based on JCT and CBO data.

[1] See "Tax Deal Could Boost Growth to 4% Next Year," December 7, 2010.

Exhibit 1

Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

(effects on revenue, billions, calendar years)	2011	2012	Included in our Dec. 3 baseline
Extend expiring tax cuts	**-136**	**-178**	
for those with incomes below $250K	-95	-120	yes
for those with incomes above $250K	-41	-58	no
Extend other expiring provisions	**-187**	**-160**	most
Extend unemployment benefits	**-56**	**0**	half
New initiatives	**-184**	**-99**	
2% payroll tax cut for employees	-114	0	no
Business expensing	-70	-99	50%
Total	**-563**	**-437**	

Note: Other expiring provisions include two-year extensions of the estate tax under the Kyl-Lincoln proposal ($5 million exemption and 35% rate), marriage penalty relief, current law for capital gains and dividend taxes, an increase in the AMT exemption amount, the combined interaction from extending EGTRRA and AMT provisions, and other expiring credits and provisions.
The total shown here over CY2011-12 exceeds the JCT/CBO estimates of the 10-year, $858 billion cost because it excludes the recapture of business expensing in the outyears.
Source: Joint Committee on Taxation, Congressional Budget Office, Morgan Stanley Research

This plan should have more bang for the buck than ARRA. The fiscal stimulus enacted in the American Recovery and Reinvestment Act (ARRA) of February 2009 (Pub.L. 111-5) did not seem to add much oomph to the economy relative to its size; why should this smaller one produce more results? In our view, there are two reasons. First, the nature of the stimulus matters: Most of the new stimulus (about 0.7 percentage point) results from the new payroll tax holiday for employees. Such cuts accrue mostly to lower-income, budget-constrained taxpayers and show up quickly in spendable income, so they are more likely to be spent. In contrast, the Making Work Pay tax credit that was a key part of ARRA was disbursed slowly, and some empirical work suggests that taxpayers spent only about 13% of the increment to income from that credit. In contrast, consumers spent about 1/3 of the one-time tax rebates incorporated in the 2008 stimulus package.[2] In addition, the MWP credit at $60 billion was smaller than the payroll tax holiday. Likewise, while grants to states and healthcare insurance premium (COBRA) assistance provided a helpful buffer for governments and individuals, they tended to be saved rather than spent. Finally, outlays for infrastructure projects featured in ARRA took as much as a year to show up in spending.[3]

A second reason that the current stimulus is likely to be more potent is that the deleveraging process for households and lenders is far more advanced today than in 2009.[4] Back then, liquidity-strapped consumers,

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[2] In a recent paper, Sahm et al. noted that, "based on responses from a representative sample of households in the Thomson Reuters/University of Michigan Surveys of Consumers, the paper finds that the reduction in withholding led to a substantially lower rate of spending than the one-time payments. Specifically, 25 percent of households reported that the one-time economic stimulus payment in 2008 led them to mostly increase their spending while only 13 percent reported that the extra pay from the lower withholding in 2009 led them to mostly increase their spending." See Claudia R. Sahm, Matthew D. Shapiro and Joel B. Slemrod, "Check In The Mail Or More In The Paycheck: Does The Effectiveness Of Fiscal Stimulus Depend On How It Is Delivered?" NBER Working Paper No. 16246, July 2010. For an analysis of the 2008 rebates' impact on spending, see Matthew D. Shapiro and Joel B. Slemrod, "Did the 2008 Tax Rebates Stimulate Spending?" American Economic Review, May 2009, 99(2): 374–79.

[3] Indeed, CBO's analysis suggests that refundable tax credits, grants to states, and infrastructure outlays likely would have a "substantial proportion of their impact" appear with a one-year lag; see Congressional Budget Office, "Policies for Increasing Economic Growth and Employment in 2010 and 2011," January 2010.

[4] See, for example, "Deleveraging the American Consumer: Faster than Expected," August 20, 2010.

suddenly denied access to borrowing in the credit crunch, were then more likely to save their tax credits and other forms of stimulus or use them to pay down debt.[5]

Four other factors already are promoting sustainable growth. First, balance-sheet healing is more advanced and, courtesy in part of the Fed's new asset-purchase program, financial conditions are gradually becoming easier. Debt-to-income and debt-service-to-income ratios continued to decline in Q3. The Fed's Senior Loan office Survey indicated that banks' willingness to lend to consumers continued to improve and that they eased lending standards for consumer loans. The glaring exception, of course, is that mortgage credit is still tight.

Second, the cyclical dynamics of recovery are finally promoting the handoff from rising output to increased hours, employment and income. While December's employment report was disappointingly weak, inclement weather likely depressed the job tally. A broader perspective shows that rising hours have supported moderate gains in wage and salary income, and the improvement in a variety of labor market indicators — declines in jobless claims, rising job openings, surveys of hiring plans, and incoming data on withheld taxes — point to renewed job gains. Third, stronger global growth finally seems to be boosting US output. Finally, pent-up demand for capital spending is healthy.

A Two-Tier Economy. These developments have created a "two-tier" economy: Strong leadership from exports and capital spending are the bright spots. The drag from weak housing activity/home prices and from cuts in state and local government budgets are headwinds that may take one percentage point or more from growth this year.

The upper tier is strong... Reflecting the strength of global growth, net exports seem likely to provide a major boost as the import surge reverses and import growth is subdued.[6] In addition, pent-up demand for capital spending is healthy; in the recession, capex slipped well below depreciation expense. Together with the acceleration we expect in economic activity and the business expensing provisions of the new tax deal, that pent-up demand should spur hearty gains in capex in the coming year. And we think improving fundamentals will boost capex outlays in 2012 despite the inevitable "payback" in outlays after the tax expensing provision expires.

...While the lower tier is still fraught. In contrast, housing imbalances remain the most significant single downside risk; we expect a 6-11% decline in home prices this year, which will limit the supply of mortgage credit, restrain consumer net worth, and thus cap growth in consumer spending. In turn, limits on the supply of mortgage credit are a key hurdle for housing demand and any significant recovery in activity. Second, state and local government finances remain weak; faced with additional shortfalls, officials are likely to cut spending and employment somewhat further, especially as federal grants fade. In particular, some $26 billion in assistance for Medicaid will disappear in July. The good news is that revenues are starting to improve, which should somewhat mitigate that risk.

Inflation inflection point. Low inflation has promoted an ultra-accommodative monetary policy and low, long-term yields, which in turn has helped to hold down Federal interest costs. We believe that is about to change. In our view, inflation is bottoming and will gradually move higher. We don't think inflation will rise back to the Fed's "mandate-consistent" rate of 2% or just below until 2012. But a rise in core inflation back above 1% in the next several months is highly likely, and that inflection point will kick off the inflation debate in earnest. A tug of war is under way: Significant slack in markets for goods and services, housing and labor will depress inflation. But stable-to-higher inflation expectations will push it higher. While operating rates are low and the jobless rate is high, changes in those gaps — so-called "speed effects" — are promoting an inflation inflection point. That is especially the case for rents, which are a major inflation component and which are already moving higher.

In addition, several global factors seem likely to contribute to US inflation over the next few months. Strong global demand and limits on supply are boosting energy and food quotes. Recent developments in

[5] See, for example, "Policy Traction: The Key to Recovery," February 17, 2009.
[6] See "Trade Tailwinds: Coming Strongly in Q4," November 5, 2010.

the Middle East point to the potential for energy supply disruptions, which could boost inflation and depress growth. Finally, many prices for imported goods are beginning to turn up again, despite the recent stability in the dollar. We believe that sellers typically pass some of these price hikes through to core prices with roughly a 2-4 month lag, and these price hikes may also contribute to US inflation by reviving inflation expectations.

Six risks to the outlook. Risks still lurk for the economy, and we've tried to capture six in our baseline outlook.

As I mentioned, two of these risks are domestic: More intense declines in home prices or larger state and local government spending cuts could pose a more significant threat to the outlook than we expect.

Four of the risks represent intensification of global challenges that are also in our baseline global view: more spillover from Europe's sovereign crisis; more intense Chinese monetary tightening; a surge in crude quotes to $120 or more; and politics interfering with appropriate policy responses.

That last risk has a new, important domestic dimension: The looming battle over budget priorities here seems likely to crystallize in a showdown over increasing the Federal debt ceiling, which could prove disruptive to financial markets.[7]

Policies to Improve the Outlook

While the outlook is gradually improving, the risks to the economy mean it is hardly time for complacency. Congress might consider other policies to improve the outlook for housing and employment, and thus the overall economy. Two years ago I testified before this Committee[8] and argued that:

> History suggests that financial crises take time to fix, because they result in deep and prolonged declines in asset values, and thus deep recessions (see Carmen M. Reinhart and Kenneth Rogoff, "The Aftermath of Financial Crises," January 3, 2009). And as I read it, history also suggests that policies that go directly to the cause of the crisis are most effective.
>
> As you debate the size and composition of a fiscal stimulus package, therefore, keep in mind that tax cuts and stepped-up infrastructure outlays, whatever their merits, don't get to the causes of this downturn. They mainly tackle its symptoms and can only cushion the blow.

Both are still true. So while the recent fiscal stimulus package will boost growth in the short run, it won't put our economy on a strong, sustainable path. Absent policies that go directly to the cause of our problems, over time such stimulus will likely boost deficits and debt, netting to a negative for the economy.

Policies to Improve Housing

First, we must address the legacy of the financial crisis for housing lenders and mortgage borrowers. Housing and mortgage markets remain dysfunctional, making any recovery in housing a remote prospect. While the proportion of delinquent loans declined from 10.6% early this year to 9.4% in December, our housing research team estimates that loans in foreclosure continue to rise well past 5%, bringing non-current loans to a new record high of more than 15%.[9]

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[7] See David Greenlaw, "The Looming Debt-Ceiling Showdown," January 6, 2011. On January 27, Treasury announced that it will begin paying down T-bills issued under the Supplementary Financing Program. The $200 billion in outstanding SFP bills on the Fed's balance sheet count against the debt ceiling. The additional borrowing room provided by the $195 billion SFP bill paydown will postpone the constraint from March until mid-May. Accounting moves involving nonmarketable debt in government trust funds could allow another $250 billion in borrowing, extending the debt ceiling constraint until mid-July.

[8] "The Debt Outlook and Its Implications for Policy," January 15, 2009.

[9] Fourteen months ago we expected only a modest recovery in housing; we were too optimistic. See "Assessing Housing Risks," November 30, 2009.

Housing imbalances and tight credit are locked in a vicious circle with housing activity and home prices, despite a record plunge in housing activity and thus supply, record declines in home prices, and plunging mortgage rates. Two metrics of imbalances throw the circle into sharp relief: the 8 million unit shadow inventory of yet-to-be-liquidated homes and the one-in-four borrowers in negative equity.[10] Absent forceful policy action, the supply-demand imbalance won't correct itself for years. Consequently, home prices, which have started to decline again, are likely to fall as much as 11% before bottoming in 2012.[11]

The best options for relief are simple, act quickly, and spread the pain broadly among borrowers, lenders, and taxpayers.[12] Several Federal programs are in place[13], but this suite of options has failed to prevent a further deterioration in mortgage and housing markets, as the November HAMP servicer report on loan modifications makes clear: For example, of the ~1.4 million borrowers who have entered trial modifications, over 54% have redefaulted.[14] In our view, lacking aggressive policy intervention to stop the downward spiral, that deterioration will continue.

Two groups of remedies. Remedies fall into two groups: (1) mortgage modifications or refinancings that reduce monthly payments and (2) writedowns or forgiveness of principal. The latter are far more likely to succeed; only when some cushion of owner's equity returns and there is less risk of declining home prices will lenders be willing to offer credit more broadly, allowing housing and housing finance to begin real recovery.

Option #1: Modifications and Refis. Loan modification or refinancing programs like HAMP can be helpful, but have not put housing finance on track for sustainable improvement. Unfortunately, they do not address the fundamental supply-demand imbalances in housing, and they are not widely available. Beyond the factors restricting the supply of credit noted above, second liens complicate modification programs because borrowers must meet certain criteria to be eligible for modification.

Option #2: Write down principal. Writedowns or forgiveness of principal are the real solution to housing woes. Policy options to reduce principal take two forms: those encouraging principal writedowns to avoid default, including so-called strategic defaults, and those encouraging short sales, which allow underwater borrowers to sell their house at market value without writing a check to the current lender. Such programs exist, and some lenders have offered them to borrowers in lieu of foreclosure, but restricted eligibility has limited their success.

Adding incentives for both borrower and lender could make such programs much more attractive. The best approach gives incentives to both. For example, in March 2010, Treasury proposed the idea of "earned principal forgiveness," where FHA refinancing would be available to underwater but performing borrowers if the lender agrees initially to forbear principal and thus modify payments, and to forgive a portion of the forborne principal at the end of each year the borrower is current on the modified payments. Such a plan gives the borrower both payment relief and an incentive to stay current, with an option on future home equity, and it gives the lender a performing asset — one with a lower coupon but also with a lower

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[10] It's worth noting that the shadow inventory includes homes that are vacant or rented; at the time of foreclosure, J.P. Morgan notes that in their experience, about 35-40% of homes were vacant and roughly 45% were non-owner occupied. See presentation at the Bancanalysts Association of Boston Conference, November 4, 2010. See also Oliver Chang, Vishwanath Tirupattur, and James Egan, "Housing Market Insights: In the Shadows," January 28, 2011.

[11] See Oliver Chang, Vishwanath Tirupattur, and James Egan, "Housing Market Insights: Now What?" September 30, 2010.

[12] See "Fixing Housing: Policy Options," November 19, 2010.

[13] The Home Affordable Modification Program (HAMP) provides eligible homeowners the opportunity to modify their mortgages; the Home Affordable Refinance Program (HARP) gives borrowers with GSE-guaranteed loans an opportunity to refinance; the Second Lien Modification Program (2MP) offers homeowners a way to modify their second mortgages when their first mortgage is modified under HAMP; and the Home Affordable Foreclosure Alternatives Program (HAFA) provides alternatives to foreclosure: a short sale or deed-in-lieu of foreclosure. See http://makinghomeaffordable.gov/

[14] Making Home Affordable Program, *Servicer Performance Report Through November 2010*, US Department of the Treasury, December 22, 2010.

probability of default. Unlike the FHA program, HAMP 2.0 has focused on principal forgiveness for already-delinquent borrowers.[15]

Streamlining short-sale programs would also help the writedown process for those borrowers who would otherwise go through foreclosure. Specifically, an expansion of the Home Affordable Foreclosure Alternatives Program (HAFA) beyond its current limitations could help clear the market of such liquidations with minimal damage.[16]

First repair, then reform. Fixing housing and housing finance requires a new regulatory architecture that will balance efficient intermediation between borrowers and lenders and a stable financial system. Key questions involve the appropriate role of government in housing finance, and how to reform the GSEs. In addition, significant attention must be devoted to appropriate rules under the just-passed financial reform legislation. For example, to improve future underwriting, the Dodd-Frank Act requires that securitizers in the future retain 5% of the credit risk in assets they originate and transfer through issuance of an asset-backed security, with exceptions for certain "qualified residential mortgages" and CMBS. Exactly what qualifies has yet to be determined.

The problem with this debate, while needed, is that it overlooks the pressing need to fix past problems. In fact, I think these debates create uncertainty for lenders and investors who are still struggling with the legacy of past loans gone bad. This underscores how critical is the sequencing of policy options: The first priority should be to focus on repair, to reduce housing imbalances and restore market functioning. Only then can policymakers implement reform of mortgage finance — including rules governing underwriting, securitization, loss taking, and the housing GSEs — critical to assure longer-term financial and economic stability.

When I appeared here two years ago, I noted that

> The economic cost of further declines in home values would likely exceed the cost of mitigation. More ominously, letting foreclosures fester may erode the sanctity of the mortgage contract for an increasing number of borrowers, who will decide that making payments is optional. If many borrowers walk away from their houses and their obligations, losses to lenders will rise dramatically and the availability of credit will dry up.

That is still true today.

Policies to Improve Employment

America still has a daunting job deficit, and diagnosing the causes is critical before recommending remedies. Clearly, much of that weakness is cyclical, reflecting the sub-par economic rebound, but four structural culprits are also at work: labor immobility resulting from negative equity in housing; mismatches between skills needed and those available; rising benefit costs; and uncertainty around policies in Washington. Compared with last summer, I am more optimistic about future job growth, partly because of new stimulus and partly because the Administration has moved more broadly and decisively to address the economy, thus reducing policy uncertainty.

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[15] The jury is still out on both the FHA program and HAMP 2.0; each has been operational for only about three months. But two hurdles currently stymie broader participation in the FHA program —dealing with second liens and adding servicer incentives. Currently, there are no servicer incentives for the FHA program, and short refinancing will deprive servicers of fee income on performing loans. Without servicer incentives ($2,000-3,000 per loan would probably suffice), this program won't likely take off.

[16] To be eligible for HAFA, borrowers must have a verifiable financial hardship and either fail to qualify for a modification or else redefault. Servicers must consider every HAMP-eligible borrower for HAFA before the homeowner's loan is referred to foreclosure. But the requirement that borrowers must be HAMP-eligible to qualify for HAFA excludes many of the borrowers the program is designed to help. And the process is slow; some triage of the borrower pool could expedite the process for those cases with little chance of successful modification.

However, more is needed. If we can fix our housing mess, labor mobility will improve. Homeowners trapped in their houses can't move to take another job — until they sell or walk away. Owners suffering from negative equity are one-third less mobile according to one study.[17] The wave of "strategic defaults" and foreclosures is undermining the economic and social fabric of communities and reducing job opportunities.

Worker skills have greatly lagged technical change and tectonic shifts in the structure of our economy, so some jobs go begging. Jobless spells degrade worker skills just when workers need re-training. One short-term remedy would pair training in basic skills that are needed for work with income support. A Job Training Corps, like Teach for America, could build a pool of training advocates who then go on to work in other occupations with the perspective and conviction that come from helping others to acquire needed skills.[18]

The Economy and the Budget

The economic outlook has clear cyclical implications for the budget. Conversely, the policy choices we make to address our structural budget problems will have a profound effect on our long-term prospects for growth and prosperity. I'd like to conclude with some remarks on both the cyclical and structural outlooks for the economy and the budget.

Cyclical outlook. A healthier economy would improve the *cyclical* budget outlook in several ways. Stronger growth would directly boost receipts and rein in outlays for automatic stabilizers such as UI benefits and Medicaid outlays as well as discretionary transfers such as FMAP assistance to state governments. More indirectly, high "bang for the buck" policies to fix our cyclical problems in housing and employment could provide a sustainable boost to the economy and thus narrow the budget gap. Moreover, curing those problems would allow us to unwind the traditional, discretionary fiscal stimulus now in place, further reducing deficits and the growth in debt.

Structural challenges. We all agree that addressing *structural* budget challenges by reducing entitlement outlays will trim long-term deficits and debt, and will thus free up resources and capital for productive investment. Three entitlement programs — Medicare, Medicaid and Social Security — will account for half of Federal outlays by 2020. In the long run, the structural budget deficit is almost entirely about Federal healthcare spending — directly through Medicare and Medicaid, and indirectly through the tax treatment of employer-provided healthcare benefits.

In addition, addressing our healthcare challenges — especially the cost side of the equation — would have important implications for employment and for state and local budgets, as well as for the Federal budget.

High and rising healthcare benefits provided through the workplace drive up labor costs, reduce employment and hurt growth. Importantly, the cost of employee health benefits is "fixed" because benefit costs don't vary with hours worked; they are paid on a per-worker basis. In my view, the high and fixed cost of those benefits helps explain why American employers cut payrolls relative to GDP more aggressively in the recession than did their counterparts elsewhere.[19]

What's more, the plunge in employment pressured state budgets, as many workers who lost their healthcare benefits when they were laid off became eligible for Medicaid. FMAP assistance as part of ARRA filled in the states' budget holes but added significantly to Federal red ink. The upshot: High fixed costs of

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[17] See Fernando Ferreira, Joseph Gyourko, and Joseph Tracy "Housing Busts and Household Mobility," forthcoming in the *Journal of Urban Economics.*

[18] http://www.teachforamerica.org/mission/mission_and_approach.htm

[19] See Sarah Reber and Laura Tyson, "Rising Health Insurance Costs Slow Job Growth and Reduce Wages and Job Quality," Working paper, University of California at Los Angeles, August 2004; Katherine Baicker and Amitabh Chandra, "The Labor-Market Effects of Rising Health Insurance Premiums," NBER Working Paper 11160, February 2005; and Richard B. Freeman and William M. Rodgers III, "The Weak Jobs Recovery: Whatever Happened To The Great American Jobs Machine?" November 2004, Revised January 2005.

healthcare benefits have enlarged both our employment deficit and our budget deficits at all levels of government.

Taking steps to reduce healthcare costs is the next logical step in healthcare reform. The Affordable Care Act includes a series of reforms aimed at cost savings for Medicare, but more work is needed to reduce the soaring costs of healthcare for employers and employees alike. In my view, changing the tax treatment of healthcare benefits would be a good place to start.

The cost of uncertainty. The debates around how to solve America's long-term challenges have only begun. In the heat of those debates, it's important to remember that uncertainty around the costs of coming policy changes, and the uncertain magnitude of prospective tax hikes that will be required to address our fiscal problems, may be weighing on business and consumer decisions to hire, to expand, to buy homes and to spend.[20] In effect, uncertainty raises the threshold that must be cleared to make a business choice worthwhile, and as uncertainty declines, the threshold falls with it.

There is an important lesson here for today's policy debates. Long-term solutions involve bipartisan leadership to tackle these complex challenges in steps that are fair and call for shared sacrifice and benefits. That means setting priorities, making hard choices, communicating the game plan, and getting buy-in for it in advance. Proposals to freeze or to cut nondefense discretionary outlays do not address our long-term budget challenges. In contrast, the Bowles-Simpson Commission's report offers sound principles and a balanced menu for action.[21] I know you agree that crafting a long-term credible plan to restore fiscal sustainability will ease concerns and uncertainty about future tax hikes and the potential loss of our safety nets.

Mr. Chairman and members of the Committee, we have many challenges ahead. Our short-term challenge is to enhance the odds for a more vigorous, sustainable recovery. Our long-term challenges are to promote a sustainable fiscal policy and to reform our entitlement and other programs that represent long-term claims on our future resources. I thank you for your kind attention today and for the opportunity to offer advice. I would be happy to answer any questions you may have.

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[20] Recent work confirms this intuition, underlining how uncertainty produces negative growth shocks. Nicholas Bloom shows how a rise in uncertainty makes it optimal for firms and consumers to hesitate, which results in a decline in spending, hiring and activity. In effect, the rise in uncertainty increases the option value of waiting as volatility rises. See "Policy Uncertainty Redux," June 25, 2010 and Nicholas Bloom," The Impact of Uncertainty Shocks," Econometrica, vol. 77(3), pages 623-685, 05, May 2009

[21] The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform, December 1, 2010.

Chairman CONRAD. Thank you very much.

Now, we will go to Dr. Johnson. Welcome back, Simon, and please proceed.

STATEMENT OF SIMON JOHNSON, SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS AND RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. JOHNSON. Thank you very much, Senator, and I would like to begin, if it is appropriate, by endorsing your call for a summit on these issues before the debt limit comes to a point and before we have a crisis.

I am, among other things, a former Chief Economist of the International Monetary Fund, and as you know, the IMF feels constrained in what it says to the U.S. Government for fairly obvious reasons. I do not feel so constrained. I would like to channel that experience and those kind of sentiments you would hear from them. They are very worried. They think that you face a potential issue with the U.S. debt, particularly as international investors shift around the world, which, as I will explain in a moment, I think is going to be happening in the shorter term towards Europe and in the longer term towards Asia.

And Senator Sessions, I think your citation of Bill Gross in this context is entirely appropriate and exactly right. My recollection, though, is that Mr. Gross, who was in no way responsible, I think, for the financial crisis, was at the forefront of people in the fall of 2008 calling for various kinds of bail-outs and calling for the public sector to use its balance sheet to support the financial sector and prevent a second Great Depression. We can go and check the record, but I am pretty sure that is where Mr. Gross was. And actually, I think at that moment, his advice was fairly appropriate. But now, of course, we see people like himself, people who are seeking appropriate levels of yield at reasonable and acceptable levels of risk, they will start to look elsewhere. They start to press us.

And I absolutely think that the Chairman put the emphasis in the right place at the beginning, which is saving the financial sector given the alternatives in fall 2008 was the only reasonable, responsible thing to do. But the fiscal costs of that were enormous.

I actually like to quote, Senator, the change in net Federal Government debt held by the private sector as you compare the CBO baseline from early 2008, before the crisis really broke in earnest, to the latest one. That is about a 40 percentage point increase, a roughly doubling of net Federal Government debt as a result of the measures the government had to take, most of which were the automatic stabilizers, most of which were the fall in tax revenue that you get from having a massive recession. A very small part of that was the stimulus.

And I would also remind you that the Bush administration had a stimulus in early 2008 and the Obama administration had a stimulus in early 2009. We can go back and second guess how maybe you would like to redo the composition. It does not really matter in terms of the impact on the debt. The fiscal issue we face is because the financial system blew itself up, and I think on this dimension, the financial crisis inquiry commission got it exactly right. The financial system, particularly some of the bigger players in the financial system, got out of control, captured the hearts and minds of the regulators, took on reckless risks, and caused enormous damage.

The Bank of England, by the way, talks of their experience, which is parallel to our experience and, of course, part of our experience, as part of a "doom loop," where you go through repeated cycles of boom, bust, bailout. But, of course, you cannot do it indefinitely because you run up against a debt constraint, which is what Professors Reinhart and Rogoff have pointed out to us. That is the general experience. And there is no reason why the U.S. would be exempt from that.

And if we look at where we are in this cycle, I agree with much of what Dick just said, but I am less positive, I am afraid, on even this moment in the cycle when we should be having some recovery. If you look at what is happening to employment and compare the same metric as you used, Senator Conrad, but just focus on loss of employment compared with peak employment before the recession started, we are down by six percent—we went down by six percent. We are still down five percent from that peak. That is not like any other recession in the post-war period. Every other recession goes down, you go down by two or three percent in terms of employment and you come back within 12 to 24 months. The 2001 recession was a slow recovery, but we did not lose anywhere near as much employment.

This, I would submit to you, is actually not a recession of the post-war variety. It is a mini-depression of the pre-1907 variety, when there used to be big financial crises in the United States, a lot of balance sheet damage, a lot of farmers would go bust, for example, out in the West and the Midwest, and it would take a long time to climb out of those debt holes. I think that is what we are looking at.

And I think in terms of the employment picture, I am very pessimistic. I was in Davos at this World Economic Forum last weekend and was asking everyone I could find, where are the jobs, because the corporate sector has come back. The big companies, the 1,600 companies represented at that forum are doing very well. Their CEOs are happy. There are plenty of profits, but they are not hiring in the United States. They are hiring elsewhere. And I think even this part of the recovery is not going to go very well for us. We are going to struggle.

And we have not fixed the problems in the financial sector. The financial sector still has too little capital. Again, this is the view of the Bank of England. David Miles, a member of the Monetary Policy Committee of the Bank of England put out a very influential paper last week. The Financial Times has its lead editorial on it today. We do not have enough capital. We did not fix the other dimensions of risk within our financial sector. Even after we propped them up and put them back on their feet on extremely generous terms, they do not want to lend, at least to the small- and medium-sized business sector. So that is not a good deal for the rest of the economy. It is not supporting the recovery and employment. And there is, I am afraid, an incentive for them to take on exactly the same kinds of risks as they had before.

Professor Admati at Stanford University and about 24 colleagues have been working on this issue and writing about it very clearly and very forcefully. We do not have enough equity in our financial system. We did not have before. We did not learn that lesson. And this is not just about the United States. It is a global problem, but we should be the leaders of this and we are not. We are, if anything, the laggards, at least compared to the British and compared to the Swiss, who are moving more decisively on this question.

In summary, I would say that while we are in a recovery phase, while we should expect the next four months to improve and we should expect some jobs to come back, this is going to be very slow and very painful. It is already worse than any other recession we have seen. It is primarily because the financial sector got out of control, and unfortunately, when we had the opportunity to fix it, we did not do it completely.

The Financial Stability Oversight Council, which has a macroeconomic responsibility—financial stability, we have learned, is absolutely critical to overall macroeconomic policy. You cannot separate it from monetary policy and from fiscal policy in the way we thought we could separate it over the past 40 years. The Financial Stability Oversight Council, I am afraid, is not so far doing a very good job on these dimensions. There is too much trying to push the banks forward with very thin capital levels and there is too much encouragement of or allowing them to take on what begins to look again like irresponsible levels of risk and excessive leverage, which, of course, again, will come back and hurt us.

Whether or not we fix the fiscal problem—and I share your worries that we will not fix it in the short term—the financial sector will come back and hurt us again and again and again unless we really reform it.

[The prepared statement of Mr. Johnson follows:]

Testimony to Senate Budget Committee, hearing on "The U.S. Economic Outlook," 10am Tuesday, February 1, 2011 (embargoed until the hearing starts).

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]

I. Short-Term Prospects

1) The latest IMF-led official consensus is that the world will follow a "three-speed" recovery in 2011, with the eurozone growing slowly (1.2 percent Q4-on-Q4), big emerging markets quickly (7 percent on the same basis), and the US roughly in between (3.2 percent). At the global level, using the IMF's standard PPP weights, this implies global growth will be 4.5 percent, comparing the 4th quarter of 2011 with the 4th quarter of 2010. This would be down slightly, on a comparable basis, from 2010 (4.7 percent) and just above what the IMF expects for 2012 (4.4 percent).

2) These figures are from the World Economic Outlook update, published on January 25, 2011. Compared with its most recent full biannual forecast in October, 2010, the IMF has marked up US growth significantly for 2011 (0.7 percentage points for Q4-on-Q4), while leaving the eurozone and emerging markets essentially unchanged.

3) The most prominent downside risks to this forecast are in the eurozone. There are three separate but related issues that suggest there is limited potential for upside in this view of Europe:

a) The weaker eurozone countries continue to face pressure from the financial markets, particularly as there are large amounts of government debt that need to be rolled over in the spring. Portugal, Spain, Italy and Belgium are all likely to face increases in interest rates and there is no clear policy framework within the eurozone for dealing with such developments.

b) The stronger eurozone countries, around a Germanic core, are growing quite fast – e.g., 1.2 percent for Germany itself this year, on its way to 2.7 percent for 2012 (according to the IMF); employment in Germany is already higher than it was before the financial crisis. When the European Central Bank begins to raise interest rates, this will put renewed pressure on Greece, Ireland, and other peripheral countries.

c) In principle, there is agreement that – in future – bondholders and other lenders to large banks and eurozone sovereigns can face losses. However, the precise rules and timing for these

[1] This testimony draws on joint work with James Kwak, including *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown* (Pantheon, March 2010) and "The Quiet Coup" (*The Atlantic*, April, 2009), and Peter Boone, including "The Next Financial Crisis: It's Coming and We Just Made It Worse" (*The New Republic*, September 8, 2009) and "Will the Politics of Moral Hazard Sink Us Again" (Chapter 10, in The Future of Finance, July 2010). 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. For important disclosures relative to affiliations, activities, and potential conflicts of interest, please see my bio on BaselineScenario.

arrangements are still not completely clear. There is room for further destabilizing markets in the short-term, particularly if there is severe pressure in some parts of the credit market.

4) The IMF and private sector forecasts all missed badly regarding 4^{th} quarter GDP in the United Kingdom – the consensus was for 0.4 percent growth, but the outcome for seasonally adjusted quarterly change in GDP was minus 0.5 percent (see the latest Eurostat data). The contraction in December was due to bad weather, but October and November were also significantly worse than expected. The UK's path to fiscal austerity, for which it is still early days, may have more negative effects on the real economy than expected.

5) For the US over the next 12 months, the IMF forecast looks more balanced and agrees with the CBO forecast, which is 3.1 percent (Q4 on Q4). (The institutions have greater disagreement about what happened in 2010, with the CBO putting growth at 2.5 percent, while the IMF has this as 2.8 percent in its latest release).

6) Some private forecasts put US growth as likely closer to 4 percent and the latest news is encouraging, in terms of non-farm payrolls, private payrolls and the ISM data. Core inflation seems under control, both in the view of the Fed and according to many in the financial markets.

7) However, the employment picture remains bleak. In other post-war US downturns, employment fell 3-5 percent relative to its peak and return to the pre-recession peak within approximately 12-24 months. The previous exception was 2001, when it took nearly 4 years to get the jobs back; but the maximum fall in total employment was only 3 percent. In contrast, we lost 6 percent of employment in this cycle and after 3 years employment is still down 5 percent from its peak. This part of the economic picture looks more like a mini-depression of the pre-1900 variety rather than a standard post-war recession.

8) Large firms are doing well, with profits having recovered faster than in earlier recessions (Section III below provides more detail). But there are limited signs that these firms want to hire in the United States. Emerging markets offer the market expansion opportunities and increasingly global firms want to hire people in India, China, and similar countries.

9) Interest rates remain low for households and firms that are deemed creditworthy. But lending standards have tightened (appropriately in some cases) and smaller firms presumably are having a harder time borrowing. At the same time, there are increasing concerns about the fact that concentration in the financial system has increased; big banks may feel less competitive pressure to lend – despite the fact that they are highly profitable.

10) Overall, the US continues to have very loose monetary and fiscal policy. As we move towards normalizing policy, which must happen in the next 12-18 months, this will presumably slow down the economy.

11) The most important wildcard in all forecasts is the rate of new household formation, which is down substantially – it was 1.1 million per annum on average in the decade before the crisis, but has averaged 600,000 per annum in the last three years. No one knows when or how this will recover and it is hard to see the housing market return to health quickly with the household formation rate around today's level.

12) There is an increasingly dissonance between the exuberance within parts of the financial sector and its push for more immediate fiscal austerity. If people begin to feel that their future social security and Medicare benefits are under serious threat, they will presumably begin to save

more. As I discussed in my August testimony to the Senate Budget Committee, it is impossible to put the longer-term federal budget onto a sustainable basis without controlling the future increases in costs for Medicare and health care more generally.

13) Growth in emerging markets remains high and, with a few exceptions, they weathered the financial crisis well. But now inflation begins to increase, partly as a result of tighter commodity markets. Higher interest rates attract more capital and tend to cause their currencies to appreciate. Most likely these economies will find the need to tighten fiscal policy before too long.

14) A great deal of success across the entire emerging and developing world is related to the rise of China and India, particularly the fact that growth is relatively commodity intensive at their levels of income. The next global cycle will likely focus on these economies, fuelled by capital being funneled through large money center "too big to fail" banks – much as the so-called recycling of petrodollars flowed through institutions such as Citibank in the 1970s. If this boom is based primarily on debt, as currently seems likely, it will end badly.

15) Not that this boom-bust cycle would be consistent with current account surpluses in emerging markets and a current account deficit in the United States. But such "global imbalances" are neither necessary nor sufficient for destabilizing capital flows – the mechanisms at work are based on gross capital flows much more than net flows.

16) Overall, the US tradeable goods sector (exports and products that compete with imports) has struggled for past decade. These problems were masked by the growth of the nontradeables sector, particularly around housing. It is very unlikely that we can go back to the same pattern of growth as before 2008. Most likely real wages will fall for Americans with less education, as unemployment for this group declines. This will further exacerbate the long-standing widening of income inequality in the United States (more on this in Section IV below).

17) In addition, the rescue of big banks at the United States comes at a considerable price that we will pay as the next economic cycle develops. Our largest banks are well on their way to becoming "too big to save". We should respond by greatly increasing their capital requirements, a point being made forcefully by Anat Admati (Stanford University) and a large group of top academic finance experts, as well as by Mervyn King, Andrew Haldane, and David Miles from the Bank of England; the actions of the Swiss National Bank are also very much pushing in this direction. Unfortunately, the bank lobbyists prevailed in the Basel III forum and the equity-financing of systemically important financial institutions is likely to remain too low in the United States.

18) The latest report from the Financial Stability Oversight Council (FSOC) is also most discouraging. Instead to moving to limit the size and complexity of our largest financial institutions, with an eye to making them small enough to fail and therefore subject to market discipline, the FSOC seems content with the dangerous status quo in which private banks have become the new implicit government sponsored enterprises. Section II below elaborates on why this is such a serious mistake with first order macroeconomic consequences.

II. The Economic Implications Of Too Big To Save Banks

In August 2010, in written testimony submitted the Senate Budget Committee, I provided an analysis of the contingent fiscal liabilities that are in inherent in having a large, concentrated, and undercapitalized financial sector.

Since that time, Ireland encountered a serious economic crisis – and received a bailout from the International Monetary Fund and the eurozone – largely because of the mistakes made by its largest three banks.

The executives running those banks and the people – mostly other European bankers – who lent to them believed that they were "too big to fail" in the Irish context, i.e., that they were implicitly backed by the full faith and credit of the Irish government. This turned out to be correct but, unfortunately, it is also the case that the financial needs of these distressed banks are so large that they overwhelmed the fiscal capacity of the Irish state.

The latest quarterly report from the Neil Barofsky, the Special Inspector General for the Troubled Asset Relief Program (TARP), is the best official articulation yet of why Too Big To Fail is here to stay in the United States – and we are likely on the path to these institutions becoming Too Big To Save.

In its executive summary, the document, which appeared on last week, discusses "perhaps TARP's most significant legacy, the moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are 'too big to fail'."

This reasoning builds on evidence presented in Mr. Barofsky's recent report on the "Extraordinary Financial Assistance Provided to Citigroup, Inc," but it goes a great deal further with regard to the general policy issues we now face.

Mr. Barofsky credits Mr. Paulson and Mr. Geithner with making it clear that TARP funds would be used to prevent any of the country's largest banks from failing during the recent financial crisis and thus "reassuring troubled markets" (p.6). But the very effectiveness of Treasury actions and statements in late 2008 and early 2009 had undeniable side effects, "by effectively guaranteeing these institutions [the largest banks] against failure, they encouraged future high-risk behavior by insulating the risk-takers who had profited so greatly in the run-up to the crisis from the consequences of failure."

And this encouragement is not abstract or hard to quantify. It gives "an unwarranted competitive advantage, in the form of enhanced credit ratings and access to cheaper capital and credit, to institutions perceived by the market as having an implicit Government guarantee."

Of course, the Dodd-Frank financial reform legislation was supposed to end too big to fail in some meaningful sense. But Mr. Barofsky is skeptical and with good reason. Our largest banks are now bigger, in dollar terms, relative to the financial system, and relative to the economy, than they were before 2008 – so how does that make it easier to let them fail?

At the end of the third quarter of 2010, by my calculation, the assets of our largest six bank holding companies were valued at around 64 percent of GDP – up from around 56 percent before the crisis and up from merely 15 percent in 1995 (this is an update of estimates James Kwak and I provided in our book, *13 Bankers*; we explain the methodology and sources there). Barofsky quotes Thomas Hoenig, president of the Kansas City Fed, who uses very similar numbers and draws the same conclusion: the big banks have undoubtedly become bigger.

Today's increasingly complex mega-banks are global – their potential collapse cannot be handled within national resolution or bankruptcy frameworks and there is no chance we'll get an international agreement on how to handle these issues any time soon. At least in private (and including at the World Economic Forum in Davos, late January 2011), I find relevant economic officials from a wide range of countries increasingly agree with the arguments made in this respect by Senator Kaufman and some of his colleagues (including Senator Sherrod Brown of Ohio) during the financial reform debate in the first half of 2010.

According to the Barofsky report, the FDIC under Sheila Bair is apparently willing to take this assessment to its logical conclusion – potentially being willing to force megabanks to simplify their operations and divest themselves of activities, if this is what it takes to make "orderly liquidation" a feasible option. Unfortunately, there is no sign that the Treasury Department is inclined to move in that direction – the quotes from Mr. Geithner here are all about preserving his freedom of action in future crises, including the ability to determine that any financial institution of any kind is "systemic" and therefore needs to be protected.

And the Federal Reserve remains completely on the fence. On the one hand, Ben Bernanke is capable of clearly defining the problem. Firms perceived as likely to be saved by the government, according to Bernanke, "face limited market discipline, allowing them to obtain funding on better terms than the quality or riskiness of their business would merit and giving them incentives to take on excessive risks." On the other hand – although it is not in the report – all indications suggest that the Fed is not taking a tough line with big banks.

Senator Kaufman and his colleagues were right to worry about the big banks, his ideas have gained lasting traction, and the debate among officials shows some promise.

But the situation is still dire. The incentives facing large private banks are now as distorted as the incentives that previously faced Fannie Mae and Freddie Mac – those institutions had too little capital and took on too much risk when they had an implicit government guarantee (although efforts to pin the crisis of 2008 primarily on those institutions are misplaced.) As the Barofsky report puts it, "TARP has thus helped mix the same toxic cocktail of implicit guarantees and distorted incentives."

III. Employment and Profits Over The Cycle

Relative to any post-war recession, the rebound in profits during the Obama administration has been dramatic. To be sure, the end of 2008 was shocking to many entrepreneurs and executives – as credit was disrupted in much more dramatic fashion than they thought imaginable. Large and immediate cuts in employment followed.

But then the government saved the failing financial sector. The means were controversial but the end was essential – without private credit, the US economy would have fallen far and for a long time.

And profits rebounded almost at once. The financial sector recovered quickly on the back of implicit guarantees provided to our largest banks – really the only bad quarter was at the end of 2008 (hence the angst about bankers' bonuses in 2009). But the nonfinancial sector has done even better. Profits for those private businesses fell by no more than 20 percent from top-to-bottom in the cycle and in 2010 through the third quarter (the latest available data in the BEA series) profits were back at the level of 2006. After the deep recessions of the early 1980s, for example, it took at least three times as long for profits to come back to the same extent. (I went through this comparison in more detail recently for the NYT's Room for Debate).

And investment in plant and equipment has also recovered fast – this was the one bright part of the domestic economy in the past two years (with the other good relatively source of news being exports). Look around at the places you work and where you do business (or shop). Is there any indication they have cut back on information technology spending recently?

Overall, the policies of late 2008 and early 2009, including the much-debated fiscal stimulus, protected corporate sector profits to an impressive degree -- despite the fact that this was the steepest recession of the past 70 years, profits fell only briefly and seem likely to be just as strong going forward as they were pre-crisis. Large global American-based companies, in particular, are well positioned to take advantage of growth in emerging markets such as India, China, and Brazil.

But the link between corporate performance -- measured in terms of profit or executive pay for U.S. companies -- and domestic employment has fundamentally changed in recent decades. At the very least, employment responds slower now than in previous cycles when output and sales recover. We are still waiting for employment to turn back up decisively; compared with previous recessions, the delay is simply stunning (see the employment charts available on the Calculated Risk blog).

Ideally, in a situation like this, we'd provide more stimulus to the economy in some form. But our monetary policy is already close to exerting its maximum efforts, and the scope for using fiscal policy was undermined by high deficits during the "boom" years of the 2000s – so there is no safe fiscal space for action (even if the politicians could agree on what to do.)

We are reduced to waiting for the private sector to recover enough to want to take on new employees. No one has a good answer for why this is so slow – perhaps because it is so easy and so cheap to hire workers in those very emerging markets that are now booming, or perhaps because the skill mix available at prevailing wages in some parts of the US is not exactly what employers want.

Or perhaps there are artificial barriers to entry at work, meaning that companies can effectively keep out new entrants – thus keeping profits artificially high and, at the sectoral level, limiting employment. The constraints on entrepreneurship in our post-credit crisis economy need careful scrutiny. Hopefully, the administration's charm offensive will not prevent it from enforcing our anti-trust laws, which were more than slightly neglected in the Bush years.

Listening attentively to the nonfinancial sector makes sense in this situation; in return, corporate leaders need to focus on creating jobs in the United States.

But bending over backwards to accommodate the wishes of the financial sector is exactly what got us into this mess to start with. Allowing our largest banks to become even bigger and more dangerous would be a very bad mistake.

IV. What Caused The Crisis?

In December, a minority on the Financial Crisis Inquiry Commission (FCIC), weighed in with a preemptive dissenting narrative. According to this group, misguided government policies, aimed at increasing homeownership among relatively poor people, pushed too many people into taking out subprime mortgages that they could not afford.

This narrative has the potential to gain a great deal of support, particularly in the run-up to the 2012 presidential election. But, while the FCIC minority writes eloquently, do they have any evidence to back up their assertions? Are poor people in the US responsible for causing the most severe global crisis in more than a generation?

Not according to Daron Acemoglu of MIT (and a co-author of mine on other topics), who presented his findings at the American Finance Association's annual meeting in early January. (The slides are on his MIT website.)

Acemoglu breaks down the narrative into three distinct questions. First, is there evidence that US politicians respond to lower-income voters' preferences or desires?

The evidence on this point is not as definitive as one might like, but what we have – for example, from the work of Princeton University's Larry Bartels – suggests that over the past 50 years virtually the entire US political elite has stopped sharing the preferences of lower- or middle-income voters. The views of office holders have moved much closer to those commonly found atop the income distribution.

There are various theories regarding why this shift occurred. In our book *13 Bankers*, James Kwak and I emphasized a combination of the rising role of campaign contributions, the revolving door between Wall Street and Washington, and, most of all, an ideological shift towards the view that finance is good, more finance is better, and unfettered finance is best. There is a clear corollary: the voices and interests of relatively poor people count for little in American politics.

Acemoglu's assessment of recent research on lobbying is that parts of the private sector wanted financial rules to be relaxed – and worked hard and spent heavily to get this outcome. The impetus for a big subprime market came from within the private sector: "innovation" by giant mortgage lenders like Countrywide, Ameriquest, and many others, backed by the big investment banks. And, to be blunt, it was some of Wall Street's biggest players, not overleveraged homeowners, who received generous government bailouts in the aftermath of the crisis.

Acemoglu next asks whether there is evidence that the income distribution in the US worsened in the late 1990's, leading politicians to respond by loosening the reins on lending to people who were "falling behind"? Income in the US has, in fact, become much more unequal over the past 40 years, but the timing doesn't fit this story at all.

For example, from work that Acemoglu has done with David Autor (also at MIT), incomes for the top 10% moved up sharply during the 1980's. Weekly earnings grew slowly for the bottom 50% and the bottom 10% at the time, but the lower end of the income distribution actually did relatively well in the second half of the 1990's. So no one was struggling more than they had been in the run-up to the subprime madness, which came in the early 2000's.

Acemoglu also points out that the dynamics of the wage distribution for the top 1% of US income earners look different, using data from Thomas Piketty and Emmanuel Saez. As Thomas Philippon and Ariel Reshef have suggested, this group's sharp increase in earning power appears more related to deregulation of finance (and perhaps other sectors). In other words, the big winners from "financial innovation" of all kinds over the past three decades have not been the poor (or even the middle class), but the rich –people already highly paid.

Finally, Acemoglu examines the role of federal government support for housing. To be sure, the US has long provided subsidies to owner-occupied housing – mostly through the tax deduction for mortgage interest. But nothing about this subsidy explains the timing of the boom in housing and crazy mortgages.

The FCIC minority points the finger firmly at Fannie Mae, Freddie Mac, and other government-sponsored enterprises that support housing loans by providing guarantees of various kinds. They are right that Fannie and Freddie were "too big to fail," which enabled them to borrow more cheaply and take on more risk – with too little equity funding to back up their exposure.

But, while Fannie and Freddie jumped into dubious mortgages (particularly those known as Alt-A) and did some work with subprime lenders, this was relatively small stuff and late in the cycle (e.g., 2004-2005). The main impetus for the boom came from the entire machinery of "private label" securitization, which was just that: private. In fact, as Acemoglu points out, the powerful private-sector players consistently tried to marginalize Fannie and Freddie and exclude them from rapidly expanding market segments.

The FCIC dissenters are right to place the government at the center of what went wrong. But this was not a case of over-regulating and over-reaching. On the contrary, 30 years of deregulation in finance, made possible by capturing the hearts and minds of regulators and of politicians on both sides of the aisle, gave a narrow private-sector elite – mostly on Wall Street – almost all the upside of the housing boom.

The downside was shoved onto the rest of society, particularly the relatively uneducated and underpaid, who now have lost their houses, their jobs, their hopes for their children, or all of the above. These people did not cause the crisis. But they are paying for it.

Chairman CONRAD. Thank you very much.
Now, we will go to Mr. Malpass. Again, welcome.

STATEMENT OF DAVID MALPASS, PRESIDENT, ENCIMA GLOBAL

Mr. MALPASS. Thank you very much, Mr. Chairman and Senator Sessions and others on the committee. It is a great pleasure to be here, and thank you for the invitation to testify.

I think we have a full-blown fiscal crisis. We have been kicking the can down the road and it is time now for action to hold the line on spending. I think we need a full upheaval in the culture of spending and deficits that is controlling our government processes.

Before turning to my testimony, I would like to give a little background. My slides are available on EncimaGlobal.com and also GrowPAC.com, which is dedicated to smaller governments, so people watching can follow on. I am going to go through some of the slides.

As an aside, Senator Sessions mentioned Paul Volcker. I was in this room—before I worked for the Reagan administration, I was on the staff of the Senate Budget Committee, like many of the people here, and I was in this room when Paul Volcker said, "Enough is enough." And I think we are at that point where people need to be saying, we cannot afford it, even though it might be a good program.

If I may, I will go to the first slide. My testimony is broken into four parts. One is the economic outlook, which is for moderate growth. The second is the fiscal outlook, which is for lots more debt and deficits. The third part, I address the risks of this high a debt-to-GDP ratio. The question is whether we are at a turning point—a tipping point where we could see investors turn away from U.S. debt, so I am going to address that in some detail.

And then in my testimony, I give some policy suggestions. In particular, I think we need to start cutting spending now rather than the summit approach which has been tried so often. I think the goal should be to find a cut that you could make tomorrow or late this week and find a process that can actually implement that. You will have the Continuing Resolution expiring on March 4, so that gives a very good opportunity to begin cutting spending.

A second policy suggestion is that we need a debt-to- GDP limit that is not there right now. When they wrote the Constitution, they had no idea that people would be able to borrow $9 trillion, as we are now, and CBO's numbers put us up to $24 trillion. So if the Founding Fathers had known that that was possible, they would have put a limit on that into the Constitution, and I think they also would have said that the maturity of the debt needs to be long-term, because we make ourselves riskier by having a short maturity for the debt. I am going to show you a graph on that.

And then two more policy points. I am very concerned about the Fed's policy of quantitative easing where it is buying up the government debt. This is a huge new role for the Federal Reserve that should be wound down without delay.

And fourthly, tax reform is critical, and I advocate putting a permanent extension of the existing tax rates into the baseline so that there can be an actual process where growth-oriented tax reform could be produced by Congress. With the baseline the way it is now, with many of the tax rates temporary, it is too high a hurdle for Congress to actually come up with growth-oriented tax reform.

So in the next slide here, I show you the economic outlook. You know, we have had a very severe recession. What this shows you is the GDP of the country and the hammer blow that was hit in 2008 and 2009. I expect GDP growth to rise from 2.8 percent in 2010 to 3.5 percent in 2011, but that is still not going to be enough to make up for the losses.

We have structural problems. I will mention three, the tax code, the labor barriers, and the regulatory expansion. So those slow down the private sector.

Secondly, we have growth of the Federal spending and debt, which is a burden on the private sector. And third, the debt and credit problems which still plague, and I will show you a graph on that.

The next slide here gives you a little bit of good news. Tax receipts are rising. This is the fourth quarter of 2010 divided by the fourth quarter of 2009. We are up eight percent in tax receipts.

The problem is—

Senator SESSIONS. Of what period?

Mr. MALPASS. So that is the fourth quarter of 2010 over the fourth quarter of 2009. So it is up through December, eight percent growth, eight percent higher money coming into the Federal Government. The problem is, as you can see, that was from a very low base, and so in our next slide, you can see the dip in receipts. Under CBO's very optimistic projections, that is going to gradually be made up, but even so, the debt is yawning widely. And so the problem is that the growth that we are envisioning does not really reduce the magnitude of the deficit.

You can see that the budget moved into surplus in the Clinton administration. It narrowed in the Bush administration, the expansion in 2007 and 2008. And so what we need is to get it much narrower than what the current CBO projections are doing. Unfortunately, in their work last week, in their new baseline, they increased the deficit to $1.5 trillion just for this current fiscal year. This is a yawning deficit.

This is the total debt of the United States, and one point for concern is even though the private sector is deleveraging, the government is borrowing as fast as the private sector is deborrowing, is deleveraging, and so we have 245 percent of GDP in debt.

The next slide shows you the break-up of that debt. So as we break down, where is that debt, so it is $35 trillion of debt in the country and it is broken down here. Household debt is roughly $13 trillion. The Federal, State, and local debt is $11.4 trillion, but let us pause. Where is that number going to go? The Federal, State, and local debt is going to $28 trillion, meaning way up in the ether of this hearing room, way off the chart, in just the next five or ten years because of the large deficits. And you can also see the noncorporate businesses at the bottom here are shrinking. They are losing credit and they are getting taken over by bigger businesses. We have an economic policy that favors big government and big business right now and that is hurting jobs.

On the next slide here, you can see the projection, Federal Government marketable debt going to 100 percent of GDP, assuming the Bush tax cuts are extended.

And on nine—I will go quickly through these first ones because I want to dwell on the maturity of the debt later on. This shows you the detailed numbers, $35 trillion, and the breakdown of the various debt, including $9 trillion of marketable Federal debt and then an additional $4.6 trillion that is in the Social Security Trust Funds. So that shows you—this is a way to tie out where the national debt really is residing.

The next slide shows you a barrier on—

Chairman CONRAD. David, can I just stop you on that point—

Mr. MALPASS. Yes.

Chairman CONRAD. —so the people that are listening maybe are able to understand. I think the point that you have just made is the total debt in the United States, Federal, State, local, corporate, individual, about $36 trillion.

Mr. MALPASS. Yes.

Chairman CONRAD. So if we were to have a one percent increase in interest rates, that would add $360 billion a year in burden to this economy. That would be like a tax increase, right? It would be the effect of a tax increase. If we had a one percent increase in interest on $36 trillion of debt, it would be like a $360 billion tax increase.

Mr. MALPASS. That is true. It would be a burden on people who are borrowing money. Now, the good news on an interest rate increase is the U.S. household sector—I will show you a graph in a minute showing that the U.S. household sector is the biggest net creditor in the world, and so much of that interest would be paid to the people in the United States who are saving money. And so you are right that it would be a burden on the people who are now maybe growing, expanding, borrowing money, but it would sure help a lot of seniors who are right now getting nearly zero interest on their savings.

I actually favor some increase in the short-term interest rates by the Fed in order to bring some stability in the short-term credit markets. It is very odd to have a country running with interest rates near zero.

But the point is exactly right. There is a giant debt burden out there, and so as we think our way through this crisis, one of the hard parts is we have not reduced the total amount of debt at all and probably will not and it makes us sensitive to interest rates.

So what are the banks doing? Here, the large banks are beginning to lend a little more. The top line is large banks. The bottom line is small banks. And you can see there is no loan growth going on from the smaller banks. They are still under the regulatory thumb. It is a very harsh regulatory environment—

Chairman CONRAD. David, can you just tell us, in terms of the chart, what is the period of time we are dealing with? I cannot read the—

Mr. MALPASS. This runs from December of 2008 through present. So just in 2009, large banks reduced their lending from $850 billion down to $650 billion—

Chairman CONRAD. So very dramatic. That is what I was referencing earlier in terms of financial crisis, dramatic effect on credit markets, huge effect on the economy.

Mr. MALPASS. That is exactly right, and we are still, as these show, not exactly digging our way out of that. Most of the new credit that is being created in the economy is coming from the government, which may have been stabilizing as it goes along, but it creates its own set of risks.

To wit, the next chart shows us CBO's various forecasts. So every couple of years, CBO says the debt-to-GDP is going to stabilize at an ever-higher level. So in 2005, they said it looked like 30 percent debt-to-GDP. In 2009, they said 50 percent debt-to-GDP. Just in August of 2010, the debt was expected to stabilize at 65 percent of GDP, and now CBO is up to 77 percent of GDP. This is not—I am not making the point that CBO cannot forecast. No one can forecast. I am making the point that the government debt is growing at a huge rate and CBO is recording it.

The next chart shows us two kinds of debt. The lower line is the publicly held debt, the marketable debt, and that is the $9 trillion number—

Chairman CONRAD. What page is that in your—

Mr. MALPASS. This is on page 12 in the graphs, and in the testimony, it is on page nine.

Chairman CONRAD. Okay.

Mr. MALPASS. And the testimony gives the background and the numbers to it. And so what we see is that the debt limit, the statutory debt limit is now up at $14.3 trillion, almost at the size of the GDP, and certainly going to go above it. My own view is that the debt limit has to be increased. It is not the right debt limit to try to regulate because it goes up with inflation. It goes up with the growth of the economy and also with the Social Security Trust Funds and the other trust funds. And so that number, Congress really, I think, could not use as an appropriate limitation on the amount of debt and I am recommending that we shift over to marketable debt-to-GDP as a ratio that you could limit for the next 100 years. That number should be decided on and then used as a limitation on government debt.

On page 13, then, this shows you—and I will not dwell—you know better than I the various breakdowns of spending, but I will note, this shows you the spending per GDP for various parts of the budget, and notable is that the interest costs are going to go up very dramatically, even in CBO's really optimistic—they are assuming interest rates stay really well behaved, nothing like what has gone on in Greece, well behaved interest rates. The interest costs shoot up, and look where the loss comes from. Defense spending is—this is the President's budget from fiscal year 2011, and also all other spending, meaning you are not controlling Medicare costs, Medicaid costs, or Social Security. It is going to come out of huge cuts just in the next five, eight years for all the other government spending and services that come out of the Federal Government.

The next chart shows us the same kind of presentation, but in dollar terms. So what you can see is the Medicare and Medicaid costs are $1.6 trillion, and notable on this graph is interest costs will almost overtake the entire defense budget by 2021 in the CBO ten-year budget window.

One point I will make on this graph is I think Congress should be looking at spending this way, meaning that there are all these things that you spend money on, and it does not matter so much whether it is an entitlement, whether it is a mandatory, whether it is discretionary. It is all just dollars and it goes out very rapidly.

So rather than dividing the debate into what we do about entitlements and what we do about the rest, just find a way to cut $1 billion this week and $2 billion next week and we would be ahead of the game. And whatever it comes out of, the public will cheer and say, good job, and then you will get some support for doing the next round of restraint.

On 15—I only have a few more here—on 15, this shows you—I am going to show you two or three graphs that are the optimistic side of the CBO forecast. CBO is assuming that tax receipts go above the 20 percent level that we have never gone above before. So look how much it does. By 2016, 2017, 2018, 2019, we are above 20 percent of the economy in tax receipts. I do not think we can achieve that. I think once you get up to that barrier, you kind of hit a wall for the economy. So I doubt—you know, we have been talking about how huge the debt projections are coming out of CBO. I am afraid it is going to be worse than that.

The next page shows you—I mentioned one saving grace for the United States that is not available in Southern Europe is we have a huge amount of assets that have been built up. This country has been growing for 200 years and people put it away in houses where the mortgage has been paid off, in corporations where you have a lot of assets. And so it is 425 percent of GDP in household assets versus that 245 percent debt. So that should give us some hope. We can dig our way out of this hole if we start restraining spending.

The next chart shows you, again, an optimistic CBO forecast. Again, these are legitimate forecasts. I am not saying anything wrong with CBO doing it this way. They get guidance from the committee, from Congress itself. What I am saying is that we will be lucky if we get the deficit and debt numbers that they are projecting because it can be worse.

This shows you the net interest per debt goes up to 4.5 percent or maybe five percent of debt, which is a lower interest rate. They are assuming the interest rates are lower on this coming debt than what we have had on the past debt, which is hard to imagine since we have so much more debt. Normally, as your debt grows, you have to pay more on it. We are assuming in their forecasts that we pay less than historical.

I want to shift now to the tipping point. The next chart shows you the difficulty here. Here is CBO's forecasts. What they shows you is that interest rates are expected to rise to the four to 4.5 percent yield curve. That means at the short end, by the end of this budget window, we will be borrowing at four percent on the short end and 4.5 percent on the long end.

That sounds good, but as the next—but challenging that is, and the next chart shows this, the very short maturity of our debt. This is a key point, that we have not only a huge, record amount of debt, but it is also a record short-term nature of that debt, which means that if we get into a hiking cycle, we are in deep trouble, and I am worried that that is what we will get to.

What this chart shows you is the effect of the Fed now buying back the long-term debt. Look, the Treasury has issued long-term debt which stabilizes the country because it means we do not have to roll it over. The Fed is buying precisely that safest debt and buying it back into the U.S. Government. And so the effective maturity on the national debt has gone down to 40 months, which is—we are back to the 1970s level of risk in terms of the short nature of the debt.

A couple more charts. If we think about how a crisis happens, a tipping point happens, the yield curve for Greece—next chart—shows you what happened to Greece. They were going along happily in 2007 with that low-yield curve, and then whammo. They hit a tipping point and the debt exploded higher.

And the same thing happened on Greece—excuse me, on Ireland. When they went above 90 percent, as the Chairman noted, the Reinhart and Rogoff book points out what happens when you hit 90 percent, and the U.S. is headed there. They hit that in 2010, and look what happened to their interest rate. They spiked interest rates in the middle of 2010 and that just created a catastrophic problem in the budget deficit as they hit that.

So as we think about the tipping point, my concern is that we are going to be stuck with such slow growth that the living standards will continue going down. Look at the two periods. The 1970s and the 2000s have seen a decline in the median household income and that puts us at risk. If we are not an economic superpower that adds to the median household income, we are in trouble as a country, and that is where we stand right now.

The next chart shows you that we do not want to get to this point. This is Europe hitting the tipping point and the interest rates shoot up, the deficits explode, and they cannot roll their debt. So that is what we are trying to avoid, and 25 shows you the Fed's explosion of assets, which is one thing that has been distorting the markets because the Fed is absorbing such a huge amount of the fiscal deficit right now. They are using extreme leverage, 40-to- one type leverage. The Fed now has its balance sheet up to, or is heading toward $3 trillion of assets with little oversight from the normal Congressional appropriations process.

So in conclusion, I will mention four policy points of view. I think you should use the opportunity of the Continuing Resolution on March 4 to cut spending. Just do a little, or do more. Do more every day, if you can. Second, you should use the opportunity of the debt limit increase— which I support, you have to increase the statutory debt limit—but use that opportunity in a thoughtful way to add new controls to the national debt.

I recommend a debt-to-GDP limit as opposed to the current nominal debt limit. A debt-to-GDP limit, say, at 50 percent and also a limitation or a requirement that the average maturity of the debt stay at five years or longer. We are cheating ourselves by having the current government issue short-term debt, putting us at risk.

And then, thirdly, the Fed should wind down its asset purchases. They are shortening the effective maturity of the debt. They are causing substantial market disruptions and they are climbing rapidly.

And finally, tax reform is a high priority and I think in order to get it done, what you should do is make the extensions of the current tax rates permanent in the baseline, and that way you could have a legitimate discussion about what to do about future tax rates.

Thank you very much, Mr. Chairman and Senators.

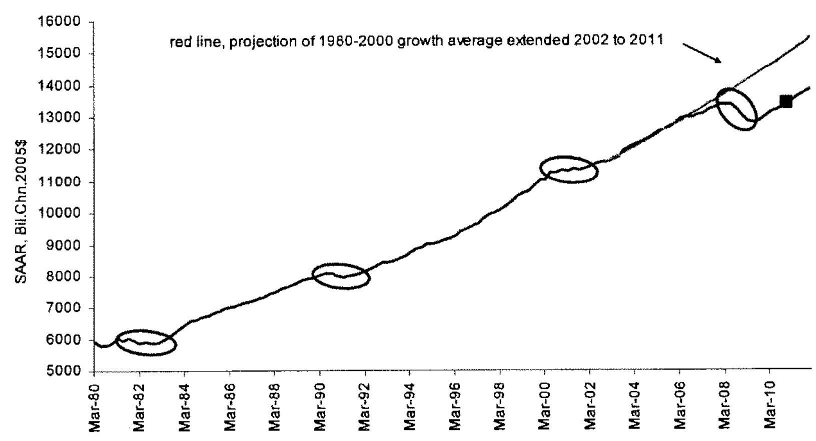
[The prepared statement of Mr. Malpass follows:]

Statement of
David R. Malpass before the
Senate Budget Committee
February 1, 2011

Chairman Conrad, Senator Sessions, members of the Committee, thank you for the invitation to testify on the economic and fiscal outlook. We have a full-blown fiscal crisis underway which requires an upheaval in our federal spending and budgeting culture. My testimony is in four sections covering the economic outlook, the fiscal outlook, the risk of hitting a tipping point where debt gets so large that investors step away, and some policy suggestions.

Before turning to the economy, I'd like to give a little of my background. I'm President of Encima Global, an economic research firm, and was Chief Economist at Bear, Stearns, where I worked 15 years. I served at Treasury and State in the Reagan and Bush-41 Administrations and was previously the tax analyst on this Committee during the 1986 tax rate cut. I'm also Chairman of GrowPac.com, an organization which supports smaller government. I ran in the New York Republican primary for U.S. Senate in 2010 and can attest to the loud demand for federal spending restraint coming from many voters. I live in New York with my wife Adele who was also on the staff of this Committee.

Real GDP Growing From a Low Base (last obs. Q4 2010, proj to Q4 '11)



Source: Bureau of Economic Analysis; Encima Global

In summary:

- The economic outlook is for moderate U.S. growth after the deep 2008 collapse, weighed down by the increasing reliance on the government for the allocation of capital and credit as its debt expands.
- The current fiscal trend is for continued mega-deficits and a marketable debt-to-GDP ratio reaching 100%, well above sustainable levels. The statutory debt limit, now $14.3 trillion, is headed toward a staggering $31 trillion in the latest CBO outlook.
- My testimony addresses the risk of a catastrophic tipping point due to our enormous federal debt and the growth in spending. Adding to the risk, the maturity of the national debt is dangerously short, made worse by the Federal Reserve's buyback of long-maturity debt.

At the end of the testimony, I give some policy views.

- The expiration of the continuing resolution on March 4 should be used as an opportunity to make numerous spending cuts now -- to put Washington on a diet where it shrinks day by day. Waiting for a deficit reduction package ducks responsibility and is a recipe for continued out-of-control deficit spending.
- The debt limit increase should be used to install a lasting limitation on the U.S. marketable debt-to-GDP ratio, enforced by escalating penalties on Washington. There should also be a minimum maturity for the debt to stop the government from artificially lowering near-term interest costs.
- By buying long-term assets, the Federal Reserve is conducting fiscal policy. QE2 should be wound down. It is shortening the effective maturity of the national debt and is causing substantial market distortions.
- Tax reform is a high priority. I favor including permanent extensions of current tax rates in the baseline to facilitate growth-oriented tax reform and modifying scoring rules to stop the practice of temporary tax rates.
- I believe these policy approaches would give new confidence to American businesses and financial markets, causing an inflow of capital and jobs to the U.S. private sector.

Economic Outlook

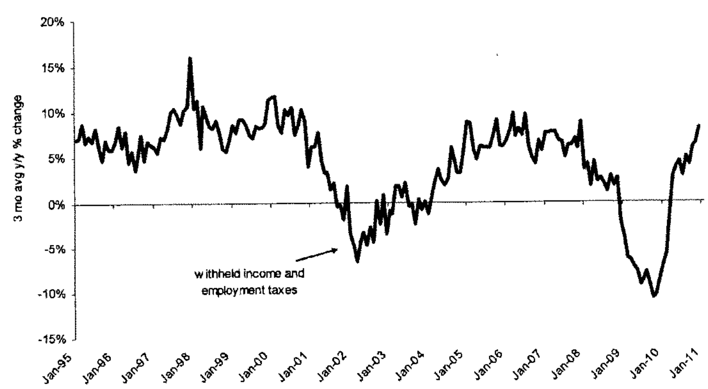
I expect moderate U.S. growth in 2011, perhaps 3.5% in real terms, up from 2.8% in 2010. The improvement is welcome, but it is still a weak expansion by historical standards. Growth is being held back by structural problems like the tax code, labor barriers and sweeping regulatory expansion; the growth of federal spending and debt, which cancels private sector investment; and the many debt and credit problems left over from the 2008-2009 recession.

- In 2010, GDP growth increased to 3.2% in the fourth quarter from 2.6% in the third and 1.7% in the second. I think much of the fourth quarter improvement was a rebound from the double dip sentiment during the mid-2010 soft patch rather than a structural acceleration.

- Strong consumption that coincides with record transfer payments and fiscal deficits is not a sustainable basis for future growth – there has to be increasing private sector investment, production and labor income. This will require a major change in core economic policies.

- Treasury's data on withholding taxes is showing a strong 8% gain in the fourth quarter of 2010 from the fourth quarter of 2009...

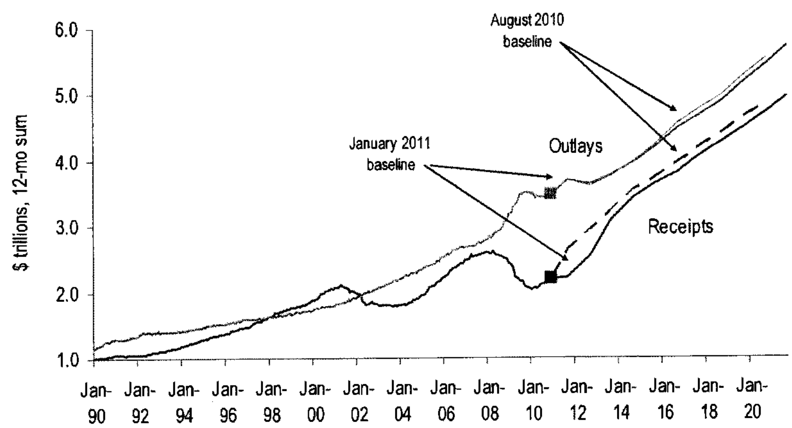
Federal Withheld Income and Employment Taxes
(year-over-year, last obs. December 2010)



Source: U.S. Treasury; Encima Global

- ... but not enough recovery to materially reduce the fiscal deficit expectations.

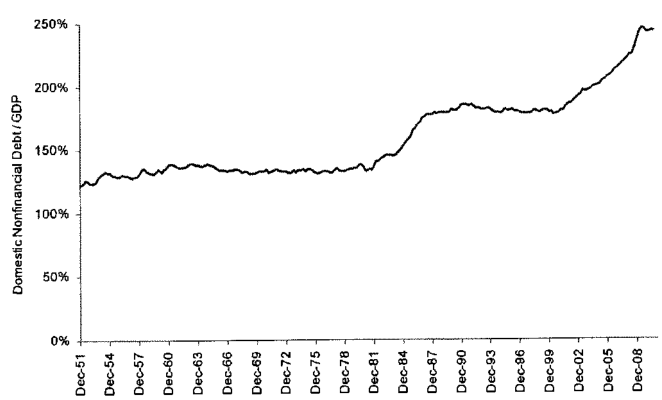
Federal Receipts and Outlays
($ trillions, last obs. December 2010, CBO projected to 2021)



Source: CBO; US Treasury; Encima Global

- **Despite private sector deleveraging, overall U.S. debt levels are near their peak due to the burst in federal debt.** At $35.8 trillion, total U.S. nonfinancial debt stands at **243% of GDP** in the Federal Reserve's most recent flow of funds data.

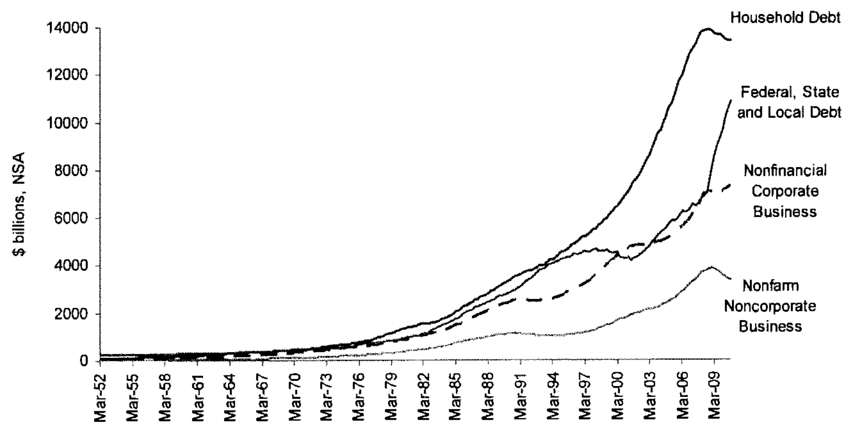
Total U.S. Debt per GDP (includes household, gov't and non-financial corporate debt, last obs. Q3 2010)



Source: Federal Reserve; Encima Global

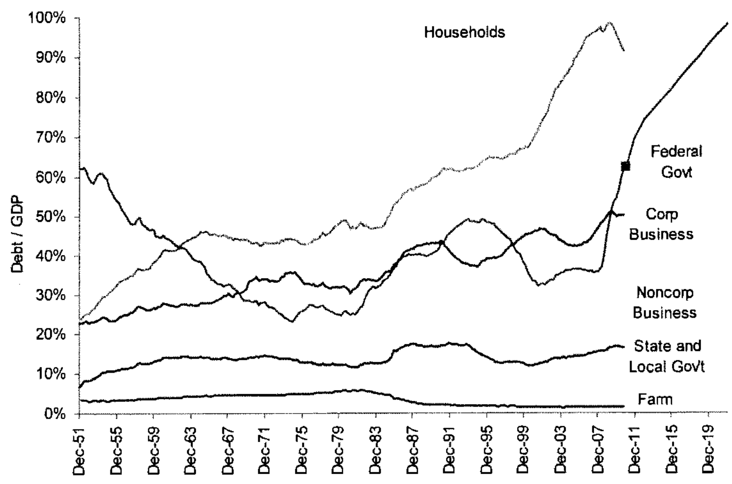
- Debt has been growing for the federal government and corporations.

U.S. Debt in $Billions By Category (last obs. Q3 2010)



Source: Federal Reserve; Encima Global

U.S. Debt per GDP (CBO-based projection of fed debt through 2021)

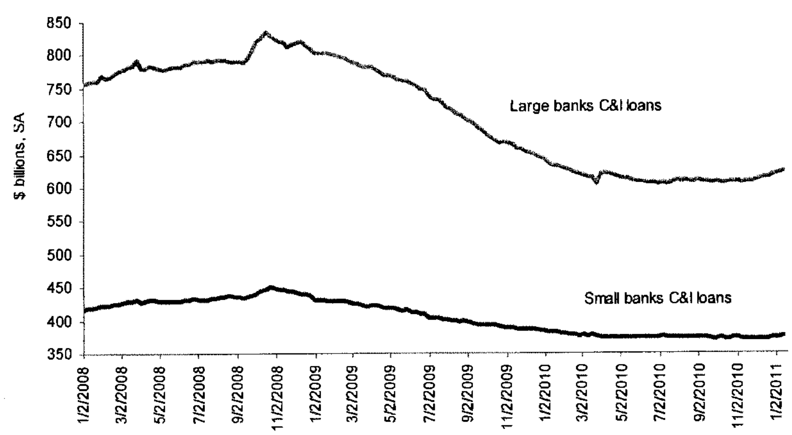


Source: Federal Reserve; CBO; BEA: Encima Global

- Through the third quarter of 2010, households and small businesses saw their debt shrink. In contrast, **federal debt has jumped to over 60% of GDP (the square on the graph above), and the latest CBO assessment shows debt rising to 100% of GDP assuming current tax rates are extended.**

- **In recent months, small businesses have been getting some oxygen** -- large banks are lending more -- but many debtors are still underwater including homeowners, small and medium sized businesses, states and municipalities. Unless growth speeds up markedly, many will be unable to maintain debt service. It will take more time in 2011 and 2012 to see how far these debt problems really extend and how severe their drag on growth.

Bank Lending Through Commercial and Industrial Loans
($ billions, last obs. January 12, 2011)



Source: Federal Reserve; Encima Global

- The **housing situation**, foreclosures and mortgages remain in bad condition, which reduces labor mobility. Some parts of the country will improve in 2011, but mortgage rates are rising and there are still severe conflicts between property owners, first and second mortgage holders and the legal system.

- Excess debt and over-spending at the **state and municipal level** will pit pensioners and current government services against lenders. This will take a long time to resolve.

- **Overall U.S. debt is $35.8 trillion**. Of that, the marketable debt of the federal government is $9 trillion. It grows with the fiscal deficit. In addition, the federal government also owes trust fund accounts $4.6 trillion. The Federal Reserve's holdings of Treasury debt were over $1 trillion in December and are expected to rise by $110 billion per month through June. Though the Fed will likely own bonds for years, the debt is still considered 'marketable' and part of the "debt held by the public."

$35.8 Trillion in Credit Market Debt Outstanding (last obs. Q3 2010)

	2010 Q3 ($ trill)	2010 Q2 ($ trill)	Yr/Yr % chg 2010 Q3	Yr/Yr % chg 2009 Q3	Yr/Yr % chg 2008 Q3
Domestic Nonfinancial Sectors	$ 35.8	$ 35.3	3.7%	4.3%	6.5%
Households	$ 13.4	$ 13.5	-1.8%	-1.7%	2.2%
Corporate Business	$ 7.3	$ 7.2	3.4%	0.3%	8.3%
Noncorporate Business	$ 3.4	$ 3.4	-7.5%	-4.8%	8.7%
Farm Business	$ 0.2	$ 0.2	0.3%	0.6%	2.2%
State & Local Govts	$ 2.4	$ 2.4	3.3%	3.7%	4.4%
Federal Government	$ 9.0	$ 8.6	19.5%	30.1%	15.3%
of which Fed Holds	$ 0.8	$ 0.8	5.5%	61.4%	-38.9%
as of Q4 $1.01 trillion					
memo:					
Federal Govt Trust Funds	$ 4.6				
of which Soc Sec	$ 2.6				

Not counting contingent liabilities from GSEs or underfunded trust funds

Source: Federal Reserve; OMB; Encima Global

Fiscal Outlook

In its new outlook, **CBO increased its deficit projections for 2011 to $1.5 trillion** from $1.1 trillion and for 2012 to $1.1 trillion from $700 billion. Under its baseline scenario (higher tax rates in 2013, but no impact on economic growth), the 10-year deficit (through 2020) and increment to marketable national debt is $7.7 trillion, up from $6.2 trillion in CBO's August 2010 outlook.

- Outlays are expected to remain very high relative to GDP, with record transfer payments currently running over 18% of personal income. Receipts will stay lower, leaving an **expected deficit of 10% of GDP in the current fiscal year.**

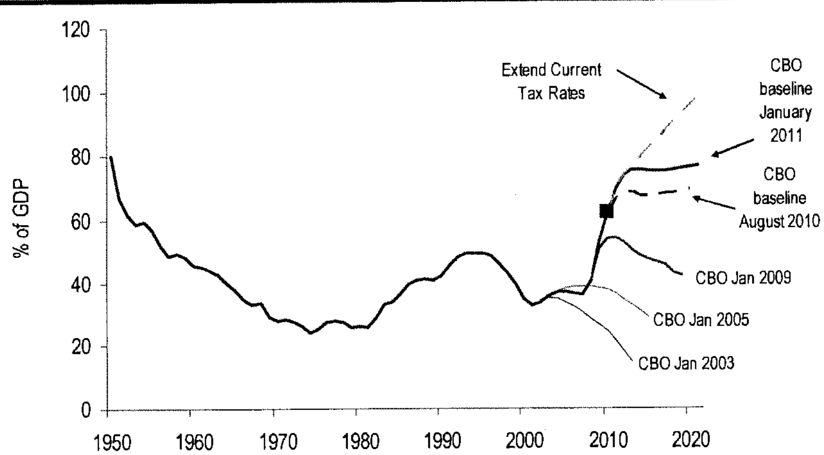
The current marketable debt is $9 trillion (62% of GDP). Under CBO's baseline, it would rise to $18.3 trillion in 2021.

- Previous CBO baseline estimates had the debt-to-GDP ratio flattening out at lower levels – at 40% of GDP in the 2009 baseline and 65% of GDP in the August 2010 baseline. The new forecasts have it flattening out around 77% of GDP (page 20 of the CBO report).

- These new debt figures are based on CBO's optimistic assumptions -- no recessions, much slower growth in discretionary spending, interest rates on the national debt stay low, and the proposed 2013 tax increase, the biggest in history, remarkably allows growth to speed up to an average 3.4% in 2013-2016.

- These assumptions leave a substantial understatement of the likely deficit and debt. More likely, either current tax rates are extended and CBO adjusts its deficit estimates upward to more realistic levels; or tax rates rise and hurt growth, receipts and the deficit. Assuming current tax rates are extended again in December 2012 as they were in December 2010, **CBO would adjust the national debt forecast up by an additional $5.5 trillion, pushing the marketable debt-to-GDP ratio to nearly 100% of the expected $24 trillion GDP in 2021** (CBO page 128).

CBO Forecasts of Federal Debt Per GDP (last obs. Dec 2010)

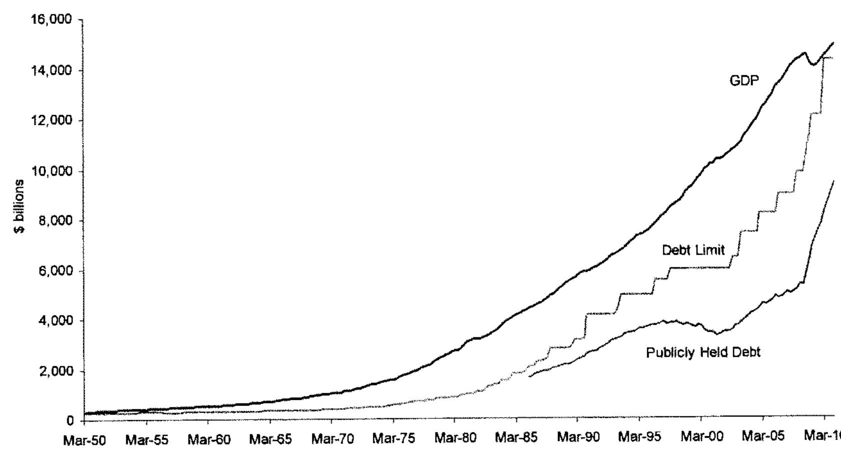


Source: CBO; OMB; Encima Global

Statutory debt is over $14 trillion, nearly 100% of nominal GDP (which was $14.66 trillion in 2010). The limit on statutory debt is now $14.3 trillion and will have to go above GDP very quickly given the $1.5 trillion deficit forecast.

- Statutory debt grows by the combination of the fiscal deficit plus the increase in the holdings of trust funds (roughly $220 billion per year). If government grew along with GDP, then statutory debt would also increase at the rate of economic growth plus inflation. Using CBO's baseline deficit (probably optimistic) plus the extension of current tax rates, **the statutory debt limit will rise to $31 trillion or 130% of GDP in the 10-year budget window** -- $31T/$23.8T (page 125 in the CBO report plus the tax extenders on page 22).

National Debt Limit At $14.3 Trillion (last obs. Q4 2010)



Source: BEA; US Treasury; Encima Global

- **The statutory debt limit stabilized for about four years in the late 1990s, while the marketable debt to GDP ratio fell** as the federal government moved into fiscal surplus.

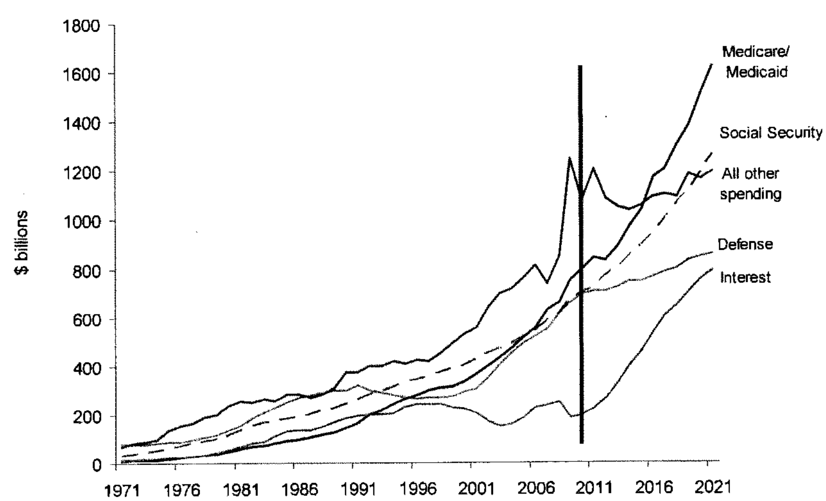
- There were strong tax receipts related to the high-tech stock market boom, a decline in noninterest outlays per GDP (mostly defense-related), and a brief demography-related period of very slow growth in entitlement spending. In addition, there was a rapid increase in the debt of government sponsored enterprises like Fannie Mae and Freddie Mac that substituted for government programs but was not counted in the statutory debt limit. **Those factors probably won't repeat in the next few years, leaving the fiscal deficit large and all debt measures -- statutory debt,**

the statutory debt limit, marketable debt and the marketable debt-to-GDP ratio – rising substantially.

Much attention has been focused on the U.S. entitlement problem and the underfunding of the social security and Medicare trust funds. **It is more clear from an economic perspective to consider all government programs as a commitment of future spending, funded pay-as-you-go** whether accounted for as an entitlement (like Medicare) or as discretionary spending (like defense.)

- CBO's baseline shows **$5.7 trillion in expected spending in 2021. Interest expense, even with very optimistic assumptions about debt levels and debt service costs, will be rising sharply while defense and non-entitlement spending barely grows.**

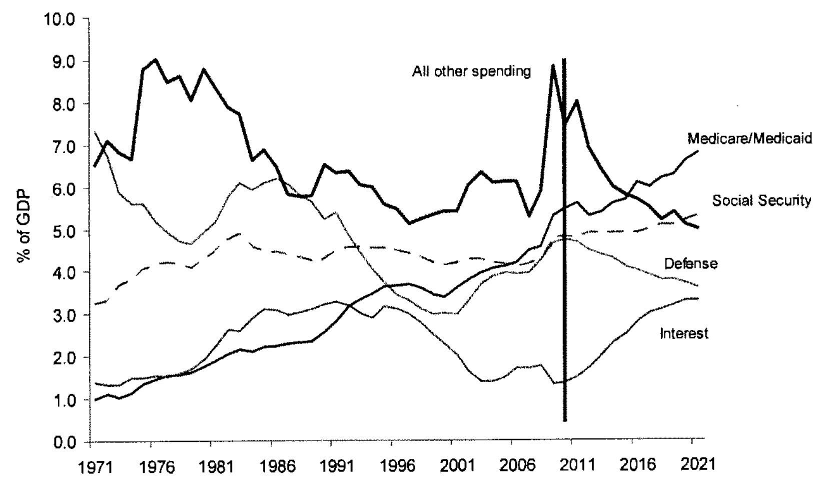
Expenditures in $ billions by Major Category (last obs. 2010, CBO projections to 2021)



Source: CBO; Encima Global

- The Administration's FY2011 budget has defense spending declining sharply relative to GDP through 2015, resuming the sharp "peace dividend" decline that occurred in the 1990s. **Future budgets will contend with fast growth in medical spending and interest expenses crowding out other spending.**

Expenditures as a Percent of GDP by Major Category (last obs. 2010, CBO projections to 2021)



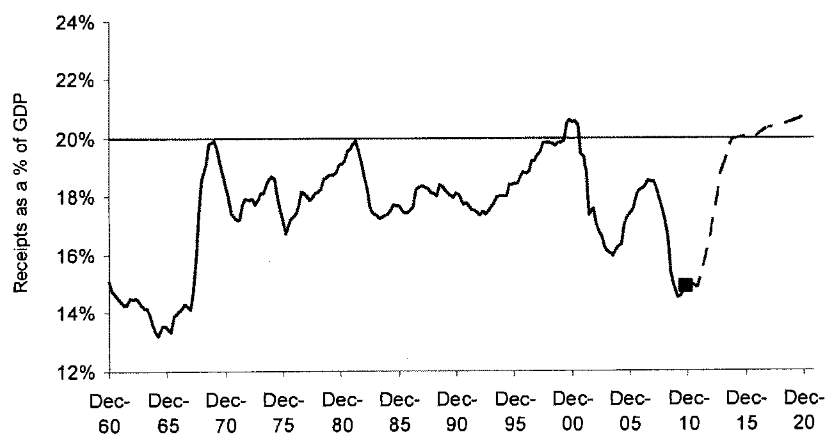
Source: CBO; Encima Global

Reaching the Limit of Washington's Debt Expansion

No one knows whether the U.S. will hit a tipping point where creditors stop buying our debt. We do know that such a problem would be catastrophic and that responsible public policy should be aimed at lowering the risk.

- The CBO forecasts discussed above give a sense of **sustainability by using the optimistic assumptions of faster GDP growth, no recessions, interest rates staying low, and receipts rising quickly** above their historical limit as a share of GDP (Hauser's limit graphed below). Using these assumptions, we might have years to solve the problem if all goes well. However, **for responsible policy-making, we should use more cautious assumptions. This argues for deep, urgent spending cuts so that we don't test the tipping point.**

Federal Receipts as a Percent of GDP Exceed 20% in CBO Baseline (last obs. Dec 2010, CBO projected to 2021)

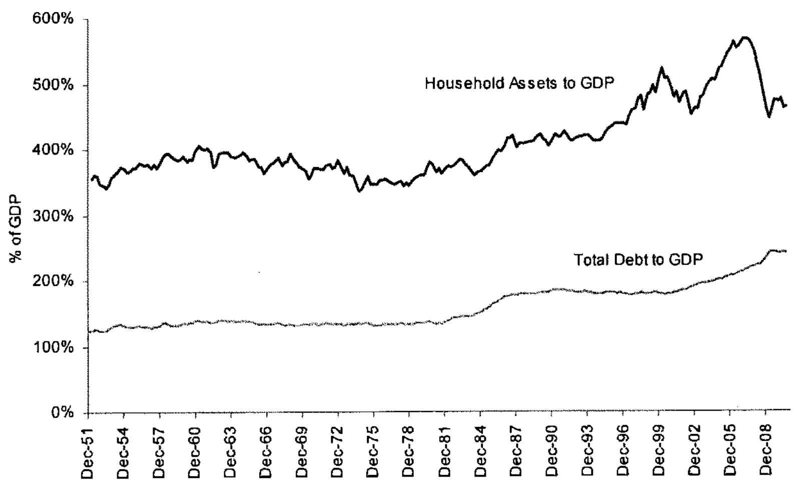


Source: CBO; US Treasury; BEA; Encima Global

In evaluating the U.S. debt problem versus other countries, I look at the current debt burden relative to GDP (our's is now high); the rate of growth of the debt burden (our's is fast, given the fiscal deficit); the foreign currency exposure (our's is minimal); the nation's offsetting assets (our's have fallen, but are still very high); and the maturity of the debt (our's is way too short).

- On the positive side, very little of the U.S. national debt is non-dollar. Crises in Asia and Russia in the late 1990s and Mexico in 1994 involved foreign currency debts that mushroomed during their devaluations.
- And U.S. household assets are the largest in the world by far ($69 trillion or 425% of GDP).
- By these metrics, the U.S. is in a less precarious debt position than several European countries, arguing against a near-term federal crisis.

Household Assets and Total Debt / GDP (last obs. Q3 2010)



Source: Federal Reserve; BEA; Encima Global

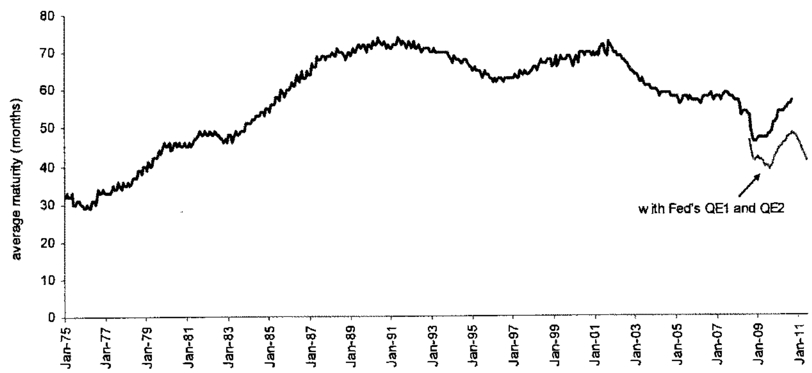
However, federal spending and debt are growing so fast from a very high level that they are already clouding the U.S. outlook, especially given the short maturity of the debt.

- **The stated maturity of the U.S. national debt has shortened from 70 months in the 1980s and 1990s to under 60 months**. One goal of good financing policy is to lengthen the maturity of the debt – the U.S. is doing the opposite in the extreme. This is a major risk in the event that interest rates rise.

- **The Federal Reserve's large buyback of longer-dated Treasury notes and bonds, paid for by over-night deposits from commercial banks, has substantially shortened the effective maturity of the U.S. national debt – to roughly 40 months, near the crisis point of the 1970s.**

- In addition to Treasury bonds, the Fed holds $1.1 trillion of long-maturity MBS and GSE agency notes financed overnight, an added exposure for the taxpayer in the event markets require higher interest rates -- as they did in the 1970s when the debt maturity was also short.

Average Maturity of Treasury Debt; Effective Maturity with Fed's QE (in months, last obs. Sept 2010, QE2 projected through June 2011)

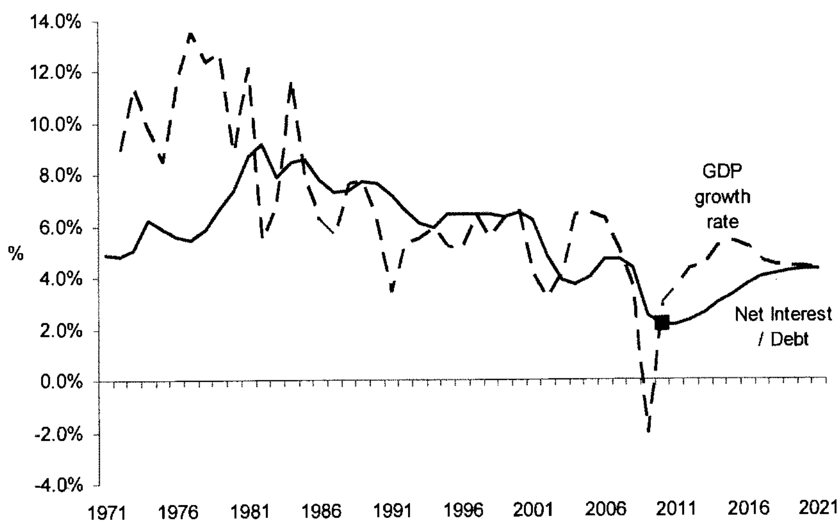


Source: U.S. Treasury; Federal Reserve; Encima Global

- A key underlying assumption in the CBO outlook that stabilizes the out-year budget deficit is that U.S. interest rates stay well-behaved, rising gradually with the recovery. CBO assumes that federal interest costs converge from the current 2% average interest rate on the national debt to a stable 4.4% in 2021, exactly the same as the nominal GDP growth rate.

- In the past, however, the average interest rate on the national debt has often been above nominal GDP growth, including most of the 1980s and 1990s. With the maturity of the national debt much shorter now, the likelihood is that interest rates will spend substantial time above the nominal growth rate in the next few years, increasing the deficit forecasts.

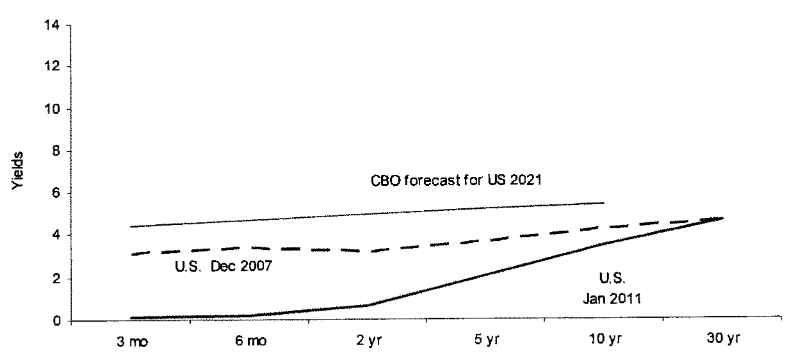
Nom GDP Growth Vs. Int Rate Paid (last obs. 2010, CBO proj to 2020)



Source: CBO; Encima Global

- After the 2008 financial crisis, U.S. interest rates moved down sharply. CBO assumes that short-term interest rates rise to more normal levels, while longer-term bond yields stay relatively stable even as debt-to-GDP rises toward 100% of GDP.

Yield Curve for US (last obs. January 27, 2011)

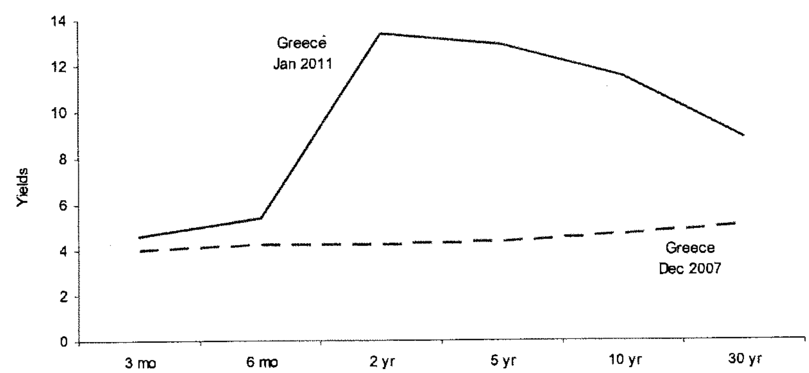


Source: Bloomberg; CBO; Encima Global

At tipping points, countries experience a sharply different market reaction than the CBO projection for U.S. interest rates.

- Greece was not having a debt problem in 2007 and enjoyed a relatively flat yield curve at roughly 4% (a bit lower than the U.S. 2021 expectation.)
- In late 2009, Greece's newly elected prime minister announced that the national debt was more than the country had been reporting, obscured in part by derivatives that lowered the current deficit at the expense of future debt (akin to the U.S. shortening its debt maturity to reduce interest).
- Greece saw its short-term interest rates jump to over 12% as it hit a tipping point and fell into a severe debt crisis. With much of its debt short-term, the impact of the spike in interest rates on Greece's budget deficit has been devastating.

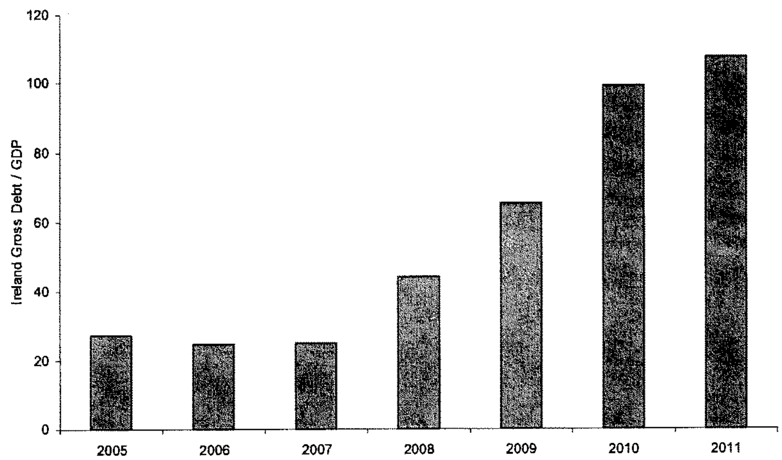
Yield Curve for Greece (last obs. January 27, 2011)



Source: Bloomberg; Encima Global

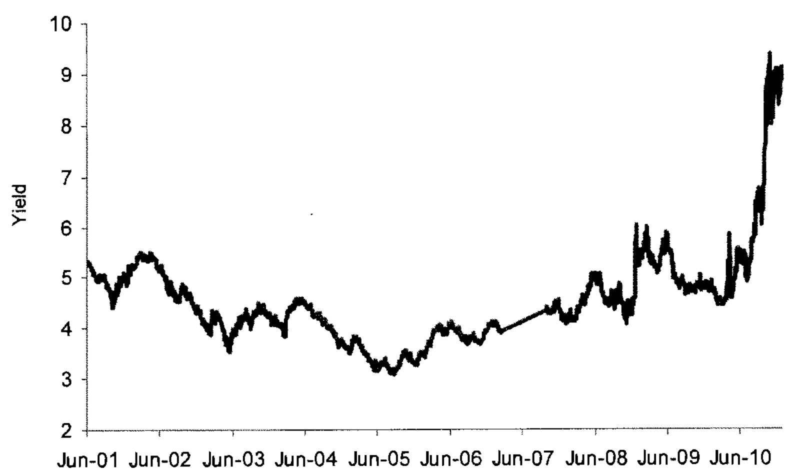
- In mid-2010, Ireland hit a tipping point in which markets would no longer finance its debt. The risk at the tipping point is a creditor's strike.

Ireland's Debt To GDP Ratio Hit A Tipping Point at 90% (last obs. 2010, IMF forecast for 2011)



Source: IMF; Encima Global

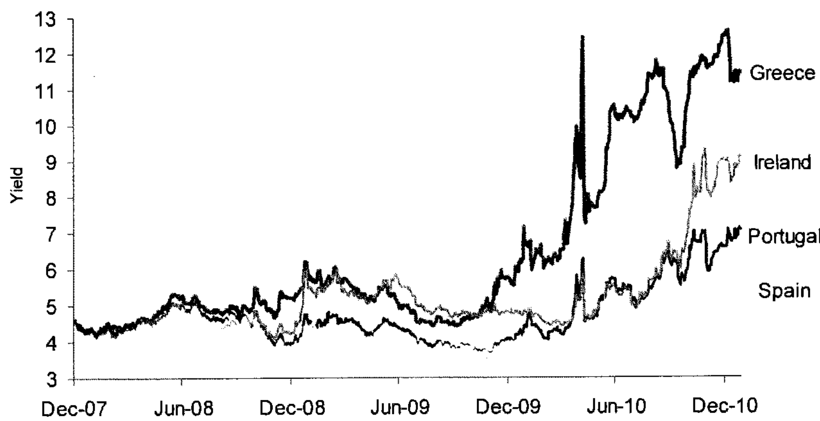
Ireland's Ten-Year Bond Yield (last obs. January 28, 2011)



Source: Bloomberg; Encima Global

- The combination of large deficits, high debt levels, debt surprises and a spike in interest rates has created a severe European debt crisis spreading from one country to another as weaker countries wait for bailouts from stronger countries.

Select European Yields (last obs. January 28, 2011)



Source: Bloomberg; Encima Global

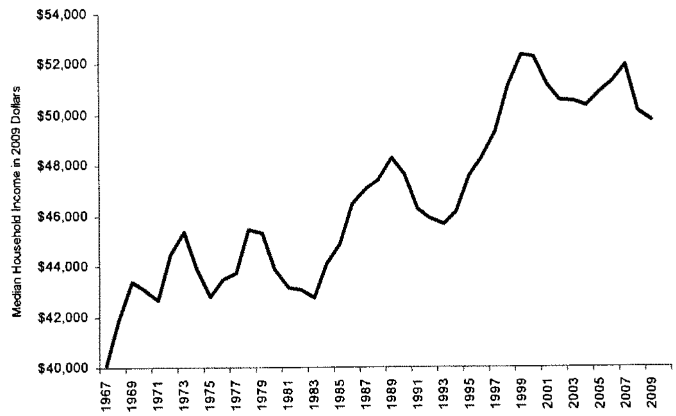
How might a U.S. crisis evolve? Each time budget deficits go up, it discourages private sector investment and pushes capital away from the U.S. That creates a vicious circle – weak investment means fewer jobs and less tax receipts, causing another overshoot in the fiscal deficit.

- As long as interest rates stay low, it's not a debt crisis. The bond analogy comes to mind – as long as the rating agencies call it AAA, then everything is ok.

- In reality, we're already suffering a slow-motion growth crisis in which interest rates have been artificially low for nearly a decade, obscuring the true debt, undercutting the dollar and hurting living standards. This in turn invites higher transfer payments and hurts tax receipts, worsening the fiscal deficit.

- Median household income is well below the late 1990s and is falling fast, the result, in my view, of a harmful weak dollar policy, artificially low interest rates and high levels of government spending.

Median Household Income, Inflation-adjusted (2009$, last obs. 2009)



Source: Bureau of Census; Encima Global

Some Policy Views

I. The expiration of the continuing resolution on March 4 should be used as an opportunity to make numerous spending cuts now -- to put Washington on a diet where it shrinks day by day. Waiting for a deficit reduction package ducks responsibility and is a recipe for continued out-of-control deficit spending.

II. The debt limit increase should be used to install a lasting limitation on the U.S. marketable debt-to-GDP ratio, enforced by escalating penalties on Washington when the limit is exceeded. There should also be a minimum average maturity for the debt to stop the government from artificially lowering near-term interest costs.

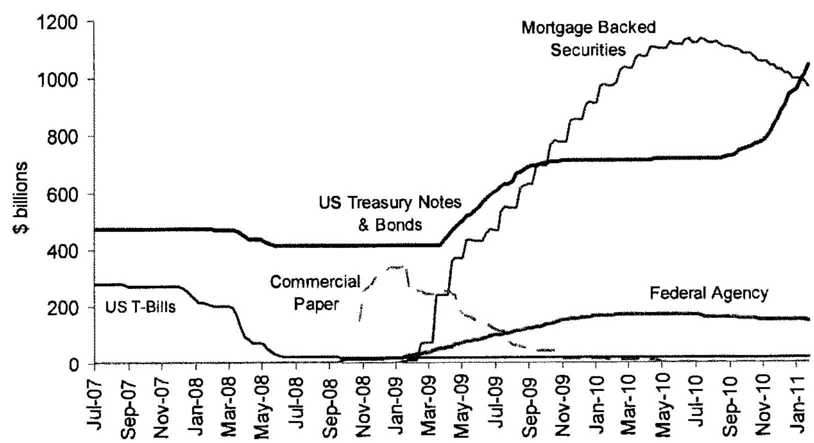
- Article I, Section 8 of the **Constitution** reads: "The Congress shall have power to lay and collect taxes... and to **borrow money on the credit of the United States.**" But there are **no boundaries on this power in the section 9 limits on Congress**. If the Founding Fathers had realized that a future Congress would borrow $9 trillion much less the $31T envisioned by CBO for statutory debt, they might have installed a lasting debt limitation. For example: "**Total borrowings shall not exceed half the annual output, and their average maturity shall be at least five years.**"
- **Absent a constitutional protection from excessive debt and short debt maturities, Congress should legislate one**. The existing statutory debt limit is flawed because it is a nominal dollar amount, currently $14.3 trillion, and is repeatedly overtaken by the country's growth, inflation and the buildup in trust funds. It doesn't include a floor on maturity. I think it would be highly disruptive to the economy and financial markets to try to avoid increasing the statutory debt limit by channeling tax receipts to debt

service while stopping other expenditures. In effect, the government would be shutting down, but in an arbitrary sequence, causing disruptions because of uncertainty about payments.

- A better limit would be based on the marketable debt-to-GDP ratio, say at 50% of GDP, enforced by escalating penalties on government leaders and institutions if the limit is exceeded. Like the Constitution, this type of limit might last decades or centuries. As a complement, I would support a spending per GDP limitation, though federal expenditures vary substantially from decade to decade based on demographic needs, defense posture and interest rates.

III. By buying long-term assets, the Federal Reserve is conducting fiscal policy. QE2 should be wound down. It is shortening the effective maturity of the national debt and is causing substantial market distortions. The Fed's total assets are climbing rapidly toward $3 trillion, an unprecedented expansion. The Fed's holdings, now some of the world's biggest, create a major conflict of interest in setting interest rate policy.

Federal Reserve Assets (last obs. January 26, 2011)



Source: Federal Reserve; Encima Global

IV. Tax reform is a high policy priority. I favor including permanent extensions of current tax rates in the baseline to facilitate growth-oriented tax reform and modifying scoring rules to stop the practice of temporary tax rates.

I believe these four policy approaches would give new confidence to businesses and financial markets, causing an inflow of jobs and capital to the U.S. private sector. Thank you again for the invitation to testify on these critical issues.

Encima Global

Senate Budget Committee:
Economic and Fiscal Outlook

February 1, 2011

David Malpass
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212.876.4400

Encima Global

Economic and Fiscal Outlook

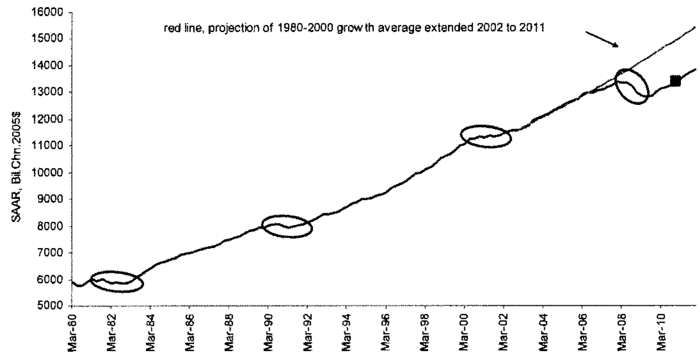
- **The economic outlook is for moderate U.S. growth after the deep 2008 collapse, weighed down by the increasing reliance on the government for the allocation of capital and credit as its debt expands.**
- **The current fiscal trend is for continued mega-deficits and a marketable debt-to-GDP ratio reaching 100%, well above sustainable levels. The statutory debt limit, now $14.3 trillion, is headed toward a staggering $31 trillion in the latest CBO outlook.**
- **My testimony addresses the risk of a catastrophic tipping point due to our enormous federal debt and the growth in spending. Adding to the risk, the maturity of the national debt is dangerously short, made worse by the Federal Reserve's buyback of long-maturity debt.**

Encima Global

Growth

Real GDP Growing From a Low Base

(last obs. blue square Q4 2010, projected to Q4 2011)



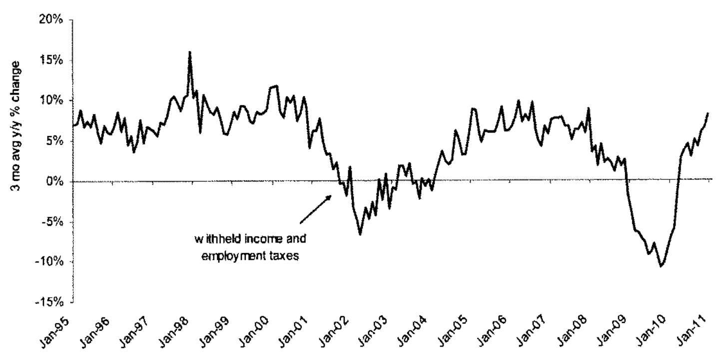
Source: Bureau of Economic Analysis; Encima Global

Encima Global

Consumer and Savings

Federal Withheld Income and Employment Taxes

(year-ver-year, last obs. December 2010)



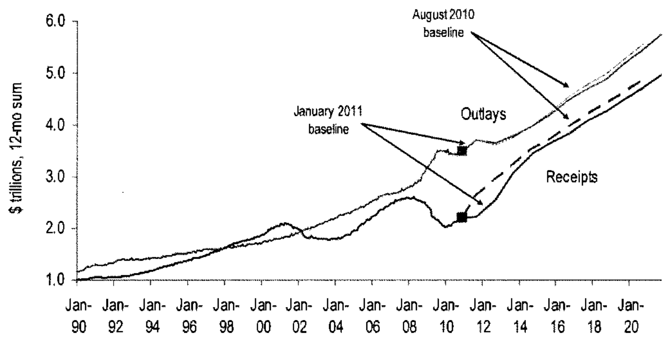
Source: U.S. Treasury; Encima Global

Encima Global

Government

Federal Government Receipts and Outlays

($ trillions, last obs. December 2010, CBO projected to 2021)



• Source: CBO; US Treasury; CBO; Encima Global

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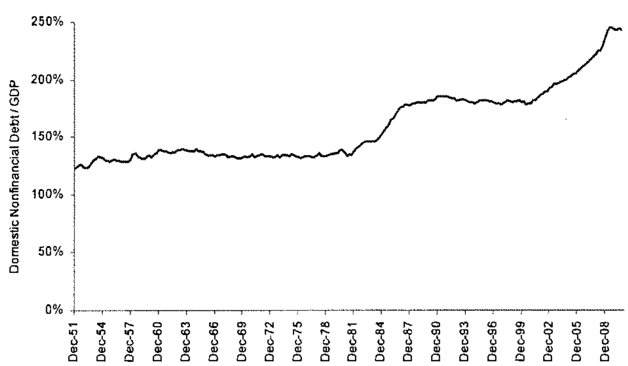
Credit

Total U.S. Nonfinancial Debt / GDP

(includes household, gov't and non-financial corporate debt; last obs. Q3 2010)



Source: Federal Reserve; Encima Global

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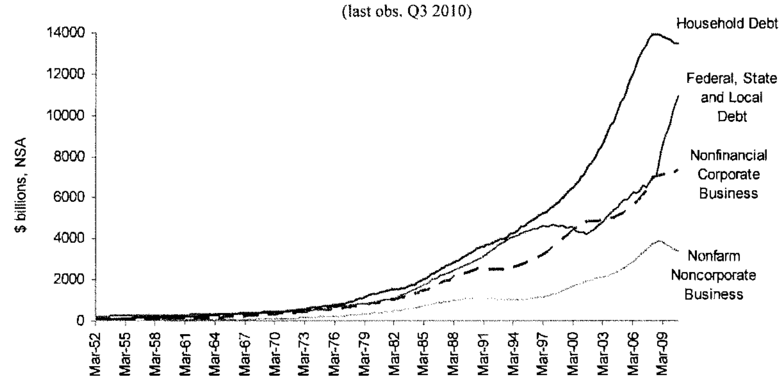
Credit

U.S. Debt in $Billions by Category

(last obs. Q3 2010)



Source: Federal Reserve: Encima Global

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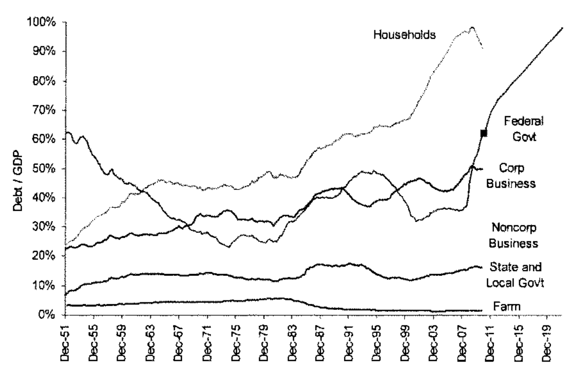
Credit

U.S. Debt per GDP

(CBO-based projection of federal debt through 2021)



Source: Federal Reserve: CBO; BEA; Encima Global

$35.8 Trillion in Credit Market Debt Outstanding

(last obs. Q3 2010)

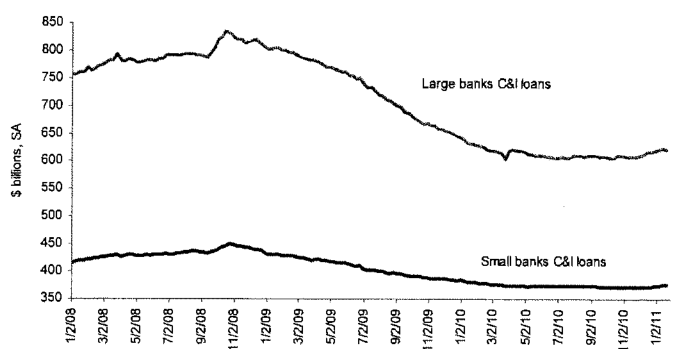
	2010 Q3 ($ trill)	2010 Q2 ($ trill)	Yr/Yr % chg 2010 Q3	Yr/Yr % chg 2009 Q3	Yr/Yr % chg 2008 Q3
Domestic Nonfinancial Sectors	$ 35.8	$ 35.3	3.7%	4.3%	6.5%
Households	$ 13.4	$ 13.5	-1.8%	-1.7%	2.2%
Corporate Business	$ 7.3	$ 7.2	3.4%	0.3%	8.3%
Noncorporate Business	$ 3.4	$ 3.4	-7.5%	-4.8%	8.7%
Farm Business	$ 0.2	$ 0.2	0.3%	0.6%	2.2%
State & Local Govts	$ 2.4	$ 2.4	3.3%	3.7%	4.4%
Federal Government	$ 9.0	$ 8.6	19.5%	30.1%	15.3%
of which Fed Holds	$ 0.8	$ 0.8	5.5%	61.4%	-38.9%
as of Q4 $1.01 trillion					
memo:					
Federal Govt Trust Funds	$ 4.6				
of which Soc Sec	$ 2.6				

Not counting contingent liabilities from GSEs or underfunded trust funds

Source: Federal Reserve: OMB; Encima Global

Bank Lending Through Commercial & Industrial Loans

($ billions, last obs. January 19, 2010)



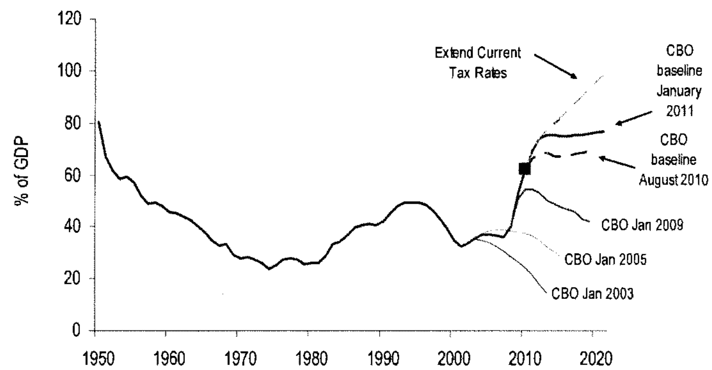
Source: Federal Reserve; Encima Global

Encima Global

Government

CBO Forecasts of Federal Debt Per GDP

(square is last obs. 2010, forecasts to 2021)



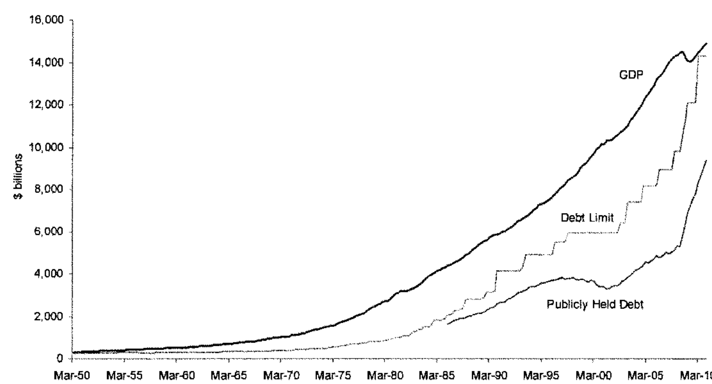
Source: CBO; OMB; Encima Global

Encima Global

Government

National Debt Limit At $14.3 Trillion

(last obs. Q4 2010)



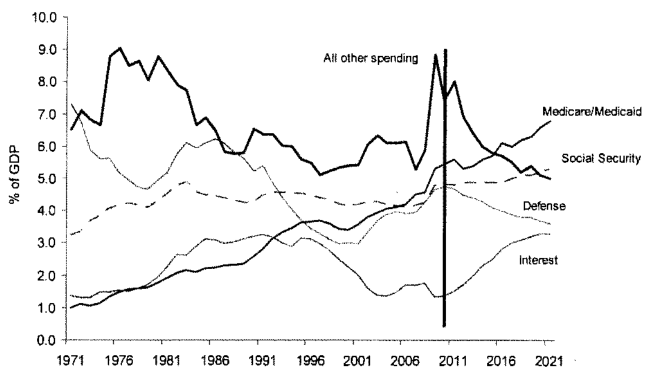
Source: Bureau of Economic Analysis; U.S. Treasury; Wikipedia; Encima Global

Encima Global

Government

Expenditures as a Percent of GDP by Major Category

(last obs. 2010, CBO projections to 2021)



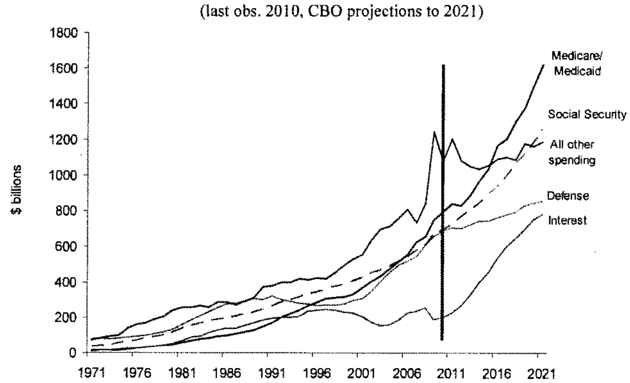
Source: CBO; Encima Global

Encima Global

Government

Expenditures in $ billions by Major Category

(last obs. 2010, CBO projections to 2021)

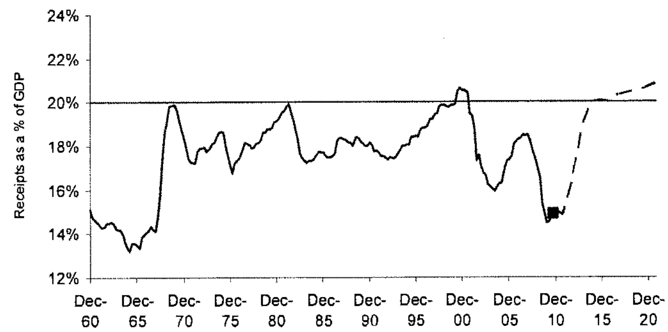


Source: CBO; Encima Global

Government

Federal Receipts as a Percent of GDP Exceed 20% in CBO Baseline

(last obs. 2010, CBO projections to 2021)

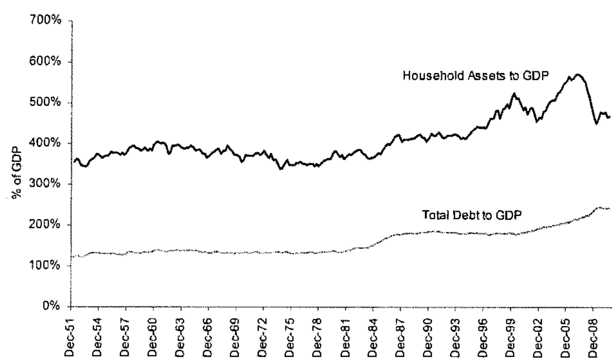


Source: CBO; US Treasury; BEA; Encima Global

Consumer and Savings

Household Assets and Total Debt / GDP

(last obs. Q3 2010)



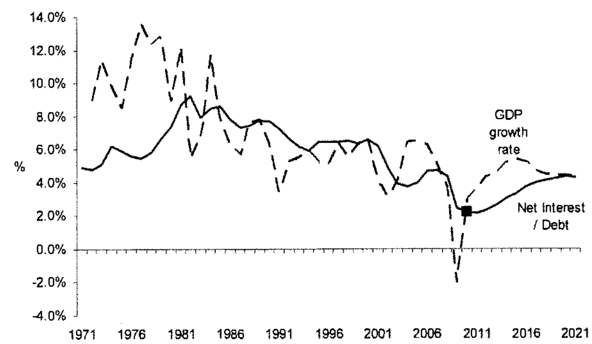
Source: Federal Reserve; BEA; Encima Global

Encima Global

Government

Nominal GDP Growth vs. Interest Rate Paid

(last obs. 2010, CBO projected to 2021)



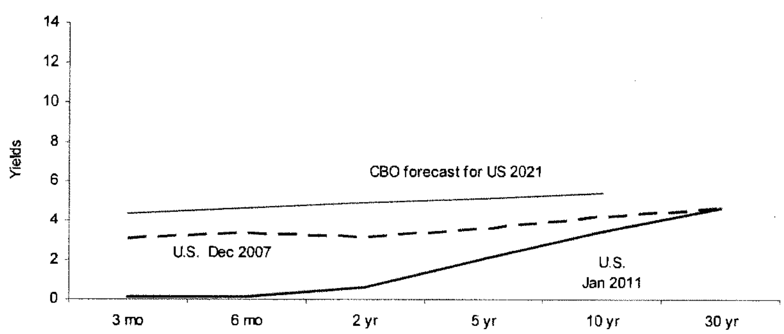
Source: CBO; Encima Global

Encima Global

Credit

Yield Curve for US

(last obs. January 27, 2010)



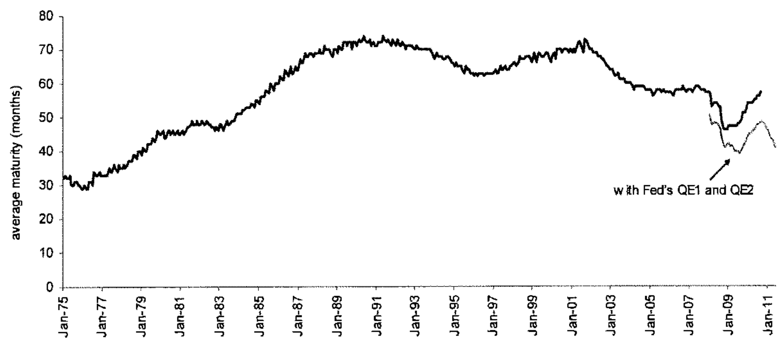
Source: Bloomberg; CBO; Encima Global

Encima Global

Credit

Average Maturity of Treasury Debt; Effective Maturity with Fed's QE

(in months, last obs. Sept 2010; QE2 projected through June 2011)



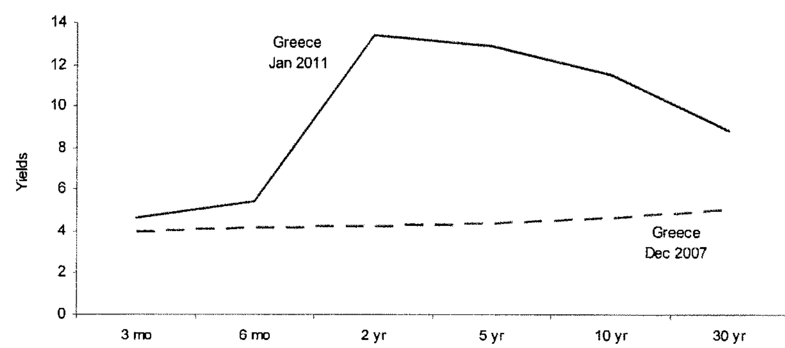
Source: US Treasury; Federal Reserve; Encima Global

Encima Global

Credit

Yield Curve for Greece

(last obs. January 27, 2010)



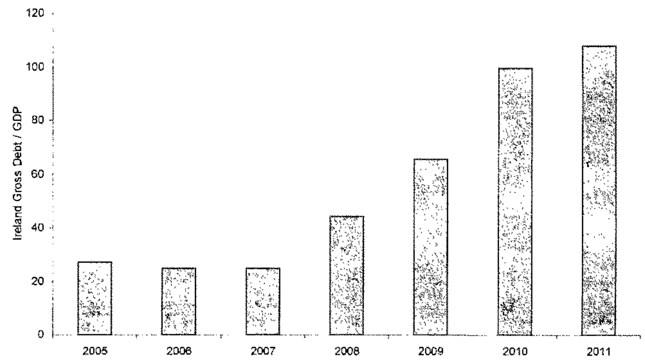
Source: Bloomberg; Encima Global

Encima Global

Credit

Ireland's Debt To GDP Ratio Hit A Tipping Point at 90%

(last obs. 2010, IMF forecast for 2011)



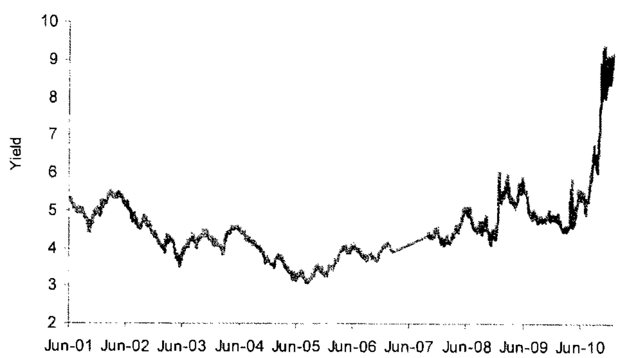
Source: IMF; Encima Global

Encima Global

Credit

Ireland's Ten Year Bond Yield

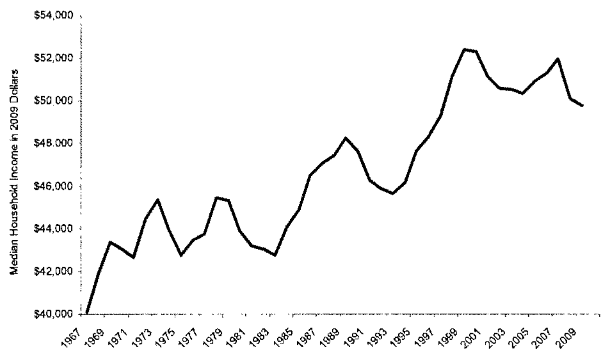
(last obs. January 28, 2011)



Source: Bloomberg; Encima Global

Median Household Income, Inflation-adjusted

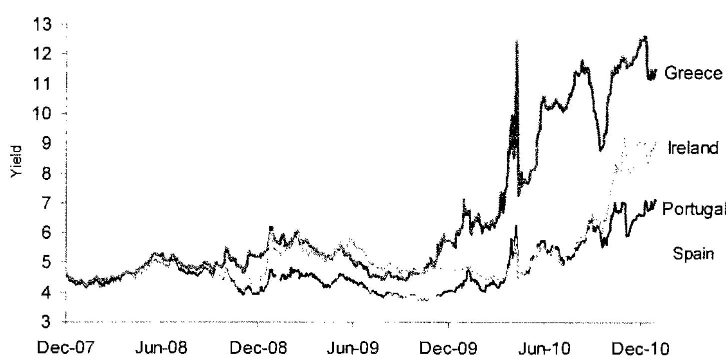
(2009$, last obs. 2009)



Source: Bureau of the Census; Encima Global

Select European 10 Yr Yields

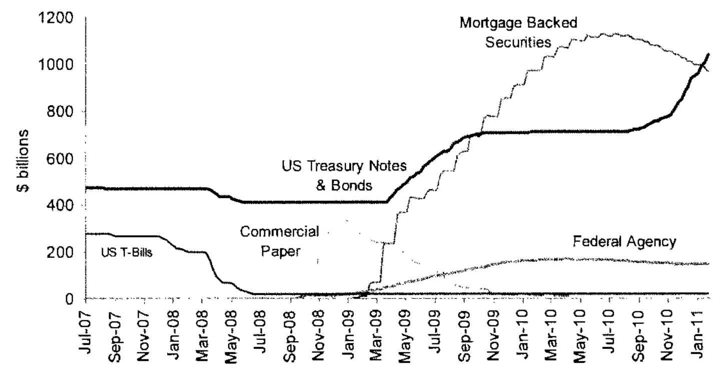
(last obs. January 28, 2010)



Source: Bloomberg; Encima Global

Federal Reserve Assets

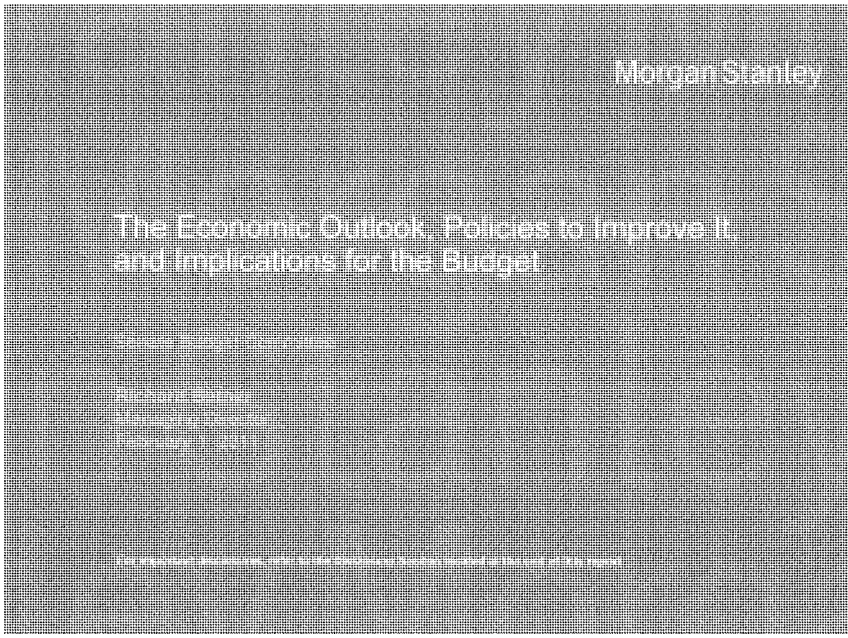
(last obs. January 26, 2011)

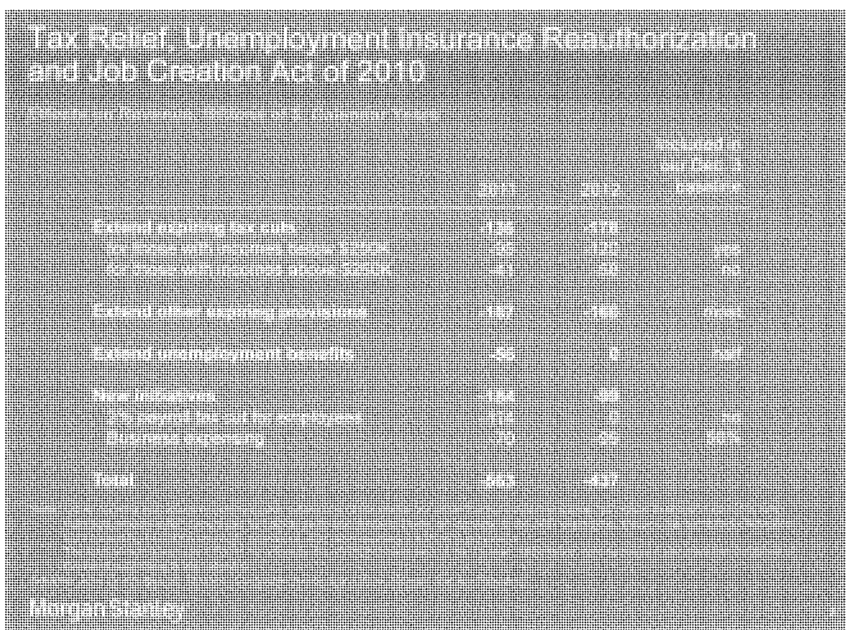


Source: Federal Reserve; Encima Global

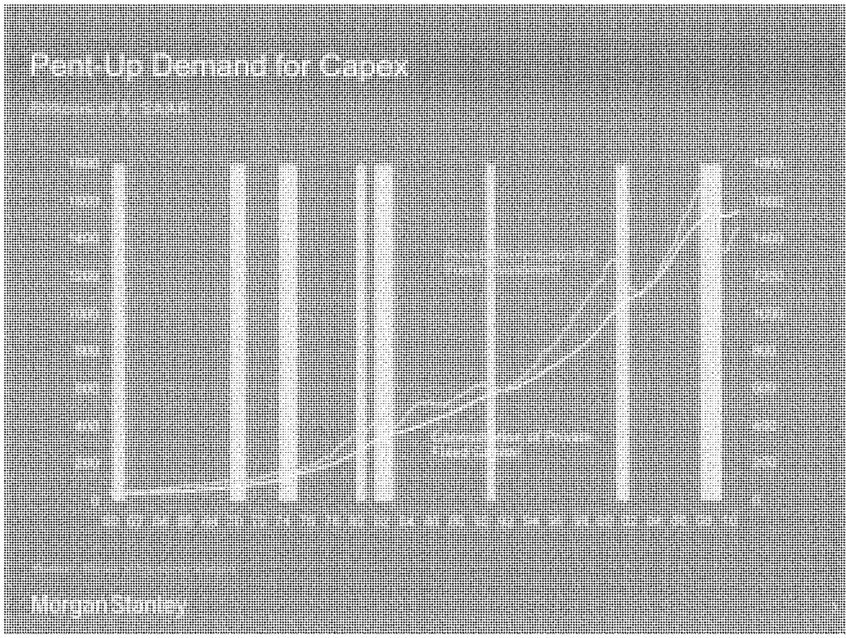
Policy Views

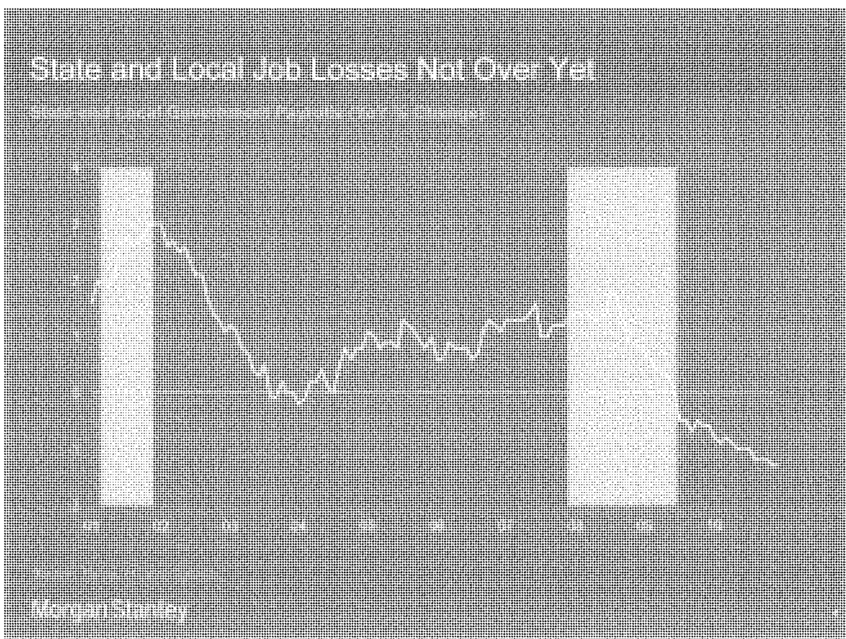
- The expiration of the continuing resolution on March 4 should be used as an opportunity to make numerous spending cuts now -- to put Washington on a diet where it shrinks day by day. Waiting for a deficit reduction package ducks responsibility and is a recipe for continued out-of-control deficit spending.
- The debt limit increase should be used to install a lasting limitation on the U.S. marketable debt-to-GDP ratio, enforced by escalating penalties on Washington. There should also be a minimum maturity for the debt to stop the government from artificially lowering near-term interest costs.
- By buying long-term assets, the Federal Reserve is conducting fiscal policy. QE2 should be wound down. It is shortening the effective maturity of the national debt and is causing substantial market distortions.
- Tax reform is a high priority. I favor including permanent extensions of current tax rates in the baseline to facilitate growth-oriented tax reform and modifying scoring rules to stop the practice of temporary tax rates.
- I believe these policy approaches would give new confidence to American businesses and financial markets, causing an inflow of capital and jobs to the U.S. private sector.



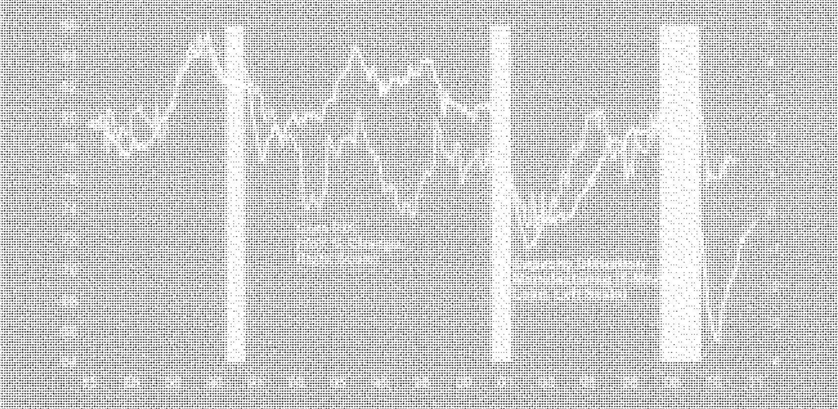


	2011	2012	Included in our Dec. 3 baseline?
Extend expiring tax cuts	-136	-178	
for those with incomes below $250K	-95	-107	yes
for those with incomes above $250K	-41	-28	no
Extend other expiring provisions	-187	-160	most
Extend unemployment benefits	-56	0	half
New Initiatives	-185	-98	
2% payroll tax cut for employees	-112	0	no
Business expensing	-70	-26	50%
Total	-563	-437	


Pent-Up Demand for Capex
Morgan Stanley


State and Local Job Losses Not Over Yet
Morgan Stanley

Change in Operating Rates is Restoring Pricing Power



Morgan Stanley

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Chairman CONRAD. Thank you. Let me just go to each of you and ask you in turn, look, we have—this Committee is the Budget Committee, and our obligation is to provide a budget outline to our colleagues. We have a lot of decisions to make. One of the fundamental questions is how quickly do we impose fiscal discipline, fiscal austerity.

The Commission concluded—and it is interesting. Not only did the President's Fiscal Commission conclude this; the Domenici-Rivlin Commission concluded this, and the Esquire Commission concluded this—all of them bipartisan Commissions. All of them concluded for the next 18 months to 2 years we ought to make modest changes, but put in place a plan that over time, over the next 10 years, substantially reduces the debt, on the rate of the President's Commission, $4 trillion of debt reduction. Domenici-Rivlin was even more aggressive on deficit reduction, as was the Esquire Commission—all of them bipartisan Commissions.

What would your advice to us be in terms of a 10-year plan? How aggressive should we be on the front end with imposing austerity? How big a chance should we be seeking to achieve over a 10-year budget window? Dick?

Mr. BERNER. Well, Senator Conrad, I think that I would generally endorse the timetable and the general tone of each of those three Commissions, namely, that we do not have a short-term debt problem; we have an enormous long-term debt problem, and we need to come to grips with that. If we had a short-term debt problem, then the market and market participants would be reflecting that.

One of the things we can use as a barometer to gauge whether we have a short-term debt problem is the response of markets, and when markets start to question whether or not you can service your debt, then you will see a rise in interest rates and a widening in spreads relative to other benchmarks in the marketplace on a global basis. We do not have that yet, so we enjoy low interest rates, and we enjoy favorable borrowing terms right now. But, of course, that is going to run out, and I think, as I emphasized in my testimony and as you just mentioned, the important thing is to craft a credible plan to address our long-term problems. And I just want to emphasize that credible does not mean saying that we are going to cut $100 billion here or that we are going to have a 5-year freeze on discretionary spending. Credible means that we are going to attack those long-term problems. We are going to look at them specifically and address the root cause of our long-term fiscal problems.

Chairman CONRAD. Dr. Johnson, what would your advice be to us with respect to the question of timing?

Senator SESSIONS. Mr. Chairman, could I ask him to do that in an economic sense, not adjusting your comments to what you might think the political realities are, because that is up to us to try to face. But we would like to have your best opinion on what we should do.

Mr. BERNER. Senator, if I could just add, my comments were not adjusted for political reality.

Senator SESSIONS. I felt that. Thank you.

Mr. JOHNSON. Well, I think we are—I am not in favor of precipitous, immediate fiscal austerity of the kind the British Government is now embarked on, and we will see in the quarters ahead how that program does. The data from the last quarter is rather shocking. They had a decline in GDP far below all the private sector forecasts in the U.K. Partly it was bad weather in December, but also October and November were very bad months.

As Dick said, we do not need—they do not need also, but we do not need that kind of immediate cuts, but I think we do need something over the medium term, in my opinion, that is even more aggressive than I think where Dick is and certainly than where David is. I think when you are carrying massive financial sector risk, which is what we are carrying—and it is also, by the way, what the Irish carry. If you look at page 21 in David's charts, the Irish were considered to have responsible fiscal policy. They blew themselves up on the fiscal side because three banks went rogue and destroyed themselves and were taken over by the government, because the government felt they did not have an alternative. That is where we are. So 50 percent of GDP or 60 percent, the number commonly used, I think is to high when you have—unless you want to deal with the financial risk. But we did not do that. So when you are carrying this amount of implied contingent liability over a 10-year period, I want to get the debt down even lower because I fear that the markets can turn very quickly. This is the Bill Gross test, Senator Sessions. Next time you or I see Mr. Gross, we should ask him: How long would it take you to change your mind and shift your portfolio, for example, towards the euro zone if they sort out their fiscal financial problems? Which I think they will do in the next 12 to 18 months. I think he would tell you it takes, you know, 20 minutes for him to move his portfolio. That is how fast the yield curve can move against this, and that is what happened, as David said, to the Irish.

Chairman CONRAD. That is what Tom Friedman called "the electronic herd."

David?

Mr. MALPASS. I think the goal is to avoid that electronic herd and actually to get the private sector to start hiring people. So I think I feel a little differently than many economists, that if we cut a lot now in the Federal Government, people would perk up and take notice. Global investors would start putting their money into the United States rather than moving it to Asia and elsewhere. So I want to emphasize that positive feedback mechanism from going on a diet now. If you are going on a diet, do not say, well, 3 months from now we will have our plan laid out. Just stop eating as much this evening, and then if you can, start your exercise program.

Chairman CONRAD. But, David, let me just say to you, you know, the problem is that is not the way the schedule of Congress works.

Mr. MALPASS. Yes.

Chairman CONRAD. You know? We have a schedule here, and the schedule is we have to have a budget resolution that guides the Appropriations Committees. I happen to agree with you. I think it would be wonderful if we could do it. But it does not work with the schedule of Congress. So we have to deal with that, and that is why, again, I asked for a summit. I think if we want to send a signal that America is going to face up to this problem and we are going to put together a credible plan, nothing would be more effective than the leadership of this country sitting down and coming up with that plan and not wait for the debt limit. You know what I am saying? I mean, we are not going to have appropriations bills for months because they come later in the cycle. So we cannot do what I think you would like to see happen, what I think would be helpful to credibility, because, you know, we just do not get to that stage until a little later.

Mr. MALPASS. Yes, this is a tough fix. I agree with all of you that we need the longer-term cuts and rethinking of how we spend money, and it needs to be rather substantial. So a wonder in the markets right now is whether there will be any ability by the U.S. Government to actually do some of these cuts. So is there some middle ground between what the U.K. did and doing nothing over the next 6 months. That at least would, I think, begin to change the minds—right now U.S. corporations are taking their money outside the United States. They borrow in the U.S. at very cheap rates and invest in Asia because they are worried that the U.S. cannot cut spending. So if there could be some symbolic or concrete types of changes to give them reassurance, I think we would start getting jobs right away.

Chairman CONRAD. All right. My time has expired.

Senator Sessions.

Senator SESSIONS. Dr. Johnson, I would just say that the TARP bailout has not cost the taxpayers a lot, but the stimulus bill cost $900 billion at 4 percent interest. that is $36 billion a year we will pay for the rest of our lives, I suppose, because of this one effort. Nobel Laureate Gary Becker, whom I quoted on the floor before that bill passed, said he did not think it would be sufficiently stimulative, and I believe he is proven to be correct. He said it would be far less than—I think he said 0.7 and should try to be above that if you could get there. But anyway, neither here nor there.

I guess in one sense you could say this is not a crisis now, but I would contend that a $1.5 trillion deficit is a huge thing, and we will pay interest on that forever, presumably. Interest is crowding out so much of our future potential to invest, as the President would say, in things we would like to spend money on. It is just going to be a huge thing even if the interest rates stay at the rate CBO projects.

Mr. Malpass, you did not comment, I do not think, on the Rogoff-Reinhart theory, but it is that if you get debt so high, it reduces growth and puts you in a serious stagnant position. Do you agree with that theory? Does that provide greater urgency for us at this point in time?

Mr. MALPASS. I think it definitely does. So as more and more of the economy is directed by the Government, as the debt goes up, that reflects the Government directing more parts of the economy, and your growth rate goes down. And I think we are already seeing that in the slower average growth rate for the U.S. over recent decades. It is a grave concern.

Senator SESSIONS. The income, revenue to GDP, you referred to—I believe you referred to it.

Mr. MALPASS. Yes.

Senator SESSIONS. 14.8 percent. One thing I believe causes that—and I have not seen any research done on it, but we have skewed our revenue to high-income individuals whose income tends to be more volatile. So now I understand it is down to—is expected to be 14.8 percent of GDP by 2015, and Moody's is concerned with our debt rating. How would you comment on that, Mr. Malpass?

Mr. MALPASS. The slower economy hits people that were earning more, and so that is showing up in this lower rate— or smaller percentage of taxes coming from high earners. I think it also means and helps explain why job growth has been so weak, that we really depend a lot on new businesses and small businesses for creating jobs. And so in the current environment, they are not doing that as much. They are not then scoring, you know, creating things like Google. We are going to have this dry period of entrepreneurism and innovation. So that will be costly to us in the long run, too.

Senator SESSIONS. Dr. Berner and Mr. Malpass, to follow up on Dr. Johnson's comment about what the U.K. is doing, I think a fundamental question is: Are they taking their medicine now that will put them in the longer term on a healthy growth path? Or is their reduction in spending and increase in taxes—I think it is three to one revenue cuts to tax increases. Is that too much austerity? And I would like the two of you to add your views on that.

Mr. BERNER. Well, you know, Senator, each country has to determine the pace at which they decide to impose austerity, and in the U.K. they have decided to stretch out over a 4-year time frame the kind of austerity that we are seeing. I think the U.K.'s particular problems right now in terms of growth relate to other things besides the fiscal austerity that they have imposed. But one thing we know is that they also have an inflation problem in the U.K., which is higher than ours and higher than most of the developed world's, and so that limits their flexibility to maneuver as well. So they have a little bit less flexibility to maneuver than we do. Right now we have low interest rates, low inflation, a Federal Reserve that is very supportive of growth. We may not have that flexibility in the future.

So the answer, I think, is to—

Senator SESSIONS. Well, with regard to the U.K., just looking at them, do you think in the long run they will benefit from the austerity measures?

Mr. BERNER. In the long run, they will benefit from those austerity measures. The question is whether they have the right balance given their other policies. That is absolutely right.

Senator SESSIONS. And, Mr. Malpass, you comment.

Mr. MALPASS. I agree with that. I think we would be better off if we could move faster even in the short run on fiscal austerity. I take to heart the Chairman's point that our system is not a parliamentary system. They have a way where a small group of people can say, look, let us change the fiscal course. Ours is going to take a lot of work among a lot of Senators, Congressmen, the administration, and so on to get it done.

I would note the pound strengthened quite a bit when the U.K. made this change, and that helps them in terms of their living standards. If you think of the dollar per capita incomes in the U.K., they have gone up while ours are going down because of that change. And, also, I do not think we should measure it only in terms of their GDP growth rate, which was weak in the fourth quarter. We have to look at jobs and future jobs that are being created, and I think by the Government showing some discipline, that is attractive to the business environment, and we will see the job growth doing a little bit better even in the short run for the U.K. than what we have been experiencing here.

Senator SESSIONS. Well, to you economists, thinkers, Masters of the Universe, as I affectionately call you, the political world is unusual. It is not quite the same. And the idea that we can just move in and out and make changes is not accurate. It happens that there are opportunities to make changes. My firm belief is right now there is an opportunity to go further than Wall Street thinks is possible in reducing spending and put us on a sound path. Now, we do not want to do something that, you know, would be disastrous to the economy, but I think we better take advantage of the opportunity to reduce spending now.

I criticized the Bush administration. We had surpluses, and somehow it got around that deficits do not matter. They forgot the political world. I am in here saying we cannot spend more because it is going to run up the debt and we will lose our surpluses, and they are saying it does not matter. But once you politically get that ideology going, it runs out of control. And so the American people are at a point of wanting to be more frugal right now. I think we better go meet them halfway and push them a little further and take the gain that we can get now.

Thank you.

Chairman CONRAD. Thank you.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman, and I thank all three of you for a fine presentation.

Before this meeting, there was an extraordinary discussion that you do not see very often in the Senate. Senator Conrad, Senator Coburn, and others put together a meeting on the debt and where the economy is headed. At a little after 8:00, there were more than 30 United States Senators there interested in actually getting into the details. You do not see many meetings like the one that was held this morning.

And what I was struck by—because the numbers are just a clear wake-up call. I mean, if you are spending $3.7 trillion and you have receipts of 2.2, it is not hard to figure out that math and what the implications are. And what I was struck by was the sense that the single most important thing here is to send a major message to the country and to the financial markets that you are getting serious, that you are doing something significant. And what Senators seemed to get focused on was the idea that you would make a substantial downpayment this year in deficit reduction and deal with at least one major long-term problem, one major structural problem.

I admit that I think the structural issue ought to be tax reform. Senator Gregg, Senator Sessions' predecessor, and I introduced legislation that would create, according to the Heritage Foundation, 2.3 million new jobs per year, and I think because of what you have described in terms of the economy, what is done in terms of the long term has to give a shot in the arm to the economy.

But I would just like to go down the row and ask each of you to give us your sense, first of all, of a number, an actual number that would constitute a real message that you are making a downpayment this year in terms of deficit reduction, and then your take on what would be the major long-term issue that Congress would actually tackle this year and enact it into law. And you have already heard my judgment that it ought to be tax reform because of growth.?

So we will just go all three of you, and I would also note Mr. Malpass spent years in Oregon, and we are glad to have an Oregonian before the panel. We will claim you.

Mr. Berner.

Mr. BERNER. Thank you, Senator Wyden. You know, we do not know exactly what the number is, but—

Senator WYDEN. Just a ballpark.

Mr. BERNER. —$100 billion is not impressing financial markets. Something, you know, quite a bit larger than that, something on the order of $400 or $500 billion. And I think what is really important here is not so much, as the discussion has revolved around, that that be implemented today, but that you commit to a large number and you have a plan to make that number understandable and to make it credible so that financial markets will take it on board and will be positively surprised by that number.

And I want to say I fully support—and I support David's argument and yours for tax reform. I think that would have enormous benefits for the economy in a number of respects, and I hope you find a co-sponsor on the Republican side—

Senator WYDEN. We will.

Mr. BERNER. —to support your proposal, because I strongly support it.

Senator WYDEN. Very good. Mr. Johnson.

Mr. JOHNSON. I think this is absolutely the right question at the right time. Clearly something on the order of tens of billions does not do anything in this context, and I doubt that even if you are talking about hundreds of billions that makes that much difference. I think you need to be talking about the big trillion-dollar items over a 10- to 20-year horizon, and there are two. One is tax reform, where the good news is our tax system is so antiquated and so messed up that even if you do not want to raise revenue as a percent of GDP over the cycle, there are plenty of ways to improve incentives. And when you are improving incentives, you will actually get some additional revenue. We take in, in terms of taxes relative to GDP, 10 to 15 percentage points less than other industrialized countries that have better-run tax systems. So you decide whether or not the revenue—it certainly makes the tax system better.

And the second is health care, Medicare in particular. That is a big budget buster by 2030, 2040. I doubt that you want to take on Medicare in this Congress, but those are really your two choices. Those are the two things that would really make the difference here. And I have to say in this context I did not support the tax deal at the end of last year. That was a big number over the next—over the foreseeable future. That was a big number in the wrong direction. That was a bipartisan consensus away from fiscal responsibility, quite contrary to the spirit of everything that has been said here this morning. And I am sorry that Senator Sessions stepped out because he said that somebody said deficits do not matter during the Bush administration. I believe that was Vice President Dick Cheney who specifically said, "Ronald Reagan taught us that deficits do not matter." And I hope as we approach Ronald Reagan's 100th anniversary next week we all reflect on how far from being appropriate for today's reality is that message.

Senator WYDEN. I do think one other part of your testimony that is very helpful is you are conveying a sense of urgency, because in this town it is all about the politics of procrastination. What I wanted as part of the end-of-the-year agreement was a 1-year extension of the Bush tax cuts so that you would force Congress to step up this year and actually deal with these kinds of issues, because my concern is unless you all and others can help us convey this sense of urgency, we will have exactly the same debate in the lame duck session of the 2012 Congress as we had during the lame duck session of the 2010 Congress. And that was why I wanted something that would force action this year.

Mr. Malpass, your thoughts, the number and the question of the big structural issue, if you get to pick one.

Mr. MALPASS. Thank you for representing Oregon. The markets are cynical about how much can be done here in our system, and so I think as you go through this, one of the most heartening things, if 30 Senators this morning were together, as you mentioned, that is a big step. That is the kind of change that people want—I mean that markets will be looking for and say, Golly, if you got all those people in the room, something might come out of it.

My view is—and I think you are hitting on it—that short extensions of existing spending where you take many bites at the apple I think would be a procedure that might work. So as the continuing resolution discussion comes up, whatever the amount of spending cuts that can be done in that resolution, if you can do it multiple times in a given year, that is going to get you a lot of credibility in terms of the financial markets and job creation from the private sector.

So I think $100 billion in near-term spending cuts would be very useful. Whatever the number is, then kind of make a promise or a pinky promise of some kind that you are going to come back 2 or 3 months later and try to do another round of things that you can work on.

As far as what is structural reform longer term, I think tax reform would be—Wyden-Gregg was very good, if you can get another co-sponsor and go forward with that, and I recommend a baseline where you look at directing the baseline so that it gives a more level playing field. Otherwise, you are swimming up this fast current. The CBO scoring undercuts the tax reform process to such a degree, the normal scoring, that you will not be able to get a growth-oriented reform.

The other procedural change I am suggesting is that you fill this vacuum of limits. A debt-to-GDP limit would be very comforting to markets because markets' concern right now is you are going from

60 percent debt-to-GDP, marketable debt-to-GDP, right up to 90, and it looks like we might go to 110, meaning right across that threshold that the Chairman mentioned. So if we could have some new kind of limitation other than the statutory debt limit, that would give some underlying confidence.

I need to make one defense of President Reagan. There was the idea that his economics were not the right economics. Remember what he was saying, that we cannot look at the deficit alone; we have to look at the tax rates and at the spending. And so we needed to cut both of those to enable the private sector, and my view is that worked very well in the 1980s, and we created a huge amount of jobs and growth out of good, sound economic policy in those years.

Senator WYDEN. My time has expired. Thank you.

Chairman CONRAD. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman. I would like to thank the panel for their testimony as well.

I have several questions. The first is I would like to follow up on something that Mr. Malpass addressed, which is the increase in the debt limit. You have advocated that we make some structural changes essentially to get this escalating deficit and debt under control. I happen to share the view that we should make structural changes. We might have a difference as to exactly which ones to make, but I do think it is very important that we use this occasion to begin to get our long-term spending problem under control.

So I am not in the camp that argues that under no circumstances should we raise the debt limit. I also accept your general premise that it is a rather blunt instrument, and the disruptions that would occur are to be avoided, if we can. However, I think it is very important as we approach this that we understand exactly what might occur and what would not occur if there is some period of time during which we do not raise the debt limit upon reaching it.

So my first question is a simple and factual, historical question, and that is, is it true that we have had recent episodes in the past several decades where we have reached our debt limit, we have not raised it immediately upon reaching it, and we nevertheless did not default on the marketable debt securities issued by the Government?

Mr. MALPASS. To me, sir? Yes. In the late 1990s, there was a period of roughly 4 years. It is on page 9 of my testimony. My view is those were rather unique years. One of the things that was happening was defense spending was being cut sharply. Another thing that was happening was there was a temporary slowdown in the entitlement spending. It had to do with the generation—you know, the baby-boom generation had not yet started to retire. So on page 9 it goes through those.

Also, in those years something was happening—yes, here it is on the screen. Fannie Mae and Freddie Mac were really ramping up, which operated almost like Government spending. Remember they were kind of off-budget, and yet they are really ending being taxpayer liabilities. So that helped paper over that particular period of time.

I do not think we could mimic that right now.

Senator TOOMEY. Well, if I could interrupt for just a second, the point is that for a short period of time the debt limit was not raised.

Mr. MALPASS. Correct.

Senator TOOMEY. And when the debt limit is not raised, is it true the tax revenue still comes in?

Mr. MALPASS. That is right. Money floods in.

Senator TOOMEY. Right. And next year, for instance, if my numbers are right, something on the order of 70 percent of all the money that the Government is expected to spend is going to come in in the form of tax revenue. Is that true?

Mr. MALPASS. Yes.

Senator TOOMEY. And something on the order of 6 percent of all the money the Government is going to spend is currently scheduled for interest on our debt.

So I guess the question is: Is it possible for the Treasury, in the event that the debt ceiling is not raised, and acknowledging that this is in some ways a disruptive thing if that does not happen, but that the Treasury could, nevertheless, ensure that those people holding the marketable securities of this Government would receive their interest payments and that those payments can be made?

Mr. MALPASS. Yes, that is plausible. The fiscal deficit is large now, so each month, the government is in a negative cash flow of roughly $120 billion. So what would happen each week is someone, meaning the Treasury Department or you, members of Congress, would have to be deciding who not to pay—

Senator TOOMEY. Right.

Mr. MALPASS. —and my concern is the disruption as—

Senator TOOMEY. I understand this is very disruptive and I have acknowledged this. The point is a narrow point, and that is do those people holding securities necessarily need to not get their interest and principal payments, and I think you are acknowledging that.

Yes, sir?

Mr. JOHNSON. Senator, I think you are playing with fire in this scenario. One point that was not covered in David's otherwise comprehensive review of the debt situation is borrowing from abroad. You have to remember that it is not just an internally funded debt. We are the world's largest borrower and this is very dangerous. There are alternative assets out there in the world. I know that the Eurozone does not look very appealing right now, but I think they will turn themselves around. The Chinese are working very hard to create alternative reserve assets—

Senator TOOMEY. Right.

Mr. JOHNSON. —including the Renminbi. I really do not think that you want to create potential disruptions of this kind, because there is nothing that says that the dollar has to be the number one reserve asset forever, and the British pound lost this position earlier in the 20th century exactly through fiscal irresponsibility and global overreach.

Senator TOOMEY. I would simply argue that I think the fiscal irresponsibility is what hasten us into this situation, and the refusal to do anything about it is the worst message we could send to the market. The fact that revenue will be more than ten times the expected cost of interest makes it very clear to me that no responsible Treasury Secretary would ever allow a default to occur on our debt. It would be so disruptive and so damaging to our entire economy, to the millions of savers, Americans as well as others, that I cannot foresee how a Treasury Secretary would permit that to happen when he or she would have more than ten times the revenue needed to prevent it from happening.

Let me move on to another question, if I could, and that is as alarming as the magnitude of the debt that we have discussed today is, I may have missed this, but I do not recall a discussion about another component that worries me, in fact, I would argue is even bigger than what we have talked about, and that is the unfunded liabilities implicit in the promises we have made through the big entitlement programs. If you quantified the present value of that shortfall, is it true that that is actually several multiples of the actual publicly traded debt that we have?

Mr. BERNER. Yes, it is, Senator. It is, and obviously different calculations will give you different results, but I think everybody agrees that the present value of those liabilities is enormous. In fact, if you add up Medicare, Medicaid, and Social Security, you come up with an unfunded liability, when added to the debt, really would exceed the value of the assets that David showed in his charts.

Beyond that, if you look at another issue, which is the unfunded liabilities of State and local governments, those that are on the books as the gap between the promises they have made for their pensions and the assets that they have, as well as the unfunded liabilities for the health care promises that they have made, that would add, on top of the Federal liabilities, to what you are talking about. So the answer is definitively yes and resoundingly so.

Mr. JOHNSON. But we also need to add and score appropriately the contingent liabilities that arise out of the financial sector—

Senator TOOMEY. Right.

Mr. JOHNSON. —because we just pushed up debt by 40 percentage points of GDP because of the way the financial sector—

Mr. TAYLOR. Agreed.

Mr. JOHNSON. So I think all of this needs to be included, and I think we agree on that.

Mr. MALPASS. And can I add one more? I agree with those points. The actual size of government is going to go on. Fifty years from now, there is going to be a defense budget and there is going to be probably a Federal education budget and so on. So I think as you think about the problem, I am not as focused on dividing entitlements from discretionary spending. They are all commitments to the people that there is going to be a government in the next generation and the next and we just do not have the money for it right now.

Senator TOOMEY. Thank you very much. I see my time has expired. If there is time in a future round, I would like to address yet another respect in which I think this problem is even worse, and that is something that Mr. Malpass mentioned briefly, which is what strikes me as potentially a very optimistic forecast about the level of interest rates, and when, of course, you have a huge debt, if you are wrong about your optimistic forecasts about interest rates, then that has devastating consequences.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you for that point, because I think that is one of the critical points, somehow, we need to be able to persuade our colleagues of. What is the risk of a failure to act?

You know, we have a very benign interest rate environment now, very low interest rates, even record low interest rates. Some are saying that is an indication we do not need to act. My own view is it is giving us a period of time within which to act. A failure to act within that period of time could lead to much more serious consequences. And if you look at that ten-year CBO outlook, they are projecting a low interest rate environment for a decade. Well, maybe that happens, maybe it does not. If there is one thing that is clear, we have seen it in the case of Greece, it was clear in Mr. Malpass's presentation, Greece, Ireland, everybody else that has run into one of these situations, the change in your interest rate environment can happen like that and then you are really in the soup.

Senator.

Senator TOOMEY. Mr. Chairman, thank you. Just a quick observation about how very optimistic this interest rate assumption strikes me, and that is the assumption is that interest rates revert to something less than their 20-year mean over the last 20 years. That, despite the fact that the Fed is embarking on an absolutely unprecedented program, the very purpose of which is to increase inflation expectations. It is my fear that they will be very successful at increasing inflation expectations, quite likely increasing inflation itself, and it is very hard to fathom how interest rates do not respond by going considerably higher. If that happens, all of these numbers change pretty dramatically.

Mr. BERNER. Senator, if I could—

Chairman CONRAD. Yes, go ahead.

Mr. BERNER. If I could add a point to that, I think one of the—beyond the inflation issue, it seems to me that one of the biggest issues that is out there is that in this global environment, market participants around the world view us as the best credit around the world. If they start to question our ability to service our debt and our ability to meet our obligations, that is when interest rates adjusted for inflation will start to rise and the risk premium on our debt will start to rise, and as you put it so eloquently, that is when we are really in the soup.

Mr. JOHNSON. But Senator—

Chairman CONRAD. Simon?

Mr. JOHNSON. Let me pile on. It is worse than this, I think, because again, thinking globally, I would commend to you this new report by McKinsey Global Institute on real interest rates. So what are global savings going to be? What is global investment going to be? In their assessment—this is a very good report led by Michael Spence, a Nobel Prize winner—their assessment is, just in real terms, looking globally, interest rates will head up. So you should add your concerns about nominal interest rates, about inflation expectations onto the real rate, and they say we are coming out of a period where we have had unusually low real rates globally because we have had savings that were higher than investments for reasons that are now receding.

Mr. BERNER. And let us be clear. If real rates go up because economic performance is good, and as Simon just put it, if we see strong growth around the world, then real rates actually should go up. But if real rates are going up because there are concerns about our creditworthiness, then that is where our economic performance on a long-term basis will really suffer and where the spiral becomes quite negative.

Chairman CONRAD. Can I just make this point? One of the concerns I have in listening to the discussion that is unfolding in this town is the focus on non-defense discretionary spending, because non-defense discretionary spending is about 16 percent of our budget. The President used the number 12 percent in his State of the Union because he had an unusual treatment of Homeland Security and some other things that he put in the defense pot that normally would not be there. I think he put international in the defense pot.

But let us go back to that basic formulation. Non- defense domestic discretionary spending is about 16 percent of our budget, and yet it is getting almost all the attention for how we solve this problem. And we are borrowing 40 cents of every dollar we spend. If you eliminate it all, you have not solved this problem.

So the part of our budget that is growing as a share of the size of the economy are our entitlement accounts— Medicare, Social Security, primarily the health care accounts, much bigger than Social Security. That is seven times the problem of Social Security. And yet, you know, somehow, we do not want to talk about it. I think I know why we do not want to talk about it, because if you ask the American people, they say you do not need to touch Medicare. You do not need to cut Social Security. You do not need to touch defense. You do not need to touch revenue.

Well, I just say this. If that is really the conclusion, that Social Security does not have to be touched and it is cash-negative today, Medicare does not have to be touched, defense does not have to be touched, revenue does not have to be touched, you cannot solve the problem. There is a mathematical certainty you cannot solve the problem.

So some of us are going to have to help the American people understand the unfortunate reality here, and the unfortunate reality is, I believe, all those things are going to have to be touched, and the sooner we do it, the better, because the less draconian the solutions will be later on. The worst time to deal with this is when you are in a crisis. If there is anything Greece should have taught us and Ireland should have taught us and Portugal should teach us is the worst time is when you are in a crisis.

Dr. Johnson, you are the former Chief Economist at the International Monetary Fund. Probably nobody that I am aware of has a deeper understanding of global economics than do you. What would be your advice to this committee with respect to the question of how you deal with this in a systematic way? What parts of the budget have to be dealt with over the longer term? Does domestic discretionary spending, non-defense, does that get you out of this hole?

Mr. JOHNSON. No, Senator, it obviously does not. The IMF advice would be, or maybe will be if we get sufficiently desperate and we need to take their advice, would be you need a medium-term fiscal framework. You need some very clear agreed upon rules. You need your summit. You need a bipartisan consensus. You need to say, this is what we are going to do on tax reform. This is what we are going to do, particularly on Medicare. Social Security is a problem, I agree, but that can be addressed in a relatively straightforward way. Medicare and medical costs explode as a percentage of GDP.

And by the way, compared with other countries like, for example, in Europe, they have the same problem. They just do not account for it as honestly as we do. If they scored their future medical spending like the CBO scores for us, we would see the same problems in most of Western Europe, also, if that is any consolation.

But if you had that framework, if you had rules that were agreed upon, then you have the flip side of the point David made about us not being a parliamentary democracy, which is it is not easy to change our rules. So if you have locked into those rules in the U.S. constitutional framework, the markets are going to know it would take a lot to undo them and you can lock into something five, ten, 15 years down the road which the markets would respect because it is hard to undo. Now, it is also hard to get there, I understand, but that is, from a global comparative perspective, the advice that you would get.

And honestly, that is what the Chinese—we are very big creditors to the Chinese. I guess the Chinese President paid us a visit recently to see how his money is doing and felt okay about that. But ultimately, they will not feel okay. Ultimately, our creditors will demand this kind of change, too. This is what the IMF has demanded on behalf of the IMF to highly indebted countries around the world.

So we should do it ourselves now, as you said, before we are rushed and before we are in a situation where it is a crisis and you can only do really, really damaging cuts that hurt a lot of people.

Chairman CONRAD. Let me say one other thing and then we will go to Senator Sessions. I hope very much when we deal with these opportunities this year we are not just dealing with short-term non-defense domestic discretionary spending. We are talking about $60 billion, $100 billion. In one year, we got a $1.5 trillion problem. And while that may send a useful signal, it does not touch the problem.

We need a multi-year, comprehensive plan that reduces the debt over the next ten years by, I believe, at least $4 trillion. Now we are talking on the scale that really has some credibility.

Senator Sessions.

Senator SESSIONS. Thank you. This is a very difficult issue. I have been with my staff since I have been Ranking Member and I still do not have a handle on it, but I can tell you, anybody who thinks it is easy to get this house in financial order is not correct, as you indicated, Mr. Chairman.

I would note, though, we ought not to think that we should ignore discretionary spending. I feel very strongly about that. We had 35 percent in the State Department just last year, 35 percent increases for EPA, double-digit increases for agriculture. President

Bush was criticized for agriculture increases. I saw his ten-year budget. I do not think he had a single year over a two percent increase. We had a 12 percent—I think it is a 12 percent increase. I am just saying, we have—2010 levels are unusually high and we are going to have to go back to 2008, if not lower.

I criticize the Debt Commission and their work on one point. They certainly served a national purpose and I may well have voted for the product if I had been on the committee. But I would just say, their goal as given to them by President Obama was to reduce the deficit to three percent of GDP over ten years, and that is what they did. I understand that projected—that deficit in ten years, three percent of GDP, is $700 billion to $1 trillion. So I would ask the three of you first, is that a sustainable deficit, first, just briefly, if you would.

Mr. BERNER. Senator, if that is the end of the story, then the answer is no.

Senator SESSIONS. It would be good progress.

Mr. BERNER. It would be good progress, absolutely, if the story continued and there was a continuing credible commitment to make further progress so that you got that deficit down, because ultimately, in order to stabilize the debt in relation to our economy, you are going to have to make further progress on it over time and that is really what is important.

Chairman CONRAD. Could I just make a point on—

Senator SESSIONS. Yes.

Chairman CONRAD. I just want to make a correction. In terms of the Commission, the President gave us the goal of three percent, but we exceeded it.

Senator SESSIONS. Oh, you did?

Chairman CONRAD. We went to 2.3 in 2015 and then down to 1.2 in 2020 because we believed, and I think it was a strong consensus, that we had to go further.

Senator SESSIONS. Well, thank you, Mr. Chairman. I am glad to correct that because it was depressing me more than I should have been depressed.

Mr. JOHNSON. Senators, could I—

Senator SESSIONS. Yes, Dr. Johnson?

Mr. JOHNSON. Look, I think you should push this as far as you can. It is a question of the risks in the global economy, where you do not know—you are going to want to borrow this money from somebody else. They may have a better use for their money. They may prefer to keep their funds in another currency. Over a 20-year horizon, I would be very surprised if the U.S. dollar has the same level of predominance as a reserve currency as it has today, and I would not be surprised if we shared the stage with a stronger Euro and a much stronger and liberalized Renminbi, the Chinese currency.

You quoted earlier that somebody said during the Bush administration, deficits do not matter. I think that was Vice President Dick Cheney—

Senator SESSIONS. I heard—I was on the—

Mr. JOHNSON. But I wanted to make sure—I said you were in the room, and I think, did he not actually say, Ronald Reagan taught us that deficits did not matter?

Senator SESSIONS. I am not sure, but I think that was a private conversation that sort of leaked out and became part of the agenda. But Mr. Greenspan recently said to a luncheon I was at that, well, in the early 2000s, we had surpluses. We could handle a little extra debt. So even, I think, the Fed was in the view that when we went into the recession in 2001, a little deficit would not hurt us. But the truth is, politically, once you lose the high ground— when you lose the political high ground in Congress, it is hard to get it back.

Mr. JOHNSON. If I could just reinforce that point, Senator, with regard to David's proposed debt-to-GDP limit. Certainly debt-to-GDP is the right way to think about this, but if you go with a 50 percent limit, or, of course, the Europeans have a 60 percent limit under the Maastricht Treaty, an intergovernmental treaty, it has not done them any good at all. It is far too high. In the modern world when you are hit with these nasty shocks and you want to be able to use fiscal policy to respond and to offset something that just strikes you completely out of the view, 50 or 60 percent of GDP, I think, is too high because the shocks are going to be big, very big, and push you over the 90 percent level that we are all worried about.

Mr. MALPASS. I take that point well, and maybe a lower number, 40 percent debt-to-GDP ratio, would be more acceptable. What you need to do, I think, is have escalating penalties if you are above it, in other words, some discipline on the budgeting process, on OMB to produce budgets that bring us down below the debt-to-GDP limit or some kind of mechanism to give it some teeth.

If I may, I have written down several—I think in terms of this problem as one where you should begin today making small decisions, or they are not really small, but do the things that you can, so I will list several things that we have talked about.

One is I think the Fed should wind down its buying of Treasury bonds. This is a huge problem where the Fed is buying the long-term debt and therefore shortening the maturity of our national debt. That puts us at risk.

Second, in the same vein, Treasury should be issuing more long-term debt. We have to get our debt maturity longer to be prepared for what comes in the future.

Third is the directed baseline in order to open a window for tax reform. Right now, the way Congress procedures work, it is not credible to embark on tax reform because you have to soak up the—making permanent the existing rates. The Alternative Minimum Tax, for example, expires, and yet everyone knows it is going to have to be patched into the future. That should not be part of the baseline, the cost of that. And so you need a directed baseline in order to create a more level playing field.

Fourth is using the Continuing Resolution—

Chairman CONRAD. David, can I just stop you on that point?

Mr. MALPASS. Yes, sir.

Chairman CONRAD. This is one—the only thing I have heard you say today with which I strenuously disagree—

Mr. MALPASS. Uh-huh—

Chairman CONRAD. —and the reason I do is if it is not in the baseline, what does that say to Congress? That it is free. And you and I know it gets added to the debt. And I will tell you, I am in the Sessions camp on this. As soon as you send a signal around here that you can cross lines and it does not matter and things are for free, that psychology takes a hold around here. When we crossed the line on Social Security and went back to raiding the Social Security Trust Fund—and I use those words, I know economists have a different view—I tell you, that broke a discipline around here. I begged Chairman Greenspan not to take that position because it is, yes, it is psychological, but it matters around here. And when you cross a line around here, Katy, bar the door.

Mr. BERNER. Senator, if I could just interrupt for a moment and agree with you on that point. One thing we have not discussed today is budget process, and back when David and I were working in Washington together, budget process was really important and Congress had a process in both Houses. That process was stuck to. Your predecessors, really Gramm, Rudman, and Hollings came along and reinforced that process. That is something we have not discussed today and something we need to restore to the discussions about the budget, because if we think in terms of credibility, what will help restore our credibility besides the commitment to really deal with our long-term structural problems is a game plan for getting there and the process—

Chairman CONRAD. Let me just say that the dirty little truth in this town is that people do not want to deal with budget process disciplines because the truth is, they do not want the discipline.

Mr. BERNER. Right.

Chairman CONRAD. They want to be free to cross every line, and it is on both sides of the aisle, I regret to say. And you are right. We should have, I think, a return to some of the strict disciplines we had that helped us get out of the hole in the 1980s and in the 1990s that really proved to be quite effective. But, you know, absent will, absent will, no process solves the problem.

Now, I took away from your time.

Senator SESSIONS. No. Well, this is fabulous. These are really serious, important issues, I think. Senator McCaskill and I offered legislation, and we got 59 votes, that would have made statutory caps using the President's budget and it would take a two-thirds vote to violate that. It would have been a firewall, although in truth, now, I think we realize that those numbers were too high. We will have to wrestle with it.

This is about the economy, and one question I would like to pursue a little further—Mr. Malpass made reference to it—is the QE2 and the Fed's action. That same Barron's article I was reading, Mr. Hickey, the editor of High-Tech Strategist in Nashua, New Hampshire, said we continue to print money, and am I not correct, Mr. Malpass, that the Fed buying Treasuries is printing money? Is that fair to say?

Mr. MALPASS. It risks that. I will make maybe a rhetorical point or a mild point here. Technically, the Fed borrows it from banks, and so as long as—and creates excess reserves at the Fed. So as long as we have this stoppage in the regulatory process where banks are not lending, then there has not been an actual expansion of the amount of money in the private sector. So—

Senator SESSIONS. But with the leverage that the Fed uses—

Mr. MALPASS. All that has happened so far is the Fed is taking on the risk of the private sector by owning long- term debt. So they are exposed if interest rates go up. We, the taxpayer, are exposed. But from the standpoint of the actual lending going on by banks, it has not expanded.

Now, this may be a distinction without a difference. So I think the point is well taken that by the Fed going down this line, people worry about the Fed. They worry about the dollar. They worry about the United States, and that is not good for us.

Senator SESSIONS. Mr. Bernanke answered similar to you at the hearing a few weeks ago when I asked that question. He said—I quoted him as being 100 percent certain that he could pull back and not allow inflation to take off. But he said he really said he is certain he has the tools to avoid that.

Mr. MALPASS. And I would say we should not be taking this risk. His original goal was to lower the interest rates on corporate bonds. That has not worked. And what we are exposing ourselves to is this shorter maturity of—they are buying the long-term bonds in. That is the opposite of the direction we should be going.

Senator SESSIONS. Leaving us more exposed to short- term.

Mr. MALPASS. That is right, and so it is like you are taking—here you are, worried about keeping your job, and the banker calls up and says, hey, would you not like to move from a 30-year mortgage down to a three-year floating rate mortgage? Now, you know what to do. Do not take that choice. And that is what the Fed is doing. They are moving the country from a long-term fixed rate mortgage to a short- term floating rate mortgage at a time when we are already a little bit shaky.

Senator SESSIONS. Well, with regard to this question, maybe I will let any of you who would like to comment on it do so. I think it is a matter out there in the public and in the financial markets. Mr. Hickey says that in 2000, easy money led to gross imbalances. In the mid-2000s, one percent interest led to a housing bubble, and then the credit crisis, and now rates are zero. To get a response from the economy, the Fed must print ever more money. It did, and everything looks great right now. But as of June when the $110 billion they are printing per month ends, things might not look so rosy. The economy has structural problems and we are not dealing with them. Money printing will not work, yet that is the prescription we continue to give the patient. If the Fed keeps printing after June, we will have higher gasoline and food prices and more imbalances until this ends, and at some point, it will end because the dollar will fall apart, and what we are now doing makes everything appear rosy, but it is devastatingly terrible policy for the long run.

I think that is a perception out there by a lot of people. You guys are really sophisticated. Let me ask you to respond to that.

Mr. MALPASS. May I interject one thing briefly? Paul Volcker in this room in the 1980s, facing a big fiscal deficit, said, "The Fed could have a looser monetary policy if Congress would have a tighter fiscal policy," meaning spend less and we will have the looser monetary policy. We are breaking that rule now in the way that you said. We are putting a near zero interest rate on top of a massively stimulative fiscal policy. So this is simply not the right mix.

Chairman CONRAD. Can I just intercede on this point? Because when I go back to what led to the financial crisis in 2008, my own reading of economic history is it was a combination of an overly loose fiscal policy—we were running massive deficits then, even in good times—an overly loose monetary policy because the Fed was very accommodating after 9/11 for an extended period of time, coupled with a failure to regulate very risky financial instruments. You know, Warren Buffett called derivatives "a nuclear time bomb waiting to go off," and in some ways that occurred, certainly with AIG.

And so you had a perfect seed bed for bubbles to form, and, boy, did we get bubbles. We got a housing bubble. We got a commodity bubble. Wheat went to $20 a bushel. We got an energy bubble. Oil went to $100 a barrel. So we did not just have a housing bubble. We had a whole series of bubbles in which we had really laid the foundation by loose monetary policy, loose fiscal policy. Unusual to get them at the same time. That is another whammy to the economy. And here we are cleaning up the economic wreckage. Dr. Johnson?

Mr. JOHNSON. Morgan Stanley has a very nice report on the so-called global carriage rate which is fed by this very low interest rate environment. I do not have my copy with me. I am sure Dick can send it to you. I think you should look at that, Senator Sessions, and think about these dynamics.

The points, by the way, that the two of you are making strike me as just incredibly parallel to the debate we had in the United States between 1907 and 1913 before the founding of the Federal Reserve. One the one hand, there was Nelson Aldrich who was making very similar points to you, Senator Sessions, worrying about the fiscal implications and the inflationary finance that would be facilitate by an overloose Fed. On the other hand, there was the Pujo Committee and Louis Brandeis, Senator Conrad, who was articulating a position very much like yours, which was that the financial sector, without a surety that the financial sector was going to be reined in and regulated and controlled—they did not use exactly those words—financial stability would be the ruin of us all. And I have to say, a hundred years later both of those individuals were right.

Mr. BERNER. And I agree with that, Senator. I would say beyond that, you know, we are using monetary and fiscal tools, which are blunt tools, to try to solve our problems. But as we have all talked about, we are just still experiencing the legacy of this financial crisis. And as I indicated in my testimony, we have not employed the tools that we could to clean up the legacy of that financial crisis. If we did, then the Fed would not have to run the kind of monetary policy it is running. And as I also indicated, we would have a better-performing economy. We could unwind some of that fiscal stimulus that we have used to help the economy in the short run.

Mr. MALPASS. Mr. Chairman, your statement was one of the best, succinct statements of the causes of the crisis. You mentioned loose monetary policy, loose fiscal policy, poor regulatory policy, and I would add in mistakes on Wall Street, and that is the sum of it. And if everyone would accept that and then try to avoid that in the future, we would be a step ahead. A very good statement of it.

Chairman CONRAD. Senator Toomey. Could I just say to my colleagues, we promised to end this hearing at noon for our witnesses, but Senator Toomey has not had his second round, and we will go to him now.

Senator TOOMEY. Thank you, Mr. Chairman, and I will just be brief. It seems to me that if you look at many traditional measures of monetary policy, we are currently embarking on a very unusual and, it seems to me, dangerous course. Please correct me if I am wrong, but my understanding is prior to the recent huge purchases of Treasuries by the Fed, the traditional measures of money supply were already growing significantly, M1 and M2 and so on.

If you prefer to look at the Taylor Rule, for instance, which some do and some do not, but by that measure interest rates are well below where they ought to be.

If you look at commodity prices across a very broad range—precious metals, agricultural, other commodities—we are seeing very, very high rates, in some cases record rates. Does not the cumulative evidence here suggest that there is a very significant risk of much higher inflation? And when CBO projects less than 2 percent, I believe, over the next several years, could each of you just suggest whether you think it is likely that inflation in the United States will remain at or about 2 percent in the coming years?

Mr. MALPASS. I think it will be above. I think you are exactly right in describing the problem. I will add in we already see the inflation in other countries where they are closer to commodities in their CPI baskets, so that evidence is there. And I will add in the point that the Fed has been very wrong on that inflation estimate in the past. So, in 2003, 2004, and 2005, when the Chairman was describing the 1-percent interest rate policy and the small increases, the Fed drastically underestimated the core PCE deflator that would come out and—

Chairman CONRAD. David, can we just stop you on that? For people who are listening, the core PCE, can you explain what that is?

Mr. MALPASS. Yes. PCE is the personal consumption expenditures, and that just means consumption, and the Fed uses the core measure, meaning excluding food and energy, let us measure inflation by core prices.

Chairman CONRAD. And they underestimated at the time that increase.

Mr. MALPASS. There is, I think, a huge mistake in the technique the Fed is using because when they look at the number today, it is based on what people bought last year and the prices of those old items. And because people are very fad oriented, meaning they want to buy the hot items, when you measure your inflation based on what people bought last year, those prices are going down. That is like taking the sale items, the old model cars, where the new model cars are going up in price. And what happened very distinctly in 2003, 2004, and 2005—and 2005, really—is after revision, the inflation was above the Fed's top limit, above the 2- percent ceiling every quarter from 2003 to 2007. And yet the Fed kept saying and promising during that period that inflation was moderating. So it is making Senator Toomey's point that we really should not be so confident of that—I mean, I am not confident at all that we are avoiding inflation. Now the Fed is very loose.

Mr. JOHNSON. I think we are definitely not avoided inflation. To state this in a slightly different way, headline inflation, which is the inflation that you care about, is going up, and there you will feel it. The Fed takes food prices and energy prices out of its measure of core inflation. Other central banks do not do that. The Canadians, for example, take out the most volatile items, but those are different items from what the Fed takes out. And this is a very conscious decision based on the historical view of what drives inflation over a longer period of time. We will see whether that turns out to be right, but certainly in terms of purchasing power of consumers, David's point, people who consume particularly things that are really commodity intensive, relatively poor people have a larger pot of—their consumption goes on food, for example. They are going to be hurt by what happens.

Mr. BERNER. Inflation is partly set globally. We are clearly seeing commodity prices and food and energy prices rising. It is already rising, as my colleagues have pointed out, in other countries. And so, you know, the Fed, as you pointed out, Senator Toomey, is trying to boost inflation expectations. We do have a tug of war going on. There is a lot of slack in the economy, and that is keeping inflation in check. But those global forces together with rising inflation expectations are going to lift not just headline inflation but, in my view, core inflation over time.

Now, a little bit of that in the next year is not a bad thing. What would be a bad thing is if we got a lot of it, obviously, we would see not only inflation rise, but we would see the interest on Federal debt, as you pointed out earlier, rise very significantly.

Senator TOOMEY. Thank you, Mr. Chairman. I would just point out that we learned in the 1970s that we can have a lot of slack, weakness in the economy, and still have very high inflation. So it is a real concern of mine. But I thank you all for answering the question.

Chairman CONRAD. Thank you, Senator Toomey.

Senator Sessions.

Senator SESSIONS. Well, forgive me if I do not think they are Masters of the Universe that fully understand the complexities of the market. You would all be billionaires instead of millionaires, I suppose. It is hard to predict what is going to happen, and I certainly do not think Mr. Bernanke has had—I do not think he deserves credit for advising Mr. Greenspan to prolong easy money too long. And I would just—Mr. Zulauf in the roundtable added this—and I will ask this as a final question since we made reference to Mr. Volcker. "In the late 1970s and 1980s, Paul Volcker crunched inflation by applying very real high interest rates for several years. Now we are seeing the same process just in reverse. Just as it took several years for the market to see that Volcker's policies would lead to declines in inflation and interest rates, it will take years for the market to realize the Fed's current policies are highly inflationary."

Any comment on that?

Mr. MALPASS. I agree with that concern, and I think the Fed should stop buying bonds. It is a high priority from both a fiscal standpoint and a monetary policy standpoint that they do that.

As far as the risk then for us of higher inflation, one problem that we run into is whenever the problem is distant, then people will not focus on it. So if I say when do I think we are going to go over 5 percent inflation, probably not for 1 or 2 years, and so that does not give you the urgency.

So one of the things we are doing today is trying to say, look, we do not know what is going to happen next month or next year, but what we do know is we are too close to the brink on the tipping point. So if you can, please stop spending. Try to find procedures that give us some confidence about the 10-year outlook on spending as well.

Mr. BERNER. I would just reiterate, Senator, the points I made earlier. Number one, if we adopted the right policies to fix our economic problems and housing and other problems, then the Fed would not be running the policy that it is running today. And I agree with David that, you know, inflation is a process that works gradually, and that gives us a little bit of leeway in terms of where it is going to go. But, of course, because it has a lot of inertia to it, once it gets going then we need to be careful, and the market reaction to higher inflation will not be kind to the Federal budget.

Mr. JOHNSON. Senator, I think there is a floor in the Federal Reserve Act. The Federal Reserve Act says that the mission of the Board in this instance is to aim for full employment and price stability. There is no mention about financial stability. None of the discussion that you were both putting before us in terms of the financial dynamics and how things went wrong and what is likely to happen in the cycle, none of that is seen as their top priority. And as a result, they feel the need to pursue this policy that makes you uncomfortable, and I think you are right to feel uncomfortable and very nervous about it. This is a very bad place to be. It would be better if we had had more fiscal space coming out of the last boom. Then you would—I mean, you could still argue whether you want to do the tax cuts or the spending increases. Fine. But you would have had more space within which to react to the financial crisis without pushing up against the Reinhart-Rogoff limit or David's debt limits. But that is not how we ran things in the boom, and as a result, we have over 9 percent unemployment. The Fed's job is to get that down, and that resulted in this monetary policy that is a huge Hail Mary pass, if I may use a Super Bowl metaphor.

Chairman CONRAD. Thank you. Thank you all. We appreciate very much your contributions to this Committee, and I think this has been an excellent hearing. I want to thank Senator Sessions for his contributions as well.

We will stand adjourned.

Questions for the Record
From Senator Begich
For Dr. Richard Berner
Private Sector Forecasting of the Economy
February 1, 1011
Senate Budget Committee

1) Can you speak to the economic consequences of shutting down the government and allowing the CR to expire with no path forward? 1b) Treasury Secretary Timothy Geithner has said the U.S. could hit its current debt ceiling of $14.3 trillion, set last year, by the end of March. Can you also speak to the economic consequences to not raising the debt limit? Can you discuss the confidence you believe the credit markets will or will not lose in the Treasury, if we do not raise the debt limit?

A: The economic consequences of shutting down the government and allowing the CR to expire with no path forward would depend on how long the shutdown persists. If the shutdown lasted more than a few days, the consequences could be noticeable, as some spending programs stop. There have been six Federal government shutdowns since 1981. The first five lasted from less than a day to a few days and had no noticeable impact on the economy or markets. In 1995-96, a three-week shutdown furloughed about 300,000 workers, delayed applications for social security benefits and passports, and closed national parks. The uncertainty over such a longer shutdown would likely mildly disrupt financial markets. However, it is important to note that a lapse in a CR would only affect discretionary spending programs and there is even a waiver for personnel and services deemed to be "essential".

In contrast, the economic consequences of not raising the debt limit would potentially be severe. A debt ceiling crisis is far more serious than a government shutdown because it affects all government obligations – interest payments, social security, Medicare, etc. — and nearly all Federal debt. In the very short run, the Treasury can forestall a crisis by paying down certain Treasury bills on the Fed's balance sheet under the Supplementary Financing Program, and with accounting maneuvers to make room for borrowing under the debt ceiling. These maneuvers could extend Treasury's ability to borrow into the summer months, but not beyond.[1] If the crisis escalated with no path forward, it could rattle investor confidence with negative consequences for the Treasury's cost of finance, for the dollar and for equity and credit markets. Persistent negative market reactions likely would depress the economy.

Past experience suggests that the impact on financial markets of such a standoff would likely be modest, however, especially as investors anticipated a timely resolution to the showdown. It's impossible to isolate the market impact of such developments, because many factors influence markets simultaneously. But some evidence suggests that there was a noticeable spillover effect on bond and currency markets during the 1995-96 experience. For example, in the lead-up to the 1995-96 episode, House Speaker Gingrich delivered a speech on September 20, 1995 in which he warned that he was prepared to default on the debt unless the President agreed to Republican demands. "I don't care what the price is," Gingrich said. The Washington Post on September 21, 1995 (partially) attributed a 5% intraday plunge in the dollar and significant drop in bond prices to the speech, although noting that markets partly recovered by day's end.

The extent of any loss of confidence in the Treasury following failure to raise the debt limit would depend on the duration of the crisis, as well as the actions that market participants expect to resolve it. It is difficult to know what markets expect, or to use investors' terms, what is "in the price." We guess that most investors expect the Administration and Congress will compromise and pull back from the brink. In contrast, a crisis that takes both sides beyond that point would likely trigger a severe loss of confidence —

[1] See David Greenlaw, "The Looming Debt-Ceiling Showdown," January 6, 2011. On January 27, Treasury announced that it would begin paying down T-bills issued under the Supplementary Financing Program. The $200 billion in outstanding SFP bills on the Fed's balance sheet count against the debt ceiling. The additional borrowing room provided by the $195 billion SFP bill paydown will postpone the constraint from March until mid-May. Accounting moves involving nonmarketable debt in government trust funds could allow another $250 billion in borrowing, extending the debt ceiling constraint until mid-July.

not just in the Treasury, but also in our ability to govern and pay our bills. The consequences for markets and the economy could be severe indeed.

2) Can you please provide a reasonable time to the significant lowering of the debt?

A: It would be reasonable to make significant progress on our fiscal challenges over the next five to ten years. In considering policies to put the US on a sustainable fiscal path, Congress should aim first at stabilizing the level of debt in relationship to GDP and then at reducing it over time. Such policies, if credible, will reassure investors that our debt obligations have value. Over time, they will also free up resources and capital for productive investment.

Investors don't require immediate results. They understand that our fiscal challenges are long-term in nature; that changes to entitlement programs must be phased in because of the nature of their promises to present and future generations; that getting buy-in from voters on specific changes will require time; and that debt/GDP is likely to rise further in the short run under any scenario. However, investors do know that the longer it takes for us to get our fiscal house in order, the more at risk we are and the tougher adjustment will be in the end. So in order to retain their confidence in our policies, investors do require a credible game plan for getting there.

There is no shortage of credible ideas first to stabilize and then to reduce the debt/GDP ratio over time. For example, according to the authors, the Bowles-Simpson Commission's plan would, if implemented, achieve nearly $4 trillion in deficit reduction through 2020, stabilize debt by 2014 and reduce debt to 60% of GDP by 2023 and 40% by 2035.[2] The tax reform proposals embedded in the plan, moreover, would probably enhance productivity and potential GDP growth over time. However, there is no free lunch in any of those proposals or in others like them, they create both winners and losers. But there would be a significant, long-term cost to everyone from continuing to kick the can down the road. The sooner policymakers explain why sustainable fiscal policies are needed, the sooner we can start moving towards them.

3) As Dodd-Frank gets implemented; one of the issues that continues to surface is how the "Qualified Residential Mortgage (QRM)" safe harbor should be defined. Some are suggesting a very narrow definition that would require significant downpayment (e.g. 30% down payment) on a 30-year Fixed Rate Mortgage. Others, want a more broad definition that includes products that historically, and currently, perform well. Can the witnesses speak to the potential impact that a very conservative, narrow definition of QRM – for example supporting a 30-yr fixed rate mortgage with 30% down payment – will have on the housing market, and in-turn the national economy?

A: To improve future underwriting, and thus limit the risks to the financial system and the economy, Dodd-Frank requires that securitizers in the future retain 5% of the credit risk in assets they originate and transfer through issuance of an asset-backed security, with exceptions for certain "qualified residential mortgages" and CMBS. Limiting the QRM to 30-year, fixed-rate mortgages with a 30% downpayment would limit the supply of mortgage credit relative to what it would be with the broader spectrum of mortgage products that have performed well over time. Indeed, the ongoing uncertainty over how to define the QRM safe harbor is in itself having a negative impact of the ability and willingness of originators to securitize mortgages, and thus on the supply of mortgage credit.

However, policymakers must balance the need for financial stability (via appropriate underwriting standards) against the desire for ample, affordable housing finance. As a benchmark for the QRM standards, it would be reasonable to choose the traditional 80% loan-to-value (LTV) ratio, prime credit, owner-occupied, full documentation loan; in the past, such mortgages have balanced those needs well.

The most important variable in defining the QRM in any case is the maximum LTV; the maturity of and rate applied to the loan are less important (but credit underwriting standards and documentation are also critical ingredients in any such standard). That's because housing is a leveraged investment, so the LTV is

[2] The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform, December 1, 2010.

the key determinant of credit availability. Low LTVs force the borrower to have more skin in the game, and thus to have the capacity to absorb the losses from a decline in home values. Less-levered lending reduces the potential threat to the financial system from such a decline. Conversely, reducing allowable LTVs would reduce credit availability; for example, cutting allowable LTVs from 80% to 70% (or equivalently, raising required downpayments from 20% to 30%) for all mortgages would substantially reduce the pool of eligible borrowers.

It's critical to note that the QRM criteria are moot in today's markets, and will probably stay moot until housing finance is back on firmer ground. The supply of mortgage credit is still impaired by the legacy of massive housing imbalances and the threat of future losses. That is manifest in LTVs averaging 70% today for conforming loans, and as high as 40% for jumbos. Lenders are also demanding higher FICO scores; increases average 25-50 point. Finally, the risk of mortgage "putbacks" is restricting the supply of credit. Mortgage loans are eligible to be put back to originators for material breaches of representations and warranties made to the buyers of those loans. Unfortunately, such breaches typically only surface in the event of default or foreclosure proceedings. "Reps and warranties" typically involve the validity of the lien, compliance with underwriting criteria and applicable laws. The GSEs (e.g., Fannie, Freddie and Ginnie), the trustees of private-label MBS, the monoline credit insurers, and other investors can put these securities back to the originators. Originators, fearful of future putbacks, are only willing to refinance or extend new credit to borrowers with the most pristine credit and ample housing equity.

Policymakers should be aware that implementing a 5% risk retention rule with a QRM safe harbor provision is far from the only way to improve underwriting standards. Indeed, there is no substitute for tried and true underwriting processes developed by lenders over decades. These include adequate downpayments, limiting monthly payments to a reasonable share of income, and documentation of income, net worth, and credit history.

The broader point is this: In taking steps to fix housing finance, it is completely appropriate to look ahead to the new regulatory architecture that will balance efficient intermediation between borrowers and lenders and a stable financial system. What should be the appropriate role of government in housing finance and reform of the GSEs? What are appropriate rules under the just-passed financial reform legislation?

The problem with these discussions, while needed, is that they create uncertainty for lenders and investors who are still struggling with the legacy of past loans gone bad. This underscores how critical is the sequencing of policy options: The first priority should be to focus on repair, to reduce housing imbalances and restore market functioning. Only then can policymakers implement reform of mortgage finance — including rules governing underwriting, securitization, loss taking, and the housing GSEs — critical to assure longer-term financial and economic stability.

4) As the financial crisis has abated, and our attention has become focused on the causes and culprits, the U.S. housing finance system – specifically, the secondary mortgage market – has come under attack for providing too many people with access to mortgage capital. We all agree that the pendulum had swung too far toward "easy credit"; however, swinging the pendulum back too far the other way, or just scrapping the secondary mortgage market as some suggest, may also impact our economy as negatively. Can you provide us with your thoughts on the impact that a fully privatized secondary mortgage market will have on the housing sector and the overall economy when another economic downturn occurs?

A: The impact on housing and housing finance of would depend on the speed of such a move. Quickly moving to such an arrangement in today's circumstances would be devastating for housing; credit availability would dry up and the cost of credit would rise significantly. As noted in Question 3, this underscores again that the sequencing of policy options is critical: The first priority should be to focus on repair. Only then can policymakers implement reform of mortgage finance.

Assuming those steps are taken, moving gradually to a fully privatized secondary mortgage market with no government support likely would provide a lower level of residential mortgage credit through the credit and business cycles than has been prevalent under the public-private hybrid system of housing finance that developed over the past forty years. The lack of a countercyclical government backstop for mortgage markets — a role played in our current system by our housing GSEs and the home loan bank system — could also make such a private system more vulnerable to financial or economic shocks, and worsen housing downturns and their spillover to the rest of the economy. Indeed, the desire for greater credit availability and a buffer for housing finance were two key reasons for setting up the present system in the first place.[3] And it seemed to work: In the wake of the Asian financial crisis, LTCM and the Russian debt default, the GSEs intervened in mortgage markets and played a countercyclical role.

However, the financial crisis has exposed the flaws in that system. It was successful at providing ample credit, but "easy credit" likely contributed to the housing bubble and the severity of the ensuing bust. The government backstop for the mortgage market may have worked in the short run, but it created moral hazard, giving lenders and originators comfort that they could sell or securitize loans with thinner borrower equity cushions and lower credit standards than otherwise. The GSEs themselves used their implicit government guarantee to emphasize growth over prudence. The fact that their stakeholders received the profits while taxpayers were on the hook for losses also increased the GSEs risk appetite. And their implicit guarantee undermined the private secondary mortgage market, because private participants could not compete with the GSEs.

Currently, private mortgage markets remain dysfunctional. Policies to deal with the legacy of that bust have so far been ineffective. The GSEs are not playing their previous countercyclical role. Housing imbalances and tight credit are thus locked in a vicious circle with housing activity and home prices, despite a record plunge in housing activity and thus supply, record declines in home prices, and plunging mortgage rates. Until housing imbalances are virtually eliminated, it is hard to imagine a fully functioning secondary mortgage market, let alone one that is fully privatized.

Could a fully privatized system, one without the moral hazard of government-sponsored easy credit, limit the potential for future housing booms and busts? It would likely reduce lending excess but taking away government support won't eliminate lender exuberance in a boom. Lacking appropriate regulation and oversight, the competition among private lenders/investors for yield in a boom will likely contribute to excess and mispriced loans. Moreover, when financial shocks hit, acute market stress would spur pressure to provide government support to the mortgage market and/or to firms seen as critical to its functioning. Both underscore the need for appropriate regulations governing, and supervision and oversight of mortgage lending, or any lending. And they highlight the need for (macroprudential) tools to manage risks across the financial system.

Policies towards housing finance must balance the need for efficiency and entrepreneurship with safety, soundness and financial stability. Financial institutions must be able to earn a positive return over their cost of capital; otherwise, they could not attract the private equity or debt capital essential for their functioning. And the financial system requires a lender of last resort — typically the central bank — to provide liquidity at a penalty rate to going concerns under stress and to the system in the event of shocks.

But to assure safety, soundness, and financial stability, the financial system also requires appropriate regulations for lenders' capital and liquidity, regular testing to assess their capacity to absorb idiosyncratic and systemic shocks, appropriate supervision and oversight, a mechanism to resolve large complex institutions, and rules regarding margins and haircuts for securitization.

[3] However, see comments below about the pressure for government intervention in periods of acute stress. See also Congressional Budget Office, Fannie Mae, Freddie Mac, And The Federal Role In The Secondary Mortgage Market, December 2010

April 26, 2011

Simon Johnson

Responses to written questions posed by Senator Begich

1) With regard to including low-income children and families in the push for competitiveness and higher productivity, I would strongly support any measures that (a) address health issues for that part of the community (e.g., asthma and other illnesses that reduce school attendance, (b) strengthen access to programs such as Head Start. Our education system is under great stress.
2) It is very hard to provide effective support to poorer families during very sharp economic downturns. The most important measures we could now take are with regard to making our financial system safer and less prone to collapse. The Financial Stability Oversight Council should be pressed for decisive action in this direction.
3) I'm not an expert on the detailed accounting used by the Social Security trust fund. As a general principle, however, what matters for that and other trust funds is the level of revenue available to the federal government as a whole looking forward over some decades – relative to future commitments.
4) United States Treasuries are one of the lowest risk investments in the world. Reports that we are at risk of losing that status have been greatly exaggerated. Nevertheless, it is important that no irresponsible actions are taken with regard to increasing the debt limit –the goal should be to ensure that markets are not disrupted. Also, while we have time to conduct a serious longer-run budget debate, this needs to be concluded within the next few years. There will be greater competition from other countries and currency blocs to offer safe "reserve assets", particularly after 2015.

TAX REFORM: A NECESSARY COMPONENT FOR RESTORING FISCAL RESPONSIBILITY

WEDNESDAY, FEBRUARY 2, 2011

U.S. SENATE,

COMMITTEE ON THE BUDGET,

Washington, DC.

The Committee met, pursuant to notice, at 10:01 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Murray, Wyden, Nelson, Stabenow, Cardin, Sanders, Whitehouse, Warner, Merkley, Begich, Coons, Sessions, Grassley, Enzi, Crapo, Ensign, Cornyn, Graham, Alexander, Thune, Portman, Toomey, and Johnson.

Staff present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

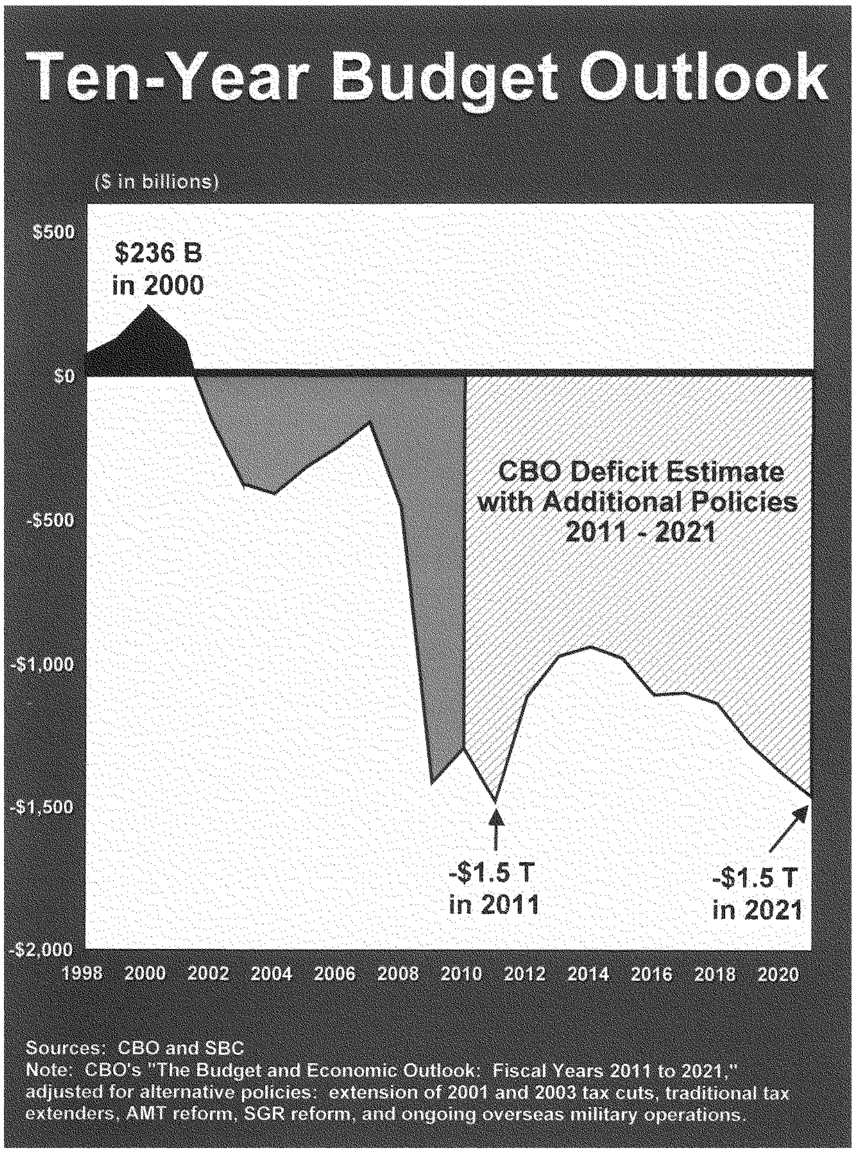
Chairman CONRAD. The Committee will come to order.

I want to welcome everyone to the Senate Budget Committee today. Today we focus on tax reform and the important role that many of us believe it can play in addressing our Nation's long-term budget challenges.

We are fortunate to have four outstanding economists with us this morning who are deeply knowledgeable about tax reform.

Dr. Gene Steuerle, Senior Fellow at the Urban Institute. Gene has been before this Committee many times. He is somebody that enjoys credibility on both sides of the aisle. Dr. Donald Marron, the Director of the Urban-Brookings Tax Policy Center, somebody who is very familiar to the Committee as well, and we very much respect his advice. Dr. Rosanne Altshuler, Professor of Economics at Rutgers University, who testified before the President's Fiscal Commission, as did Dr. Marron and Dr. Steuerle. And Dr. Larry Lindsey, President and CEO of the Lindsey Group, very well known in economic circles as well. We thank all of you for agreeing to give us some of your time. We deeply appreciate it.

Let me just begin by reviewing the State of our fiscal affairs. Last week, the Congressional Budget Office released its annual outlook report. That report should serve as a wake-up call to everyone who is concerned about the Nation's finances. The chart depicts CBO's new 10-year baseline projections, with additional policies added in, those policies that are most likely to be adopted. We all know that CBO does not do a forecast of what might be adopted. They do a forecast based on current law. Then we try to add to that things that are most likely to be adopted to get the most realistic look at where we are headed.



That shows that due to passage of the tax extension package and the slow pace of economic recovery, CBO is now expecting to see deficits of more than $1 trillion a year continuing through at least 2012. It then shows that deficits will briefly fall before rising again as the bulk of the baby-boom generation begins to retire and health care costs continue to climb. Now, if this is not a sobering picture of where we are headed, I do not know what would be sobering.

Make no mistake. We are at a critical juncture. We are borrowing 40 cents of every dollar that we spend. Spending is at the highest level as a share of our economy in 60 years. Revenue is at its lowest level as a share of our economy in 60 years.

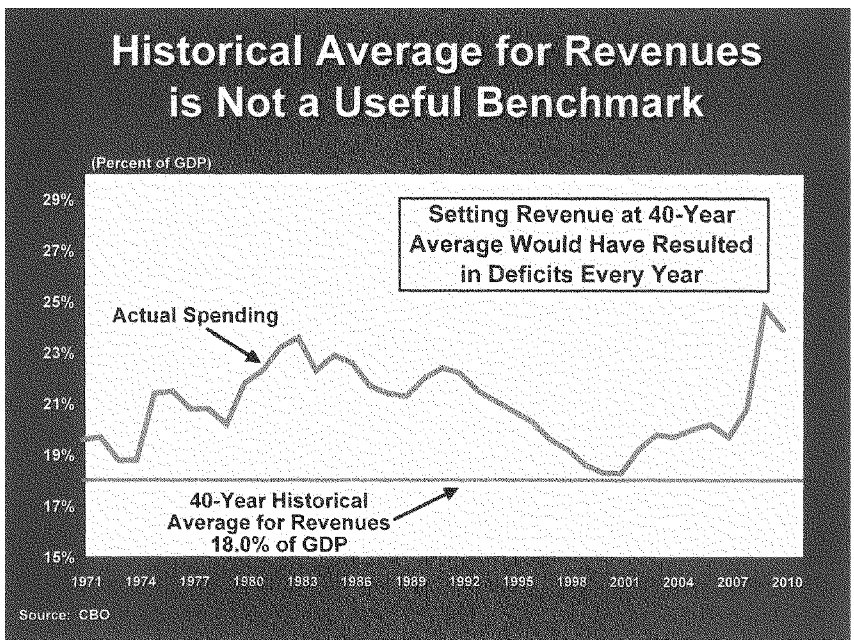
Many of us believe that tax reform must be part of an approach to addressing our fiscal problems. The current State of the Tax Code is simply indefensible. Our Tax Code is out of date and clearly hurts U.S. competitiveness.

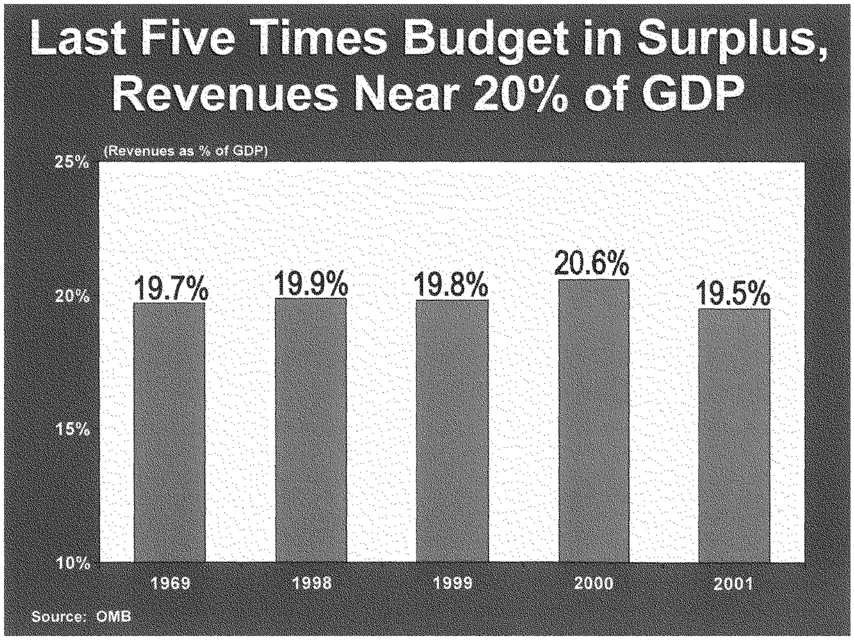
No. 2, it is hemorrhaging revenue. The tax gap, tax havens, and abusive tax shelters undermine the effectiveness of the Tax Code, depriving the Treasury of revenue. I believe the combined effect of the tax gap, offshore tax havens, and abusive tax shelters is leading us to lose more than $500 billion a year. More than $500 billion a year.

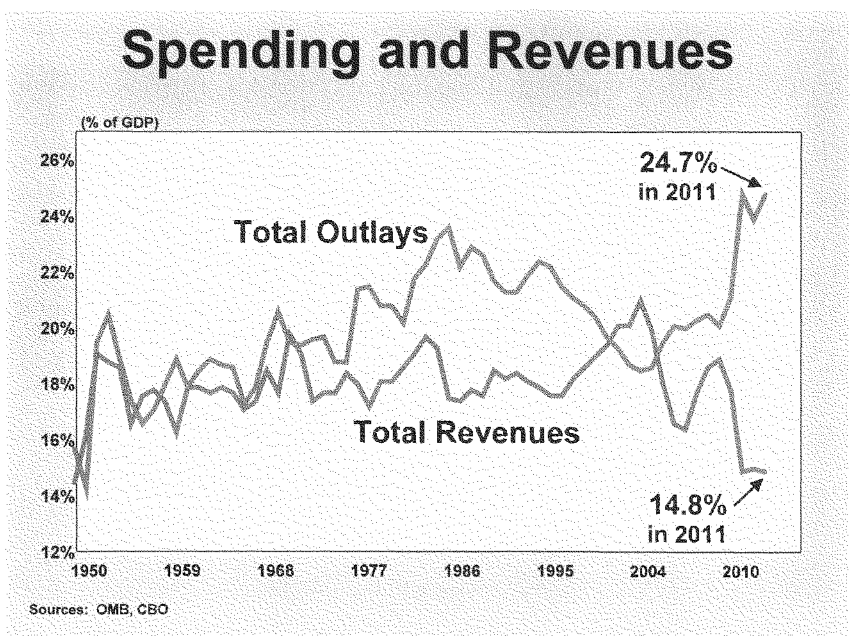
In addition, the Tax Code is riddled with expiring provisions. This creates enormous uncertainty for citizens and businesses, making it difficult for them to plan. If we took steps to simplify and reform the Tax Code, we could reduce tax rates below where they are today and still get more revenue.

Now, let me repeat that. If we were to broaden the base and fundamentally reform the tax system, we could actually lower rates, helping America be more competitive and generate more revenue. Along with lower tax rates, the tax reform would then allow us to increase revenue to help reduce the deficit.

I think we also need to be realistic about what is necessary to meet the needs of the Nation and return the Nation to a sustainable, long-term fiscal trajectory. Looking at revenues has led some to argue that revenues should be held at the historic level over the past 40 years, about 18 percent of GDP. Revenues, I want to point out, at that level would not have produced a single balanced budget in all of that time because spending exceed 18 percent of GDP in every year. In fact, on the five occasions when the budget has been in surplus since 1969, revenues have ranged between 19.5 percent of GDP and 20.6 percent of GDP. It is this higher level of revenue that I believe provides a more useful guidepost for what is needed if we hope to dig ourselves out of the fiscal hole and set the budget on a sustainable path. Let me indicate that would mean we would have to have very significant cuts on the spending side because we are well over 21 percent of GDP on the spending side. We are over 24 percent of GDP on the spending side.







Tax reform gives us an opportunity to lower tax rates at the same time we are raising revenues. Tax reform achieves this goal by broadening the tax base by eliminating or scaling back so-called tax expenditures. Tax expenditures are all of the deductions, exclusions, credits, and set-asides in the Tax Code. They are costing the

Treasury more than $1 trillion in revenue a year. That matches all of domestic discretionary spending, and many are no different than traditional spending programs. They are simply spending through the Tax Code.

Economist Feldstein on Need to Reduce Tax Expenditures

"Cutting tax expenditures is really the best way to reduce government spending.... [E]liminating tax expenditures does not increase marginal tax rates or reduce the reward for saving, investment or risk-taking. It would also increase overall economic efficiency by removing incentives that distort private spending decisions. And eliminating or consolidating the large number of overlapping tax-based subsidies would also greatly simplify tax filing. In short, cutting tax expenditures is not at all like other ways of raising revenue."

– Martin Feldstein
Professor of Economics at Harvard University
Chairman of Council of Economic Advisers under President Reagan
"The 'Tax Expenditure' Solution for Our National Debt,"
Wall Street Journal
July 20, 2010

Here is how well-known conservative economist Martin Feldstein described tax expenditures in a recent piece in the Wall Street Journal, and I quote—this is, again, from Martin Feldstein: "Cutting tax expenditures is really the best way to reduce Government spending. Eliminating tax expenditures does not increase marginal tax rates or reduce the reward for saving, investment, or risk taking. It would also increase overall economic efficiency by removing incentives that distort private spending decisions. And eliminating or consolidating the large number of overlapping tax base subsidies would also great simplify tax filing. In short, cutting tax expenditures is not at all like other ways of raising revenue."

I think this is a critically important point.

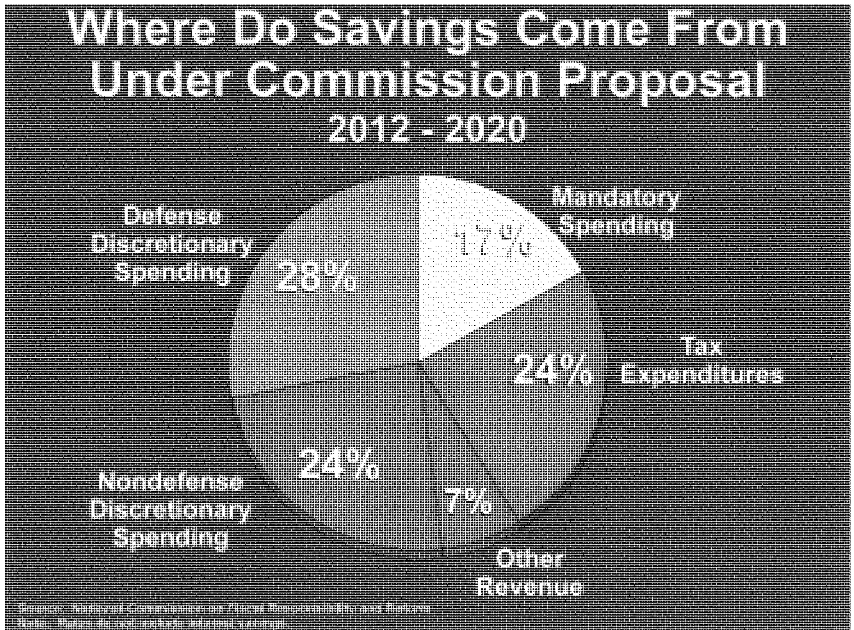
Tax Reform in Fiscal Commission Plan

- Eliminates or scales back tax expenditures, and *lowers* rates
- Promotes economic growth and improves America's global competitiveness
- Makes tax code more progressive
- "Illustrative" tax reform plan:
  - Three rates for individuals - 12%, 22%, 28%; corporate rate of 28%
  - Capital gains / dividends taxed as ordinary income
  - Reforms mortgage interest and charitable deductions
  - Preserves Child Tax Credit and EITC
  - Repeals AMT
- Revenues grow to 21% of GDP by 2022

The President's Fiscal Commission, of which I was a member, issued its report last December, and I believe that tax reform may be the most important component of the Fiscal Commission's plan. Here are the key elements of tax reform included in the Fiscal Commission's plan:

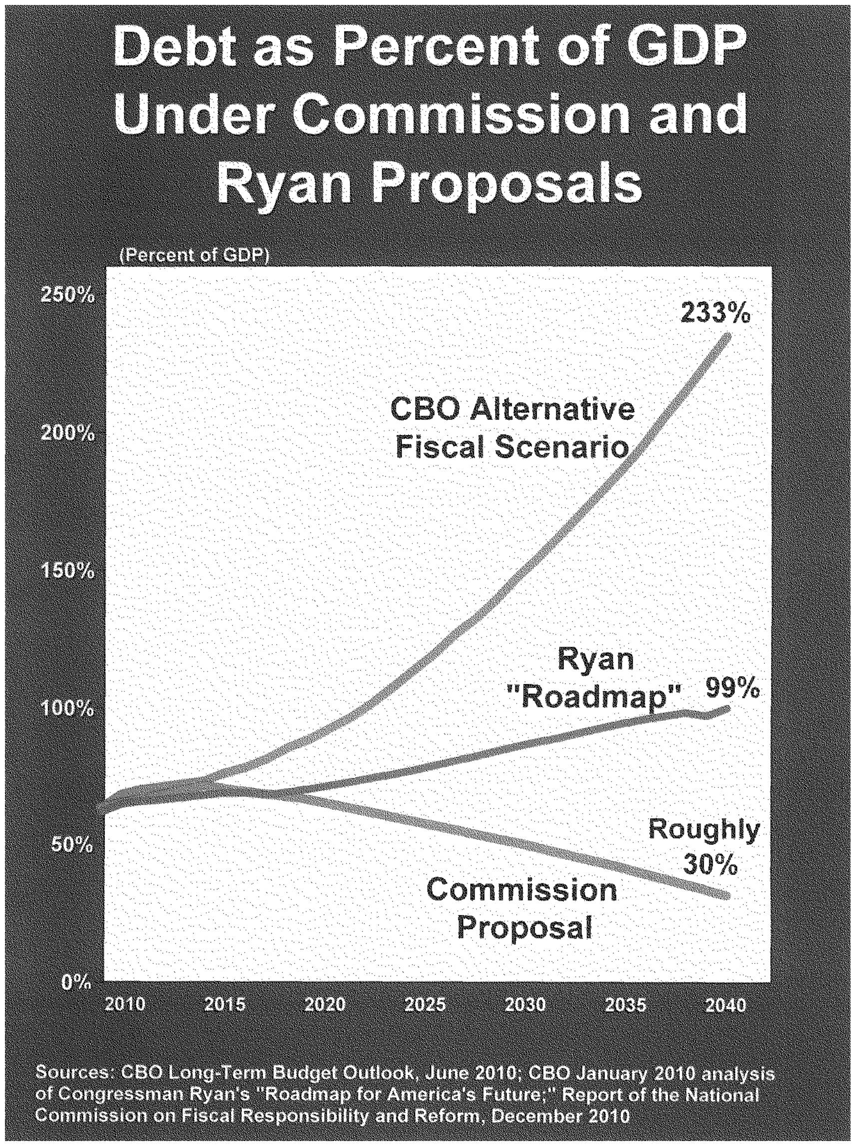
One, eliminates or scales back tax expenditures and lowers tax rates. This promotes economic growth and dramatically improves America's global competitiveness. It makes the Tax Code more progressive. The Commission's report included an illustrative tax reform plan that demonstrates how eliminating or scaling back tax expenditures can lower rates. Instead of six brackets for individuals, the plan includes just three brackets of 12, 22, and 28 percent. The corporate rate would also be reduced from 35 to 28 percent, helping improve the competitive position of the United States.

Capital gains and dividends are taxed at ordinary rates. The mortgage interest and charitable deductions would be reformed, better targeting these tax benefits. The child tax credit and earned income tax credit would be preserved to help working families. And the alternative minimum tax would be repealed. That is the kind of tax reform that I believe we need to adopt.



The Commission plan was also important because it showed how to reduce the deficit and debt in a balanced way. It included cuts in discretionary spending, entitlement reform, and tax reform. You need to have those three fundamental components to be successful. At least I believe that is the case.

In total, about two-thirds of the deficit reduction between 2012 and 2020 in the plan resulted from reductions to spending. The proposed spending cuts were significant. I would even argue on the domestic side probably went too far. Taking revenues out of the equation would have made it impossible to obtain the desired deficit reduction goals. Cutting spending alone or, as some would suggest, only cutting non-defense discretionary spending would require such Draconian reductions that they simply could not be sustained.



Let me just conclude on this chart. Chairman Ryan's road map that he has laid out—this is the Chairman of the House Budget Committee—I believe proves the point that revenues have to be part of a plan to reduce the deficit and the debt. He proposes discretionary and mandatory spending cuts, but actually makes things worse on the revenue side. The result is that his plan increases the debt as a percentage of GDP for the next 30 years. In fact, he does not achieve balance for 53 years. He does not achieve balance for 53 years. He dramatically increases the debt, both in dollar terms and as a share of GDP.

To solve the long-term challenge, it will require real compromise and a great deal of political will. We need everyone at the table, and we need to have both sides, Democrats and Republicans, willing to move off their fixed positions in order to achieve a result important for the Nation. We cannot continue to put this off. We need to reach an agreement this year. It is time, I believe, for the administration and leaders of Congress, Democrats and Republicans, to sit down and hash out a long-term plan.

We will now turn to Senator Sessions for his opening remarks. I apologize to my colleagues for the length of that introduction, but I thought it was important in light of the subject we have before us today. Senator Sessions.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Mr. Chairman. I am glad to see your passion and leadership showing itself on this issue because we have to do some things. We cannot continue business as usual. The article in the Wall Street Journal in which the International Monetary Fund—I believe it was in the Washington Post, in which the International Monetary Fund called on the United States to get its house in order like other nations in the world, used the phrase that all the other developing nations who are facing debt crises—and most of them are—are entering into a dialog with their people to explain to them why changes have to occur. So I have been critical of the President's State of the Union address in which he spent very little time in an honest, direct, open way discussing with the American people why business as usual cannot continue.

I so much appreciate your Statement that this Committee may be where the leadership has to come, and I would be there with you.

I am totally appreciative of the concept that you, Senator Wyden, the Deficit Commission, and others—conservatives, writers, and intellectuals—who favor tax simplification. Mr. Lindsey, I was really—I hope you do not mind me quoting from your remarks. But you quote a number of economists who say that sensible, revenue-neutral tax reform could result in 5 to 10 percent more of GDP growth over 10 years in one study, an 18-percent increase in GDP output. Larry Summers, the recent former adviser to President Obama, found in another study that there was 19 percent more growth. These are stunning numbers. So we would leave that on the table. Frankly, I doubt they are that high, but if we could get close to that, if we could get a third of that, that would be marvelous for us because it would be, as you indicated, sort of free money, Mr. Chairman. In other words, it would create more growth which would create more revenue.

President Obama in his State of the Union address said, "For example, over the years, a parade of lobbyists has rigged the Tax Code to benefit particular companies and industries. Those with accountants or lawyers to work the system can end up paying no taxes at all. But all the rest are hit with one of the highest corporate tax rates in the world. It makes no sense, and it has to change. So tonight, I am asking Democrats and Republicans to simplify the system. Get rid of the loopholes. Level the playing field.

And use the savings to lower the corporate tax rate for the first time in 25 years—without adding to our deficit. It can be done.''

Well, I think if we simplify the corporate tax rate properly, we can in a revenue-neutral way probably create more revenue.

But let me tell you, the problem is far more serious than that. We have, even in the real rate terms, one of the highest if not the highest corporate rate in the developed world. Corporations are making decisions every day where to expand, where to hire workers. We learn things in airports. I happened to be on the plane with a very impressive CEO of an international corporation. CEO North America had an Alabama plant, and he was so frustrated. I ended with an empty seat, and he came by and sat by me and told me this story. This is the story he told: that they had competed within their plants worldwide in this big company to do a new chemical process that would create 200 jobs. They had worked extremely hard at the Alabama plant and had won the competition. He submitted it, and they had the lowest cost per gallon of chemical stuff, and the plant was going to be expanded in Alabama, we were going to gain 200 jobs—until the people back in Europe said, ''We have to calculate the taxes,'' and they recalculated the bid based on taxes. We lost 200 jobs.

This is not academic. This is going on every day. We have an unemployment rate that is unacceptable, and to have the highest corporate tax rate virtually in the world, and other nations are seeing the light and reducing it, and we remain high. So even if we eliminate certain deductions and have a flat rate that appears lower, it seems to my simple mind that we have no less real burden on the corporate community than we had before. So I think we need to figure out a way to reduce the rates. And if it has to be paid for by some tax increase in some other area, I am willing to consider doing that.

So I believe we need to simplify, but I also think it would be a big mistake if we do not reduce the rates. Of course, the U.K. is reducing their rates. Canada, I understand, is going to 16 percent. So if we are at 28, 27 after we have adjusted, we are still way above that, and a company making the decision of where to produce a product might well choose another country than our own country to produce that product and cost us jobs.

So, Mr. Chairman, that is kind of where I am. I do not think I am prepared to support just a tax simplification of the corporate rate because I believe the entire world is recognizing that the corporate rate is a job factor, a big job factor. And I think in terms of the Laffer factor, if you want to call it that, reducing the corporate rate I believe is—one of our colleagues said the other day a study has come out and shown that if you reduce that rate, you get more economic growth than you would in almost any other place in the economy.

Thank you for your leadership. Thank you for this good hearing. I look forward to the testimony of our excellent panel.

Chairman CONRAD. Thank you very much, Senator Sessions.

Now we will turn to our panel. We will start with Gene Steuerle, Senior Fellow, the Urban Institute. Welcome back to the Committee, Gene, and please proceed.

STATEMENT OF C. EUGENE STEUERLE, PH.D., INSTITUTE FELLOW AND RICHARD B. FISHER CHAIR, THE URBAN INSTITUTE

Mr. STEUERLE. Thank you, Mr. Chairman, Mr. Sessions, and members of the Committee. Many tax and budget reforms know no ideological or party boundaries. No one favors the unequal justice, inefficiency, and complexity we see in our Tax Code today. Neither does anyone really favor the ways that tomorrow's scheduled deficits threaten our economy and our children.

You have asked that I concentrate my remarks on what makes reform most likely. Reform often starts from a common consensus that a variety of fixes would be better than what we have. Bipartisan agreement led to past successful tax reforms such as in 1986, 1969, and 1954. Such bipartisan consensus also informed close to two-thirds of the members of President Obama's own Debt Commission. And such agreement, I would suggest, with admitted bias, is displayed by the panel before you. Three of us are from the Tax Policy Center. We are former Deputy Assistant Secretaries and heads of CBO, and senior economists on advisory panels, appointees by both Republicans and Democrats, often come to very common conclusions. We are not led by any party identification.

The more general point is that good Government at either 17 percent or 23 percent of GDP trumps bad Government at both levels. When Theseus, the mythical founder-king of Athens, went into the Labyrinth to slay the half-bull Minotaur, he was able to escape only by following a ball of string back to where he had entered. If we are ever to escape the tax labyrinth into which we have journeyed, I suggest that, like Theseus, we follow the string back along four dimensions that define our larger budgetary problems.

First, we must move to an era of more fundamental reform. A simple explanation of the Tax Code's evolution in recent decades is that it broke away from its narrow revenue-raising foundation and began to evolve much like the spending side of the budget. Yet large systemic reforms require fundamentally different strategies than the tax cuts and benefit expansions that seem only to identify "winners." Many domestic reforms—like Social Security reform in 1983, tax reform in 1986—are the harbingers of the types of trade-offs that modern Government must increasingly engage.

Second, we must limit how much any Congress can commit for the future—before that future arises. I no longer divide the budget balance sheet into spending and taxes, but into give-away and take-away. Especially after the 1990 and 1993 budget administrations, both political parties have increasingly come to believe that it is political suicide to operate on the take-away side of the budget to balance the sheets. The consequence of fiscal democracy I have developed shows that in 2009, for the first time in U.S. history, all revenues were committed before the new Congress even walked in the door.

Third, we must account for and report to the public in a more honest way. Right now, for instance, tax subsidies show up in the budget as a reduction in taxes when they are bigger Government in disguise.

And, fourth, we must cut across institutional boundaries. Even today, tax reforms are unable to replace an education tax credit with the higher Pell grant or a housing tax credit with a housing voucher. At the same time, I believe that serendipity arises by playing the odds in the right way. Tax reform's probability of success can be increased by the following steps.

First, we must seize today's and not yesterday's opportunities. Yesterday's included large individual tax shelters, very high tax rates, and ever increasing taxation of families with children on children and the poor. Today's include the deficit, high corporate rates, and the extraordinary complexity of the tax system.

Second, we must base reform on well-established principles of public finance. Principles like equal justice have powerful appeal and lead logically to a whole host of reforms.

Third, we must comprehensively tackle the problem. Yes, reforms create headlines over who loses some subsidy and who pays more tax. But the size of the headline is often indifferent to the size of the reform. If one is going to take a political hit, one ought to achieve something valuable, such as a simpler Tax Code or a more sustainable budget.

Fourth, we need to shift the burden of proof. Let opponents argue why they oppose a standard based on equal justice or simplicity. When the standard is current law, the burden of proof resides with reformers who appear to be picking on particular groups.

Fifth, we must form coalitions based on legitimate liberal and conservative principles. Tax reform in 1986, for instance, in no small part was supported by two broad coalitions: pro-poor and pro-family, and lower rates and reduction in tax shelters.

Sixth, we must seek better ways to present information. In 1986, the old way of presenting tax burdens would have treated those with tax shelters as poor people with large tax increases.

Seventh, we must empower knowledgeable, non-partisan staff to navigate the complexities before too many political constraints are placed down. The tax reform acts of 1986 and 1969 came out of studies of the Treasury Department that were conducted mainly with non-partisan staff, with most of the political decisionmaking held off until later.

And, finally, at the political level, we must encourage elected officials, A, to lead; B, to be held accountable; and, C, to be empowered. In 1986 tax reform, Dan Rostenkowski and President Reagan led by agreeing not to criticize each other. Also, as the effort moved through at least four different stages, someone was always held accountable and feared being shamed by the failure to enact tax reform. At the same time, tax reform succeeded because leaders were empowered to execute a strategic plan as they moved through the political minefield.

Thank you, Mr. Chairman.

[The prepared Statement of Mr. Steuerle follows:]

REFORMING FEDERAL TAXES: SOME LESSONS FROM HISTORY

Testimony

Before the

Committee on the Budget

U.S. Senate

February 2, 2011

*C. Eugene Steuerle**

Richard B. Fisher Chair

The Urban Institute

*The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders.

Mr. Chairman and Members of the Committee:

Many tax and budget reforms know no ideological or party boundaries. While legitimate debates transpire on degrees of progressivity or size of government, no one favors the unequal justice, inefficiency, and complexity we see in our tax code today. Neither does anyone really favor the ways that tomorrow's scheduled deficits—over and beyond any amount related to recession—threaten economic slowdown and place unfair burdens on our children.

You have asked that my testimony concentrate on what makes reform most likely, given the lessons of history. As Heraclitus noted, "You cannot step twice into the same river; for other waters are ever flowing on to you." Yet, as I will attempt to illustrate here, a little planning can still help one cross the stream. Let me engage in a bit of literary license and distinguish between serendipity and luck. Luck is random. Serendipity involves good things happening because one takes steps to increase the probability that they will, although almost never in the exact way one originally intended.

With hindsight, commentators typically note how serendipitous circumstances allowed past tax and budget reform to happen. With foresight, they are more likely, as in the early 1980s and today, to be writing books calling such reform "the impossible dream." Yet such reforms begin with a common consensus that something is broken and that, while we disagree on the perfect fix, a variety of fixes would be better than what we have. It was that type of bipartisan agreement that led to past successful tax reforms, such as in 1986, 1969, and 1954. Such also was the consensus of close to two-thirds of the members of the President Obama's recent debt commission.

I also suggest (with admitted bias) that the advantages of nonpartisanship are displayed in the witnesses you have asked to testify today on the basis of their knowledge, not ideology. Three of us today are associated with the Urban-Brookings Tax Policy Center, where former deputy assistant secretaries of the Treasury under both Republicans and Democrats co-mingle with former heads or acting heads of the Congressional Budget Office appointed by members of both parties, as well as with the senior economist to the President's Advisory Panel on Federal Tax Reform in 2005, to mention only a few. Party lines and affiliations are neither issues nor criteria when we discuss which types of reforms we think might work.

The more general point is that most of us, elected officials and professionals alike, are about the same business: to try to find ways that government can best serve the public. And the dirty little secret of tax and budget politics is that while enormous attention is given to a decades-old fight over whether government should be 17 percent of GDP or 23 percent of GDP, good government at either 17 or 23 percent of GDP trumps bad government at both levels.

Understanding How We Got Here

If reform always seems within reach, then why do we perennially fail to grasp it? When Theseus, the mythical founder-king of Athens, went into the Labyrinth to slay the half-bull Minotaur, he was able to escape only by following a ball of string back to where he had entered. If we are ever to escape the tax labyrinth into which we have journeyed, we must first figure out how we got here.

I suggest that four factors have contributed significantly to the mess that has become our tax code today and our seeming inability to fix it: (1) the sometimes disorganized growth of domestic policy during what I view as modern government's adolescence; (2) the political ascendency of the budgetary politics of "two Santa Clauses at the same time"; (3) misleading budget accounting; and (4) jurisdictional limitations within the executive branch and across congressional committees.

Seeking Adulthood. For most of U.S. history, the spending side of government was addressed to the items like defense and public works, along with a government infrastructure of administration and justice. Transfers were few, and tax issues revolved around what source of revenues might best be used to pay for those public goods. With the vast expansion of the domestic side of government over the 20th century, as well as the higher subsidy values that accompanied deductions and exclusions as tax rates rose, tax policy increasingly became inseparable from other domestic policy—in particular, transfers in areas like health, Social Security, pensions, housing, and welfare. From an economists' viewpoint, transfers are merely negative taxes, taxes negative transfers. As these transfers came increasingly to dominate a growing domestic spending budget, it is not surprising that they came to dominate the tax side as well.

Thus, a simple explanation of the tax code's evolution in recent decades is that it broke away from its narrow revenue-raising function and began to evolve much like the spending side of the budget. To say one is for tax reform today is like saying one is for spending reform: in neither case does it tell us very much. Is the goal stimulus, lower rates, incentives, revenue raising, deficit reduction, base-broadening, progressivity, redistribution, simplification, capital formation, or preferences for favored ventures or groups? As one consequence, today around a quarter of all spending items are in the tax code and, what is equally important but given little attention, a huge number of the tax rates people face are hidden in phase-outs of both direct spending and tax subsidies. While we can explain this development as a consequence of government's movement through adolescence, we have yet to develop the processes and laws more applicable to adulthood.

Two Santa Clauses at the Same Time. Partly due to the large number of spending items in the tax code and effective taxes due to the phase-out of various benefits, I no longer divide the budget balance sheet into spending and taxes but, instead, as "giveaway" and "takeaway." Especially after the 1990 and 1993 budget agreements, both political parties have increasingly come to believe that it is political suicide to operate on the takeaway side of the budget. Indeed, with perhaps one exception, most members in today's Congress have never voted for any significant deficit reduction or for the systemic reform of any major spending or tax program. Both deficit reduction and systemic reform, you see, require identifying "losers"—those who must give up something to balance the sheets. Whatever one thinks of the exception—health reform—controversy over it tends to center less on whether it works than on who might be the losers. Accordingly, both political parties for a long time have only enacted tax cuts and spending increases while hoping that the other party will enact the tax increases and spending cuts that balance the government's books.

Even when we know that the situation is no longer viable—as today, when we only collect $2 for every $3 we spend—the stalemate continues.

Taxes & Spending per Household

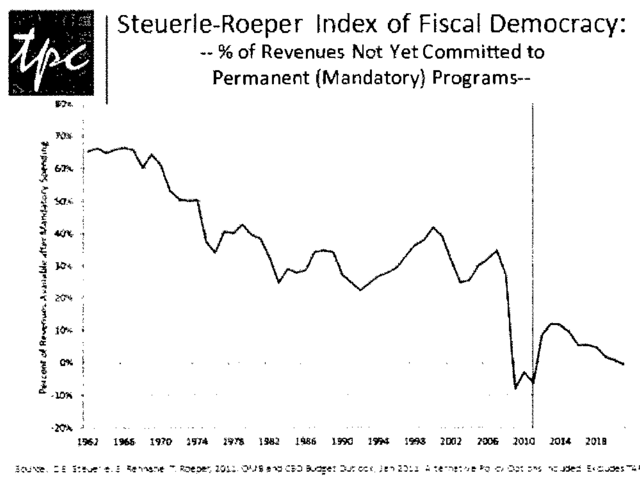
($2011)

	2011	2020
Taxes per household	$ 18,400	$ 27,000
Total Spending per household	$ 30,700	$ 37,000
Tax Expenditures per household	$ 9,600	$ 12,400
Interest Spending per Household	*$ 2,000*	*$ 6,200*

Source: C. E. Steuerle and S. Rennane, Urban Institute, 2011. CBO Budget and Economic Outlook, Jan 2011. Alternative Policy Options Included

To make matters worse, both parties think that the reward for such political suicide is only to strengthen the other party's ability to control the future; that is, from one perspective, spending cuts will only lead to tax cuts, and from the other, tax increases will only lead to spending increases. Actually, I think there is some truth on both sides, and each is trapped in a classic prisoners' dilemma—a complicated situation where it is always costly to lead and where making any tough choice *alone* always results in less-than-optimal results.

To give one major example of the consequences, I have developed a fiscal democracy index that shows that in 2009, for the first time in U.S. history, all revenues were committed before the new Congress walked in the door. Effectively all discretionary spending had to be paid for with borrowing, and no new reform could be adopted without rescinding some past promise made to the public for low taxes and high spending.



Again, what is unique in all our history is that stalemate can't help get us out of the problem. Traditionally, receipts rose as the economy grew, while future spending under the law on the books was flat or declining. Unless one party or the other got new spending items or some new tax cuts, future budgets went from deficit to surplus. With the spending curve now growing automatically faster than the revenue curve, that option is no longer available—and it explains why so many policymakers are perplexed as to why one can't simply engage in the types of "giveaway" to which we became accustomed for decades in budget, tax, and spending bills.

Misleading Budget Accounting. Regardless of which agency should administer any particular subsidy, one thing is clear: tax subsidies and spending items put in the tax code mislead the public as to extent of governmental influence over the economy. A tax subsidy effectively raises tax rates that must finance the subsidy in the same way as an equivalent spending item. Put $1 billion of tax subsidies for farmers in the tax code, and taxpayers must fork over an additional $1 billion in taxes on their earnings and profits to pay for them. The complication is that the tax subsidies show up in the budget as a *reduction* in taxes, whereas the corresponding spending items show up as an *increase* in spending. The former looks like smaller government when it really is bigger government in disguise. Accordingly, it is not unusual for a secretary of the Treasury to favor a tax credit on the grounds that an equivalent expenditure item can never get through Congress.

Jurisdiction. Two anecdotes show how hard it is under current practices to make reforms that cut across jurisdictions. When I served as original organizer and economic coordinator of the Treasury's 1984–86 tax reform effort, some of those assigned to write up reasons for particular reforms suggested that many tax preferences would be better handled as direct expenditures. I explained to them that such an argument had limited application to a tax reform that could only make trade-offs among various tax provisions. For instance, even as successful as many consider the 1986 reform to be, our effort could not, say, replace an education tax credit with a higher Pell grant because we—and the committees to which we submitted our recommendations—had no authority over both direct spending and spending hidden in the tax code.

Another time came when testifying before the Ways and Means Committee on the possible superiority of direct housing vouchers to low-income housing tax credits. Representative Rangel leaned over the podium, smiled down at me, and said (paraphrased), "You know, when this committee gets jurisdiction over vouchers, we can discuss such trade-offs, but, for now, we'll deal with what is under our control."

Lessons from 1986 (and 1969 and 1954)

You have asked me to spend some time on lessons from the 1986 reform and why it was successful. While history never fully repeats itself, these lessons can still provide guidance.

Seizing Today's "Opportunity." The opportunities of each age differ. In the mid-1980s, individual tax shelters were running amuck and threatening the tax system; both the poor and households with children were bearing ever-heavier shares of the tax burden; high tax rates combined with inflation were adding to stagnation by playing havoc with how people invested their money; and the income tax was becoming ever more complex. Tax reform could help deal with all those issues.

Some of these issues repeat today, some do not. The extraordinary growth in permanent or mandatory programs both on the spending and tax expenditure sides of the budget, along with the low level of revenues raised, are far more serious today than even in the 1980s. As I have already noted, never in our history has there been less give or slack in the budget—in fact, the situation has become so bad that even economic growth can't get us back into the black. Also, in the early 1980s, Congress and the president had already begun—admittedly gingerly—tackling the deficit issues through deficit reduction acts in 1982 and 1984 and Social Security reform in 1983. This provided greater opportunity to propose a deficit-neutral tax reform.

Principles. On what basis can reform proceed, given so many programs in the tax system? Principles are crucial and must be distinguished from mere goals. Established principles of public finance include equal justice (equal treatment of equals), efficiency (which includes operating within a budget), progressivity, individual equity (one is entitled to the rewards from one's own efforts), and simplicity. There is seldom any excuse for violating equal justice or for establishing programs with open-ended budgets, though both are done all the time. Some principles like progressivity must be balanced against concerns for efficiency, but, even here, it is easy to find examples of programs that simultaneously violate almost every principle.

A simple history of post–World War II budget policy is that when operating on the giveaway side of the budget, *first feeding at the trough* seems to be a primary way that legislative goals are set, and there is little political price to pay as long as everyone appears to come out ahead. When operating on the takeaway side, on the other hand, principles come much more into play since elected officials must justify to skeptical audiences why they made the choices they did. Principles not only guide initial decision-making, they can be used to control the process as it moves along.

Comprehensiveness. From a public policy perspective, we ought first to identify comprehensively what needs fixing before proceeding to the politics. This was a major fight during tax reform; many people did not want us at Treasury to suggest a comprehensive reform, but, instead, merely to identify a few items. I pushed for comprehensiveness on three grounds. First, that was our job as public servants. If not then, when did we get around to telling the public just how much was broken? Second, under what I label the "hopper theory of democracy," the more good things that go into the hopper, the more good things that might happen down the road (regardless of the success of any particular reform).

Third, the political cost of major reform is often less than the cost of minor reform. Why? In today's media, editors demand that their reporters provide controversy. That's what sells. That means that the first screaming headline of any reform effort is to identify who pays—who loses some subsidy or pays some more tax on the takeaway side of the budget. But the size of the headline often doesn't change and certainly doesn't change proportionately to the size of the reform.

As for the lobbyists, they suffer from what is called an "agency problem": they represent themselves more than any particular client. That can be turned to the reformer's advantage. Lobbyists, too, gear up to favor their funders, but not in any manner proportionate to the issues at hand. Their incentives are to scare their funders and members of their associations, irrespective of the amount at stake or even whether they should be scared. Therefore, if one is going to take a hit politically, one ought to get as much as possible out of the hit. The reform ought to achieve something quite valuable—a simpler tax code, long-term budgetary balance, a Social Security system without long-run deficits, and so forth.

Shifting the Burden of Proof. Comprehensive reform serves another purpose: placing the burden of proof on those who oppose reform. During tax reform, those who fought against reform generally fought to restore a provision against a standard of equal justice and a comprehensive tax base, with few exceptions. They bore the burden of proof. When current law is established as the standard, the burden of proof resides with the reformers, who must justify why they are picking on one group or another.

As some of you know, this last reason compelled me early on in the debt commission's proceeding to push through the staff for a "chairmen's mark" that solved such problems as long-term debt and Social Security imbalances, so that those favoring current practices would have to be put on the defensive. Had the debt commission merely put out a set of options, as have so many past commissions, it would not have succeeded in shifting the burden of proof.

Liberal-Conservative Coalitions. Tax reform in 1986 in no small part was supported by two broad coalitions: (1) pro-poor and pro-family; and (2) lower rates and reduction in tax shelters. These didn't just appear *deus ex machina*. Prior to reform, I did some work that got front-page headlines on the extent to which families with children had increasingly borne the largest tax increases in the post-war era. The same work showed that the poor were increasingly subject to tax. The first issue was taken up especially by social conservatives who felt the family was under attack, and the second especially by liberals concerned about the poor. Meanwhile, lower rates were always foremost in President Reagan's mind, and he didn't object to giving up items like accelerated depreciation or investment credits to get them; while the tax shelters of the day were looking increasingly slimy to everyone.

Presentation. So many reform efforts fail because no plan is in place to gather together the information that can present the problem in the most forthright manner. The 1984–86 reform effort worked in part because nonpartisan staff worked well ahead of the game on what data to gather, what models to run, and how information could be most honestly presented. As a prime example, distributional tables in 1984 were reported in such a way that many doctors and lawyers with +$300,000 in professional income and –$290,000 in fake partnership losses would have shown up as "low-income taxpayers" with $10,000 in total income. Raising their taxes would appear as a tax increase on the poor. To deal with this issue, we had to adopt a better measure by which to classify taxpayers. We also worked closely with IRS to reveal much more data on the uses of partnerships as tax shelters.

Empowering Nonpartisan Staffs at Treasury and Elsewhere. Over the past three decades, a belief has arisen within both the White House and Congress that information needs to be centralized and controlled. Why, it is thought, make political enemies by identifying what is not working, especially if those particular issues are not on the president's or a political party's current agenda? In addition, why not place more and more political staff over nonpartisan staff and civil servants so as to please more constituencies and restrict any news that might offend them? With a few major exceptions, such as the Congressional Budget Office, one consequence has been the multidecade downgrading of nonpartisan staff to the point that they are less able to serve the public with the information and knowledge that they have.

There is no doubt that the Tax Reform Act of 1986, as well as the Tax Reform Act of 1969, came out of studies that the Treasury Department conducted mainly with nonpartisan staff, with little political interference, and with most political decision-making held off until after the results of the studies could be released. In the 1969 act, hardly a beat was lost as Treasury studies (on foundations and on high-income taxpayers paying no tax) largely conducted under a Democratic president were used to back a reform in 1969 under a Republican one. In 1986, we dug into the heart of many, many issues—ranging from tunnel bores to depreciation rates—in ways that haven't been repeated since. Since then, the plumbers have not really been allowed to do their work; as one piece of evidence, the Treasury and the IRS for decades have failed to fulfill the requirement for performance review of the hundreds of programs under their purview.

Leadership. With the gift of hindsight, many people claim leadership, as in making the 1986 reform happen. In truth, when President Reagan first asked for a study in his 1984 State of the Union address, Congress immediately burst out in laughter. Internally to Treasury, some people thought we would treat this like a lot of other studies that never quite got done. And it was quite clear that the White House initially had little more in mind than to put this request in the State of the Union to keep the tax debate out of the 1984 presidential election. In fact—and this was *good* for reform—the White House didn't want to know what we were debating internally because they didn't want to have to defend it. Even after the Treasury's study was released, Secretary Regan started to back off, indicating that it had been written on a word processor and could be changed.

Still, after release, the study itself began to receive praise from many Democrats and Republicans. Momentum started to build. People like James Baker and Richard Darman saw both opportunity to lead and a way to establish an agenda for the president's second term. At a crucial moment, President Reagan and Representative Dan Rostenkowski came to an agreement that each would not criticize the other in advancing this ball to the next stage. Also, President Reagan didn't get hung up on narrow issues of consistency, such as whether some reforms went against provisions that he favored in 1981 legislation or in the previous election campaigns. And clearly some members of Congress, led by Senator Bill Bradley, had already helped create momentum through bills such as Bradley-Gephardt, Kemp-Kasten, and many others.

Accountability. Interestingly, tax reform in those days was declared dead at least three times after Treasury's original report gave it some life. But as the effort moved from a Treasury proposal to a presidential proposal to a Ways and Means bill to a Senate Finance bill to enactment, one person at each step (first Treasury Secretary James Baker, then Ways and Means Chair Dan Rostenkowski, then Senate Finance Chair Bob Packwood) ended up responsible for getting it to the next stage. When the press started reporting at each stage that reform was dead, the onus of failure became greater than onus of success. This shame factor is important: figuring out how to hold particular people (and not a committee) accountable for failure is a crucial ingredient for the success of any reform.

Empowering Someone to Be in Charge. Whether we build a glass building or a steel building, the builders should still want the architects and engineers initially to design something that can stand. But in a political system, someone then needs to be empowered to get reform through the political system without losing its core objectives. With respect to this stage of reform, I here paraphrase comments made by Richard Darman, passed onto me by O. Donald Chapoton, a former assistant secretary of the Treasury. Darman, deputy secretary of the Treasury during the 1985 and 1986 stages of tax reform, emphasized that he and Secretary Baker took overall charge, mapped out a strategic plan, relied upon their past experience in getting legislation through Congress, operated when necessary in secret, bargained with various interest groups to get their support for reform, and involved the White House only when necessary (partly to avoid too many chefs).

Conclusion

How, then, do we escape from the current tax and budget labyrinth and move forward on reform? I suggest, like Theseus, we follow the string back out along the four dimensions I have laid out.

- First, we must move into an era of fundamental reform—one that no longer centers simply on growth and multiplication of programs. Large systemic reforms require fundamentally different strategies than those simple tax cuts and benefit expansions that seem only to identify "winners." Whatever one thinks of the final results, the few major domestic reforms of the past three decades--Social Security reform in 1983, tax reform in 1986, welfare reform in 1996, and health reform in 2010—are harbingers of the size and types of trade-offs that modern government must increasingly engage.

- Second, we must limit how much any political party or any Congress can commit for the future—before that future arises. In like manner, we should expect that budgets must be roughly balanced over the economic cycle. The only way to achieve these reforms is through agreement among political parties that they will abide by rules that constrain how much of an unknown future either party can control through fore-ordained spending increases or tax cuts.

- Third, we must account for and report to the public in a more honest way that doesn't hide the cost of government in tax programs or tax rates in spending programs. We should also report the tax burden enacted by each Congress as equal to the revenues it collects plus the taxes necessary to cover the deficits it leaves behind.

- Finally, we must cut across jurisdictions in ways that allow us more systematically to reform particular areas of the budget where both tax subsidies and direct subsidies are used, such as housing, welfare, and jobs programs.

At the same time, I believe that serendipity arises by playing the odds in the right way. I do not know the day or the hour that tax reform will take place; taking the lessons of history, I do know that its probability of success is increased at the analytic level by

- seizing today's opportunities;

- basing reform on well-established principles of public finance;

- comprehensively tackling the subject at hand;

- shifting the burden of proof to those who oppose a comprehensive standard based on principles such as equal justice;
- forming coalitions around legitimate liberal and conservative principles;
- preparing well in advance for how information is presented;
- empowering nonpartisan staff with detailed knowledge of the subject matter to lay out a principled plan for reform before laying on political constraints (that are often contradictory);

and at the political level by

- exercising leadership;
- holding particular leaders publicly accountable for failure; and
- empowering the right leaders to execute a rigorous plan for how to move through the political minefield.

Chairman CONRAD. Thank you, Gene. Excellent testimony.
Dr. Marron? It is good to have you back.

STATEMENT OF DONALD B. MARRON, PH.D., DIRECTOR, URBAN-BROOKINGS TAX POLICY CENTER, AND VISITING PROFESSOR, GEORGETOWN PUBLIC POLICY INSTITUTE

Mr. MARRON. Thank you, Mr. Chairman, Ranking Member Sessions. It is a pleasure to be here to talk about the important issue of fundamental tax reform.

Kind of echoing some of the things that have already been said, America's tax system is clearly broken. It is needlessly complex, economically harmful, and often unfair. It fails at its most basic task, which, lest we forget, is raising enough money to pay for the Federal Government. And increasingly, it is unpredictable, with large temporary tax cuts not only in the individual income tax, but also in corporate payroll and eState taxes.

For all of those reasons, our tax system cries out for reform. Such reform could follow many paths. Some analysts recommend the introduction of new taxes, such as a value-added tax, national retail sales tax, or pollution taxes to supplement or replace our current system. Those ideas are worth serious discussion, but in today's testimony, I would like to focus on a more traditional approach to tax reform, redesigning our income tax.

I would like to make seven main points. First, as has already been mentioned, tax preferences pervade the tax code. These preferences total more than $1 trillion annually, which almost as much as what we collect from individual and corporate income taxes combined. These preferences narrow the tax base, reduce revenues, distort economic activity, complicate the tax system, force tax rates higher than they would otherwise be, and are often unfair.

Second, the first step in any tax reform should be to broaden the tax base by reducing or eliminating tax preferences. Doing so would help level the playing field among different economic activities, reduce the degree to which taxes distort economic behavior, and make taxes simpler to file and administer.

Third, policymakers can use the resulting revenue, potentially hundreds of billions of dollars each year, to lower tax rates, reduce future deficits, or both. Lowering tax rates would further reduce the economic distortions created by the tax system and would encourage economic growth. Reducing future deficits would help tame our Federal debt, which threatens to grow to unsustainable levels in coming years and thus poses a significant risk to our economy.

Fourth, many tax preferences are effectively spending programs run through the tax code. That poses a challenge for how we talk about tax reform and the size of government. Any cuts to these spending-like preferences will increase Federal revenues, but will reduce the government's influence over economic activity. Advocates of smaller government are often skeptical of proposals that would increase Federal revenues. When it comes to paring back spending-like tax preferences, however, an increase in revenues actually means that the government's role is getting smaller.

Fifth, other tax preferences, however, are not spending programs in disguise. More and more observers have embraced the idea that tax preferences resemble spending through the tax code. That is a promising development. Unfortunately, that enthusiasm has sometimes led to the misconception that all items identified as tax preferences are akin to spending. That is understandable, given that these items are often called tax expenditures, but it is not correct. Preferential tax rates on long-term capital gains and qualified dividends, for example, are an admittedly imperfect effort to limit the double taxation that can occur when investment income is subject to both personal and corporate taxes. Such provisions should be viewed and evaluated as tax measures, not as hidden spending programs.

Sixth, many tax preferences provide benefits to millions of taxpayers. They are not just tax breaks for special interests. For example, the three largest tax preferences are the exclusion for employer-provided health insurance, preferences for retirement saving, and the mortgage interest deduction. Americans should understand that to get the benefits of tax reform, lower rates, simpler taxes, and a more vibrant economy, they will need to give up some popular tax breaks.

Seventh, policymakers should reevaluate the design of any tax preferences that they decide to keep. Some preferences are needlessly complex and could be simplified. That is true, for example, of the preferences aimed at low-income workers and families. Other preferences might operate more efficiently as credits rather than as deductions or exclusions. Credits can provide more uniform incentives to particular activities, for example, home ownership, than deductions or exclusions whose value depends on whether a taxpayer itemizes and what tax bracket they are in.

Bottom line: By reducing, eliminating, or redesigning many tax preferences, policymakers can make the tax system simpler, fairer, and more conducive to America's future prosperity, raise revenues to finance both across-the-board tax cuts and much-needed deficit reduction, and improve the efficiency and fairness of any remaining preferences.

Thank you. I look forward to any questions.

[The prepared Statement of Mr. Marron follows:]

Cutting Tax Preferences Is Key to Tax Reform and Deficit Reduction

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Testimony before the Senate Committee on the Budget
February 2, 2011

Chairman Conrad, Ranking Member Sessions, and Members of the Committee, thank you for inviting me to appear today to discuss the need for fundamental tax reform.

America's tax system is broken. It's needlessly complex, economically harmful, and often unfair. It fails at its most basic task, raising enough money to pay our government's bills. And it's increasingly unpredictable, with large, temporary tax cuts not only in the individual income tax, but in corporate, payroll, and estate taxes.

For all those reasons, our tax system cries out for reform. Such reform could follow many paths. Some analysts recommend the introduction of new taxes—such as a value-added tax, a national retail sales tax, or pollution taxes—to supplement or replace our current system. Those ideas are worth serious discussion, but in today's testimony, I will focus on a more traditional approach to reform: redesigning our income tax.

My message is simple: the income tax is riddled with tax preferences. These preferences narrow the tax base, reduce revenues, distort economic activity, complicate the tax system, force tax rates higher than they would otherwise be, and

* The views expressed here are my own; they do not necessarily reflect the views of the Urban Institute, its funders, or its trustees.

are often unfair. By reducing, eliminating, or redesigning many of these preferences, policymakers can

- Make the tax system simpler, fairer, and more conducive to America's future prosperity;
- Raise revenues to finance both across-the-board tax rate cuts and deficit reduction; and
- Improve the efficiency and fairness of any remaining preferences.

I elaborate on these points in the remainder of my testimony.

1. **Tax preferences pervade the tax code.**

The individual and corporate income taxes together contain almost 200 tax preferences—credits, deductions, deferrals, exclusions, exemptions, and preferential rates. These preferences total more than $1 trillion annually, almost as much as we collect from individual and corporate income taxes combined (Office of Management and Budget 2010).[1]

Of course, identifying provisions as tax preferences is not without controversy. Doing so requires a benchmark notion of an "idealized" tax system. Experts differ on the best benchmark. Government analysts use a comprehensive income tax, with a few adjustments to reflect the practical realities of administering the tax system. But other analysts believe a broad-based consumption tax would be a better benchmark. In that case, several important tax provisions—including accelerated depreciation,

[1] This figure comes with several caveats. First, it reflects only reductions in income taxes; some preferences reduce other taxes. Second, each preference is estimated individually; interactions among the preferences may increase the overall revenue loss (Burman, Toder, and Geissler 2008). Third, the estimates are static—they do not account for how taxpayers might respond if the preferences were eliminated; such responses would likely lower any potential revenue gains. Finally, estimates of how much revenue could be gained from eliminating preferences that change the timing of tax payments—such as accelerated depreciation or deferral of tax on contributions to retirement accounts—differ from the tax expenditure estimates, which assume an alternative tax system was permanently in effect.

lower rates on some capital gains and dividends, and many retirement provisions—would not be identified as tax preferences.

This disagreement reflects a fundamental debate about tax policy, but it does not undermine the larger point that tax preferences are enormous. Most provisions that are preferences relative to a comprehensive income tax are also preferences relative to a broad-based consumption tax.[2]

2. **The first step in any income tax reform should be to broaden the tax base by reducing or eliminating tax preferences.**

Tax preferences often distort economic behavior. Taxpayers naturally undertake more of those activities that qualify for preferences and cut back on those that don't. Such responses can be beneficial if they serve a larger social goal—for example, encouraging donations to charity. But that often isn't the case. The mortgage interest deduction, for example, encourages taxpayers to purchase larger homes and to take out bigger mortgages, but does little to increase homeownership.[3] It is hard to believe a tax preference that encourages people to go deeper into debt and directs capital into larger homes is socially beneficial.

Tax preferences are also a primary reason that the tax system is complex, costly to administer, and difficult to comply with. Every preference requires extra paperwork and creates new opportunities for error or fraud.

By reducing or eliminating many tax preferences, policymakers could help level the playing field for different economic activities, reduce the degree to which taxes distort economic behavior, and make taxes simpler to file and administer.

[2] In preliminary work, Eric Toder and I (2011) estimate, for example, that in dollar terms 70 percent of the tax preferences identified by government analysts for fiscal year 2009 would also be preferences relative to a consumption tax benchmark.

[3] Toder and colleagues (2010) provide a helpful review of this literature.

3. **Policymakers can then use the resulting revenue to lower tax rates, reduce future deficits, or both.**

An aggressive effort to trim tax preferences could increase federal revenues by several hundred billion dollars each year. Policymakers should use that money to lower tax rates and reduce future deficits.[4] Lowering tax rates would further reduce the economic distortions the tax system creates and would encourage economic growth. Reducing future deficits would help tame our federal debt, which threatens to rise to unsustainable levels in coming years.

President Obama's National Commission on Fiscal Responsibility and Reform (2010) and the Bipartisan Policy Center's Debt Reduction Task Force (2010) (on which I served) both endorsed this strategy in their recent deficit reduction proposals. The fiscal commission's "Illustrative Tax Plan" would scale back and redesign many of the largest tax preferences (e.g., mortgage interest, employer health insurance, and retirement saving), eliminate many others (e.g., state and local interest), and use the resulting revenue to

- Cut individual tax rates, bringing today's six brackets (10, 15, 25, 28, 33, and 35 percent) down to three (12, 22, and 28 percent);
- Repeal the alternative minimum tax (AMT), the personal exemption phase-out (PEP), and the phase-out of itemized deductions (Pease);
- Cut the corporate income tax rate from 35 to 28 percent; and
- Reduce the deficit by $80 billion in 2015 and more in later years.

[4] There are two ways to reduce tax rates on businesses. The one that has recently received the most attention is reducing statutory tax rates on business income (the corporate rate for most large businesses and individual rates for pass-through businesses). Another approach would be to move toward full expensing of business investment (while eliminating the deductibility of interest); that would lower what's known as the effective tax rate on business investment.

The Bipartisan Policy Center task force recommended a similar reform, eliminating many preferences and fundamentally redesigning those that would remain. Like the fiscal commission, the BPC would then cut individual tax rates (to just two brackets, 15 and 27 percent); eliminate the AMT, PEP, and Pease; and cut the corporate rate to 27 percent—all as part of a larger package that would cut future deficits and bring the federal debt under control.[5]

4. **Many tax preferences are effectively spending programs run through the tax code; that poses a challenge for how we talk about tax reform and the size of government.**

Tax preferences are often called "tax expenditures." That moniker reflects the fact that many of these provisions—but not all—resemble government spending programs in their economic and budget impacts. The tax exemption for interest on state and local bonds, for example, provides a subsidy for municipal borrowing. The federal government could accomplish the same goal through an explicit subsidy to state and local issuers, paid out of general revenues. The exclusion for employer-sponsored health insurance could be recast as an explicit subsidy for insurance coverage. The domestic production credit could be replaced with explicit payments to companies engaged in domestic manufacturing. And similarly for scores of other preferences.

These spending-like tax preferences pose a challenge for how we think about the size of government. Analysts usually invoke official budget measures—revenues and outlays—when trying to measure the federal government. For example, we often hear that federal revenues have averaged about 18.1 percent of gross domestic product (GDP) over the past four decades, while outlays have averaged about 20.7

[5] The Bipartisan Policy Center proposal would also introduce new taxes, most notably a value-added tax.

percent. But those measures are incomplete—and potentially misleading—if some tax breaks are effectively spending programs.

In some preliminary research, my Tax Policy Center colleague Eric Toder and I (2011) have tried to estimate how large the government is when we recognize that many (but not all) tax preferences are effectively spending programs. For fiscal 2007, we estimate that spending-like tax preferences amounted to 4.1 percent of GDP. Adding that to official outlays yields a broader definition of spending, 23.7 percent of GDP in 2007, about a fifth larger than the official 19.6 percent. Similarly, our broader definition of revenues—official revenues plus revenues foregone through spending-like tax preferences—is 22.6 percent of GDP rather than the official 18.5 percent.

These figures illustrate that conventional budget measures understate the extent to which federal fiscal policy affects economic activity. They also suggest that some policy proposals that increase revenues, as conventionally measured, may nonetheless reduce the size of government. If policymakers reduce the tax preference for employer-provided health insurance, for example, that would increase federal revenue but reduce the government's role in private insurance markets.

Advocates of smaller government are often skeptical of proposals that would increase federal revenues. When it comes to paring back spending-like tax preferences, however, an increase in revenues may actually mean that government's role is narrowing.

5. **Other tax preferences, however, are not effectively spending programs.**

Many observers have recently embraced the idea that tax preferences resemble spending through the tax code. That's a promising development. Unfortunately, that enthusiasm has sometimes led to the misconception that all items identified as tax preferences are akin to spending. That's understandable given that these items are often called "tax expenditures." But it is not correct. Some items identified as tax expenditures really are tax provisions, and should be viewed and evaluated as such.

As I noted earlier there is a long-standing debate whether the best approach to taxation would be a comprehensive income tax, a broad-based consumption tax, or some combination of the two. Several important features of our tax system are effectively compromises within that debate. Accelerated depreciation, for example, allows businesses to write off their investments faster than under a comprehensive income tax, but slower than the full expensing a consumption tax provides. Accelerated depreciation is flagged as a "tax expenditure" because government analysts use a comprehensive income tax as their benchmark. But that does not mean that accelerated depreciation is a spending program in disguise. Instead, it is a compromise between different visions of taxation.

A related issue arises with the lower tax rates on long-term capital gains and qualified dividends. In this case, the debate is not only between income and consumption taxation, but also about the best way to implement a comprehensive income tax. The lower capital gains and dividend tax rates provide one way to limit the double taxation that can occur when investment income is subject to both personal and corporate taxes. Analysts continue to debate the merits of these lower rates and the extent to which they may allow income to avoid taxation. But, again, those disagreements reflect different visions of taxation, not disputes over hidden spending programs.

6. **Many tax preferences provide benefits to millions of taxpayers; they aren't just "tax breaks for special interests."**

When discussing the opportunity to pare back tax preferences, commentators often describe them as "tax breaks for special interests," "loopholes," or, more recently, "tax earmarks." Some narrow provisions certainly warrant those names. But the reality is that many of the largest, most economically relevant tax preferences affect millions of taxpayers:

Table 1. The 10 Largest Income Tax Preferences in 2009 ($ Billions)

Employer-sponsored health insurance	144
Employer pensions and retirement plans	85
Mortgage interest	79
State and local taxes (property, income, etc.)	74
Accelerated depreciation	57
Capital gains	53
Earned income tax credit (includes outlays)	49
Child credit (includes outlays)	45
Capital gains step-up at death	41
Charitable contributions	37

Source: Office of Management and Budget (2010)

Note: These figures are only for income taxes. Some preferences also reduce payroll taxes; the health insurance exclusion, for example, reduced payroll revenues by $97 billion in 2009.

As Nina Olson, the national taxpayer advocate (2011), recently put it:

> Tax complexity doesn't occur just because of "big money" special interests. It occurs because of the tax provisions that benefit each one of us. We are the special interests. And until we acknowledge that, tax reform discussions will deteriorate into shouting matches and finger pointing about cutting "their" special tax breaks and not "ours."
>
> The road to true tax reform requires each and every one to be willing to stop protecting our own tax breaks long enough to begin a dialogue about what we want our system to look like, so we remain a vibrant nation with a tax system that is transparent to its taxpayers—one that is simpler to understand and comply with. If we want to run business incentives or social programs through that system, then we need to have a way to evaluate those programs so we can describe to their taxpayers what is being done and how effective those programs are.

Americans should understand that to get the benefits of tax reform—lower rates, simpler taxes, and a more vibrant economy—they will need to give up some popular tax breaks.

7. **Policymakers should re-evaluate the design of any tax preferences that they decide to keep.**

Policymakers will likely want to maintain some current tax preferences. Some preferences may be the most efficient way to accomplish widely shared social goals (e.g., the earned income tax credit). Others may be sufficiently popular that it isn't politically practical to eliminate them entirely (e.g., preferences for homeownership).

In these cases, policymakers should look for opportunities to improve the tax preferences that remain.

Some preferences are needlessly complex and should be simplified. The preferences for low-income workers and families, for example, are notoriously complex; that weakens their effectiveness and imposes unnecessary costs on intended beneficiaries. Analysts have developed various proposals to consolidate these preferences into streamlined provisions for work, children, and child care (Bipartisan Policy Center 2010; Maag 2010; President's Advisory Panel on Tax Reform 2005; President's Economic Recovery Advisory Board 2010)

Other preferences should be redesigned as credits rather than deductions or exclusions. If policymakers want to continue to support homeownership through the tax system, for example, a more effective approach would be to replace the mortgage interest deduction with a mortgage interest credit. The president's fiscal commission suggested one way to do this: a 12 percent, nonrefundable credit on interest on a first mortgage up to $500,000. This approach would provide a fairer, more uniform incentive for homeownership than today's mortgage interest deduction, which is available only to itemizers and whose value is larger for taxpayers in higher tax brackets. Other options would make such a credit refundable (thus making it even more uniform) or link the credit to homeownership rather than interest payments (thus avoiding an incentive for greater debt). Similar ideas apply to other preferences structured as deductions or exclusions.

Conclusion

Tax policy experts have long known that high tax rates disproportionately harm the economy. A rough rule of thumb is that doubling a tax rate increases the resulting economic harm by a factor of four. The best tax systems thus keep tax rates low and apply them to a broad base.

America's income tax system violates that principle. Widespread tax preferences narrow the tax base, distort economic activity, and force rates higher than they need to be. That has real economic costs.

At the same time, America faces large deficits as far as the eye can see. Unless Washington demonstrates unprecedented spending restraint in coming years, the pressures of an aging population and rising health care costs will require greater revenues to avoid an unsustainable build-up of debt.

Well-designed tax reform can help address these challenges. By reducing or eliminating many spending-like tax preferences and using the resulting revenue for a mixture of rate cuts and deficit reduction, policymakers could enhance U.S. economic performance and slow the build-up of debt.

Thank you again for inviting me to appear today; I look forward to your questions.

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Chairman CONRAD. Thank you.

And now we will go to Dr. Altshuler. Welcome.

STATEMENT OF ROSANNE ALTSHULER, PH.D., PROFESSOR, RUTGERS UNIVERSITY

Ms. ALTSHULER. Thank you. It is an honor to appear today to discuss the need for and the benefits of fundamental tax reform.

Building the case for tax reform is easy. The current system is riddled with tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers. These provisions, as you know, create complexity, generate large compliance costs, breed perceptions of unfairness, create opportunities for tax avoidance, and encourage the inefficient use of our economic resources.

The many changes we have made to the tax code, more than 4,400 over the past 10 years, have made the income tax even more difficult for taxpayers to understand, less stable, and increasingly unpredictable. We seem to have forgotten that the fundamental purpose of our tax system is to raise revenues to fund government. Reducing the deficit to an economically sustainable level, as we must do, will require both a scaling back of expenditure programs and an increase in tax revenues.

The question I address today is how best to reform the tax system so that it can raise revenue in a manner that is simple, efficient, and fair. I will make three broad points.

First, the fiscal challenges ahead require that we reform our income tax system or turn to new revenue sources. Raising significantly more revenue from the current tax system is politically infeasible and would be damaging to economic growth.

Second, we must broaden the base of our income tax. Although politically difficult, this type of reform is implementable and follows a wave of similar base-broadening, rate-reducing tax reforms that have been enacted in developed countries over the past 30 years.

Third, the current U.S. approach to international corporate taxation needs to be updated to reflect the increased competition our U.S. multinationals face from foreign-based corporations. Broadening the base and lowering the rate are essential and straightforward first steps to international tax reform. We should also consider updating our system to reflect the international tax rules used by our major trading partners. The remainder of my testimony elaborates.

Before considering fundamental reform, you might ask, can we not just dial up the current system, increase statutory marginal tax rates to raise the revenue required to bring the deficit under control? A 2010 Tax Policy Center study suggests that the answer is no. We considered illustrative changes to the current system aimed at reducing the deficit to an average of 3 percent of GDP. Let me briefly summarize the results.

It cannot be done. We cannot reduce the deficit to a sustainable level with personal income tax increases alone. It is not feasible. We looked at the revenue raised by proportional increases in all of the current marginal tax rates. Roughly speaking, if the system we have today were extended, we would have to increase all statutory rates by 50 percent to reach our deficit target—all statutory rates.

What if we tried to protect low- and middle-income taxpayers from these marginal tax increases? This would result in top rates that would stifle economic activity. The two top rates would need to rise to 84 and 89 percent. It is shocking. And we did not even take individual behavior into account. Changes must be made to the tax base if we hope to raise much more revenue from the current system.

What about the corporate tax? Can it raise significant revenues for us, significantly more than now? In my written testimony, I argue that the answer is no. Most revenue from today's corporate income tax comes from corporations that are competing in a global market. Increasing the corporate rate is problematic given how high our rate is. In 2010, the average combined national and State corporate tax rate in the OECD was 25 percent. The U.S. rate was 39.2 percent, second only to Japan. But do not worry. On April 1, Japan will reduce its corporate rate by 5 percentage points and we will have the dubious honor of imposing the highest corporate tax rate in the OECD.

Keep in mind that any increase in the corporate tax rate can be expected to induce tax avoidance through transfer pricing and other methods of income shifting. This leakage in revenue, along with the small role played by the corporate tax in the current U.S. revenue structure, suggests that corporate rate increases can, at best, move the deficit only marginally toward a sustainable path. Our fiscal challenges require either more comprehensive income tax reforms or new sources of revenue.

What are the economic benefits of base-broadening reforms? The income tax imposes efficiency costs on the economy when taxes distort the economic decisions of individuals and businesses and divert resources from productive uses. Economists call the efficiency cost the excess burden, and economic theory shows, while it is hard to understand that, roughly speaking, if you double the tax, you quadruple the excess burden. So as you increase the tax, the burden on the economy increases more than proportionally.

It is easy to understand that raising a set amount of revenue with a narrow base requires higher tax rates, but what is often ignored is the drag on the economy created by higher rates. The National Commission on Fiscal Responsibility and Reform demonstrated that cutting back tax preferences and broadening the base—by doing so, the current system could generate revenues of about 21 percent of GDP, with top individual and corporate statutory rates of 28 percent.

Stripping away tax provisions that distort economic activity and lowering the rates would leave us with a system that is less costly to our economy. It would be fairer than the current system, less complex, and easier to administer. Senators Wyden and Gregg also have a plan that shares these attributes.

Let me focus on the corporate base for a second. Broadening the base and lowering the rate could reduce a number of distortions caused by the current system. It will not be easy to cut corporate tax preferences to raise revenue for a corporate rate reduction, however. While some preferences benefit only a limited number of businesses, and we hear about those a lot, others cut taxes for a broader set, and in addition lower the costs of domestic investments. But it is just not possible for us to stay competitive and grow our economy with a tax rate that is 14 percentage points above the OECD average.

One often hears that the statutory rate, the fact that it is high is not important, since our narrow rate reduces the effective tax rate. But this argument ignores the important role that statutory rates play in business decisions. They influence where our corporations do business, how they finance investments, how much they invest, and their incentives to shift income to avoid taxes. Retaining a corporate rate that is significantly out of line with our competitors is just not a viable path for increasing U.S. investment, jobs, and economic growth.

What about the international tax system? You will not be surprised to hear ours is very complex and induces inefficient behavioral responses. Under our system, all income of U.S. corporations is subject to U.S. corporate tax whether it is earned at home or abroad. A number of reform proposals have recommended a territorial tax system, which would exempt foreign-source income from U.S. corporate income tax. All other G–7 countries and all but six other OECD countries have adopted territorial tax systems. Abandoning our worldwide approach would be a major policy move and it deserves careful analysis. We should be doing this analysis now.

The fiscal challenges ahead are daunting. Instead of spending the next 2 years engaging in an endless debate of whether to extend the 2001 and 2003 tax cuts, I urge you to instead focus on building support for and designing a base-broadening reform of the current system that can reduce our future unsustainable debt burdens and enhance the growth of the U.S. economy and the wellbeing of Americans.

Thank you. I look forward to questions.

[The prepared Statement of Ms. Altshuler follows:]

Testimony of Dr. Rosanne Altshuler
Professor, Department of Economics, Rutgers University

Before the
Senate Committee on the Budget

Hearing on Tax Reform: A Necessary Component for Restoring Fiscal Responsibility

February 2, 2011

Chairman Conrad, Ranking Member Sessions, and Members of the Committee, it is an honor to appear today to discuss the need for and the benefits of fundamental tax reform.

I am a professor in the economics department of Rutgers University. During various leaves from this position, I have served as Special Advisor to the Joint Committee on Taxation, chief economist for the President's Advisory Panel on Federal Tax Reform in 2005, and director of the Urban-Brookings Tax Policy Center. I have worked on building the case for tax reform, evaluated the economic consequences of different tax reforms, and studied the implementation issues and transition costs associated with various reforms.

Building the case for tax reform is easy. The current system is riddled with tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers. These provisions create complexity, generate large compliance costs, breed perceptions of unfairness, create opportunities for manipulation of rules to avoid tax, and encourage the inefficient use of our economic resources. The many changes we have made to the tax code --- more than 4,400 over the past ten years --- have made the income tax system even more difficult for taxpayers to understand, less stable, and increasingly unpredictable. The state of our current system reflects that we have forgotten that the fundamental purpose of our tax system is to raise revenues to fund government.

Congressional Budget Office (CBO) analysis shows that the government begins this year with a projected budget deficit of 9.8 percent of GDP and its future growth is driven by rising health care costs, an aging population, and the interest payments on an ever-increasing public debt. Reducing the deficit to an economically sustainable level will require both a scaling back of expenditure programs and an increase in tax revenues. The question I address in my testimony today is how best to reform the tax system so that it can raise revenue in a manner that is simple, efficient, and fair.

I will make three broad points in my testimony today.

1. **The fiscal challenges ahead require that we reform our income tax system or turn to new revenue sources.** Raising significantly more revenue from the current tax system is politically infeasible and would be damaging to economic growth.

2. **We must broaden the base of our income tax.** While there are many fundamental reforms that could be considered, a reform that broadens the base would not only raise revenue but would simplify the system, increase transparency, make the system less distortive by both allowing for a lower rate and reducing tax-induced biases towards certain activities, and improve the fairness of the system. Although politically difficult, this type of reform is implementable and follows a wave of similar base-broadening, rate-reducing tax reforms that have been enacted in developed countries over the past twenty years.

3. **The current U.S. approach to international corporate taxation needs to be updated to reflect the increased competition our U.S. multinationals face from foreign-based corporations.** Broadening the base and lowering the rate are essential and straightforward first steps to international tax reform. We also need to consider updating our system to reflect the international tax rules used by our major trading partners.

The remainder of my testimony elaborates on these points.

Must we reform the current system to meet the fiscal challenges ahead?

Before considering fundamental reforms of the tax system, a natural question is whether the current U.S. tax system can simply be "dialed up" through increases in statutory marginal tax rates to raise the revenues required to bring the deficit under control. A 2010 study I coauthored with by Katherine Lim and Roberton Williams of the Urban-Brookings Tax Policy Center suggests that raising significantly more revenue from the current system is politically and economically infeasible.[1] We considered a series of illustrative incremental changes to the current income tax system aimed at reducing the deficit to an average of 3 percent of GDP over the years 2015 to 2019 (the last five years of the 2010 budget window).[2]

Using figures from the March 2010 CBO budget update, we found that no tax increases would be necessary to reach our 3 percent average deficit target if the 2001 and 2003 tax cuts were to sunset as scheduled in 2010 and Congress stops "patching" the alternative minimum tax (AMT). While tax policy under this scenario raises substantial revenue, it would subject almost one-third of taxpayers to the AMT by 2019[3] and remove some significant benefits for lower and middle income taxpayers.[4]

[1] See Rosanne Altshuler, Katherine Lim, and Roberton Williams, "Desperately Seeking Revenues," *National Tax Journal*, June 2010. The estimates discussed in this testimony were recalculated from the original article using the March 2010 CBO budget update.
[2] There is a range of suggested targets for the budget surplus/deficit. The 3 percent of GDP target is sometimes put forth as consistent with stabilizing the debt to GDP ratio at current levels.
[3] See Katherine Lim and Jeffrey Rohaly, "The Individual Alternative Minimum Tax: Historical Data and Projections, Updated October 2009," Urban-Brookings Tax Policy Center Working Paper (October 2010), for estimates of the number of taxpayers subject to the AMT under different baselines.
[4] The Urban-Brookings Tax Policy Center website provides detailed information on the Bush tax cuts at http://www.taxpolicycenter.org/taxtopics/Expiration_Bush_Tax_Cuts.cfm.

If the 2001 and 2003 tax cuts were extended, the AMT were patched, the estate tax was maintained at 2009 parameters, and the budgetary effects of the 2010 healthcare reform act are taken into account, all income tax rates would have to increase proportionally by 30 percent to reach the 3 percent average deficit target. The proportional increase in statutory rates would have to be 50 percent if, in addition, several expiring provisions that were enacted in the American Recovery and Reinvestment Act of 2009[5] and other expiring provisions that have been in effect for a number of years were extended. This would increase the current 10 percent bottom statutory marginal rate to 15 percent and the top 35 percent rate to 51 percent. In effect, the continuation of the 2001 and 2003 tax cuts, the AMT patch, and all of the extenders --- as Congress just did for this year and next --- would force the administration and Congress to turn elsewhere for additional tax revenue.

Protecting low and middle income taxpayers from these marginal tax increases would result in top rates that would stifle economic activity. If families with income under $250,000 were protected from the rate increase required to meet the deficit target, the top two rates would need to rise from their current 33 and 35 percent rates to 66 and 70 percent if the 2001 and 2003 tax cuts were extended (and the AMT were patched, the estate tax was maintained at 2009 parameters, and the budgetary effects of the recent healthcare reform act were taken into account) and to 84 and 89 percent if the other expiring tax provisions described above were also extended.[6]

Our exercise clearly demonstrates that simply increasing statutory marginal income tax rates within our current system is not a realistic approach to reducing the deficit. Further, it shows that raising revenue solely from high-income individuals is not the answer to the revenue problem going forward.[7] Changes must be made to the tax base if we hope to raise any additional revenue from the income tax system.

Can the corporate tax system raise significant revenues?

Increased revenues from the corporate tax could be a target for deficit reduction. However, raising the statutory corporate tax rate will do little to buy down the deficit. In 2010, corporate revenues were less than ten percent of total revenues and one percent of GDP. Going forward, CBO forecasts corporate revenues as averaging about ten percent of total revenues and two percent of GDP for the period 2012-2021. Moreover, any increase in the corporate income tax rate will reduce domestic income and lower wages (through an outflow of capital) and adversely affect economic efficiency. And in the domestic context in particular, the corporate income tax is

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[5] These provisions include the Making Work Pay tax credit, the American Opportunity tax credit, and the exclusion from taxable income of certain amounts of unemployment benefits.

[6] We did not take behavioral effects into account in our analysis. Tax rates would have to be even higher if changes in taxpayer behavior in response to the increased rates were factored into the analysis.

[7] A CBO revenue option finds that raising the tax rate on ordinary taxable income in excess of $1 million for joint filers ($500,000 for other filers) by 5 percentage points would raise about 223 billion over the ten year period 2010-2019 (see CBO, *Budget Options: Volume II*, August 2009). That amounts to less than one-third of the revenue required to hit the 3 percent deficit target if the Bush tax cuts are extended, the AMT is patched, the estate tax was maintained at 2009 parameters, and the budgetary effects of the recent healthcare reform act were taken into account and less than one-fifth of the revenue required if other expiring tax cuts are extended as well.

essentially optional for all nonpublic companies because they can use legal forms of business that provide limited liability but that are taxed at the individual level as pass-through entities. As a result, only about one-half of domestic net business income is subject to the corporate income tax.[8]

Most revenue from today's corporate income tax comes from multinational corporations that are competing in a global market. Raising revenue from corporate tax rate increases is problematic now that the United States is about to have the highest statutory corporate tax rate (counting state corporate taxes) among OECD countries. OECD data shows that in 2010, the average combined national and sub-national corporate tax rate in the OECD was 25.1 percent. The U.S. combined rate was 39.2 percent, second only to Japan. The Japanese government has proposed a 5 percentage point reduction in its corporate rate as part of tax system reforms for 2011. As of April 1, when Japan reduces its rate, we will have the dubious honor of imposing the highest combined corporate tax rate.

Any increase in the corporate tax rate can be expected to induce additional U.S. tax avoidance through transfer pricing and other methods of income shifting. Clausing (2009) finds that every one percentage point differential between the U.S. and a particular foreign corporate tax rate is associated with a 0.5 percentage point increase in reported profits abroad.[9] Clausing notes that an effect of this magnitude implies that, in 2004, the corporate tax rate differential induced U.S. and foreign-owned multinational corporations to shift over $180 billion in profits—and over $60 billion in tax revenues—out of the United States.

This leakage in revenue due to income shifting, along with the small role played by the corporate tax in the U.S. revenue structure, suggests that corporate rate increases can, at best, move the deficit only marginally toward a sustainable path. A more credible perspective would use a broadening of the corporate tax base to "pay down" the current law's high marginal corporate income tax rates.[10] That in turn means that corporate tax reform is unlikely to be a significant net revenue raiser. Ameliorating the United States' fiscal challenges will require either more comprehensive personal income tax reforms or tapping new sources of revenues.

The economic benefit of base broadening tax reform

The income tax imposes efficiency costs on the economy. These costs arise when taxes discourage work, savings, and investment; distort the economic decisions of individuals and businesses; and divert resources from productive uses in our economy. When taxpayers change their behavior to minimize their tax liability, they often make inefficient choices that they would

[8] U.S. Department of Treasury, Treasury Conference on Business Taxation and Global Competitiveness Background Paper, July 2007.

[9] See Kimberly Clausing, "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal*, December 2009.

[10] A closer look at the potential sources of corporate base broadening, however, suggests that it may not be possible to enact a revenue neutral corporate tax reform that produces a meaningful corporate rate cut. See Eric Toder's January 31 blog entry on TaxVox (http://taxvox.taxpolicycenter.org/2011/01/31/corporate-tax-reform-wheres-the-beef/) for a clear explanation why it will be difficult to significantly lower the corporate rate through corporate tax expenditure reform alone.

not make in the absence of tax considerations. These tax-motivated behaviors divert resources from their most productive use and reduce the productive capacity of our economy. These distortions waste economic resources, reduce productivity, and, ultimately lower living standards for all.

Economists call the efficiency cost of the tax system the "excess burden" indicating that the true cost of the tax system exceeds the revenue collected. Economic theory shows that the excess burden, or cost, of a tax is approximately proportional to the square of the tax rate. Roughly speaking, this means that if you double the tax you quadruple the excess burden.

It is impossible to design an income tax system that does not impose some efficiency cost on the economy. The goal should be designing a system that raises the required revenue in a way that minimizes tax distortions to behavior and has desirable distributional consequences. It is easy to understand that raising a set amount of revenue with a narrow tax base requires higher tax rates than a broader base. What is often ignored is the drag on the economy created by the higher rates.

The tax plan in the December 2010 report of the National Commission on Fiscal Responsibility and Reform demonstrated that by cutting back tax preferences and broadening the base, the current system could generate revenues of about 21 percent of GDP with top individual and corporate statutory rates of 28 percent.[11] The lower rates made possible by the reform combined with the stripping away of tax provisions that distort economic activity would leave us with a system that is less costly to our economy. At the same time the new system would be perceived as being fairer than the current system and would also have the benefits of being considerably less complex and easier to administer.[12]

Should the corporate tax be reformed?

Both our individual and business tax systems are inefficient and hopelessly complex. A high statutory rate and numerous deductions and exclusions distort corporate behavior in many ways. By reducing the after-tax return to investments, the high statutory rate discourages saving and reduces aggregate investment. The patchwork of rules that govern the taxation of business activity create incentives that favor debt over equity, encourage investment in tax-favored equipment and certain other assets over other kinds of investment, and drive capital out of the corporate sector into non-corporate forms of businesses. The current tax treatment of income from cross-border investment also creates inefficiencies that I discuss in the next section of my testimony.

There are many possible reforms of the corporate system ranging from scrapping it and replacing it with a VAT to incremental reforms of the current system. For example, one of the

[11] See, National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, 2010.
[12] Prior to the report of the National Commission, Senators Ron Wyden and Judd Gregg put forward the "Bipartisan Tax Fairness and Simplification Act of 2010." Their plan base-broadening plan would have similar attributes. The Bipartisan Policy Center's Debt Reduction Task Force has also crafted a base broadening, rate-lowering plan. See Bipartisan Policy Center Debt Reduction Task Force, *Restoring America's Future*, 2010.

recommendations of the 2005 President's Advisory Panel on Federal Tax Reform proposed moving the corporate income tax system to a cash-flow tax.[13] Professor Alan Auerbach of the University of California at Berkeley has proposed replacing the corporate income tax with a destination-based cash-flow tax.[14] These tax reforms have many merits. Most significantly they enhance economic growth by encouraging saving and investment and have the potential to significantly simplify the tax system. It is important to note, however, that these fundamental reforms have not been adopted in other countries and may be difficult to implement. While these reforms deserve careful study and consideration, today's competitive world economy demands that we begin updating our system for taxing business income now.

Transforming our current system from one with a high rate and a narrow base to one with a broader tax base and a lower tax rate could reduce a number of distortions associated with the current corporate tax system. In addition, a lower rate will enhance the U.S. economy by encouraging investment in the United States by both U.S. and foreign countries.

It will not be easy to cut corporate tax preferences and we will have to choose carefully. While some tax preferences benefit only a limited number of businesses, others cut taxes for a broader set and, in addition, lower the cost of domestic investments. It is not possible for us to stay competitive and grow our economy, however, with a statutory corporate tax rate that is 14 percentage points above the OECD average. And if we delay reform of our system, this gap will surely increase. As noted above, Japan is lowering its statutory corporate rate. Both the UK and Canada also plan to reduce their rates in the coming years. The UK corporate statutory rate will land at 24 percent in 2014 almost 10 percentage point higher than the 15 percent statutory rate Canada will have in place by 2012.

One often hears that the fact that the statutory rate is high is not important since our narrow base reduces the effective tax rate below the statutory rate. This argument ignores the important role statutory rates play in business decisions. The statutory rate influences tax planning and higher rates mean that more tax planning is necessary to lower the tax cost of running a business. Tax planning is especially important for U.S. multinationals that compete with foreign corporations subject to significantly lower taxes on their worldwide earnings. While aggressive tax planning has become a necessity it represents a pure waste of our economy's resources.

Statutory rates also influence where corporations do business. High corporate rates increase incentives for shifting income out of the United States and magnify the attractiveness of investing in low-tax locations. The statutory rate also influences financing decisions. The tax advantage to debt is an increasing function of the statutory rate. Finally, statutory tax rates play a role in determining the effective marginal tax rate of an investment. A high U.S. statutory rate can decrease the incentive to increase investments in the U.S. by both U.S. and foreign firms.

Retaining a corporate statutory rate that is significantly out of line with our competitors is not a viable path for increasing U.S. investment, jobs, and economic growth.

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[13] See, President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, 2005.
[14] See Alan J. Auerbach, *A Modern Corporate Tax*, 2010, available at http://www.americanprogress.org/issues/2010/12/pdf/auerbachpaper.pdf.

Should we reform our system for taxing cross-border income?

Our current system for taxing the income earned abroad by U.S. firms is very complex, induces inefficient behavioral responses, and leaves both companies and policy analysts dissatisfied. Under our current system, all income of U.S. corporations is subject to U.S. corporate tax whether it is earned at home or abroad. A number of proposals have been put forward to reform our system by adopting a territorial tax system which would exempt foreign source income from the U.S. corporate income tax.[15] For example, one proposal of the 2005 President's Advisory Panel on Federal Tax Reform recommended combining a territorial tax system with a simplified income tax. More recently, the National Commission on Fiscal Responsibility and Reform put forward a base-broadening individual and corporate tax reform with a territorial system. The remainder of my testimony discusses issues associated with territorial taxation.

The U.S. is one of only a handful of advanced economies that taxes the dividends of their home country corporations when they are repatriated home. All other G-7 countries and all but six other OECD countries (Chile, Ireland, Israel, Mexico, Poland, South Korea) have adopted territorial or "dividend exemption" tax systems that exempt some (or all) of active foreign earnings from home country taxation.

Understanding the economic consequences of moving to a territorial system requires some background on how the current U.S. system operates. Two features of the U.S. international tax system are illustrative of the issues associated with our current rules. The first concerns the timing of the U.S. taxation of foreign earnings of foreign subsidiaries. The active business earnings of foreign subsidiaries of U.S. parent corporations generally are not taxed at home until they are distributed as dividends. As a result, the tax on dividend payments can be thought of as being elective, much like the tax on capital gains. Because of the "time value of money" advantage of postponing tax payments, this "deferral" of U.S. tax allows foreign business income to be taxed at a lower effective rate than it would be if it were earned in the United States thereby influencing when and in what form foreign subsidiary profits are repatriated to the United States.[16]

Another distorting feature of the U.S. system that affects incentives involves the mechanism to prevent the double taxation of corporate income. The U.S. provides a credit for foreign taxes paid to foreign governments. The credit is limited to the U.S. tax that would be owed if the income were earned in the United States. Two steps are important in the foreign tax credit limitation calculation. First, the foreign income is separated into baskets to restrict cross-crediting, i.e., credits flowing over from highly taxed income to shield income that has been lightly taxed. There are effectively two foreign tax credit baskets: one for active income and one

[15] For an extensive analysis of proposals to reform the taxation of international income see Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," in *Fundamental Tax Reform: Issues, Choices and Implications*, John W. Diamond & George R. Zodrow editors, 2008. This part of the testimony borrows some material from this paper.

[16] U.S. tax is not deferred on passive investment income or other easily moveable income. Provisions contained in "subpart F" of the tax code prevent businesses from moving this income to low-tax countries and retaining it there indefinitely. These rules can influence how foreign operations are financed and structured.

for passive income. Within any basket, excess credits generated by one type of income (e.g., dividends in the active income basket) can flow over to other income in the basket (e.g., royalties in the active income basket) and shield that income from any residual U.S. tax.

In the second step of the foreign tax credit limitation calculation, parent overhead expenses such as interest are allocated to each basket to calculate the net foreign income on which the credit can be claimed. This only affects companies if they cannot credit all the foreign taxes they have paid. If a company has excess foreign tax credits, allocation of expenses to foreign income increases U.S. tax by reducing allowable credits. If the company does not have excess credits, or is currently not repatriating income, the allocations have no effect on current U.S. tax liability. As pointed out in a series of papers by Harry Grubert of the U.S. Treasury Department and co-authors, allocations of overhead expenses can play an important role in the design of a territorial tax system.[17]

The credit and deferral features of our current tax system create a situation in which the tax consequences of investment abroad depend on the circumstances of the taxpayer. For instance, certain corporations may be able to set up their operations in a way that either avoids the repatriation of foreign profits through deferral or avoids taxation on repatriated foreign profits through the credit. Either approach may effectively "self-help" the corporation to territorial tax treatment.

By establishing repatriation of a dividend as a taxable event, the U.S. worldwide system distorts various business decisions. To redeploy earnings in the U.S., U.S. tax generally must first be paid, unless tax planning has ensured that sufficient tax credits are available. Further, the tax planning opportunities engendered by the complicated rules surrounding deferral may allow some corporations to help themselves to results that are even more favorable than territorial taxation. In these cases, the United States government effectively subsidizes marginal investment abroad. As a result, our system is worldwide for some corporations, territorial for some other corporations, and better than territorial for a third set of corporations.

Whether or not this outcome is intended, the current system arguably distorts more economic decisions and is more complex than a system that simply exempted active foreign business income from U.S. tax, while raising little revenue from U.S. multinational corporations. At the same time, arranging affairs to avoid taxation of foreign earnings is costly for U.S. multinational corporations, and these costs differ across companies. The result is a system that distorts business decisions, treats different multinationals differently, and encourages wasteful tax planning.

A territorial tax system would eliminate the burden of repatriation taxes on dividends. This would eliminate the incentive for firms to hold income in foreign operations abroad instead of sending it back home. Firms would no longer have to devote resources to planning how to send

[17] See Harry Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System*, Washington, D.C.: American Enterprise Institute, 2001; Harry Grubert, "Enacting Dividend Exemption and Tax Revenue," *National Tax Journal*, December, 2001; Rosanne Altshuler and Harry Grubert, 2001, "Where Will They Go if We Go Territorial? Dividend Exemption and the Foreign Location Decisions of U.S. Multinational Corporations," *National Tax Journal*, December, 2001; and Harry Grubert and Rosanne Altshuler, Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income, in *Fundamental Tax Reform: Issues, Choices and Implications*, John W. Diamond & George R. Zodrow editors, 2008.

funds home in a tax efficient manner. And our tax system would more closely resemble those of our major competitors. If we were to adopt the type of territorial systems used by our competitors, our firms would face the same effective tax rates abroad as firms headquartered in competitor countries.

The treatment of dividend remittances, however, is only one element of any option to move our system towards territorial taxation. Royalties would be fully taxed under a territorial tax system since there would no longer be excess foreign tax credits on dividend payments to shield taxes due on these payments. Income shifting becomes more attractive under territorial taxation but only to the extent of the burden of the repatriation tax faced by individual firms. As explained above, some firms are able to "self-help" to what is effectively a territorial tax system. For these firms, the income shifting incentives are not much different under territorial than under current law.

Designing a territorial tax system involves deciding how and whether to allocate overhead expenses incurred domestically to support foreign investments to exempt foreign income, defining what types of foreign income should qualify for exemption, deciding on whether royalties should be given special treatment, re-examining the rules we use to protect the tax base from income shifting through inappropriate transfer pricing, and devising transition rules among many other policy decisions. The behavioral distortions and revenue consequences of any move to territorial depend critically on these decisions. Treasury estimates from the report of the tax subcommittee of the President's Economic Recovery Advisory Board (PERAB) indicate that a territorial tax system with no expense allocation rules could lose $130 billion over ten years.[18] The PERAB report notes that JCT, Treasury, and CBO have studied the revenue consequences of territorial tax systems with expense allocation rules and estimated that these systems could generate from $40 billion to $70 billion in tax revenues over ten years.

Abandoning our worldwide approach to cross-border taxation would be a major policy move and deserves careful analysis. We need to ask and explore why the Japan and the UK have moved to territorial tax systems. And, among many other questions, we need to understand how the incremental incentive to engage in income shifting and invest in tangible and intangible assets abroad changes if we were to both lower the corporate rate AND adopt a territorial tax system. The time to do this analysis is now so we can make an informed decision on how to update our international tax system. Without more analysis we cannot move forward on choosing a new system for taxing international income.

Conclusion

The fiscal challenges ahead are daunting. Instead of spending the next two years engaging in an endless debate of whether to extend the 2001 and 2003 tax cuts, I urge you to focus on building support for and designing a base-broadening reform of the current system that can reduce our future unsustainable debt burdens and enhance the growth of the U.S. economy and the well-being of Americans.

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[18] The President's Economic Recovery Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, August 2010.

Chairman CONRAD. Thank you very much.

Dr. Lindsey, thank you for coming, and please proceed.

STATEMENT OF LAWRENCE B. LINDSEY, PH.D., PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE LINDSEY GROUP

Mr. LINDSEY. Thank you, Mr. Chairman. I appreciate your invitation and that of the members of the committee.

It is amazing, listening to my colleagues. I have to tell you, we did not collaborate in writing our testimoneys and I will change what I am going to say, in part to avoid redundancy.

As Senator Sessions pointed out, there is a broad consensus in the economies profession that substantially more economic growth can be had through a sensible tax reform. I would add to that that in addition to the growth issues, it is important to take a look at the static behavioral issues that my colleague, Professor Altshuler, mentioned, and that is she observed that the excess burden of a tax doubles—is proportional to the square of the tax rate. So if you double the tax rate, you quadruple the excess burden.

Senator SESSIONS. What does that mean?

Mr. LINDSEY. Well, it is how much——

Senator SESSIONS. It sounded important when I heard her say it.

Mr. LINDSEY [continuing]. you distort the taxpayers' behavior, how much more you make them worse off on top of the rate that he has to pay. So you not only have to send a check to the government, but because you face these high rates, you have to do things you would not ordinarily do just to comply with the tax code.

Just to put it into context, in the current income tax, when you add all taxes in, including things like the Medicaid tax, we are now debating whether we should be at 40 percent or 50 percent. When you go in that range, the excess—the burden on the taxpayer, the total, the tax check he has to pay and the excess burden is at $1.70 for every dollar the government collects. When you start going over 50 percent, the numbers become quite high. You make the taxpayer four times as worse off as you make the government better off.

So no sensible person should think, you know, let us make the government as well off as we can simply by taxing the population when we know we are making the people we are taxing one-and-a-half, two times, three times, four times worse off than we are making the government better off. That is not the way to enhance the wealth of the Nation.

Where I would separate myself from my colleagues, and I certainly endorse their ideas of trying to make the income tax better, I think looking at the problem here, we really have to move away from an income tax-based system toward something else. The current high economic cost of the tax system is due to a number of factors that I think lead me to that conclusion.

The first is complexity. A lot of the tax code is really a judgment call about what income should be taxed and what should not. Now, in the context of our various financial problems in the last two decades, a line came up that we should all bear in mind. Cash is a fact. Income is an opinion. And in our income-based system, a tax system is really about creating an opinion about what should be taxed and what should not.

We have a lot of opinions out there. There is GAAP accounting, Generally Accepted Accounting Principles. Those, by the way, are not fixed over time. They change. The SEC has certain modifications to GAAP accounting to get another opinion about what income is. And then our tax code has a third opinion about what income is and that changes over time. It seems a little bit odd that the government at one time is rendering three or more different opinions about what income is. We have to move toward a cash-based system.

Let me give a very simple example. I have a small company and just one of the peculiarities I face every year has to do with my health insurance premiums for my company. Now, I am obviously an employee of my company and that cash item is considered deductible. It is a business expense for my employees. I am in exactly the same health system. It is not considered a business expense, what I pay for myself and my family. And then when I take that, it is considered an adjustment on the income tax, but it is fully taxed on the payroll tax side, but not to my employees. So here you have one cash item, identical across the board, two different taxes have a different opinion about it, and they have a different opinion depending upon whether you are the owner of the company or whether you are an employee of the company.

That leads to the second problem, which people have talked a lot about. It is horizontal inequality. Because you have all these different taxes and each has a different opinion, essentially, similarly placed individuals pay radically different amounts of tax. I know Mr. Buffett is often up here talking about tax reform and he has admitted that his taxes are too low. He has an average tax rate of about 16 percent, if I believe the papers. That is about half what other entrepreneurs have.

Now, how do you fix that? Well, you do not fix it by raising the taxes on the other entrepreneurs. You fix it by moving toward a system that defines the income he gets in a way that is similar to what others receive, and that is why I think we have to move to a cash-based system.

The third problem has been touched on by a number of comments, and that is that our income-based system, because of the nature of the opinions that it renders about what should be taxed, encourages economic activity to go abroad. So, for example, an item that is manufactured in China but purchased in America has a cost structure that involves no U.S. income or payroll taxes on its labor content or on the profits that are rendered. China, of course, does have a tax system, but its rates are quite low relative to ours. The Chinese individual income tax produces just 1.2 percent of GDP. Ours produces 7 percent. So our income tax burden is six times what China's is. The largest tax in China is the value-added tax, which produces a third of their revenue and is rebated on the exports they send here.

So having an income-based system while most other countries in the world, including Europe and Canada, are moving away from an income-based system and toward value-added taxation or indirect taxation, puts us at a competitive disadvantage. We complain a lot about the advantages the Chinese give themselves through their exchange rate, but we have a major self-inflicted wound that we cause ourselves because we have income-based taxation.

So again, I do not believe that these fundamental problems with our tax structure can be adequately addressed by changes to the income-based system. Rate reductions within the current system have been economically successful because the excess burden within that is so great. But further revenue reductions are not possible. America must move away from its income-based system toward a cash-flow system.

This should not be done as an add-on. We do not need extra complexity. We need simplification. So adding yet another layer of complexity is inappropriate.

Goods that are imported from abroad, even those that find their way into products produced here, would not have to pay an American business receipts tax, and so would not be available for such a deduction by an importing firm.

Governments and nonprofit entities could be given separate treatment so that only the labor component of their expense structure would be covered by the tax.

The problems of horizontal inequality in such a system would be minimized by having all receipts taxed once and at a single source, regardless from where they were derived. Issues of vertical inequality, making sure that the rate was higher for higher-income individuals, could be accomplished through the two-tier business receipts tax system, where the higher tax rate exempted employee compensation below a certain amount. The problem with encouraging lower taxes for very low-income people could similarly be incorporated in there.

We certainly need to address our budgetary challenges, but I do not believe that we can move forward tackling those issues with a tax system that imposes such high economic costs when we raise our rates to produce additional revenue. Our tax system is limiting American prosperity through needless complexity, horizontal inequities, and implicit subsidies of economic activity outside of our borders. A switch to a cash-flow-based tax system, such as a business receipts tax or even a value-added tax, would greatly facilitate our ability to address these budgetary issues.

Thank you very much, Mr. Chairman. I would be happy to take your questions.

[The prepared Statement of Mr. Lindsey follows:]

Dr. Lawrence B. Lindsey

President and CEO of The Lindsey Group

Testimony before the Senate Budget Committee

February 2, 2011

The Budgetary Case for Fundamental Tax Reform

Lawrence B. Lindsey

Thank you Mr. Chairman and members of this committee for the opportunity to be here today to discuss the long term budgetary situation and the need for fundamental tax reform in order to put the country on the path to long term fiscal stability. The link between tax reform and our fiscal future comes down to one simple observation. A look at the current income based tax system suggests that we are getting as much blood from the stone as can be reasonably expected. The economic cost of additional revenue under this system is extremely high. To the extent additional revenue is needed in the future, the economic cost of collecting it through higher rates in the context of the current system is prohibitive.

Moreover, there is a widespread body of consensus among economists in both parties that fundamental reform would significantly increase tax revenue. A survey of the economics literature by Kevin Hassett and Alan Auerbach finds that a revenue neutral switch to a more sensible tax regime would add between 5 and 10 percent to U.S. GDP over a decade[1]. Thirty years ago Larry Summers estimated that such a switch would generate an 18 percent gain in output[2] and more recently Dale Jorgenson estimated a 19 percent increase in national wealth from such a switch[3]. Suffice it to say that an economy that is 10 percent larger can produce at least 10 percent more tax revenue without increasing tax rates or burden.

While some commentators have focused on the concept of a "revenue maximizing" tax rate, I believe this is beside the point. Focus on a revenue maximizing rate presumes all you care

[1] Alan J. Auerbach and Kevin A. Hassett, "Toward Fundamental Tax Reform," AEI Press, 2005, 6.
[2] Summers, Lawrence H, "Capital Taxation and Accumulation in a Life Cycle Growth Model," American Economic Review, American Economic Association, 1981 vol. 71(4), pages 533-44, September.
[3] Dale W. Jorgenson, "Efficient Taxation of Income," Harvard Magazine, March-April 2003.

about is tax revenue, not what is really important, the cost to society of raising that revenue. Two factors combine to make the cost of raising additional revenue through higher rates on the existing base a very expensive proposition for the economy. First, we know, and have known at least since the time of Adam Smith, that higher tax rates shrink the tax base on which they are imposed. This stems from straightforward economic theory since taxes either tend to raise the cost of production and/or the cost of purchasing the good in question. When labor or capital income is taxed the attractiveness of working, saving, investing, or taking risks is directly impacted.

Second, we know from basic economic theory that the excess burden of a tax – the cost to the taxpayer above and beyond the check that he must write to the government to pay the tax – rises with the square of the tax rate. So for example, the excess burden of a 20 percent tax is four times the burden of a 10 percent tax; the burden of a 50 percent tax is 25 times as much as a 10 percent tax. This excess burden is an economic concept that measures how much worse off taxpayers are because their decisions are distorted by taxes. So as tax rates rise not only does the additional revenue rise less than proportionately to the rise in the rate because the tax base shrinks, the burden of the tax rises much faster than in proportion to the rate.

Consider a very real world example. At present, the all-in marginal rate on entrepreneurial income is roughly 40 percent, depending on the precise situation of the taxpayer. The recently passed health bill will raise that by between 0.9 and 3.8 points and an expiration of the 2001 and 2003 cuts will add another 5.8 points to the rate, making the rate roughly 50 percent. Based on my work on tax changes in the 1980s, a 10 point rise in the rate from 40 percent to 50 percent would cut the base of affected taxpayers by about 10 percent[4]. At the most

[4] Lawrence B. Lindsey, "Individual taxpayer response to tax cuts: 1982-1984: With implications for the revenue maximizing tax rate," Journal of Public Economics, 1987, p. 173-206.

simple level, a 40 percent tax on a one dollar base would produce 40 cents in revenue, but if the rate went up to 50, the one dollar base would drop to 90 cents, of which the government would take half, producing 45 cents in revenue.

Note that this is the estimated response at the top income tax rate. But the same responsiveness to the tax rate exists throughout the tax code. Greg Mankiw and Matthew Weinzierl estimated that a change in labor income taxes across the board would change revenue by only 83 percent of what a static model would predict while the same figure would be just 50 percent for across the board changes in capital income[5]. Adjusted for tax rates, these estimates are quite similar to the ones I just discussed.

In addition, we need to consider the excess burden of the tax. This adds an extra cost in economic well being above and beyond the revenue collected and rises roughly 3 and half cents on each dollar in the existing tax base. Put the two together, and the economic burden to the taxpayer rises by about 8 and a half cents – 5 cents in the form of extra revenue the government collects and 3 and a half cents because the tax distorts his decision making in a way that makes him less well off. Stated plainly, the taxpayer suffers a loss in economic well being that is almost twice as much as the extra revenue the governor collects.

The effect gets even worse as rates rise further. At a 60 percent tax rate the base would shrink still further – to just 77 percent of its size at 40 percent, meaning the government would collect just 1.6 cents more in revenue than at a 50 percent rate Meanwhile the excess burden rises a further 4 cents. This means that for each additional dollar collected by the government, the taxpayer is made about four dollars worse off. There is a clear lesson here: a high tax rate

[5] N. Gregory Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back-of-the-Envelope Guide," *Journal of Public Economics, 2006* (90): 1415-1433

that might still raise revenue for the government is by no means an economically optimal rate from the point of view of society.

Adam Smith broke with the existing mercantilist view of the well being of a nation in 1776 by arguing that it was not the revenue the state was collecting, but the overall well being of society, that determines the true wealth of a nation. Obviously governments must collect revenue. But it is hard to argue that society is really better off when the government is enriched by a dollar at the expense of two to four dollars for the citizens footing the bill. That is true even if those citizens are politically out of favor – such as the "rich" – which many seem to think should pay ever increasing amounts of taxes.

The high economic cost of the current tax system is the result of a number of factors. The first is complexity. Much of the tax code involves what amounts to judgment calls about what should be taxed and what should not. The reason is that we levy taxes on income and not on cash flow. There is an old saying that gained a lot of credence during the recent economic crises and accounting scandals of a decade ago – "Cash is a fact, income is an opinion."

The accounting profession exists to tell the difference between the two, and has created a set of rules – Generally Accepted Accounting Principles, that by the way, aren't even fixed in the opinion they render, but evolve over time. Then, the Securities and Exchange Commission has certain modifications to these GAAP rules that must be reported to shareholders and the public. Of course, none of these definitions bear much resemblance to a whole different set of of opinions that the IRS has about what is income. Isn't it at least a little bizarre that the government itself requires a business to keep several sets of books?

Even at the level of a very simple company like the one I now own, this complexity makes absolutely no sense. Let me give one simple example: health insurance contributions.

The health insurance payments I make to my employees are considered to be a business expense and therefore not part of my company's income, but the same premiums my company pays for me and my family under the same health insurance program are considered income to me. Now the income tax renders an opinion that these can be treated as an adjustment to my income for income tax purposes, but not for payroll tax purposes. Does anyone have an explanation why this piece of cash flow is considered income to some but not to others, and is considered income under some income based taxes but not under other income based taxes?

This complexity is the major cause of a second problem with the current income based tax system – what economists would call "horizontal inequality". Some people are able to design their economic behavior in ways that minimizes tax liability while others do not. As a result, individuals with relatively similar incomes often pay quite different amounts and rates of tax. This is all very annoying to both taxpayers and to the country. The question is how to fix it. Some very high income people, Warren Buffet comes to mind, admit that their tax rates are quite low and feel that rich people like themselves should pay more and support raising tax rates as a result. According to news paper stories, Mr. Buffet pays about 16 percent of his income in taxes, about half what other entrepreneurs pay, even ones far less successful than he. But the way to fix this inequality is not to raise tax rates on those who are already paying twice the rate that Mr. Buffett is. It is to eliminate the "opinions" that define some of Mr. Buffett's income as exempt from tax or subject to lower rates.

The third major problem with our income based system is that it encourages economic activity to go abroad. An item that is manufactured in China but purchased in America has a cost structure that involves no U.S. income or payroll taxes on its labor content and virtually no U.S. corporate tax on the capital involved in the production. Of course China does have an income tax, but it is quite low compared to ours. The Chinese Individual Income tax produces revenue equal to just 1.2 percent of GDP compared to roughly 7 percent in the United States. The largest component of the Chinese tax system is the Value Added Tax, which generates roughly one third of all Chinese tax revenue. But Value Added taxes are rebated on exports, so this tax does not apply. Conversely, an item built in America and then sold to China involves labor costs that pay both income and payroll taxes and capital costs that involve the whole panoply of U.S. taxation. When they arrive in China the import cost is subject to Chinese Value Added Tax. And this is not just the Chinese. Throughout Europe Value Added Taxation has increasingly replaced direct taxation on personal and corporate incomes over the last couple decades and under World Trade Organization rules it is perfectly legal for them to rebate the tax on exports and impose it on imports.

We complain a lot about the advantages the Chinese give themselves through manipulation of their exchange rate. At the same time we induce this massive self inflicted wound on ourselves in the form of our income based tax system. And whenever someone advocates raising rates within our current tax regime they are implicitly calling for these distortions to be larger and therefore for Chinese goods to become even more competitive here and our goods to become even less competitive overseas.

I do not believe that these fundamental problems with our tax structure can be adequately addressed by changes to our current income based tax system. Rate reductions within the current tax system have proved economically successful because the excess burden associated with current rates are so high that the economy naturally prospers when rates are cut and the benefits to the economy of those cuts have consistently exceeded the foregone revenue. But further revenue reduction is not possible given our current debt position.

America must move away from an income based system – where what is taxed is an opinion – to a cash based system based on the gross receipts of a business less those items the business has purchased on which it has already paid tax to another business. Such a tax system should not be an add-on to our current system. Adding yet another layer of complexity on top of what we already have would be among the worst ideas we could come up with. Instead, we need to replace all of our existing income-based tax concepts with a cash-based tax on net receipts. Congress should also define receipts in terms of a border-adjusted way so that goods we export should not be treated as receipts. Obviously goods imported from abroad, even those that find their way into other products, would not have already paid an American business receipts tax and so would not be available for such a deduction by the imported firm. Governments and non-profit entities could be given separate treatment so that only the labor component of their expense structure would be covered by tax. This would be necessary to level the playing field between economic activity in the for-profit business sector and similar activity outside it.

Problems of horizontal inequality would be minimized by having all receipts taxed once at a single source, regardless from where they were derived. Issues of vertical equality – making sure that the rate was higher for higher income individuals – could be accomplished with a two tier business receipts tax where the higher tier rate exempted employee compensation below a certain amount.

We certainly need to address our budgetary challenges. But, I do not believe that we can move forward tackling these issues with a tax system that imposes such high economic costs when rates are raised to produce additional revenue. Our tax system is limiting American prosperity through its needless complexity, horizontal inequities, and implicit subsidies of economic activity outside of our borders to produce goods and services consumed at home.

Fundamental reform is desperately needed. A switch to a cash-flow based tax such as a Business Receipts Tax or even a Value Added Tax would greatly facilitate our ability to address these issues.

Thank you and I would be happy to address your questions.

Chairman CONRAD. Thank you. Thank you. Really excellent testimony, Mr. Lindsey. All of the members, I think, have made a real contribution to the beginning of this discussion.

Let me go, if I could, to a concept that was proposed by Professor Graetz at Yale. I think he is now at Columbia. He made a proposal that we go to a system that is really a hybrid, which is what most countries do. He proposed we go to a consumption tax for the vast majority of people, take 100 million people off the income tax system completely, substantially reform and reduce the corporate rate, broaden the base, and he argued that this would dramatically improve the efficiency of collection, that is that we would have less leakage in the system; No. 2, that it would make America far more competitive.

Let me just go down the line and ask if you have looked at Dr. Graetz's work and what you think of his proposal and what it would mean for both helping us reduce the deficit and at the same time improving the competitive position of the United States. Dr. Steuerle?

Mr. STEUERLE. Well, as I tried to outline very briefly in my testimony, I think there are actually a variety of fixes that would be better than current law, so I would certainly say what Michael Graetz suggests is better than what we have now. The question is how far you want to go in adding on what would be essentially a VAT, a value-added tax, which is the basic tax that he would use to collect revenues from the majority of people.

My principal concerns with Mr. Graetz's proposal, and I think it actually is very illuminating, is at the very bottom of the income distribution, the very top, and not the middle, so he solves and simplifies a lot of things in the middle of income distribution.

At the bottom, I do not think he has really grappled with the very tough issue of how you integrate things like Earned Income Credits and Child Credits—we could have separate testimony on this—with Food Stamps and TANF and now health subsidies that phaseout when your income goes up. So we have all these indirect tax systems at the bottom that are based on income and I do not believe that he actually has solved that problem for the bottom.

And at the top, he leaves in place all of these deductions and credits for high-income people, so the notion of high-income people getting a home mortgage interest deduction and low-income people not getting any subsidy for their housing, it seems to me, does not quite work, either.

But if you asked for the base, the core of the proposal, would you consider replacing a significant portion of the current income tax with a value-added tax, I think that a lot of economists might not agree that that is the reform they would favor—Mr. Lindsey indicated another way he would go about it—but I think they would say it is better than the current law.

Chairman CONRAD. If you were to move in that direction, how do you protect the most vulnerable among us? How do you protect those that are at the lowest end of the income scale?

Mr. STEUERLE. This is a subject that has not gotten much attention lately, but as I say, we now have low-and moderate-income tax payers and so many phase-outs of so many programs that their marginal tax rates are among the highest in the Nation. Some of them face 70 or 80 percent rates. Forty or 50 percent rates are very common. You lose your Food Stamps. You lose your—the new health law, there is a ten cents or more phase-out of your health benefit. You lose your Earned Income Credit. You lose your Child Credit. All these phase-outs basically start adding up, and then you add on the Social Security and the income tax rate.

I think we have to actually think about reform of what we want to do at the bottom of the income distribution, in the middle of the income distribution, and at the top of the income distribution, almost think about them separately so we take the progressivity issue on the side. We decide how much we are going to collect or how much we are going to get from these groups and then we try to simplify for each group. I think that requires a reform effort that even goes beyond what we are discussing today.

Chairman CONRAD. Dr. Marron.

Mr. MARRON. Thanks. I guess my approach is to say that there are several things we are trying to accomplish in a tax system. One is to raise as much revenue, the revenue we need to pay for the government without harming the economy, and the best way to do that is to go toward a consumption tax.

One of the other things we would like to do is achieve certain progressivity goals. The tax system is a very important way that we think about the distribution of after-tax income in the United States, and frankly, income taxes tend to be a better lever for doing that. And what the Graetz proposal is trying to do is, in essence, find a compromise sweet spot in there that is recognizing that for the economy as a whole, it is better to have more of the tax base be consumption-based—that is why he introduces a VAT—but then recognizing that if you want what I think is widely held as kind of a fair conception of what the distribution of the tax burden ought to be, that you are going to need something like an income tax at the higher level to collect that, and he is trying to strike that balance.

My sense is that he succeeds in the sense of creating a tax system that would strengthen the economy, be beneficial for competitiveness. As Gene says, there are a lot of difficult details about how you actually implement that and accomplish all the goals throughout the income distribution, but as a basic structure, I think it is an interesting one to think about.

Chairman CONRAD. Dr. Altshuler.

Ms. ALTSHULER. Yes. I agree with Donald. I am a fan, and I very much believe that all roads lead to a VAT. I just think that that is where we are going to have to end up. Adding a VAT onto the system would allow for lower rates, so you get all the benefits of the lower rates. You would have a system that is much less complicated, I believe. You would have much less incentives for income shifting.

It is implementable. We can do this. Canada, I mean, all other countries in the OECD have a VAT. This is how they raise their revenue. Virtually every other country in the world has a VAT. So it is something that could be done.

Chairman CONRAD. But how do you protect those who are at the lowest end of the income distribution, those who are the most vulnerable among us? How do you protect them in that system?

Ms. ALTSHULER. That is the difficulty and that is what Gene and Donald have also talked about. Now, remember that you are going to be retaining the income tax, so you can run refunds and transfer programs through the income tax. So by retaining the income tax——

Chairman CONRAD. You could keep the Earned Income Tax Credit——

Ms. ALTSHULER. Absolutely.

Chairman CONRAD [continuing]. you can keep the Child Care Credit-——

Ms. ALTSHULER. Exactly. So you can help the distributional consequences of moving to a VAT through the income tax system. I know—I believe the Tax Policy Center is studying this right now, and as Gene said, with more study into this, I do think that we could get the distributional consequences to be something that we desire, and I think what we need to remember is that we are keeping the mechanism of the income tax, so that is going to help us out at the bottom of the income distribution.

Mr. LINDSEY. Well. first of all, I think we all agree that almost anything would be better than what we have, and that would be what I would think about Mr. Graetz's comment.

I also agree that, as I said in my testimony, I think we have to move toward a business receipts tax or VAT.

I would reject retaining the income tax along with it because I do not see where adding yet another definition of income or another calculation everyone has to do is a net gain. I think within the context of a business receipts tax, you can have substantial progressivity.

For example, you could have a base business receipts tax rate, call it 20 percent.

Chairman CONRAD. Explain that for those listening and for the members of the Committee. What do you mean by that? How does that work?

Mr. LINDSEY. Well, a business receipts tax or a VAT are very similar concepts. Essentially, the base would be total receipts by the company minus what was paid and taxed to a different company. So, for example, if I am making a car and I buy steel, I send the steel company a check to buy the steel, and the value-added tax on that steel is part of that. So to avoid double taxing, if I can show that I have-—basically it is called an invoice. If I have an invoice that says you paid tax on that once, you do not have to pay tax on it a second time. So the base would be all the money coming in minus the cash going out that you paid a tax on.

Now, if I bought that steel from China, I did not pay a VAT on it or a business receipts tax, no deduction, and so we would be leveling the playing field between purchases of goods here and purchases of goods from overseas.

Chairman CONRAD. So that would help the competitive position of the United States vis-a-vis taxes with respect to one of our toughest competitors, and all of our competitors who have a similar system.

Mr. LINDSEY. Absolutely. And if you think of it, that is the central issue, and I think that it really is our central economic issue. You have to say why wouldn't I want to throw as much—if I am going to move to that system anyway, why wouldn't I want to move as much of our tax base into that system as possible? If I know I am going to gain competitiveness by doing it, why would I only want to gain competitiveness on half my tax system? Why wouldn't I want to gain competitiveness on all of my tax system? And that is why I would move to the one tax. Now——

Chairman CONRAD. This one goes to—it takes us right back to this fundamental question. If you do it all on that side of the ledger, how do you maintain progressivity in the system so that especially those who are the least vulnerable who benefit from the current tax system through the earned income tax credit, child care tax credit, how do you maintain that support for that end of the spectrum?

Mr. LINDSEY. Sure. Let me mention the high end as well. There is no reason why—again, you have the business filling out its tax form. They do the calculation on the base I just said. Then you have a second line that says subtract the first $10,000 a month you paid to every employee; in other words, wages up to $10,000. You get another line. You put another tax on top of that. So that high-end wages and profits, including interest and dividends, would be subject to the higher rate. I think that is how you get progressivity on the higher end.

On the lower end, this is not a hard problem. I mean, there is no reason why you cannot have wage subsidies built into an EIC—an EITC. Right now we incorporate the EIC right into the payroll checks of most companies. You can get—I think it is called prepaid. There is a way. We have it in the tax system where you can get—you do not have to wait for April 15th to get your earned income tax credit now. You can get it in every paycheck you file. There is no reason why you cannot do that in the VAT system either.

The other aspect of the help for people on the lower end of the income distribution, it has been pointed out that right now we have among the most complicated set of rules because we have different rules for food stamps, for health care, for what have you. So that is something that you can reform separately. You can run it through the tax system. You can run it through a direct payment system, which is what a lot of what we do now is. When you think about "welfare" in the old days, it had nothing to do with the tax system. It was a direct payment to people based on their income and based on the number of children they had. So I do not see where there is an obstacle toward providing progressivity in our combined tax transfer system by moving to a value-added tax or a business receipts tax.

Chairman CONRAD. All right. Senator Sessions.

Senator SESSIONS. Thank you. Mr. Chairman, I would yield my time to Senator Portman. I would just note that we have three new Senators that have joined our Committee. Senator Portman was, of course, at OMB, which is the heartbeat of Federal money management, and a member of the Ways and Means Committee in the house for a number of years. And Senator Toomey was on the Budget Committee in the House for a number of years and was a businessman. And Senator Johnson, who is not with us now, is a full-time career businessman who got elected to the Senate. So I think they all three are going to add some real experience and perspective to our debate. Senator Portman, thank you for being with us, and I yield my time to you in the first round.

Senator PORTMAN. Thank you, Senator Sessions. I appreciate your yielding your time. You know, we have all got four or five things going on at once here, so I am going to have to step out after my questions. But I really enjoyed the testimony, and, Mr. Chairman, thank you for bringing this panel together. It looks like we need to get Michael Graetz here next time so he can talk about his ideas. You know, I did read his book, and I am intrigued by his concepts. I will tell you, I think in the politics of today and with the urgency of addressing our fiscal crisis, I am not sure where to make that leap.

I will also say to the Chairman's question that one of the thoughts that came up in relation to the Graetz ideas was to deal with progressivity among lower-income workers by offsetting the payroll tax, which is a good way, I think, to both simplify the Tax Code and also to provide relief because most low-income workers are working and do pay payroll taxes. Those who do not, there are other ways to do it, as the panels have talked about.

But I kind of want to take us maybe back to the kinds of proposals that the Commission has looked at and the kinds of proposals that the Wyden-Gregg legislation would indicate, and that is simplifying the current code. Again, as interested as I am in what Dr. Lindsey and others are talking about in terms of moving to a VAT tax, I am not sure I see that as politically viable here in the short term.

But perhaps we could move to an income tax that is simpler, that has fewer economic distortions, that makes us more competitive, that moves us toward eventually looking at some of the more dramatic changes in terms of a consumption-based tax. So a couple questions for you.

One, what should the corporate rate and the individual rate be? There is a study we talked about in the last hearing that is out recently by Alex Brill and Kevin Hassett from AEI indicating that we are leaving money on the table right now with the corporate rate being so high. In fact, I think they say the optimal corporate rate is in the mid–20s, and the point has been made here this morning that we are not competitive with our OECD trading partners. Japan is going to relinquish first place to us in terms of the highest corporate rate come April. And this is a jobs issue.

What should the rate be? And what should the interaction be between the individual rate and the corporate rate? The question I, of course, have is: Given the fact that most businesses in America do not pay their taxes at the C rate but rather at the sub-chapter S or as partnerships and sole proprietors, what kind of behavior will result if the corporate rate, let us say, were at 26 percent and the individual rate was relatively higher? Would you see that shift back to the C corporations? And is that good for taking the economic distortions out of our system? I do not think so because then you would have more double taxation on the corporate side.

So I will start with you, Gene, if you do not mind and just go down the panel, if you all could tell me again in sort of a realistic scenario here of getting a corporate rate down, what is the right corporate rate? And what should the right top rate be for individuals?

Mr. STEUERLE. Well, thank you, Senator Portman. It is good to work with you on this side of the Congress this time.

Let me answer your second question first, which I think is the easier one. I think the individual rate and the corporate rate should be fairly near to each other. That is the conclusion we came to in the mid–1980s, and I think it is the right conclusion today. And I think if you ask me personally where I would come, I would actually try to keep the rates down into perhaps the high 20s.

But here is my dilemma. I believe that the effective rate of tax on the public is equal to the spending rate, and the spending rate right now is about 24 or 25 percent of GDP. The typical tax base, the income tax, Social Security, value-added tax, is only about half of GDP. So you are really running rates. If we really add them all together, so you add in how you come in the back door, through Social Security taxes, you phaseout this, you phaseout that, most people are facing 40, 50 percent rates if you really look through the system. So the statutory rate is hiding the effective rate that they are facing from being phased out of all these programs, from having all these combined tax systems. And so it is very hard for me to give you a rate in the individual and the corporate tax that get balanced. And the system is so out of balance—in fact, one thing, Mr. Chairman, I hope you will consider that I think you could even work with the House Budget Committee on is ways to report to the public better. I really think that one way to get at the deficit issue is to start reporting to the public that the tax rate is equal to the spending rate, that what we are spending as a society now and what we are spending in the future is the taxes we are collecting, just as if it were a household, and we're spending $100,000 and borrow $50,000, we are still spending $100,000. We still have to pay that $100,000, and somebody is going to pay it, and we need to report that unidentified payer, which is the person who has to pay for that deficit in the future. We need to start reporting that as a tax or a burden on future generations or on future taxpayers.

So to answer the question, I would put the rates near to each other, but I have to solve the question of where you want the system as a whole to come out. I think that the rate of tax we pay should be equal to the spending we promise the public as a way to get the deficit in order. And even if that makes the tax rate way too high for where I want Government to be, at least it is an honest system, and we are not trying to hide the rates in the deficit.

Senator PORTMAN. We also need to do both. The Chairman talked about that earlier, on the spending side as well.

Dr. Marron.

Mr. MARRON. So perhaps not surprisingly, I will be in a similar place to Gene. On the corporate side, the pressures around the world are such that the world is moving into, you know, tax rates that have a 2 at the beginning of them, and that would seem to be where the United States ought to go if it can figure out a way to get there. You would like the individual rate, the personal rate to be near that. I am not sure they need to be necessarily identical, so it could possibly be somewhat higher. But you are going to want them to be similar.

But you have the challenge that Gene said, which is, you know, we have to pay for the Government that we are going to have and whether that is going to be possible with those lower rates. And I would say, you know, going back to my testimony, the emphasis on the tax preferences, that how one feels about being able to bring the rates down by a sizable amount I think is going to depend a lot on how aggressive folks can be in rolling back tax preferences, both in finding what will count as revenue, although often I think as effectively spending to offset any budget impacts from that. And then also if you are concerned about the distributional impacts, you know, if you are bringing down top rates, you are going to want to find—look at the tax preferences in particular that systematically benefit those folks as an offset to that.

Senator PORTMAN. Let me just ask, Dr. Altshuler, before you answer, just a simple year or no. Does it make sense to reduce the corporate rate, which I think there is a broad consensus on now, without dealing with the individual rates? Yes or no. The answer is no. Just say it.

[Laughter.]

Ms. ALTSHULER. I am going to lead the witness.

Ms. ALTSHULER. It is going to be difficult.

Senator PORTMAN. But, seriously, if you still have a top rate of 35 percent and you do reduce the corporate rate to the mid–20s, that creates——

Ms. ALTSHULER. I think there is going to be a problem, yes. Yes, yes.

Senator PORTMAN. So yes, no.

Ms. ALTSHULER. I guess the answer is no, right.

Senator PORTMAN. Thank you.

Ms. ALTSHULER. And so can I go on to——

Senator PORTMAN. Yes.

Ms. ALTSHULER. OK. Now I am confused as to what yes and no mean.

Well, just getting back to the question that you asked me directly, I think it is going to be hard through revenue-neutral corporate income tax reform to get the corporate rate down to 25 percent. So I do not really see that—I would love to be able to do that, but just looking at corporate tax expenditures and just cleaning up the base, I do not think we get to 25 percent. And I think that is where we do need to go.

So in answering your question, you know, it makes sense to try to get to the OECD average because of the competitive pressures that we face that are not going away. Other countries besides Japan, Canada and the U.K. are also lowering the rates. I am not saying that we should engage in a race to the bottom. I do not think that is good for the world either. But the reality is that our rate is 14 percentage points higher than the OECD average right now.

As Donald said, the two rates do not have to be identical, but they should not be too far apart. What you are pointing out is absolutely right. If you have a corporate tax rate that is much lower than the individual tax rate, then all of a sudden the corporation becomes a tax shelter for high-income individuals, and there are tax lawyers that are just going to jump all over that and advise people how to deal with that. But you should keep in mind that once I incorporate myself to get money out, I am going to be paying the corporate rate along with the individual rate, and that is why there is room for there to be a little bit of a difference between the two rates.

How do we get to these rates that begin with a 2? Well, I think we have all been saying the same thing, and the Commission showed us: broaden the base. Take a deep breath; broaden the base.

Senator PORTMAN. Larry.

Mr. LINDSEY. Yes, the answer to your question is I think you do have to lower the rate. What has increasingly happened since S corporations have become common is that the corporate rate is really a way to purchase—it is a convenience for the business organization to be structured that way. And the only people for whom it really makes sense anymore are large institutions that are internationally competitive.

So I actually think that although it would be ideal to lower both, the damage done would probably be manageable in part for a reason that Professor Altshuler mentioned, which is if you are now a sub-chapter S and you switch over to a C, you pay the 25-percent rate that a C corporate rate would be. But then your money is stuck in the firm, and you have to take it out somehow; and as soon as you take it out, you are subject to the personal rate. So the advantages, I think—I mean, this gets back to the main point that an income-based tax system really, really does not make sense, because you get into all these complexities. Is it going to be taxed once, twice, two and a half times, three times? And I know it is politically difficult, but in the end, as Rosanne said, we have no choice. All roads are going to lead to a VAT. If we intend to be competitive, that is where we are going to end up.

Senator PORTMAN. Thank you, Mr. Chairman, for the time.

Chairman CONRAD. Thank you.

Let me just say to colleagues we are at 11:10. We have a good turnout. We have more colleagues coming, so I think we are going to have to go to 5-minute rounds, and we will start with Senator Wyden. Senator Portman was on Senator Sessions' time.

Senator WYDEN. Thank you, Mr. Chairman, and I thank all the panel.

As far as I can tell, reforming the Federal income tax is the only major policy response with an actual track record—an actual track record of creating millions of private sector jobs without adding to the deficit. And here are the numbers.

Two years after a big group of populist Democrats and Ronald Reagan worked together, the economy created 6.3 million non-farm jobs. That is twice as many—twice as many jobs as were created between 2001 and 2008, the period of time when tax policy was partisan.

So my question particularly for you, Mr. Steuerle, because you have this great history of 1986: Is there any reason why the principles of tax reform that were pursued in 1986 would not be once again an engine for job growth? The Heritage Foundation scored Senator Gregg's proposal with me as creating 2.3 million new jobs per year. That is in the here and now. We have to create more good-paying jobs, and because of your history, the first thing I want to ask is: Do you see any reason why the principles of 1986 tax reform would not be an engine for job growth again?

Mr. STEUERLE. Well, you sort of set me up, Senator Wyden. I agree with your conclusion. I think tax reform, lowering the rate, broadening the base, is good for the economy.

Now, how far and how fast it goes, I am one of these people who is always a little reluctant to make that type of prediction, but it is in the right direction. And I believe that there are so many areas of tax and budget reform where we know what to do, and if we do them and move in the right direction, we often get surprised. And what actually happened in 1986, we actually thought that perhaps there was a transition period where we might have actually had a little bit of a slow growth to be able to compensate for the reform. And you may remember, by 1986 we were already into about the third or fourth year of an expansion at a time when we often slow down. Instead, what happened after tax reform was that things actually sped up.

So, yes, I think tax reform especially is good for long-term growth. What happens in the short term is hard to predict, but the lessons of 1984 to 1986 actually are fairly positive.

Senator WYDEN. Well, those numbers are just stunning. I mean, twice the job growth in the 2 years after bipartisan tax reform compared to the whole period between 2001 and 2008, and that is a matter of public record.

The second question I want to ask, we will get you, Mr. Marron, and you, Professor Altshuler. I will tell you, I find it pretty alarming how short shrift small business is getting in this whole discussion about tax reform. Now, in the proposals Senator Gregg and I put together, we get the corporate rate down to 24 percent. That was scored by Joint Tax, so, again, that is a matter of public record. But small business, that is 80 percent of the businesses in this country, sole proprietorships and partnerships and the like. And it seems in much of the discussion small business is almost getting to be an afterthought. And I am going to do everything I can to keep that from happening.

I wonder what your sense is about how small business is fitting into this discussion, Professor Marron and Professor Altshuler.

Mr. MARRON. Well, the first point, which is I think where you are going, is that, as was discussed before, we now have many businesses that are structured so that they pay their taxes through the individual income tax, and that as passthroughs—as you think about tax changes, it may make life easier for businesses to create jobs, you are going to want to think not just about corporate tax reform but possibly about the benefits of, say, lowering rates and what-not on the individual side.

Now, the caveat with that is that while many, many companies and businesses show up on personal income taxes, the really, really large ones and the multinational ones are still over on the corporate side.

Then, with the security and safety of being a think tank and academic guy, I will inject the one thing that there has been a lot of interesting recent research on what are the key things for creating jobs and moving the economy forward. And it turns out that small business is not exactly the slice that drives it; that it turns out that there are a lot of small businesses that do not grow—I mean, the perfectly respectable businesses we like, but that if you are interested in kind of what are the job creators, the things that move the economy forward, it is a small subset of them that turn out to be really the gazelles that really create a lot of jobs. And one of the challenges in thinking about public policy is how do you design things particularly if you want to help those.

Senator WYDEN. I would only say—and I want to get you into a different area, Professor Altshuler, because I know my time is up. That is where most of them are, and certainly small businesses can become big businesses because of the entrepreneurial ingenuity, and that is why I just do not want them forgotten.

A question for you, Professor Altshuler and Dr. Lindsey. More than 90 United States Senators voted against a VAT, and as far as I can tell listening to the debate, the only surprising part was that it was not more than 90. And I think the big concern for those who have been for a VAT is there is a sense that it is just a backdoor plan to hike taxes, and particularly taxes that are seen as regressive.

Since both of you are for this, how would you deal with the politics today of more than 90 United States Senators coming out against this concept? And, of course, the Volcker Commission did not bring forward a proposal that was in favor of it. I look back at the Bush proposal, and they said, well, you can talk about it, but they certainly did not come out for it. How would you deal with trying to bring people around to your point of view given that recent Senate vote and certainly the product of the other reports.

I thank you for this extra time, Mr. Chairman.

Chairman CONRAD. Let me just say it is very clear 5-minute rounds are not going to work, so we will go to 7-minute rounds.

Senator WYDEN. Great. Thank you, Mr. Chairman.

Ms. ALTSHULER. Senator Wyden, thank you for the question. The answer is perseverance; education, education, education; helping people understand that the current income tax is broken and that the VAT is an efficient tax, and it is not necessarily a money machine. This is what people are afraid of. There is this idea that it is a hidden tax. It absolutely does not have to be a hidden tax. You just put it right on the receipt like Canada did. Speak about the Canada experience. They are just north of us. They adopted a Federal VAT. It is not a perfect VAT, but if you talk to Canadian policymakers, they will say that it works very well for them.

So I think education—I mean, the problem is that when you support a VAT, it is politically very difficult.

Senator WYDEN. My time is up, but, Dr. Lindsey, the people of my State have voted against a VAT something like 850 times, which is barely an exaggeration. So you should know that your education challenge will be great.

Mr. Chairman, you have given me lots of time. Can Dr. Lindsey just respond quickly?

Chairman CONRAD. Go ahead.

Mr. LINDSEY. Thank you. First of all, if it were an add-on VAT—in other words, you were adding it on to what we already have—I think the 90 Senators were correct. Why do we want to add another layer of complexity? But I do think in the end, if you want to regain competitiveness, that is going to be the only avenue that is available.

Chairman CONRAD. Senator Toomey. And we will go to 7-minute rounds now for everybody.

Senator TOOMEY. Thank you, Mr. Chairman. I just want to followup on a point that Dr. Steuerle made earlier with which I fully agree, which is the idea that we ought to really equate and think about the total tax burden by looking at the total amount of spending. Ultimately, all spending has to be funded, and it is all going to come from taxes, whether the—at any given point in time there is a combination of debt and taxes. The real measure of the burden on the economy is the level of taxes.

Now, to just connect a few dots here, it is also interesting to hear the discussion about how there is a disproportionate negative impact—in other words, the negative impact from higher taxes exceeds the revenue benefit to the Government from an increase in taxes. If we are saying that taxes are essentially equivalent to spending, then what we are saying is that as Government spending grows and, therefore, the corresponding taxes, we are doing harm to our economic growth, which is what—I think we are well within the range at which increases in spending are doing net negative consequences to our economy.

The question I have is also about the VAT. Now, Dr. Lindsey has argued against a combination of income taxes and VAT, and I think if I understand you correctly, it is because of a concern about an additional layer of complexity. But I wonder about something else also that concerns me, which is if we had both, we could at least initially have both at what would appear to be nominally relatively low rates since you have two different sources of revenue. And I worry that that would make it easier politically to raise rates and to increase the total tax burden on the economy, which we have already established from this panel has a disproportionately negative impact on economic growth and, therefore, job creation.

So I wonder if those of you who, I think, you might support a combination of a VAT and an income tax, if you share that concern that it could lead more easily to a higher total tax burden and, therefore, poorer economic performance and lower job creation.

Mr. STEUERLE. Well, Senator, again, part of the dilemma is our spending rate is so much higher than our tax rate where basically for every $2 we collect in taxes, we are spending $3 now. And, actually the spending rate goes up in the future, particularly because we have these mandatory spending programs that have growth rates that are faster than the economy and they are unsustainable—as well as, by the way, a number of tax subsidies as well that have very high growth rates.

So we have a dilemma here, and I go to some elaborate ways in my testimony a little bit, but the dilemma for both political parties is that there is a sense that if they do not control the future, the other party will. So for Republicans, it is often—you know, if I actually raise rates to balance the budget, all that is going to happen is that is going to keep spending higher. And for Democrats, you know, our experience is if we basically get spending under control, which some of them believe that they did in the 1990s, well, then all that happens is we end up financing these tax cuts. And, actually, I think both parties are right. I mean, in technical academic language, they are in what I call a classical prisoner's dilemma. Without going into the details of it, it is basically you always want to argue for one side because if you do not, somebody else is going to take advantage of you. But it is an unsustainable situation, and so to me, the answer to your question, which sort of goes beyond tax policy, is I think you have to come up with budget rules that limit both political parties, whether they are in power or not in power, from controlling the future. So that, yes, if the public wants to vote for higher spending in the future and finance it with a higher VAT, then they get it, but they cannot do it in a way that they vote for higher spending now that forces the taxes to go up. But, similarly, on the other side of the aisle, you cannot vote for tax cuts now that basically try to force spending cuts into the future because of these deficits, because what both political parties have succeeded in doing is creating not only this enormous deficit but boxing themselves in so much that, as I say, we have now got a Government where when you walk into the office—when you walk into the Congress, both this Congress and the last Congress, every dollar of revenue was already committed. You did not have a single dime of discretionary to spend on discretionary spending or to do any reform because it had already been committed by your colleagues in the past.

Senator TOOMEY. I understand. I am wondering if we could focus a little bit on the narrower question I am trying to pose, the danger of escalating—the increasing danger of escalating taxes if we had both a VAT and an income tax.

Mr. STEUERLE. I guess the bottom line is I am saying, yes, I think the danger is there. The danger is on both sides of the aisle unless you figure out ways to constrain both parties as to how much deficit they can do now that they ended pushing the tax rate up or, if you want, the spending rate down.

Senator TOOMEY. Dr. Marron.

Mr. MARRON. So a couple of thoughts. First, as Rosanne said, I would invoke the example of Canada as an interesting, important one to keep mind, where they introduced a VAT in the early 1990s at a 7-percent rate. They made it very visible. And then eventually, over time, they actually brought it down to 6 percent and, I believe, 5 percent, which shows that a country that is relatively similar to ours in many regards was able to introduce a VAT as an add-on and not let it grow like Topsy.

The other would be I would just sort of echo some of what Gene said. Ultimately, the challenge is that we have to afford the government that we are going to choose. What you discover if you look internationally is that societies that have chosen to have larger governments tend to choose more efficient tax systems. So they tend to do more consumption taxation in relative terms and less income taxation in relative terms.

And I think the reason folks here have been talking about a VAT as a possibility is that we think that given the pressures of an aging population and rising health care spending, that that may be what the future looks like for the U.S., and that rather than try to pay for that by just racheting up income taxes, it would be much better to go to a mix and more toward the consumption end.

Ms. ALTSHULER. I do not think I can add much more to what Donald just said. I think I agree with everything that he just said. I think the idea that by having a VAT you automatically have a bigger government is based on this idea that it is a hidden tax and that people will just let that tax go up and up because they do not feel it or because they do not see it, and I just do not see that as being the case.

Senator TOOMEY. But Dr. Marron did seem to be suggesting that there is certainly at least a correlation between big governments and a VAT and that some here who are advocates for expanding government see that as a good way to get there. My concern is that ever-bigger government, however you fund it, leads to slower economic growth and lesser job creation and a lower standard of living.

Dr. Lindsey, I would if you could comment.

Mr. LINDSEY. I think you are exactly right on the hybrid system. Because you have two apparently lower rates, it makes it easier to raise one and then the other. So I think you are right.

I was struck by Senator Wyden's question. I had an answer which I will direct to you, but it is really to his, on a political issue. You know, there is a large movement in the country for something called a fair tax. Now, I personally do not think that is as effective as what I am suggesting, but economists disagree. But there is an example of something that is close to a VAT that has a large political constituency for it in a place you would not expect. And so I do not think it is at all an impossible task.

Chairman CONRAD. Thank you. Let me go to Senator Coons. Senator Coons, I want to welcome to the committee. He is a new member here, actually filling out the term of Senator Biden, who was a founding member of the Senate Budget Committee. Senator Coons was the County Executive of Newcastle, the largest county in Delaware, so he has actually balanced budgets and worked on ways to promote economic growth. We are delighted to have you join the committee, Senator Coons, a graduate of Amherst, a Bachelor of Science in Chemistry and Political Science. He holds a graduate degree from Yale in Law and Divinity, so maybe we can get some spiritual guidance here, as well. That would be valuable to the Budget Committee. And he is the first Truman Scholar to serve in the Senate.

Senator Coons, welcome to the committee.

Senator COONS. Thank you very much, Mr. Chairman, and thank you for your leadership on these very important issues. I very much look forward to working with you and with Senator Sessions.

As you both said in your opening Statements, we recognize, I think, across the partisan divide of the Congress and broadly across the country, regardless of region, background, experience, or education, that we have, as this panel has so uniformly and compellingly testified, a simply unsustainable and unworkable tax system in the United States. We face a crushing national debt burden, a challenging deficit. You have all worked clearly very hard in putting together a series of proposals, and as the questioning so far has surfaced, one of our big challenges is taking insightful, detailed, thorough proposals and actually moving them into political reality, and we have some very real challenges doing that.

In my role as County Executive, as you mentioned, Chairman Conrad, I did balance six budgets. It was not easy. It required a broad recognition of a need for shared sacrifice, both reductions in spending and broadening our base and increasing revenue. And before that, I spent 8 years as in-house counsel for a multi-national corporation that is one of Delaware's most innovative manufacturers.

I will focus my questions, if I might, on the question of corporate taxes. I am very interested in how we might successfully encourage or incentivize through repatriation of foreign-earned profits, increase corporate investment in R&D, in manufacturing, and in new hiring in the United States, and in what our longer-term trajectory for it ought to be on treating corporate tax rates, and I am really more interested in this exchange, in larger corporations who have significant offshore balances.

One of the comments that was made, I think it was by Dr. Marron, was about the sort of distorting effect of temporary tax programs. As a participant in the lame duck session, I was particularly disappointed that we made some large tax moves that were for 1 year. As someone who was long concerned about or interested in the R&D tax credit, for example, it makes absolutely no sense to me that it is here, gone, here, gone. We do not do long-term sustainable tax policy.

So if I might, to every member of the panel, please, I would really appreciate a response. If we are in a global situation where, as I have heard from you, most of our competitors are at a VAT style system, a cash system rather than an income system, and we do have, or will have the honor as of April of having the highest of the OECD countries combined corporate income tax rate, what is the best path forward to incentivize both in the shorter term the repatriation or the mobilization and deployment of capital from American-led corporations, and then in the longer term, what is the balance that makes us most competitive as a national economy, given the political realities that were pointed to by the panel of the difficulty of moving easily to a VAT.

Is it to dedicate the VAT to particular purposes? Is it to apply it only to narrow classes of economic activity? Some have proposed a repatriation of foreign-earned profits holiday or for limited purposes. How do we strike a balance here that allows us to most effectively access and mobilize the innovative capital reserves of the American corporate sector? Please.

Mr. STEUERLE. Senator Coons, I confess that when it comes to international, my complication is I do not think there is ever a perfect answer. You start with inconsistent tax systems——

Senator COONS. Of course.

Mr. STEUERLE [continuing]. because different countries have different tax systems. So you never can get all the neutrality you want across the systems. You start with inconsistency and then you have to decide how can you try to minimize some of the distortions that result. So I can only make some suggestions that I think move in the right direction without giving you a perfect solution.

I should comment that in tax reform in 1984, I went around to every staff member—I had divided up tax reform into 20 modules with like several hundred pieces, which is an issue we have not even gotten to here today. There are thousands of provisions we are talking about here and we are talking in a very shorthand basis. I went to the national people. They hesitated. They hesitated. They hesitated on what form to propose. They ended up suggesting something. We finally got it in our proposal at the last minute. Three weeks after we got it in the proposal, they came and they said, you know, we do not think we got that right. So ever since then, I have been skeptical about getting a perfect solution.

So my colleagues, especially Rosanne Altshuler, who is a real expert in international, have made several suggestions. If you lower the rate, you move in the right direction. Nothing else that really helps a lot. Just lowering the rate moves it in a long direction. With the value-added tax, you can do border tax adjustments to the extent that makes a difference.

The repatriation issue, I think, is a bit of a bogus issue. You know, basically, that is where the people put a little check mark on where they are keeping their account. I mean, the money is accessible in a lot of different ways regardless of whether they repatriate. I do think that we have not given much attention to the way that our current system allows people to arbitrage——

Senator COONS. Right.

Mr. STEUERLE [continuing]. moving debt abroad. But it is not just corporations that can do it. We individuals can do it, too.

Senator COONS. Individuals do it, too.

Mr. STEUERLE. We borrowed to put money in our pension accounts, and that is one way of getting at some of the arbitrage in the system.

So I think there are several things we can do to move in the right direction. I am less enamored of whether—I am not opposed to it, but I do not necessarily favor whether going to a territorial or not makes a difference.

Senator COONS. And Dr. Altshuler in her testimony said that we really should not have a race to the bottom in terms of lowering corporate rates. Is there a point below which—I mean, this is obviously a hypothetical—is there a point below which you should not keep reducing income tax rates for corporate income?

Ms. ALTSHULER. Is this a question——

Senator COONS. Sure.

Ms. ALTSHULER [continuing]. a question for me? Is there a rate—boy, then what you are thinking about is we are all in this together as a world and how are we all going to behave as a world, and I think that you are not going to get——

Senator COONS. No, I am pretty narrowly interested in how we are going to——

Ms. ALTSHULER. Yes, exactly. You are not going to get cooperation. The point is, just to answer your original question in terms of what can we do, as Gene pointed out, step one, lower the rate.

Step two, look at that rate. If the rate is low enough, then it really does not matter if you are territorial or if you are worldwide. That becomes less important. Getting the rate to that level is going to be very difficult. You could not do it without a VAT.

So step three is deciding—is stepping back and saying, incremental reform at this point does not work anymore. We cannot just do a repatriation tax holiday. As Gene mentioned, it does not necessarily lead to firms bringing back money and then investing it in the economy. It is just—it keeps us going down this temporary tax holiday path that is very unhealthy, unpredictable, and not good for the economy. It is time for us to sit down and get the information that we need to decide whether or not territorial would be good for us, and that does depend on what rate we get down to, or should we go to a worldwide system, for instance, that gets rid of deferral. But we need to be thinking about fundamental reform of the international tax system, not incremental reforms.

Senator COONS. Thank you.

Chairman CONRAD. Thank you, Senator.

Senator COONS. If I might, Mr. Chairman, any other comments from the panel just in response to that?

Chairman CONRAD. I think we had better, in fairness to the colleagues who are here, we should go——

Senator COONS. Thank you very much.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE. Thank you.

Chairman CONRAD. Oh, I am sorry. Wait a minute. I skipped Senator Sessions. He had ceded his time initially, so we have to go back and forth here.

Senator SESSIONS. I will followup on Senator Coons's excellent line of questioning. It is something I do not fully understand. Mr. Lindsey, you did not get to comment on it, but maybe you could start. I understand we are one of the very few nations that tax out-of-territory income, and is this good for jobs in America? Is it good for the economy? And do you have any comments to followup on Senator Coons's question?

Mr. LINDSEY. I am going to give you an answer that you are going to hate and I hate, and the answer is it depends, and I think that was the comment about whether or not we should move to a territorial system. We set it up that way. Remember, we tax everything, but then we give a credit against the foreign income taxes paid, and then we tax the money when it is repatriated. It gets to be very complicated.

If one looks at why we did what we did when we did it, it was really a decision post-World War II to encourage the global participation of American firms in the rebuilding of the world. At that point, it made sense because we did not have competition. It makes less sense now.

I think, Senator Sessions, that the theme you heard here was the single first thing you can do here is lower the rate, and as evidence, in all the agony that Ireland has gone through recently, the one thing they refused to give on, with all the pressure on them, was their 12.5 percent corporate rate, because for them, that is a key competitive advantage and it just underscores the importance of us lowering our rate as a first step if that is what you are going to focus on.

Senator SESSIONS. I have heard it Stated, some might suggest that that low rate was somehow a problem in causing their economic difficulties. I have been told that is really not so. Do you have an opinion on that?

Mr. LINDSEY. Well, they have—most of their problems are self-inflicted and has to do with their financial system.

Senator SESSIONS. Financial condition.

Mr. LINDSEY. But what they have been able to do is attract a lot of headquarters from manufacturing companies, particularly the European headquarters, by offering that low rate and it is of enormous competitive advantage to Ireland. We are not Ireland, but I think lowering the rate would be the consensus first thing you could do. And again, there is a lot of evidence that you could raise revenue without broadening the base simply by lowering the rate here to something that is more of an international norm.

Senator SESSIONS. A lot of people do not realize how close the competition is among businesses in the world for market share. Let us say Canada goes to 16.5, as I think they are, and we were to reduce our rate to 28 or 27. Companies seeking to build a plant along the border, would that be a factor in whether or not they built that plant in the United States or Canada?

Mr. LINDSEY. It would certainly be a factor, and it might be a decisive factor, but there would be a lot of issues.

Senator SESSIONS. There would be a lot of factors, but I do not think there is any doubt that it has the potential to cost economic growth in our country. A corporate tax higher than the worldwide rate is a threat to us, and at this point in history, job creation is so important. Everybody is saying the corporation is doing pretty well and this is happening, the stock market is doing well, but jobs are not moving much and we cannot have tax policies that depress job creation.

Briefly, let me ask you, committee members, as part of complexity, should not we consider the uncertainty of our tax situation, the temporariness of it? For example, we have the rates just for 2 years. The death tax is set for 2 years. The AMT comes up every year. Nobody ever knows for sure. Physicians are worried over their doctor fix on Medicare. Are those factors that have an adverse impact on our economy, the uncertainty of what will be in the future? Mr. Steuerle?

Mr. STEUERLE. Mr. Sessions, the answer is clearly yes, and I think everybody at the table will say that. I am going to give one caveat, though. Sometimes people say, well, let us deal with this uncertainty by making permanent everything in the code, and there is this tendency to look at mandatory spending and say, well, gee, we have all this stuff on automatic pilot. We need to get it off of automatic pilot. I think we have to be careful when we talk about getting rid of the uncertainty. We do not want to put everything in the tax code, including a lot of things we do not like, say five educational subsidies instead of one or none if we put it in the direct spending budget, to put those on automatic pilot, too.

So when you go toward certainty, that not mean you have to make something permanently growing. You may put it on a 5-year fix or 10-year fix or something like that. I am hesitant on solving that problem by making everything permanent.

Senator SESSIONS. I recognize that is a fair point, but I think all of you would agree that that uncertainty is another negative factor for our economy.

Mr. MARRON. Yes, if I can, absolutely. I think, as I said in my opening remarks, I think it is quite striking today that every single significant component of the U.S. Federal tax code now has significant temporary tax cuts in it. That is not something that we should aspire to in the long run. We ought to eventually settle in for everyone understands what the tax code is, and as Gene says, make sure you have a system in place so you can review important provisions periodically to see if they make sense, but allow people to have some notion of what is coming.

The one caveat I would put on that is just the elephant in the room is the unbalanced fiscal situation we have, which even if we allegedly passed a permanent tax system today, unless we have some solution to that so that we are going to be able to avoid the unsustainable buildup of debt, there is still going to be uncertainty out there about where we are going. So solving the long-run fiscal challenges is going to be part of eliminating uncertainty.

Senator SESSIONS. Well, Mr. Lindsey, you have been there in the government. To do tax reform and deficit reduction all at the same time sounds almost unthinkable, but in a way, politically, sometimes it may come together better in a crisis than in a non-crisis. Do you agree, Mr. Chairman?

Chairman CONRAD. I do.

Senator SESSIONS. So would you agree with that, Mr. Lindsey?

Mr. LINDSEY. Yes. I think that we have no choice. Sometime in this decade, economic circumstances are going to force us into solving our problems.

Senator SESSIONS. Briefly, let me just say, Mr. Chairman, that I think Senator Toomey is correct, and for you thinkers, the reality politically is that it is not that American people oppose something like a value-added tax. The Neal Boortz Fair Tax idea is very popular with a lot of average American people. But what they believe, and I think they are correct, if we make another revenue stream possible for the government to extract a larger percentage of their wealth to send to Washington, they are not happy about it.

So, Mr. Lindsey, you suggested you could solve that problem. Briefly—maybe we should not go there, Mr. Chairman, but do you think you could do it in a way that would give confidence that we were not just adding a new way to extract more money from the American people?

Mr. LINDSEY. Well, I am not the expert at the politics of it, but it would seem to me one of the concerns is if you add on another tax, not only is it bad from an economic point of view because of the complexity, but you also have the issue that you are talking about. And so, again, I would stress of getting rid of all of the current taxes, and I would add the payroll tax, as well. If we are disadvantaging American workers because we do not have border adjustability, you want to make everything border adjustable. Throw as much of the tax system into something that is rebatable at the border as you can.

Senator SESSIONS. And you think that is doable? I mean, we could actually accomplish such?

Mr. LINDSEY. Well, the members of the panel might be able to think it is doable. We do not have to run for reelection, so——

[Laughter.]

Senator SESSIONS. Thank you.

Chairman CONRAD. All right. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman.

I noticed the other day that the IRS had reported that the 400 top income earners in the country, who averaged income each of $344 million in the year that they were reporting, had paid total Federal taxes of 16.6 percent. So I asked my staff to tell me at what point in the income level an ordinary working American got to start paying 16.6 percent. It turns out it is $28,100. So I said, well, what are some regular jobs that are in that area? Give me an example I can use. Well, a hospital orderly in Providence, Rhode Island, earns, on average, $29,100 a year.

So if you look at our current tax system and you start with the average taxpayer, who makes $60,000 a year and pays about 20 percent in taxes into the system. And then you drop to my orderly who makes less and so he pays less. He pays 16.8 percent, it turns out. Then you drop to the 400 highest income earners in the country, who pay less still. They pay only 16.6 percent. Then you drop to General Electric, which on $11 billion in income paid 14.3 percent. Then you drop to Prudential Financial, which on three-plus billion dollars in income over 5-year averaging here paid 7.6 percent. And if you go to the Ryan plan, those $344 million earners will drop to around zero percent, maybe one or 2 percent at highest because of the elimination of the capital gains.

I cannot help but agree that the facts show that we have a tax system that is upside down and that the better off you are and the more powerful you are, the less taxes you pay as a percentage of your income, with the poor hospital orderly in Providence, Rhode Island, paying a higher percentage of his income than the average of the top 400 income earners in the country at $344 million a pop. So I applaud your direction. I think we need to go there.

In evaluating the VAT tax, which a great number of you have talked about, my question is this. Could you tell me a little bit more about the trade and competitiveness effect of the VAT tax, particularly in light of how many other nations have gone to one, and given what appear to be its trade and competitiveness benefits, do you believe that the huge move by other nations which export a great deal into our economy was done strategically to take advantage of those trade and competitiveness effects? So in a nutshell, are there valuable trade and competitiveness effects to a VAT tax, and do you think other nations that have gone to it did it with that purpose?

Mr. STEUERLE. I think most economists would argue that competitiveness is not driven by whether you have a VAT. The competitive—if you want to call it the competitive advantage of a VAT is that it keeps you from raising high tax rates through an income tax. That is——

Senator WHITEHOUSE. Well, let me give you an example——

Mr. STEUERLE [continuing]. if that makes sense.

Senator WHITEHOUSE. Let me give you an example. Let us say that you have a car made in Sweden or Germany and they have a VAT tax. So the revenue that they are collecting from the VAT tax, it never attaches to that product. It leaves their country tax-free and it comes over to our country and is sold tax-free here in our country, in effect, from their home tax burden.

We, on the other hand, have home companies that pay corporate income tax and various other taxes. That tax burden gets put into the price of the car, so when the Ford comes up against the Volvo in the American market, the Volvo is, in fact, tax advantaged versus the Ford because Sweden chose to collect revenue in a VAT tax that we choose to collect through a corporate tax. The VAT tax does not go into the price of their export product. The corporate tax does go into the price of our competitiveness product. And if that is accurate, does that not create a competitiveness effect, at least as to that transaction?

Mr. STEUERLE. Again, your analysis is correct. I think that the higher tax rates on the income taxes do create some minor competitive disadvantages. I do not want to overState the case, however, because I do want to emphasize that a lot of issues of competitiveness have to do with wage levels, have to do with entrepreneurship, have to do with education levels, and so I just do not want to over-emphasize——

Senator WHITEHOUSE. I was trying to isolate that.

Mr. STEUERLE. The advantage of the VAT that I see—I do favor a VAT for those reasons, but I do not want to over-emphasize that I see the main advantage is that it keeps you from raising rates outside the VAT. It is not that putting on a VAT gives you a competitive advantage, it is avoiding some of these high rates.

Senator WHITEHOUSE. Dr. Altshuler?

Ms. ALTSHULER. Let me answer the question about why the other countries had a VAT. I think when you look back at history, what happened was they had very inefficient cascading retail sales taxes, and the reason that they went to the VAT was to replace those retail sales taxes with a more rational system of VAT as a more efficient sales tax.

If you look at Canada, and I have looked at that experience, it really was, we have a big deficit problem. We need this revenue.

I do not think that us adopting a VAT on its own is going to have huge competitiveness—if we were to just take the system today and add a VAT on, what would happen is, over time, exchange rates would adjust and it would not add to competitiveness. What Gene said is exactly right. What the VAT would allow us to do is buy down—the VAT in combination with broadening the base would allow us to buy down our corporate income tax rate and that would have a big competitiveness impact for us.

And do keep in mind that those other countries do have corporate income taxes, also. It is not like they do not have corporate income taxes. They do.

Senator WHITEHOUSE. Thank you all very much.

Chairman CONRAD. Senator Sanders.

Senator SANDERS. Thank you very much, Mr. Chairman. These hearings are like a narcotic to me. I can be here all day. I really get hooked on these things because they are absolutely fascinating, and I appreciate the panelists who are here. As we mentioned the other day, Mr. Chairman, I do applaud the panelists, but they have a perspective and I hope at another point we can bring in some economists who have a somewhat different perspective.

I think Dr. Steuerle made a point a moment ago which I agree with, that you cannot just look at one—if you are talking about international competitiveness, for example, you just cannot look at tax rates, for example, or a dozen other factors. I live an hour away from Canada and my Canadian friends would be very impressed by the degree to which you laud Canada. We do not always hear that. The Canadian health care system costs about half of what our health care system does.

By the way, do you think that moving to a single-payer national health care system, as they have in Canada, would help our economy? I mean, if we are going to talk about the Canadian government and their policies, they have a single-payer national health care system which spends about half per capita that we do. Health care is a huge burden, as you all know, on our economy. How is the Canadian health care system? Should we adopt that? Dr. Steuerle?

Mr. STEUERLE. Well, I would not necessarily say that it is that Canada is successful because it has a single-payer system, but the simple fact that they have a much lower health spending rate——

Senator SANDERS. Right. That is what I am talking about.

Mr. STEUERLE [continuing]. means that they can keep a much lower tax rate, which is an advantage.

Senator SANDERS. And everybody who has studied the issue understands that if you wanted to go forward with a cost-effective health care system—and I do not want to get into a health care debate now—single payers, Canada versus the United States. Should we look at that?

Mr. STEUERLE. I guess what I would suggest is that—this is the Budget Committee. My own belief is what—we always have a debate over what health system we will adopt——

Senator SANDERS. But you told us——

Mr. STEUERLE. To me, the simple answer I have is whatever health system we adopt, no matter what the hybrid, it should be within a budget, and you——

Senator SANDERS. But that is not my question. My question——

Mr. STEUERLE. You cannot have an open-ended system.

Senator SANDERS. But you talked about the Canadian tax system. You lauded certain provisions of that.

Dr. Marron, should we look at the Canadian single-payer system which provides health care to all of their people at about half the cost of the American——

Mr. MARRON. I am trying to figure out the right words to wiggle out of this question the same way Gene did.

[Laughter.]

Mr. MARRON. it is absolutely true that there is a lot of wasted spending on health care in the United States, and if we could eliminate that, that would be broadly——

Senator SANDERS. All right. You wiggled out of it. Canadians are doing just great. How about our health care, Dr. Altshuler?

Ms. ALTSHULER. I am not an expert on health—on health care.

Senator SANDERS. But economically you will all agree that health care is a huge burden on our economy. No one disagrees with that. Canadians seem to have done substantially better.

Dr. Lindsey, something we should look at?

Mr. LINDSEY. Oh, we should look at everything, and I think what really decides competitiveness is cost-effectiveness. So you could have a—I mean, the worst thing you can have is a high-tax, low-benefit system. If you have a State, for example, in the United States with, you know, relatively modest taxes but efficiently delivered public services, those States are the ones that are gaining population and jobs. So I do not think you can look at anything in isolation, but we need to improve efficiency.

Senator SANDERS. And that is my point. I think we look at—for example, we could talk about Canada again. Again, I live an hour away from Canada. When Wall Street collapsed here, their banking system did not collapse because of much heavier levels of regulation. Right?

Mr. LINDSEY. Senator, that is something I do know something about, and I would not wish the Canadian banking system on America. It is basically a four-company oligopoly and——

Senator SANDERS. Good point.

Mr. LINDSEY [continuing]. and that is what protects——

Senator SANDERS. All that I am saying—all that I am saying is that on these issues you cannot isolate—if you are talking about international competitiveness, not to talk about wages, not to talk about environmental protection, not to talk about trade policy, they are all lumped together. I do not think anyone disagrees with that.

All right. The other point that I wanted to make, not to talk about a Canadian single-payer system, is what I have not heard discussed, while taxes are enormously important, everybody agrees that our current system is not working, needs fundamental reform, we have to look at it within other contexts as well.

For example, during the Bush years, we saw substantial tax reductions given to the wealthiest people in this country, and yet we had perhaps the worst record of job performance at any time since Herbert Hoover. So it is not quite so clear, and other factors may be involved in that. But under Bush in 8 years, we lost 500,000 private sector jobs. We gave tax breaks to the very wealthy. Gentlemen, we lost jobs. Dr. Steuerle?

Mr. STEUERLE. Well, Senator, there are a lot of factors involved. At the end of the Bush years, we went into a recession. When politicians in the executive branch brag about the job growth they have had, 90 percent of what they are talking about is the influence of demographics. And what we have dodged for several decades is when we moved into the—after 2008 and we have all these people starting to retire almost at the rate that we are bringing people into the work force, it is going to dramatically decrease the amount of jobs. And I would suggest——

Senator SANDERS. And I am not arguing—I am just saying that—my only point was that these things are complicated.

Mr. STEUERLE. Yes, but as a matter of revenues, I mean, I have emphasized in a lot of other testimony it is something that has been hard to get into the budget calculus. But if we can figure out ways to get older workers to work who I think are the largest group of potential workers, the most—the largest pool of underutilized human capital in our economy, people 55 to 75 to 85, it has a revenue effect that right now we do not score—a potential revenue effect we do not score——

Senator SANDERS. When we have such a——

Mr. STEUERLE [continuing]. when we talk about revenue. So there are other reforms that can affect revenues beyond——

Senator SANDERS. I do not have a whole lot of time. Great—that is what I mean, I get hooked, Mr. Chairman. We could go on for many hours.

Dr. Lindsey, you mentioned that you thought it might be advantageous to eliminate the payroll tax. You just said that a couple of minutes ago, if I heard correctly.

Mr. LINDSEY. What I said was that if you go to a value-added tax, you want to roll everything into it.

Senator SANDERS. OK.

Mr. LINDSEY. Because the value-added tax—again, it gets back to the competitiveness issue and how you play it out. If you are going to take advantage of the competitiveness advantages of the value-added tax—and I think there are some, and I also acknowledge exchange rate issues—then why wouldn't you want to do it for all our taxes? I mean, it is American labor that gets——

Senator SANDERS. All right. But because we live in the real world and as of today, to the best of my knowledge, Social Security is completely funded by the payroll tax, what would you do with Social—do you believe in Social Security?

Mr. LINDSEY. Of course.

Senator SANDERS. OK.

Mr. LINDSEY. What I am suggesting is that if you are going to take advantages of tax reform, you want to roll as much of the Tax Code as you possibly can into the most efficient tax you can. And obviously you would continue to fund Social Security with that new tax. I do not see where there is any inconsistency there at all.

Senator SANDERS. Well, the——

Mr. LINDSEY. Also, Senator——

Senator SANDERS. Let me—one second. Excuse me. I——

Mr. LINDSEY [continuing]. you said something about the Bush——

Senator SANDERS. Hold it, hold it. Hold it, hold it. Mr. Chairman, I do not have a whole lot of time here, so let me just ask you the questions, OK? My point was that right now we are having a major debate about the future of Social Security.

Mr. LINDSEY. Yes.

Senator SANDERS. And Social Security is funded independently of the U.S. Treasury by the payroll tax. Lumping—let me finish. That is a fact. Lumping all—you can certainly fund a retirement program for the elderly in ways other than the payroll tax. I am not arguing that. But right now the strength of the payroll tax in terms of protecting Social Security is that it has nothing to do with the deficit. If you lump everything together—and there are guys around here who say, well, you know, we have to make cuts. You will agree with me that one of the areas that could be cut if you are funding a retirement program for seniors out of the general

Treasury could be programs for the elderly. Is that a fair Statement?

Mr. LINDSEY. This Congress has cut Social Security any number of times, even though it is funded by the payroll tax. So there is no linkage between how a program is funded and whether or not it is cut.

Senator SANDERS. Oh, I would not say that.

Mr. LINDSEY. 1981, 1978, those would be two good examples. Changes in the tax on Social Security benefits, I forget which year it was passed. Mr. Chairman, you may remember.

Senator SANDERS. 1983, I think.

Mr. LINDSEY. So, yes, there were many, many times when we have adjusted Social Security——

Senator SANDERS. You adjusted Social Security, yes.

Mr. LINDSEY. Cuts. We cut Social Security benefits without changing the payroll tax one bit, so I——

Senator SANDERS. Well, actually, we raised the payroll tax in 1983 so that it is now a viable program. All right. I do not want to belabor the point.

I guess I have run out of time, Mr. Chairman. Thank you very much. Thank you.

Chairman CONRAD. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thanks to the panel for your presentations. I want to compliment my colleague from Oregon, Senator Wyden, for consistently and effectively raising the issue of tax simplification and putting forward the bill he has this year.

One dimension of this is that Oregon and our Federal taxes may have something in common; that is, a fairly high marginal rate, but then tons of exceptions in terms of deductions and credits. A few years ago, when I was in the State legislature, I went to the Portland Development Agency and said, you know, Oregon is 47th in the Nation—in other words, one of the lowest States in terms of the tax burden it places on business. Is this a selling point in attracting business to the State of Oregon? And the answer was, no, it is not. And I said, well, we are 47th, one of the lowest effective tax systems in the country. Why isn't it a selling point? And the answer was, well, we have a very high marginal rate, and companies largely look at that marginal rate. They do not count on getting the exceptions and the credits of the deductions and the credits, and so it has proved of little value in attracting business to our State.

So I said, well, wouldn't it make a lot more sense for us then, if we are going to be 47th, to be 47th with a very low marginal rate and fewer deductions and credits, and wouldn't that prove more attractive? And the answer was, yes, that would be a much better sell. And I think the United States as a whole seems to have a parallel problem. So I just wanted you all, as you would like, to comment on this question of whether we become much more attractive to companies deciding whether to site themselves in the U.S. or overseas if we had—we collected the same amount of tax we do now, but did so with a far lower marginal rate.

Ms. ALTSHULER. Just a quick answer. Absolutely, and that is what I wrote about in my testimony. You hear a lot of people saying, well, you know, the statutory rate is really high, but once you take all of those credits and deductions and loopholes into account, the effective tax rate is really low. So we really do not have to do anything about the statutory rate.

I have two problems with that. One is that I think if you look at effective tax rates, they are not as low as you may think. They are not that much lower than the statutory tax rate. But most importantly is it depends—it is very individual firm-specific. The statutory rate is an important factor as you just pointed out. It affects location decisions. It affects financing decisions. It affects how much wasteful tax planning you do. It affects how much you invest. So it is a very important policy lever, and it does make sense to lower the corporate tax rate.

Senator MERKLEY. Anyone else want to comment on that?

Mr. STEUERLE. Senator, I think we would all agree. I have a somewhat tangential point, but a lot of the discussion we have had at this table has gone to issues like international tax, which can be very complex. But I would like to bring us back to where maybe all our testimoneys began, which is there are a whole variety of tax changes that appeal to both sides of the aisle that are not—when we have these debates on taxes—but, remember, taxes is the entire revenue side of the budget and a quarter of the expenditures, so we are talking about thousands of programs. There are so many things that cut across the aisle that both sides would agree we do not need five educational subsidies, we do not need ten capital gains tax rates. We could report on the burden on taxpayers is including the deficits we are putting on them. This is the type of thing Senator Wyden I think went through when he did his tax reform, is you can narrowly—you can start with the issues on which there is a consensus, and then build out to the issues on which there is not a consensus. And one of them is the one you are including, that if we can broaden the base—at least to the extent we broaden the base and lower the rate, that there are a lot of common elements. There is a certain beyond which—well, that does not work because, as Dr. Altshuler keeps mentioning, there are certain rate reductions that are hard to finance with the base broadened. That does not mean you cannot go as far as you can with the type of proposal you are suggesting.

I think there are a lot of things that we can agree to across the aisle if we are just willing to sit down and do them. Start with them as a base and hold off the issues on which there is more controversy across the aisle.

Senator MERKLEY. Let me turn to another topic. When I was here in 1976 as an intern, there was a tax reform up that addressed a lot of various exemptions, deductions, credits, and so folks from Oregon were writing in with all their perspectives on could their home office be deducted and blah, blah, blah and so forth. Just a lot of anxiety over each and every one of those potential changes.

But a number of changes were made, and then in 1986, Senator Packwood led a major effort, a much larger effort, to do the same, to simplify in large degree. But it appears to me that between 1986 and now we basically have had a 24-year period where we have not gone back. So instead of having 10 years of handing out credits and deductions and then kind of, OK, let us come back to some form of sanity, we have had 24 years in which we have been handing out complexities in the Tax Code without coming back. Are we long overdue for this type of major discussion?

Mr. MARRON. Yes, absolutely. And I think going back to one of the issues I raised in my testimony, I think one of the things that has driven that over the last 25 years is that you can dress up special deductions, exemptions, and credits as tax cuts, which are often politically more palatable than if you form them up as spending increases. Nonetheless, many of them look from an economic and budget point of view basically to be the same thing, where you are using the Federal Government to direct resources to a certain kind of activity, but politically they have looked to be tax cuts.

And going back to one of the things that Gene has emphasized several times, I think there is a challenge in the way we communicate about these issues and that clarifying that some of these provisions really are effectively spending programs will be part of the steps toward addressing them.

Mr. LINDSEY. Senator, in addition I would point out we took the top statutory rate up from 28 to 39.6 over that same period of time, and the two go hand in hand. And so both I think is what is on the table.

Senator MERKLEY. OK. I want to slip in one final question—oh, go ahead.

Mr. STEUERLE. It is just that when I have looked at the numbers, what has increasingly happened over the years you are talking about is that Congress has increasingly gone to what I call the give-away side of the budget, that is, on both spending and—both tax cuts and spending increases, which is what one wants politically, and the challenge always for the Budget Committee is you recognize there is the other side of the ledger. And we have to figure out a way to raise the importance of what that means. We cannot let deficits act as if they are free money when we do spending increases and tax cuts.

Senator MERKLEY. Mr. Chair, I think I am out of time. Is there a possibility of slipping in one more question?

Chairman CONRAD. Yes, sir.

Senator MERKLEY. OK. Thank you.

I have asked my team to help identify specific examples of how our Tax Code subsidizes the export of manufacturing or jobs overseas, and one specific example that they have put forward is that when an American company decides to build an overseas factory, if they take their loan out to build that factory in the United States, the interest becomes tax deductible. So essentially the American taxpayer is, therefore, subsidizing the financing of the overseas construction that then incentivizes the shifting of jobs overseas.

Is there a rational argument for this? Or is this just plain out a crazy thing to do, to subsidize the construction of factories that compete with American factories?

Ms. ALTSHULER. Do you have an hour to get into this and a lot of headache medicine?

Senator MERKLEY. It sounds like we are going to have a followup discussion.

Ms. ALTSHULER. Yes. It is not the case that all corporations are able to deduct all of their interest expenses that support foreign investment from the U.S. rate. We do have a system where interest on domestic lending is allocated abroad so that you are not allowed to deduct 100 percent of your interest on foreign—domestic interests to—you are not allowed to deduct 100 percent. There are interest allocation rules. They are very, very complicated. We have a better rule that actually is on the books to be enacted, but we just keep pushing it out. I am not sure when it is. It is called worldwide fungibility. Maybe it has been pushed out to 2018 now? I am not sure, but we keep pushing it out.

What you raise is a really interesting issue because if a firm can deduct interest on loans that they take out in the United States to build a company abroad, they have generated for themselves a negative marginal effective tax rate, which means that we are subsidizing their investment abroad.

The difficulty of this is understanding the extent to which this is happening to specific corporations. It is complicated.

Chairman CONRAD. But it is happening. I mean, I have had people come to me who are in very large multinational accounting firms who have had clients who were doing precisely this. And it so troubled them that they came to me, and they did not divulge the company because that would be a breach of their confidentiality agreements. But they showed me very specifically companies from the United States developing a net marginal negative tax rate and in effect being subsidized by American taxpayers to put jobs overseas. And I tell you, this is, I think, a bigger problem than has been acknowledged. It is, according to people who have come to me from very large accounting firms, they believe, a rapidly growing problem as people figure out this mechanism.

Before I go to Senator Wyden for an additional question, just as a factual matter, earlier on we were talking about Canada's deficits, so I asked to look into that. They were at 101.7 percent of GDP in 1996. They brought that back down to 69.7 percent of GDP, partially with the institution of a VAT. It was not exclusively a VAT, but they used a VAT in combination with other taxes. You do not see many countries that have exclusively a vat. Almost always they are hybrid systems, part income tax, part VAT. And there was an earlier question from Senator Whitehouse with respect to the competitiveness advantage. One part of the competitiveness advantage is those taxes are rebatable at the border. And so the example that Senator Whitehouse was giving is quite accurate. We have our taxes built into our products that we are trying to compete with foreign countries. They have a tax that at least partially is rebatable at the border, so when those goods come into this country, they have less of a tax burden on them. That confers a competitive advantage.

Now, we have tried to counter that with DISC and FSC and how many iterations. Mr. Lindsey, you would probably know. And the problem is we keep getting ruled GATT illegal on the things we do to try to level the playing field for our manufacturers. Many of us believe that we are on a course here that at some point we are going to lose our ability to try to make our people competitive. That is, we are going to get ruled GATT illegal. We are not going to be able to fix it. And then we are going to face a 20-percent, 25-percent, depending on what the VAT is, advantage going to the foreign manufacturer.

So, you know, one of the reasons we wanted to hold this hearing today, I mean, these are serious, serious matters for this country's competitive position. And I do not think we want to allow ideology on either side here to get us away from the practical reality of what we confront as a country, and that is the competitive position of the United States.

Senator Wyden.

Senator WYDEN. Thank you very much, Mr. Chairman. I think you make an important point. My friend and colleague from Oregon, Senator Merkley, as usual does as well. These international questions are enormously important, and I thank my colleague for making it.

That was the one I wanted to ask you about, Dr. Altshuler, and that is transfer pricing. Just to kind of put this in a little bit of context, Senator Gregg and I went at the tax reform issue week after week for 2 years in order to get where we were, essentially a modernized version of 1986, and my guess is we could have probably spent another 5 years working through the territorial and the international situation.

I think we got to where we were by asking the 1986 question, which was how low would you have to get the business rate to be in order to get rid of some of what you are doing in terms of deferral and credits. And that is how we got to the corporate rate of 24 percent and junked a lot of what currently goes on internationally in terms of deferral and foreign credits.

Transfer pricing takes this to a whole different level, and here is the question for you, Dr. Altshuler. In effect, the definition here is you can create paper transactions between subsidiaries of the same company to allocate expenses and profits to selected companies. That essentially seems to be the consensus view of the definition of transfer pricing.

What we found is people like Ed Kleinbard, who was then the head of the Joint Tax Commission, who said, look, if all you do is go to the territorial system, you are going to make these problems of transfer pricing worse, and we are already losing $60 billion offshore and it is a significant problem. Territorial will not do anything about it.

The question for you, Dr. Altshuler, and I appreciate the time the Chairman is giving me. Dr. Altshuler, do you agree essentially with that Kleinbard theory that pure territorial tax approaches as constituted today would not do anything about transfer pricing, could make the problem worse? And if you do, what would you do about it? Because that is where we bog down, and a lot of my colleagues clearly are interested in this. I want to be responsive to them. But if you agree with that Kleinbard theory, what would you do about it in order, again, to try to bring folks together like they did in 1986 and actually get something done?

Ms. ALTSHULER. This is a tough one. Going to a territorial tax system does increase transfer-pricing pressures, income-shifting pressures, but only to the extent to which the repatriation tax is a burden in the first place. So let me just be simple. Yes, income-shifting incentives will go up with the territorial tax system. How much they go up is an open question, which, again, I guess I am saying yes to you. And the question that I have these days is: How much worse does income shifting and transfer pricing get if we go territorial and lower the rate to 24 percent? Because the studies that I have been looking at and the studies that have been done in the past always look at territorial with the 35-percent rate. But if you are lowering the rate to 25 percent to the OECD average, you are taking some of the pressure off. Of course, there is still zero percent taxes out there.

Both solutions to the international tax problem are not perfect. I like your solution quite a bit. I wrote a paper on it. It is elegant because by getting rid of deferral, you get rid of the transfer-pricing problem faced by—with U.S. multinationals. That does not mean—but there are two problems that we have and territorial has problems, too, but just to bring them up.

What I worry about is if we were to get rid of deferral and what we would be doing is going in the—and I am playing a two-handed economist here, OK? So if we were to get rid of deferral going in the opposite direction of other countries, yes, we get rid of this transfer-pricing problem with our U.S. multinationals. But we are still at, you know, this 24-percent rate. The OECD average is 25 percent. Are we going to lose headquarters? In other words, you are going to have foreign multinationals that are going to be able to enjoy our lower rate, OK, but not face worldwide taxation. So do we lose U.S. headquarters? And I do not have the answer to that question, but I think it is really important.

Senator WYDEN. Mr. Chairman, you have given me a lot of time, and I think Dr. Altshuler puts her finger on really a very appropriate point as we wrap up. What the whole exercise is about is creating incentives for this economic renaissance that this country wants so much at this time. And, in fact, the reason, if you go to a labor union meeting or a business meeting, that you can get applause for a 24-percent rate, is you are junking these incentives for taking jobs overseas in order to get red, white, and blue jobs here in America by the incentives for bringing those kinds of operations back and having the headquarters you are talking about.

Mr. Chairman, thank you so much for all this time. It has been a great hearing.

Chairman CONRAD. Yes, I think it is very important time. Let me just say I used to be tax commissioner; I used to be chairman of the multi-State tax commission. I engaged in negotiations in the Reagan Administration on the question of these multinational jurisdictional issues. I have spent a lot of time in it. When I was tax commissioner, we found some amazing things. I will never forget. We followed transactions of a major grain company and found that one shipment of grain changed hands eight times before it left the continental United States before we lost track of it offshore.

I have seen other examples, not in my tax work but in conjunction with the revenue service, where a company showed no profits in the United States, a series of transfer-pricing transactions showed $20 million in profits in the Cayman Islands where conveniently there were no taxes, with one employee. And I always said that one employee was the most efficient worker in the world to produce $20 million of profits, and he actually produced nothing. The only thing he produced was tax returns and corporate Statements showing that they had had periodic board meetings to meet the requirements of that.

So, look, these are enormously complex subjects, but we have an obligation to sort through them, and I think this has been an especially valuable meeting. I also want to commend my colleague Senator Wyden. I said this in another forum. There are very few members who have come up with such significant contributions in tax reform and health care reform, operating with just his own individual staff, not a Committee staff, not a Committee chairmanship, and really sweeping, well-thought-out, bipartisan proposals. And he deserves tremendous credit for that, and I am glad we pursued the questions here today.

I thank this panel so much. I think you have been terrific and really thought provoking. I appreciate all of your participation here today.

The Committee will stand in adjournment.

[Whereupon, at 12:23 p.m., the Committee was adjourned.]

Statement for the Record from Senator Thune
"Tax Reform: A Necessary Component for Restoring Fiscal Responsibility"
Wednesday, February 2, 2011
Senate Budget Committee

I would like to thank the Chairman and Ranking Member for holding this important hearing today and the witnesses for their willingness to testify.

As we all know, our current tax code is outdated and in much need of reform.

Our corporate tax rate is the highest in the world which forces many companies to invest more overseas at the expense of both our workers and our government coffers.

Additionally, our current tax system greatly distorts the decisions made by individuals and businesses, such as the tax preference for debt financing instead of equity financing for corporations.

For these reasons and others, it is clear we need to focus on reform.

However, we need to make sure that these troubles do not become excuses to raise taxes on hard-working Americans. I believe that any tax reform proposal should be revenue neutral.

Again, I would like to thank the Chairman and Ranking Member for holding this important hearing.

Questions for the Record for Donald B. Marron
Senate Budget Committee, 2/2/2011
Tax Reform – A Necessary Component for Restoring Fiscal Responsibility

From Senator Mark Begich

1) Most experts seem to agree that we should lower corporate tax rates and broaden the corporate tax base by eliminating certain tax preferences and loopholes in order to improve economic efficiency and lower the cost of tax compliance for American businesses. Do agree with that and if so, what would be the most economically efficient or revenue maximizing corporate income tax rate?

Yes, I do agree. By cutting back corporate tax preferences and lowering tax rates, America can have a more efficient tax system.

I would offer one caveat, however. Accelerated depreciation of equipment and other business investment is sometimes identified as a tax preference that could be reduced to help pay for corporate rate reductions. Cutting the corporate tax rate would encourage business investment, but reducing the value of depreciation allowances would push the other way, discouraging investment. Policymakers should keep an eye on this tradeoff and ensure that any reform does not unnecessarily discourage business investment.

I do not have a specific estimate of an appropriate corporate tax rate, but given the declines in rates in other developed economies in recent decades, I believe that President Obama's fiscal commission and the Domenici-Rivlin task force were correct to aspire to a corporate rate in the mid-to-high 20s. (As an aside, I should also note that the most economically efficient tax rate is, in general, lower than the revenue-maximizing one.)

2) I am a firm believer in securing our borders, having said that, I am wondering about the link between Immigration and tax reform. If our undocumented workers were paying into our system their earnings would be accountable and I am wondering how this would impact our economy. Can you speak at the potential economic changes that could arise from this?

I believe that greater immigration of high-skilled, documented workers would boost long-run economic growth and be a net benefit for the federal budget. The fiscal impacts of the current population of undocumented workers are less clear. There is significant evidence, however, that many of those workers do pay payroll taxes. And they often do this in ways that don't qualify them for Social Security benefits. Most undocumented workers have relatively low incomes; as a result, I would expect that those that currently do not file income taxes would pay relatively little in income taxes if they did and some may in fact pay more income tax than the law requires if they fail to file for refunds of withheld taxes.

3) If we lower the rates and reduce the loopholes and find the right balance where we are revenue neutral; is there any long term difference between a system with lower rates and fewer loopholes? In other words, could we expect to see a sharper increase of revenue over time with a simpler system?

Done well, a revenue-neutral tax reform would have several economic benefits. First, it would reduce the degree to which tax considerations, rather than economic fundamentals, drive personal and business decisions. Second, it could encourage working, saving, and investing and thus boost long-run growth. Third, it could simplify filing and administration, thus reducing both costs and errors. Fourth, it would reduce the future cost of increasing taxes if, as seems likely, that becomes necessary to avoid unsustainable deficits. All of these changes would strengthen our economy.

Questions for the Record for Donald B. Marron
Senate Budget Committee, 2/2/2011
Tax Reform – A Necessary Component for Restoring Fiscal Responsibility

From Senator Bill Nelson

1. Some have suggested that tax revenue should be constitutionally capped and not exceed a certain percentage of the GDP, such as 20 percent. What is your view of such a cap?

   I would not support such a cap. An arbitrary cap should not guide society's fundamental decisions about government activities and how we finance them. I would also note that the popularity of tax preferences has blurred the line between the traditional budget concepts of spending and revenues. There are many examples of spending-like programs that are structured as tax incentives. This allows their proponents to describe them as tax cuts, rather than spending programs. The incentive to transform spending programs into tax incentives would become even stronger if the government faced a cap on revenues (or, for that matter, if it faced a cap on spending).

2. Others suggest a balanced budget amendment to the Constitution so that spending does not exceed revenue, except in emergency cases. What is your opinion of this idea?

   I have several concerns about the idea of a balanced budget amendment. First, the federal budget is now far out of balance. Absent major positive surprises, serious effort to get back to balance will take years. It would thus be premature to demand a balanced budget. In addition, I believe it would be difficult to design a balanced budget amendment that would give the government appropriate flexibility. From an economic perspective, a reasonable long-run goal would be to balance the budget over the course of the business cycle – running surpluses in good times to offset deficits in bad times. But that concept would be difficult to embody in a constitutional requirement.

3. If Congress tackles fundamental tax reform, are there certain ground rules we should agree ahead of time? For example, should we make a commitment that tax reform will be revenue neutral? Revenue generating? Should we focus on corporate tax reform first?

   The first ground rule should be a commitment that any reformed tax code will be essentially permanent, not the mish mash of temporary provisions that we have today. American families and business deserve a tax code on which they can plan. If some tax preferences survive the reform process (e.g., provisions like the research and experimentation tax credit), it may make sense for them to sunset every five years or so to force Congressional review, but these should be rare exceptions from the overall stability of the new code.

   Policymakers should also make a clear decision about whether to pursue revenue-neutral tax reform or revenue-raising tax reform. The former could improve our tax system, but not address our long-run budget problems. As someone concerned about our daunting budget outlook, I would prefer the latter; if that isn't politically possible today, one possibility would be to pursue revenue-neutral corporate tax reform first, but knowing the revenue-raising individual tax reform would have to be on the table in coming years. (Revenue-neutral corporate tax reform might involve a reduction in overall corporate receipts coupled with an increase in receipts elsewhere. For example, rolling back some business tax breaks to raise offsetting corporate revenues may also increase revenues from flow-through businesses whose profits are taxed on the individual tax returns of their owners.)

4. What should be the guiding principles of tax reform? Ensuring that the tax code is fair and those that can pay more do pay more? Removing distortions and promoting economic efficiency? Making the tax code simpler? All of the above? What's most important?

   I think five principles should guide tax reform. First, policymakers should try to raise needed revenue with as little economic damage as possible. Among other things, that means leveling the playing field among different economic activities. Second, policymakers should identify a specific set of social goals that they believe are best pursued through the tax code, and then design tax provisions that accomplish those goals as efficiently as possible. America doesn't need scores of tax preferences; it needs a few well-designed ones that accomplish important goals. Third, policymakers should consider fairness based not only in its vertical dimension (e.g., comparing tax burdens at different income levels), but also in its horizontal dimension (e.g., comparing tax burdens for people with the same income). Fourth, policymakers should minimize uncertainty in the tax code. Finally, policymakers should design a tax system that raises enough money to pay for our government.

5. The Florida economy is a service-oriented economy. We do not have a lot of heavy manufacturing. Our industries tend to be labor intensive, not capital intensive – tourism is the perfect example. However, I feel like most of our effort in tax policy in recent years has been focused on heavily subsidizing capital expenditures – business equipment and machinery – the type of property used in manufacturing and other capital-intensive businesses. The December tax bill is a perfect example. It includes a bonus depreciation tax provision that will inject $110 billion into the economy over the next 2 years, but all of the subsidy is aimed at reducing the cost of capital expenditures, not labor expenses. Does federal tax policy distort the market and tilt the field against states like Florida that rely on service-oriented, labor-intensive sectors of growth?

   This is a complex question. In general, the federal tax code treats labor-intensive businesses more favorably than capital-intensive ones. Labor costs can usually be expensed immediately, while many capital investment costs must be depreciated over time. All else equal, that means the tax code favors labor over capital (one exception, however, is that high levels of debt financing can tip the playing field toward capital because of the deductibility of interest payments).

   Recent stimulus efforts have included a range of tax measures that increase Americans' after-tax income (which might help Florida not only through spending by residents but also by tourists), made business investment more attractive, and encouraged hiring. In terms of the recent business incentives, it is important to keep in mind that the $110 billion in initial tax reductions from expensing will be mostly offset by higher tax payments in later years (about $90 billion, for example, over 2013-2020).

CHALLENGES FOR THE U.S. ECONOMIC RECOVERY

THURSDAY, FEBRUARY 3, 2011

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

The Committee met, pursuant to notice, at 10:01 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Cardin, Whitehouse, Merkley, Begich, Sessions, Thune, and Portman.

Staff present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, 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 today. Today we will focus on challenges that are facing the U.S. economic recovery. We are going to look specifically at challenges in the areas of unemployment, housing, and the State fiscal crises. We are really fortunate to have four outstanding witnesses with us today:

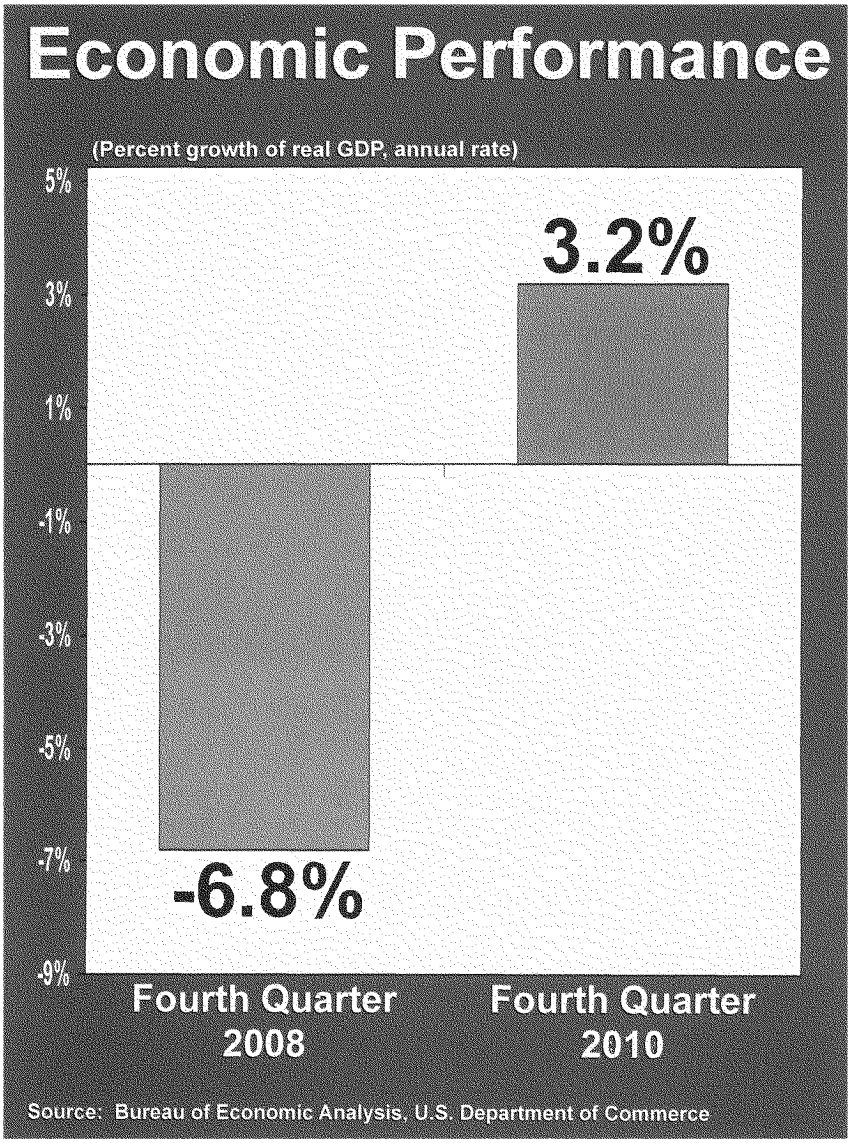
Dr. Mark Zandi, Chief Economist at Moody's Analytics. Dr. Zandi has been very helpful to this Committee and has testified here several times in the past. We are grateful to have you back again today.

Dr. Till von Wachter, Associate Professor of Economics at Columbia University, and I would just say parenthetically my daughter is getting a Ph.D. there. I was up there a few weeks ago. She was teaching a great books class. It was very interesting.

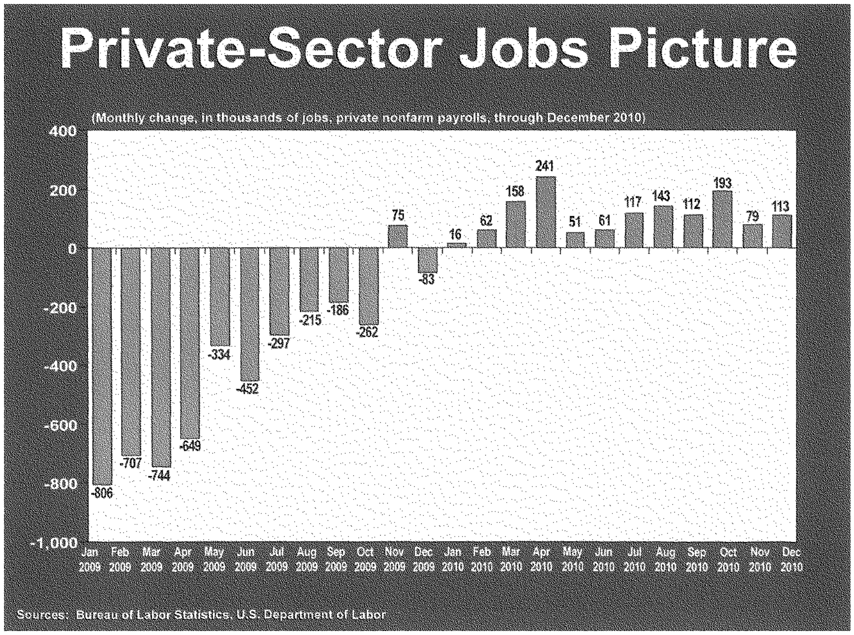
Dr. Ray Scheppach, the Executive Director of the National Governors Association. We understand that after nearly 30 years he is retiring and going to go to UVA. I commend you on your years of public service, Ray. Always somebody that has enjoyed credibility on both sides of the aisle for his professionalism.

And Mr. Chris Edwards, Director of Tax Policy Studies at the Cato Institute. Good to have you back as well. Thank you very much.

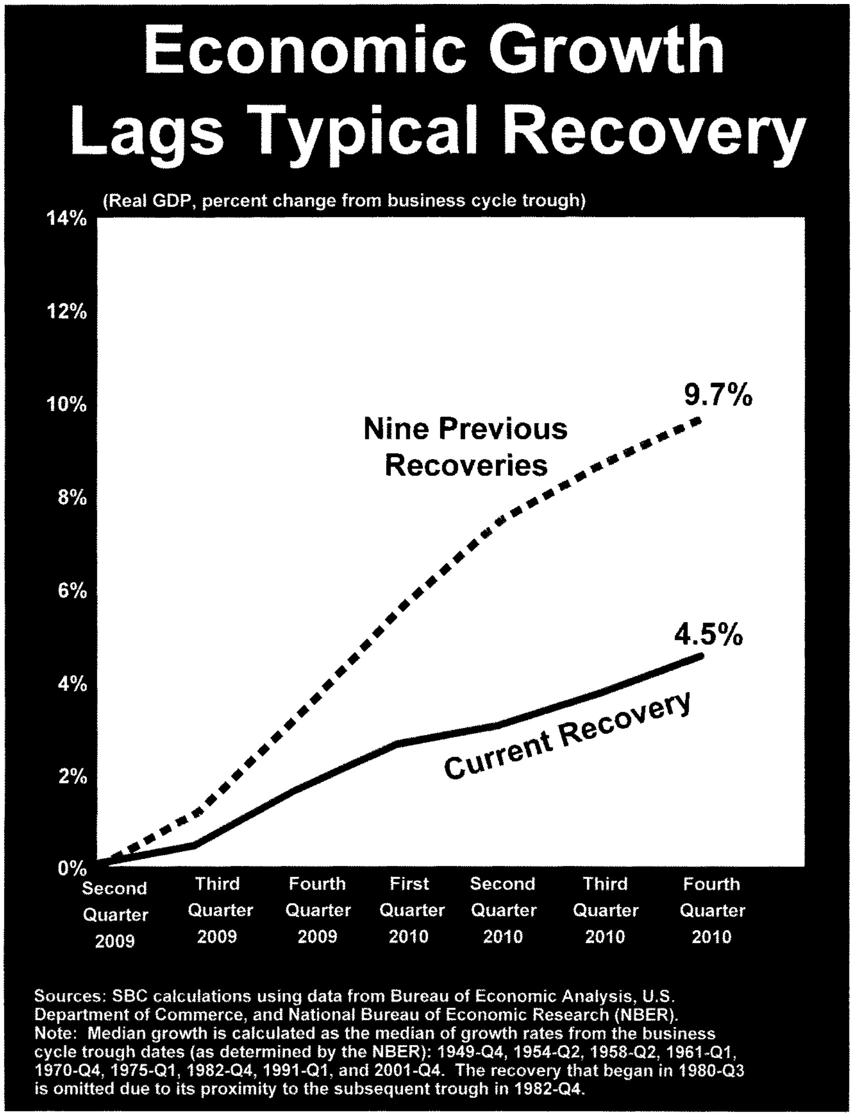
Let me begin by providing a brief overview of my own on the economic challenges that we currently confront. The Federal response to the recession and the financial crisis successfully pulled the economy back from the brink. In the fourth quarter of 2008, the economy was showing negative growth of 6.8 percent. Economic growth has since returned, although not as strongly nor as quickly as we would have liked. In the fourth quarter of 2010, we saw positive growth of 3.2 percent.



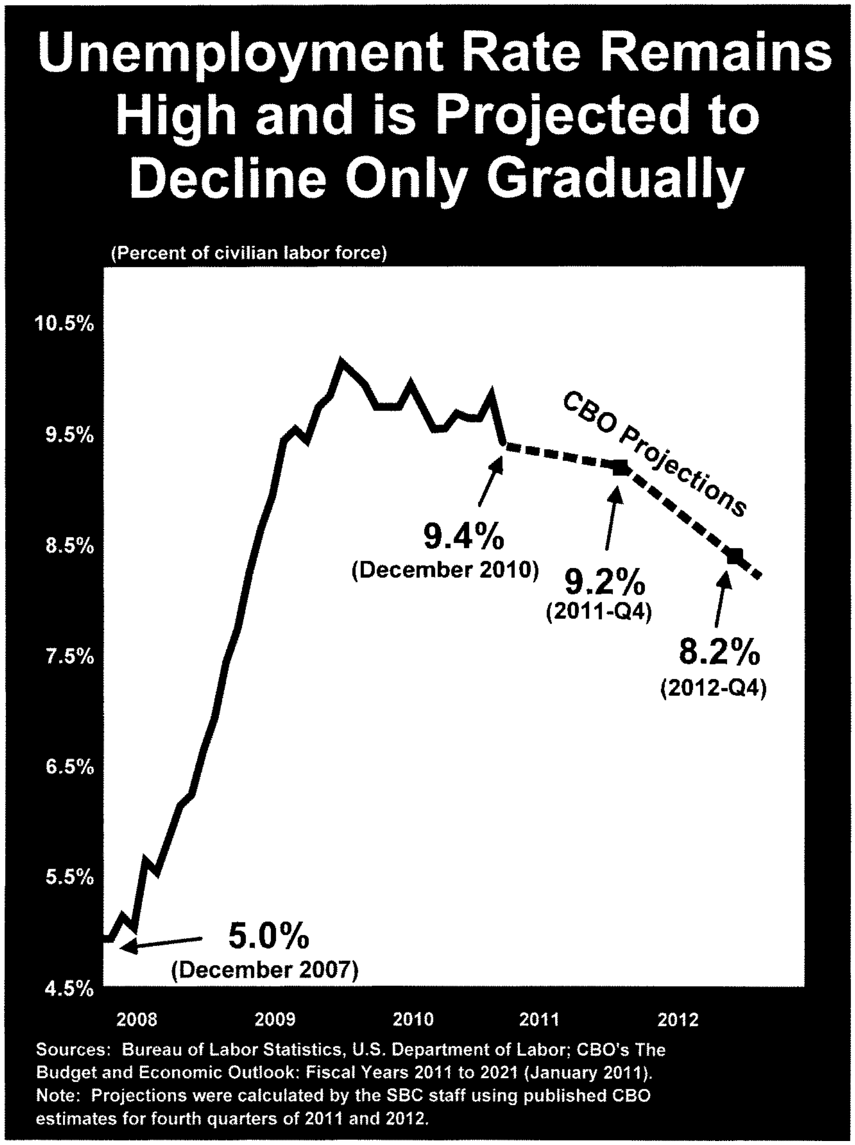
Private sector job growth has also returned, although not as much as we would like. In January 2009, I think it is important for us to remember, the economy was losing more than 800,000 private sector jobs a month. In December of 2010, the last month we have data for, the economy gained 113,000 private sector jobs. So we now have 12 consecutive months of private sector job growth.



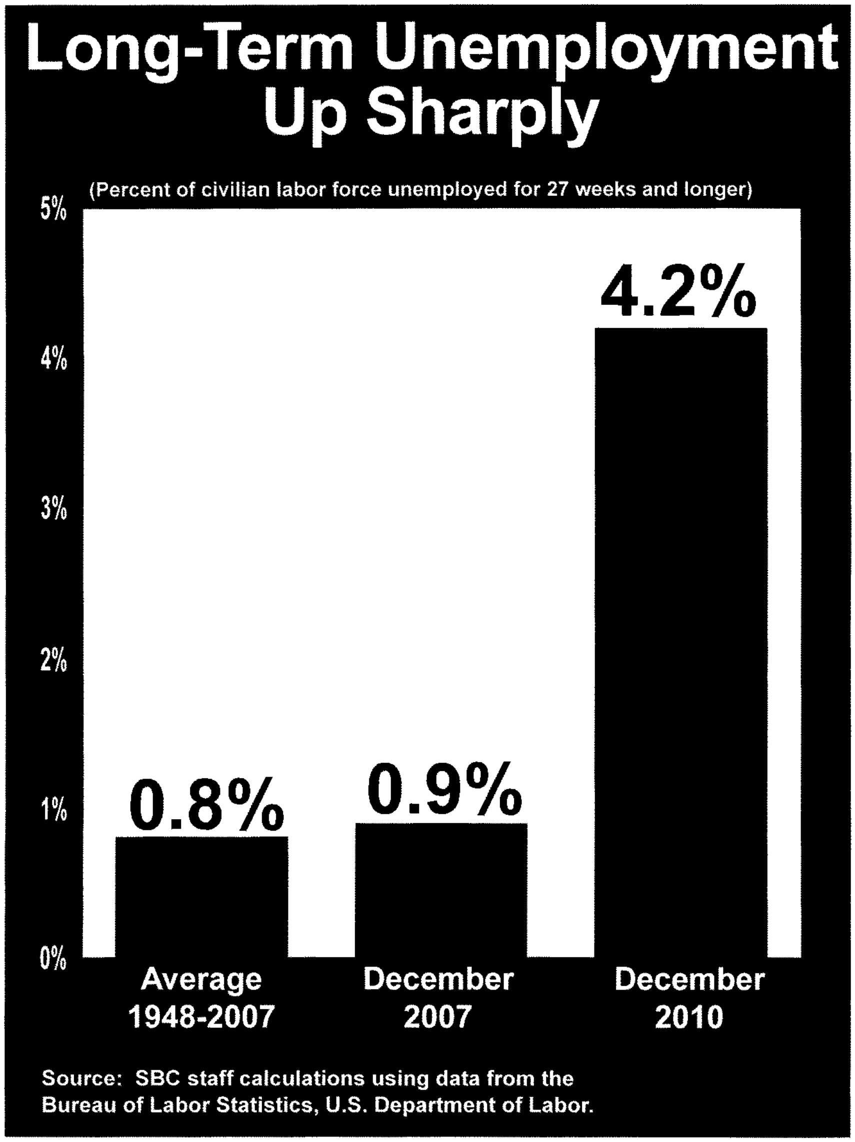
Despite this improved picture, it is clear the economy is growing at a much slower pace than in past recoveries. When measured against the nine previous recoveries over the past 60 years, we see the current recovery lags considerably the typical recovery. I personally believe a key reason for that is the damage done to the financial sector.

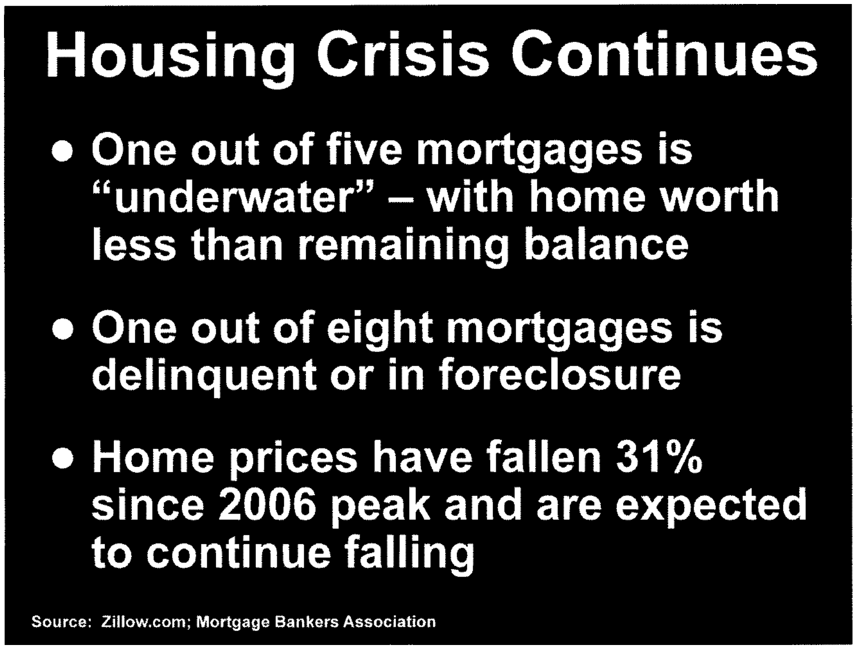


And the unemployment rate has also remained stubbornly high. Just a little over 3 years ago, it stood at 5 percent. It nearly doubled within a year's time and has fluctuated in the 9-percent-plus range ever since. The Congressional Budget Office now projects the unemployment rate will fall only slightly to 9.2 percent in the fourth quarter of this year and still remain stubbornly above 8 percent in the fourth quarter of 2012.

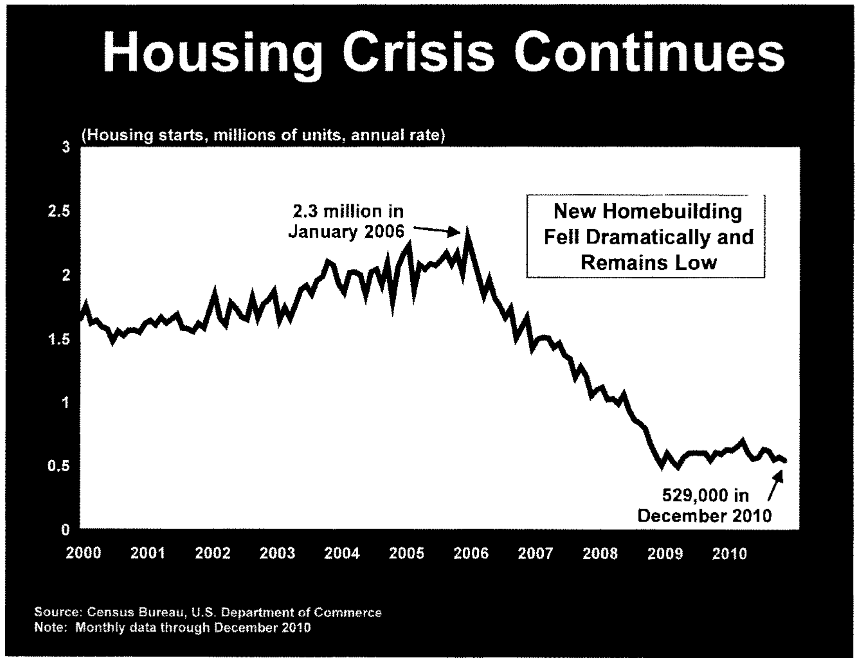


Another concern is the number of long-term unemployed, those unemployed for 27 weeks or longer, which is extraordinarily high. The average rate of long-term unemployment over the period from 1948 to 2007 was eight-tenths of 1 percent. Just prior to the recession, in December of 2007, the rate was very similar, at nine-tenths of 1 percent. Now the rate of long-term unemployed has surged to 4.2 percent. This is a clear sign of the persistent economic weakness experienced by Americans across a broad front.


Long-Term Unemployment
Up Sharply
(Percent of civilian labor force unemployed for 27 weeks and longer)
5%
4%
3%
2%
1%
0%
4.2%
0.8%
0.9%
Average
1948-2007
December
2007
December
2010
Source: SBC staff calculations using data from the
Bureau of Labor Statistics, U.S. Department of Labor.



We also continue to face a crisis in the housing market, the sector of the economy that sparked the recession. One out of five mortgages remains underwater, meaning the home is worth less than the remaining balance on the mortgage. And in some markets, that number is much higher. In addition, one out of eight mortgages is delinquent or in foreclosure, and home prices have fallen 31 percent from their peak in 2006 and are expected to continue falling in the near term.



We can see that new home building has fallen dramatically and remains low. In January of 2006, we had 2.3 million housing starts. In December, we had just 529,000 housing starts.

Finally, the Nation's economic recovery also faces a challenge from the fiscal crises occurring at the State and local level. Here is a recent headline from the New York Times. It reads: "Mounting Debts by States Stoke Fears of Crisis: Costs remain hidden; analysts who predicted mortgage meltdown see a similarity."

The New York Times

SUNDAY, DECEMBER 5, 2010

MOUNTING DEBTS BY STATES STOKE FEARS OF CRISIS

COSTS REMAIN HIDDEN

Analysts Who Predicted Mortgage Meltdown See a Similarity

By MICHAEL COOPER and MARY WILLIAMS WALSH

The State of Illinois is still paying off billions in bills that it got from schools and social service providers last year. Arizona recently stopped paying for certain organ transplants for people in its Medicaid program. States are releasing prisoners early, more to cut expenses than to reward good behavior. And in Newark, the city laid off 13 percent of its police officers last week.

While next year could be even worse, there are bigger, longer-term risks, financial analysts say. Their fear is that even when the economy recovers, the shortfalls will not disappear, because many state and local governments have so much debt — several trillion dollars' worth, with much of it off the books and largely hidden from view — that it could overwhelm them in the next few years.

"It seems to me that crying wolf is probably a good thing to do at this point," said Felix Rohatyn, the financier who helped save New York City from bankruptcy in the 1970s.

Some of the same people who warned of the looming subprime crisis two years ago are ringing alarm bells again. Their message: Not just small towns or dying Rust Belt cities, but also large states like Illinois and California are increasingly at risk.

Municipal bankruptcies or defaults have been extremely rare — no state has defaulted since the Great Depression, and only a handful of cities have declared bankruptcy or are considering doing so.

But the finances of some state and local governments are so distressed that some analysts say they are reminded of the run-up to the subprime mortgage meltdown or of the debt crisis hitting

Continued on Page 30

Since most States have balanced budget requirements, they are forced to close their budget gaps with layoffs and cuts in social services and tax increases. Such cuts have a ripple effect through State and local economies. This undercuts the recovery efforts underway nationally.

I think it is very clear there is little appetite in Congress for providing further help to States, so we need to consider what else can be done to help States get through this challenging period. I hope this hearing can shed light on all of these issues.

Senator Sessions is not here yet. He is delayed. So I think what we will do is go right to the witnesses, and we would ask you to limit your stated remarks to 5 minutes or thereabouts, and then we will have a chance to get to questions.

Again, thank you very much for participating. This is an important day for the Budget Committee because we are trying to deal with a series of challenges that the country faces all in one hearing. I cannot think of a better panel of witnesses to do that.

Mr. Zandi, why don't you proceed.

STATEMENT OF MARK ZANDI, PH.D., CHIEF ECONOMIST, MOODY'S ANALYTICS

Mr. ZANDI. Thank you, Mr. Chairman, and thank you and the rest of the Committee for the opportunity to participate in today's hearing. I should say that the views I express are my own and not those of the Moody's corporation. And you should also know, because I will be speaking about the housing mortgage markets, that I am a Director of MGIC, the largest private mortgage insurer in the country.

I will make three points in my remarks.

Point No. 1 is that I am optimistic with regard to the economy's prospects; that after 3 very lean economic years, a year and a half of recession, a year and a half of weak economic recovery, I think we will experience much stronger growth this year and in 2012.

Just to give you a sense of what that means, in terms of GDP, the value of all the things that we produce, that fell 2.6 percent in 2009, obviously a very bad year; grew 3 percent, almost 3 percent in 2010. I expect GDP growth to be near 4 percent this year, and roughly the same in 2012.

In terms of jobs, we created 1.35 million private sector jobs in 2010, December to December. I expect double that in 2011 and roughly the same in 2012. And I agree with the CBO's projections on unemployment. The unemployment rate should end this year closer to 9 percent and closer to 8 percent by 2012—still, obviously, a pretty deep hole. It will be a number of years before we get back to anything anyone considers to be good, but we are making our way in the right direction.

There are a number of reasons for this optimism. I will just mention two quickly.

First is businesses are very profitable. Big companies, mid-sized companies in particular, their balance sheets are very strong. I do not think it is any longer a question of can they invest and hire more aggressively. I think it is just a question of willingness. And I think they are going to become more willing. Sentiment is improving quite rapidly, and I expect conditions to improve.

The other key reason for the optimism is policy. I think the policy response by the Federal Reserve, by you and Congress and the administration has been excellent and has made all the difference; that without your policy response, the downturn would have been measurably worse, the cost to taxpayers measurably greater. I think you did the right thing. We can take exception with any individual aspect of the response, but the totality was, I think, quite impressive.

Point No. 2 is, despite my optimism, obviously there are challenges and risks, and I clearly could be wrong, and we are going to talk about a few of those today. State and local governments obviously face very serious challenges. The European debt situation remains very unsettled. Policymakers there need to do more, and until they do, obviously that is a concern.

The events in Egypt and the Middle East remind us of the risks posed by higher oil and other energy prices, and that is worthy of concern.

But at the top of my list of concerns, at least for the near term, the next 6 to 12 months, is the ongoing problems in the housing market, the foreclosure crisis, and let me just turn to a few slides to make the point clearer.

The foreclosure crisis continues on. You can see here the number of first mortgage loans that are in default, somewhere in the foreclosure process, or headed in that direction. They are seriously delinquent and likely to go into default. That is close to 4 million loans. For context, there are roughly 50 million homeowners with first mortgage loans, so 4 million is a lot of loans.

You will note that the good news here, if there is any good news, is that the problems appear to have peaked. But the concern is, at least in the near term, that there are many, many loans now coming to the end of the foreclosure process. REO, which is the last stage in foreclosure before a distressed sale, is building again, and you can see that here. This shows the number of properties in REO, and I have broken that down for you——

Chairman CONRAD. What does REO stand for?

Mr. ZANDI. Other real estate owned. So it is when the lending institution takes back title from the homeowner. That is now in their inventory, and that is the last point before they actually sell it into the marketplace as a foreclosure sale. And you can see it is building. And this is very important because these distressed sales will put further downward pressure on housing values.

Chairman CONRAD. Can I stop you on this point? Let me just say we are going to run this hearing a little differently than we typically do. If you are wondering why I am the only one here, the Prayer Breakfast is this morning, and the Prayer Breakfast is running long because of events, as you know. Our colleague Gabby, her husband is giving the final prayer. The President is at the Prayer Breakfast. We were informed that it would be concluded by this time. That is why we scheduled the hearing for this time. But because of the unusual circumstances, the Prayer Breakfast is running quite long. So I apologize to you that we do not have the typical turnout we would, but people will be here.

Let me just say this to you: I have been watching the question of short sales, and it is very clear that short sales where the property is underwater—they owe more than the property is worth—requires a two-level negotiation. First you negotiate with the homeowner, and then it goes to the bank for approval. And I am being told by people in the real estate industry that the gap in time is losing a lot of sales; that is, that the inability to turn around the decision at the lending institution leads a lot of people to just get frustrated. They need a house. They bail out. They go in another direction.

Is that an accurate assessment of part of the problem here? And is there anything that could be done about short sales?

Mr. ZANDI. Yes, that has been a problem, in part because the lending institutions, the banks, are very nervous of being defrauded, and they need to make sure that the short sale is an arm's-length transaction.

Moreover, many institutions really did not have the infrastructure necessary to engage in a significant number of short sales. They had not done many in the past, and to ramp up has been difficult. It is not an easy thing to do, to do well.

My sense is that the impediments to short sales are abating, that we are seeing more short sales. I will just give you a sense of the magnitude, and these are rough orders of magnitude.

If you go back to, say, 2007, 2008, in the start of the crisis, we were getting 25,000 to 50,000 in short sales per annum. We are now running probably closer to 250,000, 300,000 per annum—which is still small in the context of all the problems that we have, but it is moving in the right direction. And some of the major institutions have established within their organizations groups that are focused solely on the short-sale process.

Also, the administration, in its HAMP efforts to facilitate loan modifications and short sales, has provided incentives to all the various parties involved—homeowners, mortgage servicers, mortgage owners—to engage in more short sales. This is much preferable to everyone involved than going down the road to a foreclosure sale. That has not been nearly as successful as HOPE IV, but it is helping, I would say. So I think we are moving in the right direction.

With regard to what else can be done in this regard, I think the best thing that can be done is vigilant oversight. So I would continue to ask very strong questions of the lending institutions: Where are we? Where were you? Where do you think you are going to be? What are you doing to facilitate this? Just to make sure that, you know, they understand that everyone is watching this very, very carefully.

I think all the tools are in place, the policy tools are in place to make this work better. I just think it needs a little bit of oversight push to make sure that it works in a reasonably orderly way.

Chairman CONRAD. OK.

Mr. ZANDI. So as you can see, the REO inventory is—would you like me to proceed with——

Chairman CONRAD. Yes.

Mr. ZANDI. OK. So the REO inventory is rising. There has been, I would say, a reasonable effort to try to forestall foreclosures and short sales through loan modification efforts. But I would say I think it is now widely understood, and I think appropriately so, that the modification efforts have been inadequate or they have certainly not lived up to anyone's expectations. And you can kind of get a sense of the modification efforts here. They have improved. If you go back to 2007 at the start of the foreclosure crisis, we had 250,000 in loan mods, private sector loan mods. That has ramped up. We are now seeing loan mods of somewhere between a million and a half and 2 million per annum, which is helpful but, you know, in the context of all of the problems we have, it is still quite small.

My own view here, though, is I do not know that policymakers should do anything else with regard to the HAMP program, which is a major effort of policymakers to facilitate loan mods. One of the problems has been that the HAMP plan has been changing so much; it has been very difficult for servicers and lenders to get their arms around it and to implement it. I think we have it where it needs to be. We just need to let them use it as best they can. And, again, vigilance here would be, I think, very therapeutic to make sure that they are remaining engaged.

But, nonetheless, having said that, the mods are not going to solve our problem. We are going to see a lot of loans go through the foreclosure process to a foreclosure or short sale, and I would anticipate more house price declines. You can see that here. This shows house price growth per annum.

Chairman CONRAD. Somehow we are not getting it on the screen here. We have a little technical issue here.

Mr. ZANDI. OK. Well, I will just describe it.

House prices, as you pointed out in your slides, are down from the peak just over 30 percent. I would anticipate this year another 5-percent decline in national housing values. If that is all it is, I think, you know, we are going to be OK, and my script for the economy will roughly hold. But this is where the risk lies, a significant risk, and that is, we have 14 million homeowners underwater. If house prices decline more——

Chairman CONRAD. 14 million underwater.

Mr. ZANDI. 14 million homeowners underwater.

Chairman CONRAD. They owe more than the house is worth.

Mr. ZANDI. Yes. The value of their home is less than the mortgage debt they owe on that home.

Just to flesh that out a little bit more for you, of the 14 million, 4 million are—and these are my estimates, and they are approximations. Four million are underwater by more than 50 percent. That is deeply underwater, and obviously that is the fodder for default.

You know, in many cases these homeowners want to hold onto their home, but suppose you spring a leak in your roof and you are told you have to put $3,000, $4,000 in your home. I mean, does that make any sense to anybody for them to do that? Or your air-conditioning unit breaks, you know, and it is another $2,000, $3,000.

So with house prices falling more people will be underwater. That is fodder for more default. You get more default, that puts more foreclosure short sales, more downward pressure on prices, and you can construct a scenario where you get into a very vicious cycle—the very same vicious cycle we were in back in 2008 and early 2009 before the policy response. In this go-round, it is not clear how you would respond to that. I do not think this is the most likely scenario, but certainly it is a very significant threat and risk, a challenge to the economic recovery.

So point No. 2 is that at the top of the list of concerns is the ongoing foreclosure crisis. I do not think the coast is clear.

So this goes to point No. 3, and that is, well, what can policymakers do to try to mitigate this potential threat, this potential risk. We talked a little bit about some policy, but let me mention a few things. In fact, I will focus on—am I taking too much time?

Chairman CONRAD. No.

Mr. ZANDI. OK. So I would focus on three things.

First is I think there are things that can be done to facilitate the loan modification/foreclosure process, and let me mention a few aspects of what I mean there.

First, I think it would be very important if mortgage servicing companies appoint one person as a point of contact for the homeowner. So right now, if you are a distressed homeowner and you call a mortgage bank, each time you call, you get someone else.

They have no idea who you are. It is just a nightmare and very frustrating for everybody involved. You get documents lost. The loan officer says, "Send me this information, this information, and this information." You send it in. You hear nothing. You call back. You get a different person, and they do not know what you are talking about. They say, "Oh, you sent it to the wrong department. You should have done this. Send it here." And so the process is very elongated and very cumbersome, and I think it would be prudent for—and this is a regulatory, I think, point of contact to require servicers to have one person in charge of each loan file.

Another aspect of this is there is so-called dual tracking that creates a great deal of confusion in the foreclosure process. That is, when you are a distressed homeowner, you are considered for a loan mod, but you are also put in the foreclosure process at the same time. They are both occurring at the same time. So you could be talking to one person in the institution about your modification. Then you get a notice in the mail saying, you know, "You are in default, and we are going to take you to court." So this becomes incredibly nerve-wracking, frustrating, everyone is very upset by this.

I would suggest, another regulatory point of contact, to end the dual tracking. You go through loan modification. If you do not make it through loan modification, you cannot get through these programs. Then you go through the foreclosure process, and that gives everyone enough time to sort of get their minds around what is happening, get all the loan documents in place, and really make a good decision here.

The other thing I would suggest is third-party review. Some States—Connecticut, I believe New York, New Jersey, Florida—are now asking mortgage companies to work with a third party, and this third party would help the homeowner to go through the process: makes sure that the homeowner knows all of their rights, knows all of the options open to them, helps them get all their loan information together, and shepherds them through the process. They are an advocate for the homeowner. This is an incredibly complex, difficult, messy thing. Most homeowners really do not have the skill sets to do it well, and I think they should be given resources to do that. It would not be very costly, and I think it would make the entire process more efficient, and we would get better results.

Finally, Sheila Bair, Chairwoman of the FDIC, has made a very good proposal that I would advocate, and that is, establishing a fund financed by the mortgage servicers that would compensate homeowners that are shown to be wronged in the foreclosure process. As we know, there is a range of problems, affidavit signing issues and other related issues. I think this would be a way to light a fire under the industry and say, you know, if it is shown to be that you messed up here, then you have to compensate these individuals for the screw-up.

So these are foreclosure modification process changes that can be, I think, tweaked in the regulatory process that would make this a much better process.

I will mention one other thing because I am taking a lot of time. One other policy response which would be helpful in the next 6 to 12 months is to try to facilitate mortgage refinancing activities. As you know, fixed mortgage rates are very low. They are below 5 percent for the prime borrower. Part of this reason is because the Federal Reserve is engaged in quantitative easing and keeping—the whole intent of quantitative easing is to keep long-term rates, particularly fixed mortgage rates, down. And one of the key conduits through which low rates help the economy is through refinancing, mortgage refinancing.

The level of refinancing is incredibly low. One of the reasons for this is that for borrowers with poorer credit scores and who are underwater, they do not get that interest rate. They get a much higher interest rate. Fannie Mae and Freddie Mac, for example, charge much higher rates for people with lower credit scores and higher LTVs, even if they own the loan. Even if they own it in their portfolio or they insure it, they own the credit risk. But they are still charging these higher rates, which is forestalling refinancing activity. So I would suggest that there is a requirement on Fannie and Freddie not to charge those higher rates to facilitate more refinancing activity. And it will cost Fannie Mae and Freddie Mac in interest income, but it will benefit them in the form of fewer foreclosures, because these homeowners are going to have lower monthly mortgages payments and be less likely to go into default. And they own the loan. I am not suggesting this for anyone but Fannie Mae and Freddie Mac. So net-net it is not clear to me that they would lose money, right? And this would facilitate more refinancing now when mortgage rates are still low before they start to rise. And they will definitely rise by the end of the year. And this will put money in their pocket to distressed homeowners, like a tax cut, and it costs the Government nothing. And I think this is a very efficacious way to help very, very quickly.

So there are other things, but I will stop there.

[The prepared statement of Mr. Zandi follows:]

Testimony of Mark Zandi
Chief Economist, Moody's Analytics

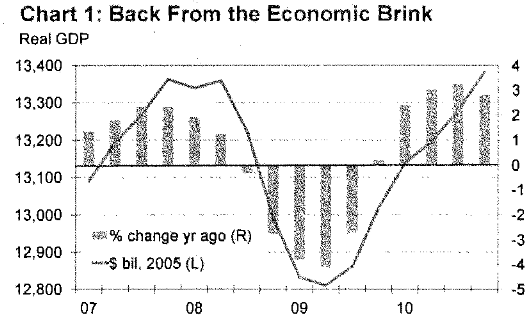
Before the Senate Budget Committee

"Challenges for the U.S. Economic Recovery"

February 3, 2011

The U.S. economic recovery is steadily gaining traction. Real GDP has finally recovered from the steep drop suffered during the Great Recession, and economic growth is accelerating (see Chart 1). The economy is expected to expand at a rate that is well above its potential this year, meaning that businesses should soon begin adding sufficient numbers of new jobs to significantly reduce the unemployment rate. Although the jobless rate may still move higher in the next few months as people who lost jobs during the recession return to the labor force, unemployment is expected to fall below 9% by year's end.

Chart 1: Back From the Economic Brink



Source: BEA

Behind this relative optimism is the financial health of U.S. businesses. Corporate profits are high and growing strongly, and business balance sheets are about as good as they have ever been. Larger businesses are doing much better than smaller businesses, but it is no longer a question of whether businesses can invest and hire more aggressively, it is a question of their willingness. With the nightmare of the Great Recession fading and the policy uncertainty that has been weighing on the collective business psyche abating, businesses are expected to soon become more willing.

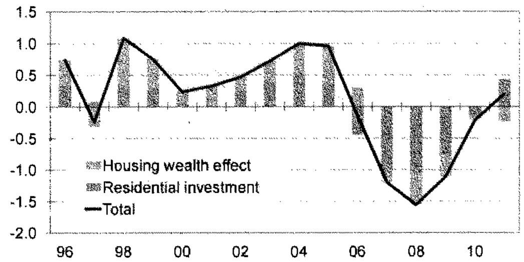
The economic wrongs that were at the heart of the financial panic and recession are being righted. The five-year-long crash in the housing market is winding down. With better job growth, near-record housing affordability, and ample credit from Fannie Mae, Freddie Mac and the FHA, housing demand should slowly revive. Barring further serious fallout from foreclosure processing problems, investor demand for distressed properties should be sturdy. House prices have fallen enough for investors to see opportunities in fixing and renting these houses.

Home construction will also slowly rebound to replenish the inventories of new homes, which have never before been this lean. Overbuilding during the bubble left the market glutted, but this excess inventory is being worked off despite depressed demand, because new construction is even weaker. The glut is concentrated in Florida, Atlanta, Nevada, Arizona and the Central Valley of California. In most other parts of the nation, inventories will return near historically normal levels next year.

Housing's historic drag on the broader economy is thus expected to fade this year. The anticipated increase in new construction will offset house price declines and resulting negative wealth effects as homeowners save more and spend less (see Chart 2). This is a big swing since the depths of the recession, when housing was subtracting a couple of percentage points from annual real GDP growth.

Chart 2: Housing Hits Bottom in 2011

Contribution to real GDP growth, %



Source: Moody's Analytics

Households are rapidly reducing their debt loads and are paying on their debts in a more timely way. Delinquency rates are falling rapidly across all types of loans, from credit cards and auto loans to even first mortgage loans. Financial institutions are benefiting from the improved loan quality and, with their higher levels of capital, are increasingly willing to lend. Credit remains tight, but the spigot is beginning to open for an increasing number of households and businesses.

The economic recovery is also being supported by continued aggressive monetary and fiscal policies. The Federal Reserve has shown no indication that it will end its zero interest rate policy any time soon, and its quantitative easing efforts are keeping long-term interest rates lower and stock prices higher than they would be otherwise. The political compromise reached at the end of last year to temporarily provide additional tax breaks and emergency unemployment insurance is also instrumental in ensuring that the economic recovery evolves into a self-sustaining expansion this year.

Despite the optimism, there are still considerable threats to this hopeful economic script. Severe budget cutting and tax increases by state and local governments, needed to fill their gaping budget holes, will be a significant impediment to the job market and broader economy. Europe's efforts to solve its debt problems or China's attempt at a soft landing could go astray and derail the anticipated U.S. recovery. The recent political turmoil and social unrest in Egypt, Tunisia, and other parts of the Middle East underscore the near-constant danger to our economy from higher global oil prices.

A mounting threat is posed by the nation's large budget deficits, rapidly rising debt load, and the fact that, without significant fiscal policy changes, global investors will soon balk at buying our debt at low interest rates. Prospects for a bruising political battle over an increase in the debt ceiling limit later this spring or summer also pose a substantial concern. Global investors are already anxious regarding our ability to come to a political consensus to address the nation's fiscal challenges; a protracted debate over the debt ceiling would be very counterproductive.

Moreover, with millions of foreclosures still in the pipeline, my optimism that the housing crash may soon be over could be upended. Indeed, more distress sales and house price declines are coming, and—given that the home is still the most important asset most households own and that many small-business owners use their homes as collateral to get loans to expand their operations and hire—it is hard to get overly enthusiastic about the recovery's prospects. It is appropriate to be concerned that the vicious cycle of more foreclosures begetting more price declines begetting more underwater homeowners and more foreclosures could be reignited.

It is also important to consider that under the best of circumstances, unemployment will remain painfully high and households' nest eggs will remain significantly diminished for a number of years. Thus, while it is improving, sentiment remains extraordinarily fragile, and it would not take much of a hit to undermine it. The proverbial economic coast is thus not yet clear. Policymakers should provide aggressive support to the economy until it is unambiguous that the forecasts of stronger economic growth and falling unemployment have definitively come to fruition.

This testimony will consider the shape of the U.S. economic recovery, the challenges that remain to the recovery, and focus specifically on what further steps policymakers might want to consider in regard to the threat posed by the ongoing problems in the housing market and foreclosure crisis.

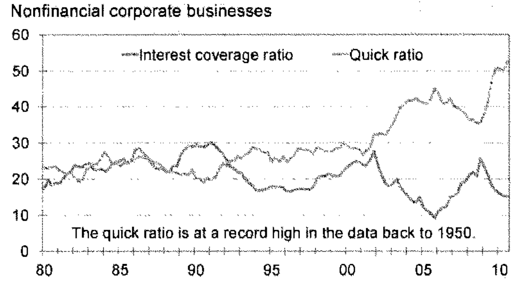
Healthy corporations

Surging corporate profits and increasingly sturdy corporate balance sheets will form arguably the most powerful boost to the economy, persuading businesses to finally boost investment and hiring. Earnings have fully recovered from the recession, after firms dramatically lowered costs and widened profit margins. This is particularly impressive given generally weak pricing and only modest sales gains. Earnings growth among both large, publicly traded companies and small, privately held firms has rarely been stronger; it is now expanding at a yearly rate of more than 25%. Such comparisons are still easy given the downdraft in earnings during the recession, but the profit gains enjoyed during this recovery are among the strongest recorded since World War II.

Business balance sheets are also about as strong as they can be. Corporations have deleveraged amid low borrowing costs; thus, the interest coverage ratio—the proportion of cash flow going to debt payment—has fallen significantly. Under reasonable assumptions regarding future borrowing, interest rates and cash flow, it will approach a record low by this time next year. Cash holdings have also surged, and in proportion to short-term corporate liabilities, they have never been higher (see Chart 3).[1] Balance sheet strength is evident in nearly every industry.

Chart 3: Solid Business Balance Sheets

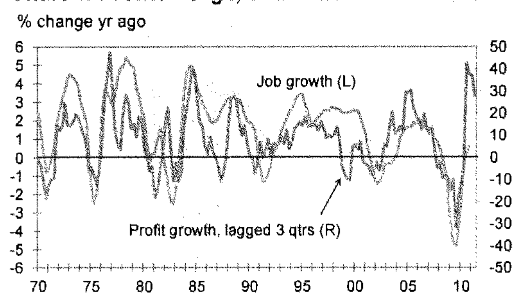
Nonfinancial corporate businesses



Sources: Federal Reserve, Moody's Analytics

There is no longer any doubt about businesses' ability to expand; the only question is when they will be willing to do so. If history is a guide, this should begin over the next few months. In past recoveries, profits improved six to 12 months before job growth picked up (see Chart 4). The logic is straightforward: Managers realize they cannot boost profits forever merely by cutting costs. To sustain strong earnings growth and to support their stock prices, they need to seek revenue opportunities. That means greater investment and more hiring.

Chart 4: Profits Surge, and Jobs Should Follow



Sources: BLS, BEA

The process has been more attenuated in the current recovery, probably because of credit constraints on smaller businesses and the psychological battering all firms have taken. Many managers still seem shell-shocked from their near-death experiences during the Great Recession. Businesses have also been unnerved by the epic policy changes of the past year, affecting healthcare, financial regulation, and the tax code. Debates have raged as well around the cap-and-trade plan to curb carbon emissions, immigration reform, and organized labor's "card check" proposal, none of which resulted in legislation. Still, each came close enough to worry business managers.

The collective business psyche should slowly improve, however, as the credit spigot reopens for small businesses and the next Congress blocks further major economic policy changes. Better business sentiment combined with strong profits and sturdy balance sheets should make for a better year.

Deleveraging winds down

With weak asset prices and high unemployment, households have been under extraordinary pressure to reduce their debts. This deleveraging has been a powerful drag on consumer spending but should begin to wind down later this year. As the pace of debt reduction slows, consumer spending and thus broader economic growth will gain traction.

Key to consumer spending growth is the pace of household borrowing. Consumer spending is powered by household cash flow, which equals the sum of income, realized capital gains, and net borrowing. The growth rate of consumer spending thus equals the rate of income growth, the change in realized capital gains, and the change in net borrowing.

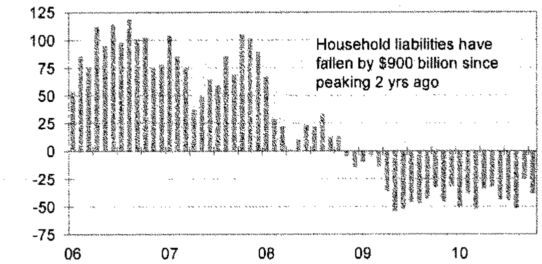
During the housing boom and bubble, households borrowed aggressively, pulling an unprecedented amount of cash from their homes via home-equity borrowing and cash-out refinancing. At the peak of the equity withdrawal in the summer 2006, homeowners were extracting almost 9% of their disposable income in cash from their homes. This compares with about 3% at the start of the decade.[ii]

With the housing crash, homeowners are no longer taking equity out of their homes, and some higher-income households are likely repaying their mortgages more quickly. With deposit rates near zero and returns on other investments uncertain, homeowners could be opting for the sure, if low, return of lowering their mortgage debt.[iii] Supporting this scenario is a relatively high share of recent refinancing deals that involve switching from 30-year mortgages to 15- or even 10-year mortgages.

Even more striking is a reduction in credit card borrowing. According to Equifax, more than 100 million fewer bank cards are in use today than in the summer of 2008, a 25% decline.[iv] With mortgage and card debt falling rapidly, total household liabilities are declining at an unprecedented rate of almost $500 billion annually (see Chart 5).[v]

Chart 5: Deleveraging Is Well Under Way...

Change in household liabilities, $ bil, 3-mo MA

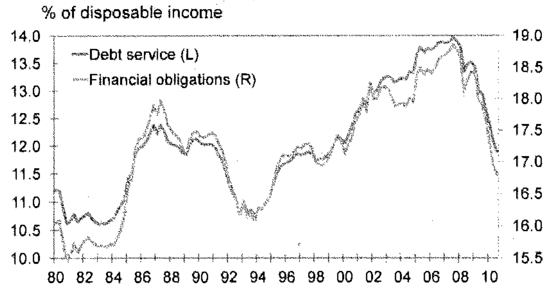


Sources: Equifax, Moody's Analytics

Deleveraging is thus at its apex and expected to slow in the coming year. Key to this view is the plunge in household debt burdens—the share of after-tax income that households must devote to servicing debt to remain current. Falling debt outstanding combined with record low interest rates, and better income gains have pushed the debt service burden down by more than 2 percentage points since it peaked two years ago (see Chart 6). The debt burden has already fallen below its long-run average and will approach a record low by this time next year, even under conservative assumptions regarding further deleveraging, interest rates and income growth.[vi]

Chart 6: ...Pulling Debt Burdens Lower

% of disposable income



Sources: Federal Reserve, BEA, Moody's Analytics

Households are less focused on how much they owe, and more on how much of their cash goes to paying that debt. With debt service burdens easing, households will relax a bit. They will not be releveraging anytime soon, but simply not deleveraging means they will be spending more freely before long.

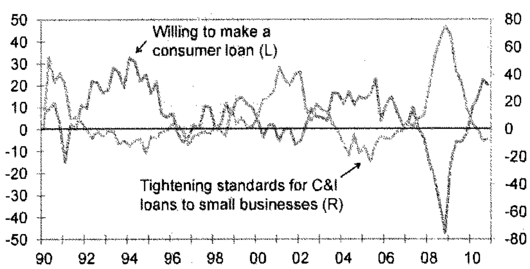
Credit spigot opens

Tight credit has been strangling the economy, but this too will ease in the coming months. Creditors will be persuaded to loosen the credit spigot by improving credit quality and by the financial system's return to profitability. More credit will fuel more spending and investment, particularly by small and midsize companies.

Credit dried up during the financial crisis and Great Recession. Even the highly liquid commercial paper market—a vital source of funding for the bluest-chip multinational corporations—would have turned dry without help from the Federal Reserve at the height of the panic. Lenders to households and smaller businesses all but shut down. The net percentage of senior bank loan officers willing to lend to consumers reached its lowest level since the 1970s, when the Carter administration temporarily imposed credit controls in an attempt to stem inflation. Nearly all loan officers said they were tightening criteria for commercial and industrial loans. (see Chart 7).

Chart 7: The Credit Spigot Is Opening

Net % of senior loan officers...



Source: Federal Reserve Senior Loan Officer Survey

Credit conditions have eased a bit already. The percentage of loan officers willing to lend to consumers is back to levels seen in better times. Lenders are also easing standards for C&I lending, and although standards remain tight, they should loosen soon.[vii]

The conditions necessary for a much more substantial easing in lending standards and better credit flows are largely in place. A large number of first mortgage loans are still in the foreclosure process or likely headed there, but otherwise credit quality is good and improving rapidly. As of October, fewer than 12 million loans (not including first mortgages) were between 30 and 90 days delinquent.[viii] This is down from more than 17 million in early 2009, and the smallest number since the early 1990s. Even early-stage first mortgage delinquency is improving, with 1.7 million loans 30 to 90 days delinquent, down from more than 2.1 million at the peak.

Improving loan quality, wide net-interest margins, and improving investment banking revenue are propelling better bank profits. Commercial banks' returns on assets are still well below their prerecession levels, but have come back strongly from the recession. Big banks are doing particularly well, after the rigorous stress tests in the spring of 2009 that forced institutions to add sufficient capital to insulate against a potential economic depression. While the recession was extraordinarily severe, it was not nearly as bad as envisaged by the stress tests; these institutions are now arguably overcapitalized, at least in aggregate. Many small banks have not been able to raise capital and are still struggling with troubled commercial real estate mortgage and construction loans, but they account for only a very small part of banking system assets.

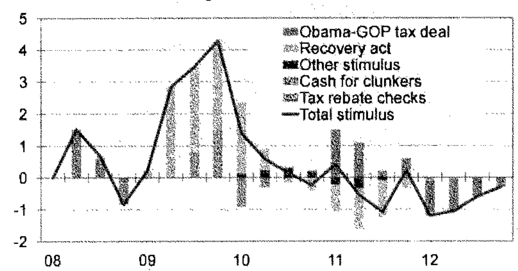
Lending is already showing signs of turning up. New originations for credit cards, auto loans, and consumer finance loans are above year-ago levels for the first time since 2007. This is even the case for borrowers with lower credit scores. The size of credit lines is also growing. Most encouraging is that C&I loans outstanding have finally turned the corner. This is one of the best lagging indicators of the business cycle, historically providing positive proof that the downturn is ending.

More policy support

The December compromise between the Obama administration and congressional Republicans on taxes and government spending adds significantly to growth prospects in 2011. The size and scope of the deal were a surprise; as a result, while fiscal policy still will add little to growth next year, at least it will not create much drag (see Chart 8). The agreement will add approximately a percentage point to real GDP growth in 2011, double expected job growth from 1.3 million to 2.6 million, and reduce unemployment by about a percentage point. Instead of hovering near 10% throughout the year, the jobless rate will fall below 9% by year's end.

Chart 8: Fiscal Stimulus a More Modest Drag

Contribution to real GDP growth, %



Source: Moody's Analytics

Even without the tax deal, the economy would probably have made it through 2011 without falling back into recession, but this compromise improves those odds significantly. It also reduces pressure on the Federal Reserve to engage in more aggressive quantitative easing, which even its most ardent supporters did not expect to substantially boost growth. Quantitative easing has complicated the Fed's dealings with other global central banks, by helping to push up the exchange value of their currencies against the U.S. dollar. It also has inflamed Republican legislators, who claim it will unleash high inflation, or that it constitutes fiscal policy that is outside the Fed's mandate.

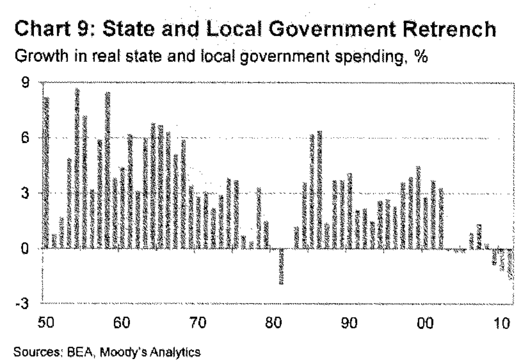
There are some downsides to the tax deal. Congress will make little progress toward reducing the budget deficit in the current fiscal year. The deficit appears set to come in near $1.3 trillion in fiscal 2011, equal to 9% of GDP, about the same as in fiscal 2010. While the impact on long-term interest rates should be limited, there is a risk of backlash by global investors rightly nervous about the U.S. fiscal outlook.

It is also important to note that U.S. economic growth will be lower in 2012 than previously anticipated, as the fiscal drag expected in 2011 is pushed off a year. The economy will end in about the same place by mid-2013 as measured by GDP, jobs, and unemployment. The compromise of tax and spending policies could have also been better designed to maximize economic efficacy. The deal includes a range of tax cuts for households and businesses, some of which pack little bang for the buck.

Local government meltdown

While there are good reasons to be optimistic about the recovery's prospects, the economy is still fragile and many things could still go wrong. Of particular note is that state and local governments are scrambling to close prodigious budget holes. This is despite stiff budget cutting in 2010, which included a quarter-million job cuts, big program reductions, and tax increases. These steps have been necessary even with the $175 billion in increased federal grants-in-aid that states are due to receive as part of the fiscal stimulus.[ix]

Without additional help from Washington, which seems unlikely, federal aid will dry up at the end of the current fiscal year, in June for most states. Nominal state and local government spending will have to remain flat for the remainder of this fiscal year and next if states are to balance their budgets, even assuming tax revenue growth of 6%.[x] This suggests declines in real state and local government spending of almost 2% in calendar year 2011; since World War II, only the 1980 recession year was harder on state and local government budgets (see Chart 9). Accounting for these spending cuts and tax increases and their economic multipliers, state and local governments will be responsible for shaving approximately 0.4 percentage points from real GDP growth in 2011.



This anticipated state and local government drag on growth is serious, but manageable. A string of sizable municipal bond defaults would be unmanageable. Investors are nervously considering this prospect. Muni credit default swap spreads—a measure of the cost of purchasing insurance against a municipal government default—and interest rate spreads between munis and Treasuries are much wider than historical norms.

Odds that a state would default on its debt obligations are remote. The biggest and most hard-pressed states, including California and New York, have graduated income tax systems that produce significant revenue when the economy improves, as it should this year.[xi] States also have low debt loads, and their interest payments account for only a small percentage of their cash flow.

The odds that local governments might default are much higher. While there have been a handful of recent small, local defaults due to mismanagement or fraud, it is not hard to construct scenarios in which defaults spread, given weaker house prices, falling property tax revenues, and mounting pension obligations. It is also not inconceivable that such a wave of defaults could reignite turmoil in financial markets and derail the economy.

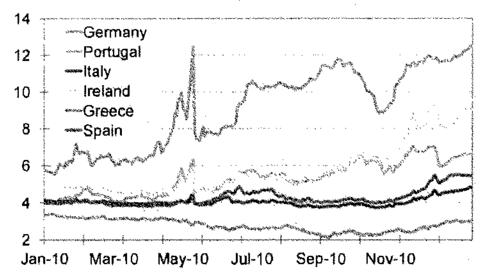
European debt crisis

Another serious worry is the European debt crisis, which has yet to be brought under control. Greece and Ireland have been forced to borrow from a $1 trillion bailout fund established by the European Union and International Monetary Fund, and it appears inevitable that Portugal will have to follow them soon.[xii]

Investors also have questioned Spain's fiscal viability, pushing up yields on that country's sovereign bonds sharply. Ten-year Spanish sovereign bond yields are just under 6%; if rates rise much above this, Spain's debt-servicing costs will be overwhelming (see Chart 10). Rescuing Spain would likely exhaust the bailout fund. Prospects of this are making global investors increasingly edgy, further driving up interest rates in what could become a vicious cycle.

Chart 10: Debt Problems Threaten to Boil Over

10-yr sovereign yields, %



Sources: Bloomberg, Moody's Analytics

To break this cycle, European policymakers—and, more specifically, German and French officials—need to do more. A bailout fund closer to $1.5 trillion is necessary to convince investors they will get back all the money they have invested in European sovereign debt. This may be too much of a financial strain for Europe to credibly handle on its own; thus the IMF may have to ante up more.

The European Central Bank will also have to step up its purchases of troubled sovereign debt. To date, the ECB has purchased close to $100 billion in Greek, Irish and Portuguese bonds, which have kept yields, and thus borrowing costs, down for these nations, but clearly not sufficiently. The ECB may also have to soon purchase the debt of other national governments, including Spain. This will weaken the ECB's balance sheet, but it would be better for the ECB to try to manage this debt than for the fragile European banks and other financial institutions that are now choking on it. The ECB may also have to end its policy of sterilizing bond purchases, although given its criticism of the Federal Reserve's quantitative easing policy, it is likely to do so only under severe duress.

European banks must also be put through substantive stress tests, with transparent results that require the banking system to raise significant new capital. Europe's stress tests last summer were opaque, and little capital was raised. It is clear that the process was woefully inadequate, given that the Irish banking system was all but nationalized just a few months later. Compare this with the U.S. bank stress tests completed in spring 2009, which forced big banks to envision a depression scenario and build capital accordingly. The depression never came, and the U.S. banking system is now well capitalized.

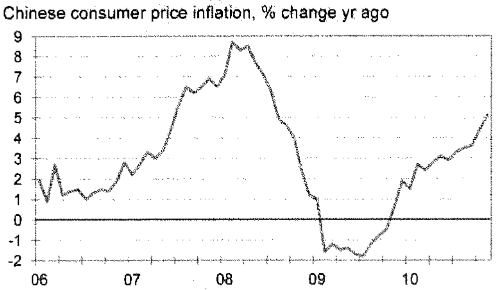
The longer European policymakers resist these steps, the greater the odds that financial turmoil will grow and that the European economy will suffer a double-dip recession, all of which would reverberate on the U.S.

Chinese hard-landing

U.S. growth prospects also depend on a relatively soft landing in key emerging economies, particularly China, where policymakers are working hard to avoid overheating. The Chinese economy was the first to recover from the global recession, and, due in large part to aggressive use of the monetary and fiscal stimulus, its subsequent recovery has been vigorous. China's economy is now operating near or above its capacity, as evidenced by sharply accelerating Chinese inflation (see Chart 11). There is also on-again, off-again nervousness about speculation in the property and equity markets.

Chart 11: China Threatens to Overheat

Chinese consumer price inflation, % change yr ago



Source: National Bureau of Statistics China

Chinese authorities have responded by raising bank reserve requirements, tightening lending standards, and raising interest rates. They also resumed a policy of gradual currency appreciation, letting the yuan rise more than 3% against the dollar since then. Faster appreciation is warranted, since it seems to be the most effective way to both address China's domestic economic challenges and quiet the complaints of its trading partners such as the U.S. Chinese authorities do not see it that way, however, remaining concerned about the impact of faster currency appreciation on their export-oriented economy.

Other emerging economies have allowed market forces to push up their currencies' values more quickly, with benign effects so far. Chile, India, Indonesia and Turkey are good examples of nations successfully following this policy approach. But this has not convinced the Chinese.

While China will likely pull off a soft landing despite its currency policy, it might not be as graceful as hoped. A hard landing seems unlikely, given the country's massive international reserves, which could be used to finance another huge dose of fiscal stimulus, but even a bumpy landing could cause significant problems. Many commodity-producing emerging economies would struggle, given the likely drop in global commodity prices—Chinese demand for everything from oil to copper and soybeans is pushing prices higher. Developed economies, including the U.S., would also suffer, given how important the emerging world has become as an export market and the fallout this would have on global equity markets.

Foreclosure crisis

Ground zero for the financial panic and Great Recession was the housing crash. Since the real estate bubble burst nearly five years ago, residential construction has fallen to pre- World War II levels, house prices have plunged more than 30%, and nearly 5 million households have lost homes through foreclosure or short sales.[xiii] While there are good reasons to believe that the housing market will bottom out this year, there are also good reasons to be nervous that the crash will continue. Most worrisome is the ongoing foreclosure crisis and prospects for more house price declines.

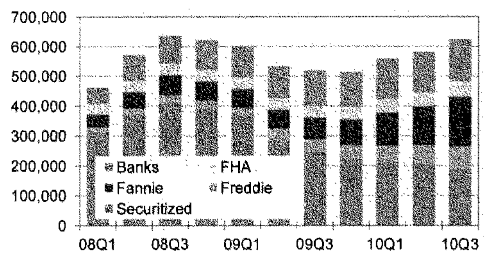
With more than 4 million first mortgage loans in the foreclosure process or likely to default, distressed properties will account for an increasing proportion of total home sales in coming months.[xiv] Loan modification efforts, including the government's HAMP plan and private plans, will be helpful in reducing the number of distress sales, but even so, the share of such sales will rise and house prices will fall.[xv]

The same vicious cycle that plagued the economy during the recession threatens to be reignited, with house price declines pushing more homeowners underwater and precipitating more defaults, which drive prices lower still. An estimated 14 million homeowners are already underwater, with far more than half owing more than 20% above their homes' market values.[xvi] Beyond this threshold, many more homeowners decide strategically to default rather than continue to make mortgage payments with little prospect of ever rebuilding equity.

The number of repossessed properties classed as "real-estate owned" by banks, the last stage before they are resold, is also rising, even though they had already reached levels similar to those seen in late 2008, when house prices were plunging (see Chart 12). Mortgage owners appear increasingly interested in pushing distressed loans into foreclosure and resale, regardless of the prices they are receiving. This is a big change from a year ago, when mortgage owners were slowing foreclosures because of uncertainty regarding the amount of capital they would need to digest their credit problems.

Chart 12: REO Inventory Is Building Again

REO inventory



Sources: Fannie, Freddie, FHA, Moody's

Nothing works well in the economy when house prices are falling; the home remains the most important asset for most households and a key source of collateral for many small businesses seeking credit. The fallout on the financial system and broader economy could be serious if house prices decline much more.

Housing policy proposals

Policymakers can take a number of steps to further mitigate the severity of the foreclosure crisis and the serious threat this poses to the housing market and economic recovery. These policy steps include:

1) *Revitalize the HARP refinancing program, which allows Fannie Mae and Freddie Mac to refinance underwater mortgage loans that they own and insure.*[xvii]

With mortgage rates near record lows, millions of American homeowners could save money by refinancing their home loans. Such savings would not only give individual households a little extra to spend each month after meeting their financial obligations, but it could also offer the struggling U.S. economy a quick boost.

One reason homeowners are not doing so is that mortgage lenders are withholding their best interest rates from potential refinancers whose credit scores and home equity have eroded, even if their mortgage payments are current. Fannie Mae and Freddie Mac—the huge mortgage finance institutions that failed in 2008 and now are wards of the federal government—appear to be emulating the private lenders. This is significant, because Fannie and Freddie own and insure about half the nation's outstanding mortgage loans.

Jump-starting HARP could be straightforward: simply require Fannie and Freddie not to charge add-on rates, even for refinancing borrowers who have lost a lot of equity or have relatively low credit scores. Keep in mind that Fannie and Freddie already bear the credit risk on these loans; anything that makes it easier for borrowers to pay their mortgages on time and avoid default will reduce the agencies' ultimate cost.

Even borrowers in an early stage of delinquency may benefit from a HARP refinancing, although many of them likely have other financial problems that make loan modification or some other foreclosure mitigation the more prudent choice. But refinancing may help. Under current rules, borrowers who refinance under HARP are then ineligible for loan modification through the government. This restriction should be eliminated.

2) *Change the foreclosure process to include a third-party review prior to foreclosure, end the dual track that continues foreclosure while loan modifications are under way, provide homeowners with a single point of access when pursuing loan modifications, and establish a fund financed by the mortgage industry to compensate homeowners treated improperly in the foreclosure process.*

The loan modification and foreclosure processes have worked very poorly throughout the housing crash. Mortgage servicers have been inadequately staffed to address the massive number of loan problems, significantly delaying the process and resulting in serious errors. The affidavit-signing scandals have been only the most recent example of these problems. The implementation of a wide range of government-designed programs to help facilitate loan modifications, refinancings and short sales has not gone well because of their extraordinary complexity, the fact that they have changed a number of times, and the inadequate resources devoted by the mortgage servicers. Many distressed homeowners have been very frustrated and poorly treated by the mix-ups and mistakes.

To address these process problems, a third-party review system should be established to help homeowners navigate the loan modification and foreclosure process. An independent reviewer would help distressed homeowners determine the various options open to them and to work with their servicer to ensure that the process is working properly. This would also help ensure that the homeowners' legal rights are being respected.

Mortgage servicers should also be required to end the practice of dual-tracking homeowners: considering their loan for a modification while at the same time moving forward with a foreclosure. This has created significant confusion, as homeowners negotiating a loan modification with a servicer have also received foreclosure notices. At times it appears that different departments within the same financial institution have been working at cross purposes. All loans should be considered for a modification first, and the foreclosure process should remain on hold until it is certain that a modification will not work.

Homeowners have also had significant difficulty in communicating with mortgage servicers. Homeowners are often confused over what documents and other information they are required to provide servicers, and these documents are often lost and must be sent multiple times. To address this problem, mortgage servicers should be required to provide homeowners with one point of contact in their organization who is responsible for shepherding the homeowner through the modification and foreclosure process.

FDIC Chairwoman Sheila Bair has also proposed establishing a fund financed by the mortgage industry to compensate homeowners who have been wronged by the foreclosure and modification process.[xviii] This will provide a stronger incentive to the industry to make sure the process is working properly and fairly.

3) *Expand the FHA short refinancing program to include delinquent mortgage loans and loans owned and insured by Fannie Mae and Freddie Mac.*

Loan modifications that include some form of principal write-down have been shown to be particularly effective in keeping homeowners in their homes. To date, the numbers of these kind of modifications have been very limited. Policymakers have devised programs to provide incentives to mortgage servicers and mortgage owners to engage in such modifications, but so far they have not proved successful.

A more recent such program is the FHA short refinance program. It is designed for borrowers who are current on their loans and owe more than their properties are worth. Borrowers must meet all FHA underwriting guidelines. Loans already backed by the FHA cannot participate. Fannie and Freddie are not participating (though they have their own programs, including HARP).

If a borrower owes more than the property is worth, the lender and servicer must agree to reduce the loan balance by at least 10% so that the new loan is no more than 97.75% of the home's current value. If they are willing to take the loss, the borrower must agree to refinance into an FHA-backed loan at the current interest rate.

If the borrower holds a second mortgage, the combined loan-to-value ratio must be less than 115%. The second-lien holder must agree to the refinance, and if the combined LTV exceeds 115%, either the first- or second-lien holder (or both) will need to reduce the loan balance further. The government will make some incentive payments for second-lien holders that reduce principal.

While still early, the program has not gotten off to a very good start. This could be addressed by expanding the program to include loans that are delinquent. Mortgage owners are reluctant to engage in modifications that involve a reduction in principal unless the homeowner is unable to make the mortgage payments. In most cases, this is not clear until the homeowner is in delinquency. Allowing delinquent loans to be considered for the program may allow for more such modifications.

4) *Begin the arduous reform of the nation's mortgage finance system.*

Washington is gearing up for its next epic policy debate: what to do about Fannie Mae and Freddie Mac. The federal government created the two mortgage behemoths decades ago and then took them over as the financial system unraveled in 2008. What policymakers decide will determine how high mortgage rates go in the future, how easy it will be to obtain a home loan, and whether the popular 30-year fixed-rate mortgage continues to exist.

No one wants to return to the situation that existed just before the financial crisis. Fannie and Freddie had evolved into odd combinations of public and private; profit-maximizing, shareholder-owned companies with unique charters and implicit—but never clearly spelled out—federal backing. Each could thus borrow more cheaply than other financial institutions could, and both used that advantage to earn rich profits investing in higher-yielding mortgages. Fannie and Freddie were also allowed to operate with very thin capital cushions to protect them if their investments went bad.

There was a political quid pro quo for these advantages: Fannie and Freddie had to give a significant share of their mortgage loans to lower-income homeowners and members of disadvantaged groups. It was not a bad goal, although it was probably taken too far, and the nation clearly paid a high price for it. Of all the federal government's bailouts during the financial panic, those of Fannie and Freddie will cost taxpayers the most—almost $150 billion. Rescuing Detroit's automakers, by comparison, cost about $15 billion, while the bank bailouts actually resulted in a net gain for taxpayers.

One solution to the Fannie and Freddie problem is to formally and permanently make them part of the federal government. The chief benefit: a guaranteed steady flow of credit, at reasonable rates, in both good and bad economic times.

But nationalizing Fannie and Freddie would saddle the government with significant new risks, as well as with the institutions' debts, which would add to an already-mountainous federal debt load. In the long run, such a system could also stifle innovation, while tempting lawmakers to subsidize mortgages for favored constituents, distorting a huge part of the U.S. economy.

Another solution would be to take the opposite approach—that is, full privatization. Allow no government backstop for the mortgage market, either implicit or explicit. Government might retain a small role, but Fannie's and Freddie's operations would be spun out to the private market.

A privatized system would give all parties more incentive to be prudent. Mortgage originators, issuers of mortgage-backed securities, rating agencies, and investors would all suffer if they made bad decisions. Nobody would be too big to fail, and taxpayers would be off the hook—at least in theory.

But full privatization probably works better in theory than it would in practice. Whatever legislators pledged never to do, global investors assume the U.S. government would rescue the housing market in a crisis. Meanwhile, a privatized mortgage finance system would significantly raise costs for borrowers and would be a much less reliable source of credit.

Privatization would also endanger the 30-year fixed-rate mortgage, a bedrock of home lending since the Great Depression. Such loans are practically unique to America; nearly everywhere else, homeowners can obtain only adjustable-rate mortgages, with monthly payments fixed only for specified short periods. But because they are risky for banks and difficult to manage, long-term fixed-rate mortgages will almost certainly disappear without some form of continuing federal support.

Fortunately, there is a middle way between nationalization and privatization. A hybrid mortgage finance system would allow private institutions and the federal government to share the risks. Such a system holds the most promise for delivering consistent, affordable mortgage loans on prudent terms to borrowers, with minimal costs to taxpayers.

In a hybrid system, some of Fannie's and Freddie's operations would be turned over to the private market, while others would be transferred to the government. Instead of the market-distorting implicit government support for Fannie and Freddie, the government would offer insurance at an explicit price. The hidden cost of Fannie's and Freddie's subsidies to homeowners would also be made visible on the government's books. Private institutions would provide the bulk of the system's capital and would also originate and own the mortgages. The federal government would insure the system against catastrophe, regulate it, and clearly spell out whatever subsidies are given to low-income families or others.

A hybrid system would preserve the benefits of both nationalization and full privatization. Investors would remain on the hook for most losses, keeping incentives in place for prudent lending and risk pricing. The government's involvement, however, would keep mortgage rates lower and help credit flow freely, especially during difficult times.

Decisions made in coming months about the future of Fannie and Freddie will affect homeowners and the economy for decades. Success will depend on striking the appropriate balance between the benefits of the private market and the backstop of the federal government. Finding the right balance will result in a stronger housing market, a more stable financial system, and a healthier economy.

Conclusions

After three lean years of recession and weak recovery, the coming year is shaping up to be much better for the U.S. economy. The wrongs that undermined the financial system and economy are slowly being righted; households are deleveraging, banks are recapitalizing, and government budget gaps, while still yawning, are finally narrowing. It will take years to work through all the mistakes that generated the financial panic and Great Recession and even longer to pay for cleaning it up, but clear progress is being made.

U.S. businesses are also in excellent financial shape. Big and midsize firms in particular are highly profitable, and their balance sheets could not be much better. Corporate executives have been reluctant to invest and hire more aggressively, but that seems set to change soon. The nightmare of the Great Recession will not be forgotten for a generation or two, but its psychological sting is fading. The policy uncertainty that may have frozen corporate decision-making will also abate, as no major new policy initiatives seem likely soon. Unless businesses begin to expand, they will be hard-pressed to maintain earnings growth that is acceptable to their shareholders.

There are substantive threats to this optimism. It is hard to get too excited as long as house prices keep falling, which seems inevitable, given the bulge of properties in the foreclosure pipeline moving toward distress sales. The tough budget and tax decisions being made in state and local government offices across the country will be a major drag, dampening enthusiasm. Europe's efforts to solve its debt woes and China's attempt at a soft landing may also not stick to script. Moreover, even under the best of circumstances, unemployment will remain painfully high, and Americans' nest eggs will be much smaller than before the crisis.

Still, while the economy is not guaranteed to meet our optimistic expectations, these increasingly seem a good bet, particularly if policymakers remain aggressive in supporting the economy until it is clear that it is off and running.

[i] This is based on the Federal Reserve's Flow of Funds data. Short-term corporate liabilities include all liabilities that come due within one year.

[ii] California homeowners were the most profligate, taking out equity closer to a fifth of income at the peak; Central Valley homeowners withdrew almost a third of their income. These are Moody's Analytics estimates based on data from the Federal Reserve and Equifax.

[iii] For the average homeowner, the after-tax rate on a mortgage is just above 5%.

[iv] The number of bankcards outstanding has collapsed from a peak of 435 million in the summer of 2008 to 327 million currently.

[v] This is despite steady growth in student loans outstanding and a recent increase in auto debt.

[vi] The financial obligation ratio—a broader measure of obligations which also includes rent, property taxes, homeowners' insurance and lease payments—tells a similar story.

[vii] The Federal Reserve's quarterly survey asks senior loan officers whether they have eased or tightened underwriting since the last quarter. In recent surveys, more officers have reported easing than tightening after several years of substantial movement in the other direction. This suggests standards are easing, even if they remain tight by historical standards.

[viii] This is based on seasonally adjusted Equifax credit file data. Lower delinquency is also reflected in improving average credit scores.

[ix] The increased federal grants-in-aid have taken many forms, including additional monies for Medicaid, educational and unemployment insurance expenses, and infrastructure spending.

[x] State and local tax revenue growth has been more or less consistent with nominal GDP growth over the past 40 years. Tax revenue growth is expected to be somewhat stronger than nominal GDP growth in 2011 and 2012 due to some further modest tax increases.

[xi] The troubled state of Illinois and its low flat income tax is a notable exception.

[xii] The European Financial Stability Fund (EFSF) established in May 2010 by all 27 member states of the European Union and IMF, can issue debt to provide loans to euro zone countries in financial trouble.

[xiii] This is based on the Fiserv Case-Shiller national house price index. This index includes distress sales, which are generally sold at a large discount to nondistress sales. The Moody's Analytics estimate of lost homes is based on Equifax, RealtyTrac and Realtors data.

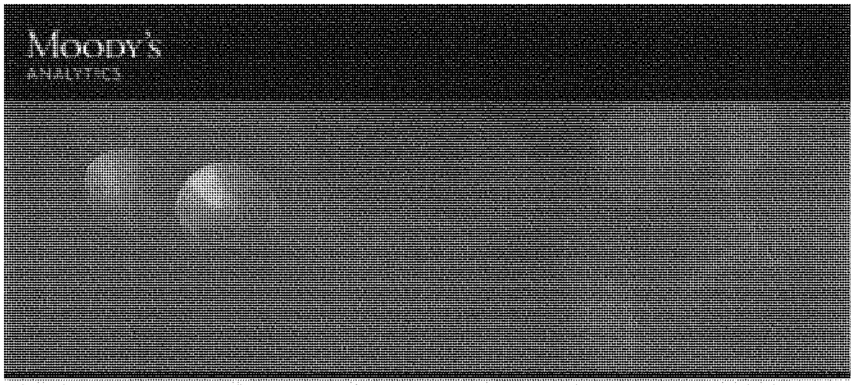
[xiv] According to Equifax credit file data, there are just over 51 million first mortgage loans outstanding.

[xv] There will be approximately 1.75 million first mortgage loan modifications in 2010, including about 500,000 HAMP modifications and 1.25 million private modifications.

[xvi] The estimate of 14 million negative-equity homeowners is based on Equifax credit file and Case-Shiller house price data and is measurably greater than the commonly used estimate from Core Logic of closer to 11 million. The Moody's Analytics estimate of negative-equity homeowners is nearly the same as Core Logic's in California, much lower in Florida, and higher most everywhere else. A possible explanation for the difference is the difficulty Core Logic may have in measuring mortgage debt in rural areas, where homeowners generally see little equity appreciation even in good times (as house prices never rise much) and assume small negative equity positions in difficult times. The Moody's Analytics estimates are much higher in Texas, for example. Core Logic also does not have data for a half-dozen small states.

[xvii] See "Restringing HARP," Mark Zandi and Cris DeRitis, Moody's Analytics special report, October 10, 2010.

[xviii] This idea was articulated in a January 19, 2011 speech to the Mortgage Bankers Association. See http://www.fdic.gov/news/news/speeches/chairman/spjan1911.html

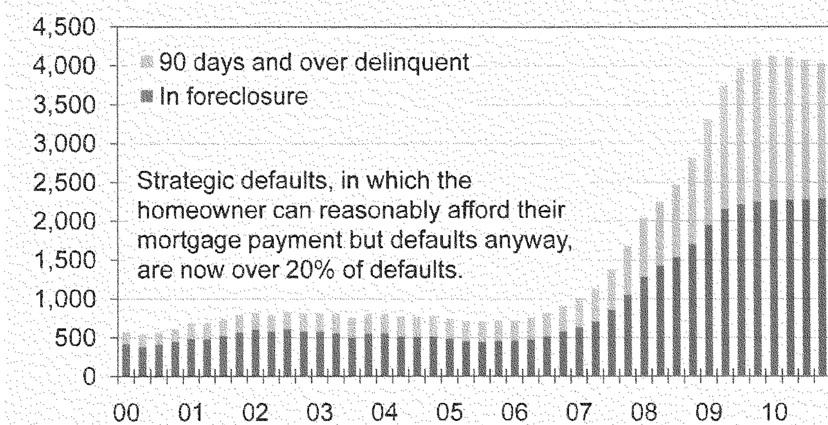


The Foreclosure Threat

MARK ZANDI, CHIEF ECONOMIST

Foreclosure Crisis Continues On...

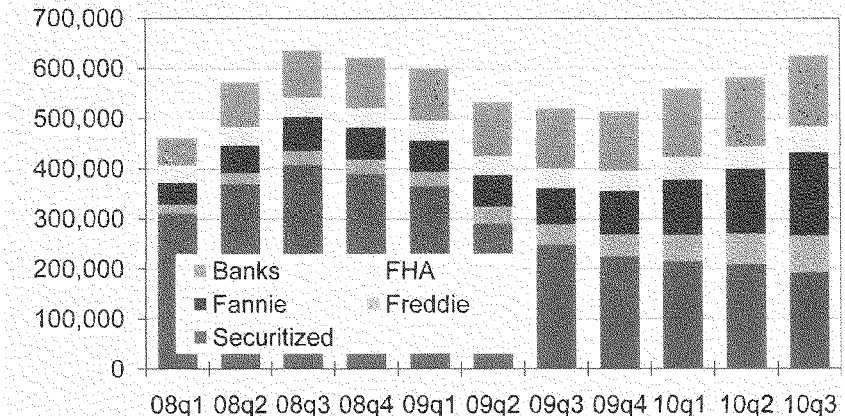
First mortgage loans, ths



Sources: Equifax, Moody's Analytics

...REO Inventory is Building Again...

REO Inventory

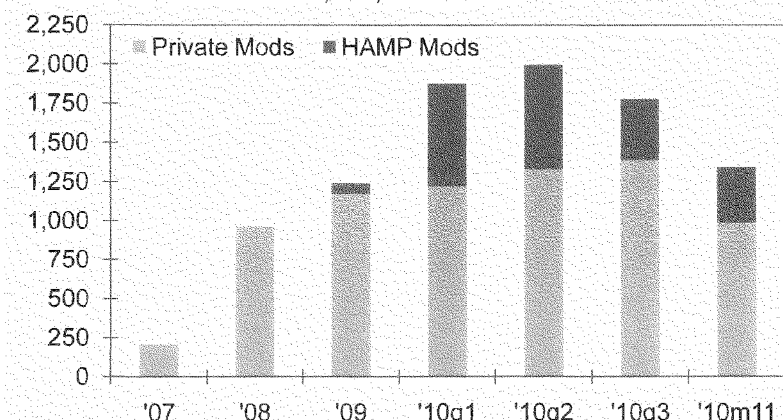


Sources: Fannie, Freddie, FHA, FDIC, Moody's Analytics

MOODY'S ANALYTICS

...Modification Efforts Have Been Inadequate...

Permanent modifications, ths, annualized

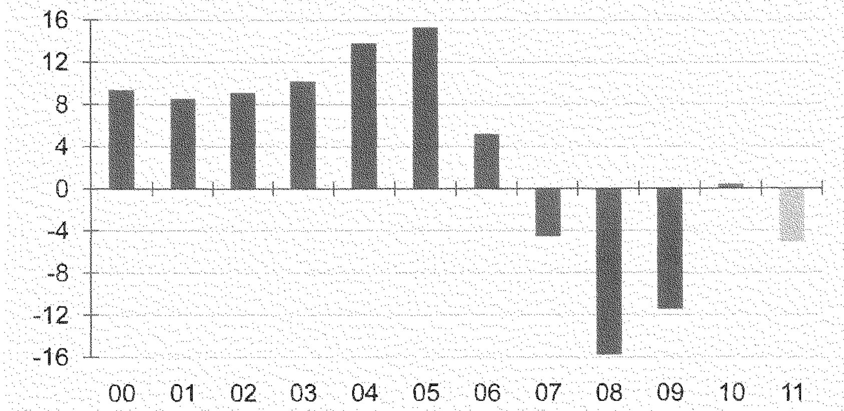


Sources: Hope Now, Moody's Analytics

MOODY'S ANALYTICS

...and More House Price Declines are Coming...

Case Shiller® Home Price Index: 2000Q1=100, % change year ago

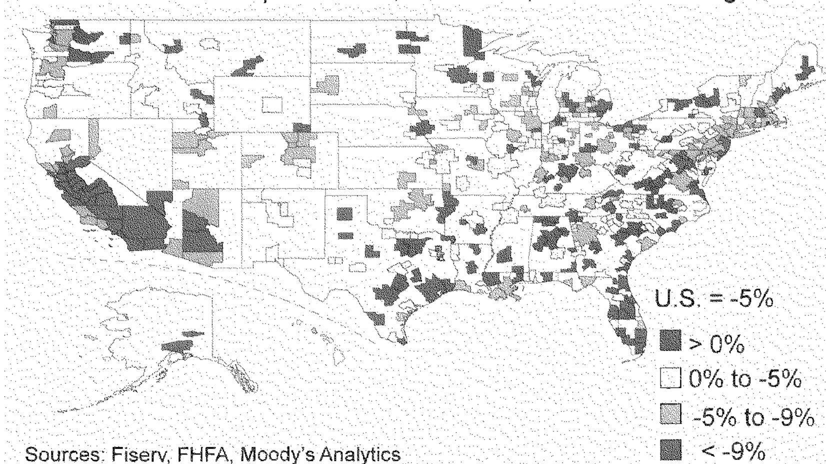


Sources: Fiserv, Moody's Analytics

MOODY'S ANALYTICS

...in These Metro Areas

Case-Shiller house price index, % decline, 2010Q3 to trough



Sources: Fiserv, FHFA, Moody's Analytics

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Chairman CONRAD. Well, this has been very useful. You have given us a lot of good ideas in a very short period of time.

Senator Sessions is now here. I was explaining the National Prayer Breakfast was this morning, and that was running long.

Senator SESSIONS. Yes.

Chairman CONRAD. Would you want to make your statement at this point, or would you prefer that we continue with witnesses? What is your preference?

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. I will just briefly say thank you for the hearing. I thank the witnesses for being here. We did have a good breakfast this morning. The President spoke eloquently, as he usually does. And I guess I have given him a hard time lately about not leading on the budget, and I think that was a valid criticism, but we all have some challenges. We have to be honest about it and see how we can work our way through this deficit cycle, and I appreciate the insights each of you bring to the key issues that face us.

Mr. Chairman, we have had a lot of hearings this week. This is the third one this week. I believe you are correct to push us because these are critical issues facing the country. We do not have time to put off decisionmaking, and it is well that we are moving forward, and I support your strong leadership.

Chairman CONRAD. I thank you so much, Senator Sessions. I appreciate you being a partner in this effort to really get serious about our deficit and debt.

This morning, we really are focusing on these special areas: State debt, housing crunch, long-term unemployment, these special challenges to the economy and what could be done.

We will now go to Dr. von Wachter for your testimony. Dr. von Wachter, Associate Professor of Economics at Columbia.

STATEMENT OF TILL VON WACHTER, PH.D., ASSOCIATE PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY

Mr. VON WACHTER. Chairman Conrad, Ranking Member Sessions, it is a great honor to be with you today. I am going to read my testimony, but feel free to ask any questions at any moment in time.

Unless we see an unprecedented job growth in the near future, our best available estimates, as we have seen earlier, suggest the process of reintegrating the large number of unemployed into employment is going to be very long lasting and gradual. During this process, many individuals are at risk of permanently leaving the labor force. Those most likely to drop out are older, partially disabled, and less educated workers. This development is potentially costly for society, since these workers, while able to work, do not pay taxes, are more likely to draw Social Security benefits early, or enter costly programs, such as Federal disability insurance.

Moreover, in the process of searching for jobs, many workers are likely to exhaust unemployment insurance benefits. It is well known that upon exhaustion of unemployment insurance benefits, families' consumption falls and the incidence of poverty rises. Moreover, only a very limited fraction of individuals exhausting UI actually find a job.

Upon finding a job, for those who do, experience from previous large recessions has suggested earnings of laid-off workers are substantially lower. For example, the average mature worker losing a stable job with a good employer in the last big recession saw earnings reduction of 20 percent lasting 15 to 20 years. So there seems to be a permanent decline in earnings of job losers.

And during this period of earnings decline, job losers can also experience a decline in health. So in severe downturns in the past, these health declines have led to significant reductions in life expectancy of one to 1.5 years.

The effects of unemployment and job loss are also felt by workers' children, who can suffer from the consequences even as adults and by their families. Similarly, evidence from past recessions suggests that entering the labor force in a large recession such as this one can lead to reduced earnings for young workers for ten to 15 years.

Now, the rest of my comments will focus on government policies that I think can reduce the impact of extended joblessness on both affected individuals and possibly on government finances. So my recommendations fall into the following four areas.

My first recommendation, and this is not news, to extend unemployment insurance benefits for those who are about to exhaust. On the one hand, extensions of unemployment insurance benefits prevent large declines in consumption for the substantial number of workers who are at risk of exhausting benefits. On the other hand, research implies that the negative effects of extending unemployment insurance benefits on employment are not that large in a large recession such as this one. So on balance, if you count the benefits for those workers who are about to exhaust benefits and the cost to society for lower unemployment, the net suggests that extending UI benefits in recessions are likely to outweigh the costs.

Extension——

Senator SESSIONS. Extensions are raising benefits. The phrase "unemployment benefits"——

Mr. VON WACHTER. Say that again?

Senator SESSIONS. Your written remarks said that raising unemployment insurance. Does that mean raising the amount received or extending the time that they are received?

Mr. VON WACHTER. Thank you, Senator Sessions, for clarifying. I mean extending the time, not the amount of benefits. So my research is focused on the typical policy, which is extensions and the durations, and what this means is that you target those workers who are really at the risk of going to zero after exhausting, not the workers who have already benefits and then would consume more.

Now, one added advantage of extending the duration of benefits is that it can prevent some of those individuals who are at risk of permanently leaving the labor force from doing so and possibly apply for disability insurance or claim Social Security benefits. Now, these possible cost savings should be incorporated into the calculations of the overall costs of UI extensions, and the available approximations we have suggests that cost savings from UI extensions through these channels could be substantial. However, although the exact quantifications of these mechanisms is in principle possible using available data, this data is currently not available to researchers. So we cannot really exactly say, tell you how much we would save in terms of Social Security benefits or disability payments by extending UI, but we could.

My second policy recommendation is the need to prepare an exit strategy for unemployment insurance recipients once the labor market shows signs of recovery, and there are several policies that have been evaluated within the current UI system that seem to be cost effective. These policies would make sure that once the labor market improves, both the unemployed would benefit and also the finances of the unemployment insurance system would benefit.

One of these mechanisms is job search assistance, and job search assistance has been widely shown to be very cost effective and efficient in getting workers back to employment, and this is very helpful because searching for a job in environments such as this one is very time consuming and also frustrating and uncertain, because many individuals do not know where the economy is leading. Now, we all do not know where the economy is leading, but there is a lot of potential information that can be provided to workers in this long and time consuming process, starting with that it is a long and time consuming process. If workers want to go back to work at the level that is not too low in terms of earnings, they really have to do a lot of work and stay in the game of searching for five to 10 years.

Now, research has also suggested that the current infrastructures of one-stop shopping or career centers could be improved and extended. So we have a system in place that could provide services to workers, but it could do a better job, and we can talk about what fixes have been proposed.

Another typical suggestion is that workers could be trained, and not all training programs work as well as others, and so finding out which training programs really work and then advising workers what training programs to take is a really important step. And again, I think the data is there to evaluate these training programs, but not all of it is available to researchers.

For some workers, a long period of time may elapse before finding a job, and especially for those workers on unemployment insurance, providing them with bonuses to find jobs might actually be cost saving from the point of view of the unemployment insurance system. Workers may have lost touch with the labor market, lost touch with what they can expect in the new labor market, may search for too long, and providing them incentives to take the job earlier may be cost savings. And if these incentives are targeted to the workers who are most likely to exhaust benefits, they have been shown to be cost effective.

Now, although these mechanisms to help workers to find a job help raise employment, at least that is what our past experiences say, none of these mechanisms have been shown to actually help reduce the earnings loss of job losers, meaning even once workers find a job, partly because of these programs, because of the economy recovery, their earnings will be lower for a very long time.

And so a recommendation I have made before—that is my third recommendation—it is worth considering trying to reduce the massive amount of layoffs that we have seen in this recession in the future, and there is a program in place to do that that is called work sharing, and 17 States have work sharing, but it is currently underutilized. It is partly underutilized because it is not a very generous system, partly because it is not well known. And more research into how we could prevent such costly layoffs in the future is very useful.

My fourth recommendation concerns assistance for those who are unlucky enough to be looking for a job for the first time in this recession. One way to help those workers who are bound for college is to provide financial aid. Financial aid can be an important buffer against labor market shocks that affect parental income or students' own ability to work while in school. But it turns out that not all eligible students apply for the aid that they could have, and current research suggests that reducing the complexity of financial aid and informing or even assisting students with applications will probably raise the take-up of financial aid and raise college attendance.

And another concern which I only touch on briefly is that many resources available for low-income college students are provided at the State level. This is subsidized community college or merit scholarships. And these resources are at risk as State budgets are being cut, and so it is worth considering how one could maintain these resources for young college graduates at the risk of dropping out.

Let me just conclude. Something could also be done for those young individuals not bound for college. In particular, recent research has shown that sectoral training programs—these are relatively small programs in which the program cooperates with an employer to find out what type of training is needed—these programs have been evaluated in randomized studies and have been shown to be very effective in placing young workers into jobs.

An alternative, of course, is to encourage the use of financial aid, such as Pell Grants, to send individuals to private institutions, private vocational schools, and that has been a tremendous growth area in the past. But again, we know very little how these private colleges and private vocational programs really affect workers' earnings outcomes later. And so mandating scientific evaluations of the returns of private schools receiving Federal funding through financial aid would be a useful policy.

To conclude, job loss and unemployment during severe recessions, such as this one, can impose substantial and long-lasting costs on affected workers, their families, in terms of earnings, health, and other outcomes. This testimony has focused on potentially cost effective ways to alleviate the burden for these workers. It is also recommending making data and information available to allow researchers to give a better assessment of the full costs and benefits of these programs. Thank you.

[The prepared statement of Mr. von Wachter follows:]

Testimony before the Budget Committee
"Challenges for the U.S. Economic Recovery"

February 3rd 2011

Till von Wachter
Associate Professor of Economics
Columbia University

Chairman Conrad, Ranking Member Sessions, and distinguished members of the Budget Committee, it is an honor to be with you today. Since the beginning of 2008, millions of individuals have lost their jobs through no fault of their own. Even though growth in domestic product has started to rise again, the situation in the labor market remains difficult. Measures of the rate of underemployment are still above 15%, and an unusually large number of job losers has been unemployed for over six months.[1] Unless we see unprecedented job growth in the near future, available estimates suggest the process of reintegrating these workers into employment is going to be long-lasting and gradual.

During this process, many individuals are at risk of permanently leaving the labor force. Those most likely to drop out are older workers, partially disabled workers, and less educated workers. This development is potentially costly for society, since these workers, while able to work, do not pay income taxes, are more likely to draw Social Security benefits early, or enter costly programs such as Social Security Disability Insurance (SSDI). In the process of searching for jobs, many workers are likely to exhaust unemployment insurance (UI) benefits. It is well known that upon exhaustion, families' consumption falls, and the incidence of poverty rises.[2] This effect is particularly large for single earner families with children. On the other hand, only a limited fraction of individuals exhausting UI benefits actually find a job.[3]

Upon finding a job for those who do, experience from previous large recessions suggests that earnings of laid off workers are substantially lower. The average mature worker losing a stable

[1] E.g., Congressional Budget Office (2010b), Bureau of Labor Statistics (2011).
[2] E.g., Gruber (1997), Congressional Budget Office (2004).
[3] Card, Chetty, and Weber (2007).

job at a good employer will see earnings reductions of 20% lasting over 15-20 years.[4] While these earnings losses vary somewhat among demographic groups or industries, no group in the labor market is exempt from significant and long lasting costs of job loss.[5] A job loss is also typically followed by an extended period of instability of employment and earnings.[6] During this period, job losers can also experience declines in health. In severe downturns, these health declines can lead to significant reductions in life expectancy of 1 to 1.5 years.[7]

The effects of unemployment and job loss are also felt by workers' children, who can suffer from the consequences even as adults, and by their families.[8] Young adults entering college with lower financial support from their families are at risk of not completing their studies. In the current labor market, these students also face fewer opportunities to finance their studies by part-time employment, further raising the risk of dropping out of college.[9]

More generally, evidence from past recessions suggests that entering the labor market in a recession can have long-lasting consequences for young workers. Entering the labor market in a large recession such as the current one can lead to reduced earnings for up to 10 to 15 years. These effects differ by education group.[10] In the short run, lower educated workers experience larger increases in unemployment than more educated labor market entrants. However, in the long run less educated individuals tend to recover faster, as do individuals at the top of the education distribution. It is workers in the middle of the education distribution that can suffer near permanent earnings consequences from entering the labor market in a recession.

Large-scale layoffs and persistent unemployment have wide-reaching consequences for

[4] Jacobson, Lalonde, and Sullivan (1993) and von Wachter, Song, and Manchester (2009) show the long-term earnings losses of laid-off workers during the 1982 recession in Pennsylvania and the U.S., respectively.
[5] Farber (2005) provides estimates of the short-term costs of job loss for the U.S. over the past two decades. Schoeni and Dardia (2003), von Wachter, Handwerker, and Hildreth (2008), Couch and Placzek (2010), and Kodrzycki (2007) show medium run estimates for California, California, Connecticut and Massachusetts in the 1990s.
[6] See, e.g., Stevens (1997) and von Wachter, Song, and Manchester (2009).
[7] Sullivan and von Wachter (2009) estimate the short- and long-term effects of lay-off on mortality. Burgard, Brand, and House (2007) give an overview of other health effects of job loss and unemployment.
[8] Stevens and Schaller (2009) and Oreopoulos, Page, and Stevens (2008) provide evidence that layoff affects children's test scores and adult earnings, respectively. Del Bono, Weber, and Winter-Ebmer (2008) show that layoff affects fertility rates.
[9] The fraction of workers working while in college has been increasing (e.g., Scott-Clayton 2007). However, there is no evidence that this work provides a return later in the labor market (Hotz, Xu, Tienda, and Ahituv 2002), suggesting that this work partly finances school attendance.
[10] Oreopoulos, von Wachter, and Heisz (2008) and Kondo (2008).

affected workers and their families, but also for expenditures on many government programs. Government policies can help reduce the impact of extended joblessness on laid off workers and their families, as well as mitigate the potential impact on government finances. My recommendations fall in four areas, comprising extensions in durations of unemployment insurance benefits; development of an 'exit strategy' for the long-term unemployed; prevention of layoffs; and assistance to young labor market entrants.

My first policy recommendation is to extend and potentially reform unemployment insurance (UI) benefits. On the one hand, extensions of unemployment insurance have been shown to prevent large declines in consumption for the substantial number of workers at risk of exhausting their benefits. Thereby, UI extensions can also provide a degree of demand stabilization.[11] On the other hand, recent research suggests that the negative effects of extending UI benefits on employment are likely to be smaller in recessions. Similarly, there is evidence neither that individuals use UI extensions to take jobs with higher wages, nor that wages decline for long-term UI recipients.[12] For these reasons, our calculations suggest that the benefits of extending UI benefits in recessions are likely to outweigh the costs.[13]

Extensions in UI duration can also prevent individuals who are at risk of dropping out of the labor force from entering more costly government programs such as Social Security Disability Insurance (SSDI) or to claim Social Security benefits early. Thus, these extensions could imply cost savings for the Social Security trust fund that should be incorporated into calculations of the budgetary effect of UI extensions. However, the exact quantification of these mechanism is in principle possible, but the available data is current not accessible to researchers. Further

[11] Congressional Budget Office (2008, 2010a) summarizes evidence that spending through unemployment insurance is an efficient means to provide economic stimulus

[12] Schmieder, von Wachter, and Bender (2011) show how slack aggregate labor market conditions, externalities from reduced search, and the fact that take-up of UI is imperfect in the United States is likely to reduce the effect of UI extensions on labor supply. In addition, recent research suggests that a sizeable part of the decline in employment may not due to the distortion in work incentives, but due to the presence of individuals facing credit constraints (Chetty 2008). If this is the case, not all of the employment effects of UI represent a distortion, but may be a sign that UI helps to alleviate credit constraints that prevent individuals to self-insure against unemployment shocks.

[13] Schmieder, von Wachter, and Bender (2011) present estimates of the effect of UI extensions in recessions and welfare calculations based on data from Germany. The German case is helpful since unlike in the United States UI durations are not a function of labor market conditions, ensuring that estimates reflect causality from UI to non-employment durations, and not vice versa. The study also presents approximate calculations based on the United States, which are similar. These calculations do not take into account the potential beneficial effect on demand stabilization. As argued in Landais, Michaillat, and Saez (2010) it also assumes that any adverse effect on job creation is negligible in a slack labor market.

extensions in UI or grants to state UI trust funds should be made conditional on data sharing between concerned state and federal agencies.

Available approximations suggest cost savings from UI extensions through these channels could be substantial. For example, using unpublished data from the Department of Labor, the Joint Economic Committee (2010) provided estimates indicating that – absent further extensions in the duration of unemployment insurance benefits – the number of disabled unemployment insurance recipients who were likely to exhaust their unemployment insurance benefits in the latter half of 2010 is 290,000. Estimates of the value of average life-time benefits of SSDI and the value of Medicare benefits accruing to SSDI recipients provided in von Wachter, Song, and Manchester (2010) imply large budgetary costs if even a fraction of these individuals apply and receive SSDI. Thus, if extensions in the duration of unemployment insurance benefits can prevent some of these individuals to apply to SSDI, this can imply substantial cost savings that partially offset the cost of benefit extensions.

At a monthly job finding rate of ten percent,[14] an extension of benefits by six month would imply that about half of these individuals find a job. Clearly, not all the 290,000 disabled individuals would apply for SSDI and, conditional on applying, not everyone is eligible.[15] Using estimates in von Wachter, Song, and Manchester (2010), the Joint Economic Committee (2010) reports that if two thirds of the 290,000 potentially eligible individuals apply for and receive SSDI, the potential cost would amount to $24.2 billion. Given that a six month UI extension would lead to reemployment of approximately half (less if the job arrival rate is lower for disabled individuals, potentially more if the labor market continues to recover), the total cost saving is likely to be smaller than this number. However, these back-of-the-envelope calculations demonstrate that the magnitudes involved may be significant.

Recessions also tend lead to early retirement from the labor force, especially for lower educated men. My own estimates based on past recessions suggest that for a five point rise in state unemployment rates, the employment-population rate of 60-64 year old high-school

[14] E.g., conforming with estimates for job finding rate by Hall (2005) at the through of the 1982 recession,
[15] Bound and Burkhauser (1999) report that among non-working disabled individuals, about 70% receive some form of disability benefits, the majority of which is likely to be SSDI.

graduates by 4-5 percentage points.[16] One reason is likely to be that earnings of older workers are particularly hard hit by a layoff.[17] The majority of these workers does not return to the labor force and is likely to claim Social Security benefits early. In the current recession, new monthly primary claims for both genders have risen steeply by about 25-30 percent from 2008 to 2010. Annual primary claims where roughly constant from 2003 to 2007 at two million per year, then rose to 2.7 and 2.6 million in 2009 and 2010.[18] Extensions in UI durations may prevent some of these workers from dropping out of the labor force and claiming Social Security benefits early.

My second policy recommendation is the need to prepare an 'exit strategy' for UI recipients once the labor market shows signs of recovery. To help the long-term unemployed to find a job amidst an improving labor market, three types of programs have shown to be able to achieve lasting increases in employment while potentially saving money for the unemployment insurance system: Job Search Assistance, Retraining Programs, and Reemployment Bonuses.[19]

To find a new job, workers laid-off in a recession may need to reorient their career goals. Job search assistance can help with this uncertain and time consuming process by providing access to job listings, but also by providing information on occupations, industries, or regions with promising job prospects. Various types of job search assistance provided within the unemployment insurance system in the United States' and in other countries have been shown to be efficient and cost effective. Yet, research has also suggested that the current infrastructure of One-Stop Career centers could be improved and extended to provide more efficient and cost-effective services to unemployed job seekers. In particular, the provision of more intensive services – involving individual career-counseling and training courses – could be made more efficient and extended to a broader population.[20] Thereby, it is worth considering targeting more expensive services such as training to workers most likely to run out of UI benefits or become long-term unemployed.

[16] von Wachter (2007).
[17] Chan and Stevens (2001), von Wachter (2007), von Wachter, Song, and Manchester (2009).
[18] Social Security Beneficiary Data (http://www.socialsecurity.gov/OACT/ProgData/awards.html). The awards were 2.3 million in 2008, consistent with the recession gaining strength in mid-year.
[19] The following summary is based, among others, on surveys of the literature in Department of Labor (1995), Heckman, Lalonde, and Smith (1999), Kluve (2006), Card, Kluve, and Weber (2009).
[20] See, e.g., Jacobson (2009).

To reorient or restart their careers and improve their job prospects, some unemployed workers will have to acquire new skills. Some training programs have been shown to be more efficient and cost-effective at raising employment of laid-off workers than others. For example, while completing technical courses at community colleges appears helpful for many workers, training in non-technical subjects is less promising.[21] Similarly, on-the-job training programs that provide on-the-job experience while matching unemployed workers with interested firms appear promising.[22] Thus, proper counseling of workers, subsidizing the right kind of training, and mandating further scientific evaluations of what training works are thus likely to be important aspects in any effort to effectively retrain workers. In contrast to job search assistance, which has been shown to quickly reduce the number of workers receiving unemployment insurance benefits, the impact of training accrues over time.[23] A combination of job search assistance and targeted training may thus lead to sustained job finding and employment rates.

Federal financial aid can also play a role in assist displaced workers in updating or modifying their skills via higher education. For example, the college enrollment rate of older students has been shown to be increased by access to Pell grants.[24] Similarly, in downturns the incidence of Pell grant recipients engaged in short-term training rises, indicating that this may be a channel through which workers upgrade their skills in recessions.[25] However, rules of the UI system in many states do not continue to pay benefits when individuals enroll in school. Reforms encouraged by the American Recovery and Reinvestment Act have led to reforms in several states that continue payment of UI benefits for workers obtaining certain types of training for up to 26 weeks.[26] It is worthwhile to consider further initiatives to encourage efforts by UI recipients to obtain retraining.

For some workers, a long period of time may elapse before they find a new job. These workers may have lost motivation, hope, or a realistic view of what wages to expect in the labor market. If targeted to workers most likely to exhaust unemployment insurance benefits, bonuses

[21] Jacobson, Lalonde, and Sullivan (2005).
[22] See the discussion in Katz (2010).
[23] See Card, Kluve, and Weber (2009).
[24] Seftor and Turner (2002)
[25] Turner (2003).
[26] See, e.g., information at the National Employment Law Project, www.nelp.org.

that pay workers for finding a new job can reconnect long-term unemployed workers to the labor force can raise employment and reduce the cost for the unemployment insurance system.[27]

An advantage of these policies is that they have been evaluated and implemented within the current unemployment insurance system. These policies cannot substitute for a rise in job creation; but such an 'exit strategy' represents a potentially important complement to help to make sure the long-term unemployed and the finances of the unemployment insurance system both benefit quickly from the onset of an economic expansion. Combinations of these policies could also be implemented simultaneously for further effectiveness. For example, a combination of stricter job search requirements, intensive counseling and retraining, plus reemployment bonuses may keep workers attached to the labor force and willing to accept jobs as soon as job creation increases. An approach of this kind would raise skills and visibility of some unemployed workers while at the same time bringing their wage expectations in line with the reality in the labor market. Such an "exit strategy" built into the unemployment insurance system may be particularly useful for older laid-off workers who face strong wage penalties and low employment rates. It may also help to address concerns regarding the effect of extending unemployment insurance benefits on the employment rate itself.

Current research suggests government policy is less effective in helping to alleviate the large and lasting reductions in wages that eventually follow a typical job loss during a recession. While some training programs have been shown to raise earnings of laid-off workers, and may do so cost-effectively from a tax-payers point of view, the resulting increases are modest relative to the losses these workers have experienced.[28] The reason is that the main factors likely underlying long-term earnings losses are deeply rooted in the workings of the labor market. The majority of long-term losses are due to losses in the value of certain skills as industries decline; due to the loss of long-term career jobs; or due to slow wage-adjustment in the labor market.[29] None of these sources of wage loss are easily manipulated by government policy.

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[27] Evidence on 'reemployment bonus experiments' suggest that short-term subsidies raise employment (e.g., Meyer 1995), but may only be cost effective if targeted to workers most likely to exhaust their benefits (Department of Labor 1995, O'Leary, Decker, and Wandner 2005).
[28] Non-experimental estimates in Jacobson, Lalonde, and Sullivan (2005) imply that one year of technical training at community college reduces the average earnings loss by about a third.
[29] See von Wachter, Song, and Manchester (2009) for additional discussion.

Given the difficulties of helping job losers and unemployed workers recover from long-term earnings losses after the fact, my third recommendation is to explore available options to reduce large-scale layoffs in the future. One way would be to avert some large-scale layoffs through 'work-sharing' arrangements (also termed 'short-time compensation'). This would prevent the decline in spending power associated with layoffs, avoid dislocation and long-lasting earnings losses of laid-off workers, and may be cost-effective from society's point of view.

For example, the cost of unemployment insurance benefits for a typical worker is a small fraction of the total earnings lost due to a layoff over the remainder of the individual's working life. If the same benefits were paid during employment to avoid job loss, this would substantially reduce the cost of recessions. An added advantage of such 'work-sharing' arrangement is that it may immediately raise employment during the current recovery by reducing ongoing job destruction.

Such a system of work-sharing has already been instituted in 17 states.[30] However, the current system may have to be extended and publicized to have a visible impact on ongoing job destruction and to have a substantial impact on employment.[31] More research is needed on the specific features of an extended work-sharing system;[32] however, by building on existing programs work-sharing may be a way to start shifting away from the notion that large-scale and costly layoffs are unavoidable if firms need to cut their wage bills.[33]

My fourth and final recommendation concerns assistance for unlucky young individuals coming of age during the recession. First, the current system of financial aid for college could be used to help prevent children of low-income background or of families who experienced a job

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[30] See Department of Labor (1997) for an overview of short-time compensation programs in different states.

[31] Hassett's (2010) testimony to the House Committee on Financial Services suggests that short-time compensation may immediately reduce job destruction. Abraham and Houseman (2009) suggest regulatory uncertainty as one reason for a low take-up of short-time compensation among states. See the Department of Labor (1997) for reasons of low take-up among employers within states that allow short-time compensation. The German experience is the most cited example of a successful implementation of a work sharing program (see Möller 2010 for a critical assessment). Vroman and Brusentsev (2009) provide an overview of short-time compensation in other European countries and Canada.

[32] Work-sharing bears some similarities to wage insurance (e.g., Kletzer and Litan 2001, Kling 2006) in that wages are replaced while workers remain employed; it shares the feature with direct subsidies or tax breaks targeted to job creation that some jobs may be subsidized that may have been viable from the outset if firms game the system.

[33] Alternative options include the relocation and retraining of workers within firms (see, e.g., Koller 2010 for an example); reductions in salary among all employees (e.g., Akerlof, Dickens, and Perry 2000); or managed employment reductions, such as early retirement programs.

loss from dropping out of college.[34] Research documents a robust correlation of parental income and the cost of college with college attendance especially of lower income individuals, and this relationship appears to have strengthened over time.[35] Financial aid can be an important buffer against labor market shocks affecting parental income or students' own ability to work while in school.[36] However, students are often not aware of available programs, and thus even eligible students do not take up available aid.[37] Current research suggests that this is partly driven by complexity of the student loan process.[38] Reducing the complexity of the financial aid process and informing and assisting students with applications would be helpful and relatively low-cost policy. Another concern is that many resources available for especially lower income students are currently provided at the state level, such as subsidized Community Colleges or merit scholarships. As states budgets are being cut, these resources are at risk. Since Community College resources and merit scholarships affect the incidence and quality of college education, federal assistance to maintain access to college for low income students would be helpful.[39]

For those young individuals not bound for college, the recent increase in idleness can represent a risk but also an opportunity to take time to invest in skills.[40] Recent research has shown sectoral training programs can be successful in raising the employment rate of participants.[41] These programs cooperate with firms in structuring their training programs and in placing workers. Expanding support for participation in such programs is worth considering. An alternative is to further encourage the use of federal financial aid such as Pell grants to enroll young workers at vocational schools.[42] However, very little is known about the actual rewards in the labor market of these schools. Mandating scientific evaluations of the returns to private programs receiving federal funding through financial aid and making the necessary data

[34] Lovenheim (2010) documents how changes in housing values of parents can also affect children's college attendance.
[35] See Demin and Dynarski (2009) for a summary. Belley and Lochner (2007) document the rise in the effect of family income on educational outcomes controlling for measures cognitive ability.
[36] Turner (2003) shows how the take-up rate of Pell grants is countercyclical.
[37] E.g., see King (2004) for an overview.
[38] See Bettinger, Long, Oreopoulos, and Sanbonmatsu (2009) for background information and suggested solutions to this problem.
[39] Turner (2003) documents a decline in state-spending on higher public education. Results in Turner and Bound (2010) imply that increasing enrollment rates in recessions could further reduce the quality of education at state institutions.
[40] See the testimony by Holzer (2010) for in depth discussion of additional training options for these workers.
[41] See Maguire, Freely, Clymer and Conway (2009) for a summary.
[42] See, e.g., Cellini (2010).

available to the academic community would be a useful policy.

To conclude, job loss and unemployment during severe recessions can impose substantial and lasting costs on affected workers in terms of earnings, health, and strain on their families. This testimony has focused on cost-effective ways to alleviate the burden of these workers. It has also recommended making necessary administrative data and program information available to allow researchers give better assessments of the full costs and benefits of these programs.

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Chairman CONRAD. Thank you. We appreciate very much your testimony. I think you have given us some interesting ideas that we can hopefully pursue as we go through the budget process this year.

Next, we are going to turn to Dr. Ray Scheppach, Executive Director of the National Governors Association. One of the things that has come before the attention of this committee and other committees is the fiscal crisis at the State level, There is probably nobody better positioned to help the committee understand the dimensions of that challenge than Ray. Welcome. It is good to have you here, and please proceed.

STATEMENT OF RAYMOND C. SCHEPPACH, EXECUTIVE DIRECTOR, NATIONAL GOVERNORS ASSOCIATION

Mr. SCHEPPACH. Thank you, Mr. Chairman and Senator Sessions. I am pleased to be here on behalf of the nation's Governors.

Let me say first, if you drop back and look at the long-run growth of State revenues, really over the last 30 years, 1978 to 2008, it grew about 6.5 percent per year, relatively robust. There was only 1 year during that period, 1983, when revenues were negative, and it was only negative by about less than 1 percent.

If you look now about what happened during this so- called great recession, we had five quarters in a row of negative revenues and the numbers went from 4 percent, to 12.2 percent, to 16.8 percent, to 11.5, and then 4 percent again, so huge declines in revenues over that five quarters.

There is some good news. Really, we have now had positive revenue growth over the last four quarters. The first three of those, it was about 3 percent. But just yesterday in a preliminary way, it seems to be that revenues for the fourth quarter of 2008 were up 6.9 percent. Now, that is based on about 41 or 42 States, so it can be modified, but it is an encouraging number. I will say, however, in spite of that, we have to remember that revenues in 2010 versus 2008 are down about 9 percent.

States reacted to this by cutting spending by $75 billion and raising taxes and fees by about $33 billion, so close to well over a $100 billion swing. Those cuts would have been much more draconian if the recovery package had not provided States with an additional about $103 billion in Medicaid and about $48 billion in education money, and then there was an additional $10 billion that went through States to locals.

In spite of that money, however, the States are still looking at a shortfall over the next two-and-a-half years or so of about $175 billion, and that includes the so-called cliff when the Federal Medicaid money goes away at the end of State fiscal year 2011.

When I look at this impact, this great recession was so deep and so broad that, unfortunately, it is going to send implications through State government for almost the rest of this decade. I think of it really in terms of three stages.

The first is we know from the previous downturns the biggest impact on States is one, two, and sometimes 3 years after the recession has been declared over, and that is largely because that is when you lose the maximum amount of income tax revenues and that is when you see the explosion of Medicaid. I think we are still in the end of that stage.

The second stage, however, is going to be the so-called jobless recovery. We do not expect States to come back to the 2008 revenue level until 2013 or 2014, and in some cases 2015. That means, Mr. Chairman, literally five to 6 years of zero revenue growth relative to a baseline where we were getting 6.5 percent per year. So that is virtually over that period, like at the end of it, a 30 percent swing.

The third stage is that at some point, they have to go back and take care of some of the unmet needs that they did not fund during the downturn. So that goes all the way from maintenance, rebuilding rainy day funds. I think the big one, of course, is the pension thing because States did not pay into the pension.

States have always had what I would call long-run structural problems, largely because they have antiquated tax systems on one hand, and you have had Medicaid, which is about 22 percent of State budgets growing at nine or ten or 11 percent. Unfortunately, what has happened with the great recession is that that long-run structural problem is a lot worse now. I would probably argue that the revenue path going forward over the long run is not going to be 6.5 percent. I suspect we may see slower economic growth.

But the revenues that are being lost in the sales tax now, which is about 40 percent of State taxes, is quite significant because we do not tax services, we do not tax downloads from the Internet, we do not tax goods sold over the Internet. In other words, if it is a new economy good and growing, we do not tax it. If it is an old economy good and contracting, the odds are we tax it. The erosion of this tax base over time now, I think, is getting to be a particularly big problem.

Medicaid is the 400-pound gorilla. It continues to be that. If you just look at the actuaries from HHS estimates, they say that the rolls will increase by 11.6 million people in 2014 and almost 20 million people by 2019. And the numbers that they have are essentially between 2010 and 2014, States will have to pay an additional $90 billion, and between 2014 and 2019, an additional $100 billion. So you are looking at States' growth over the next 10 years of virtually $190 billion.

Now, you might ask, why is that so big? There are three things coming together at the same time. No. 1, because of the recession, the case loads are higher and therefore you start with an increase with that. The second problem is, of course, that the enhanced Federal match goes away at the end of fiscal year 2011. And then you have the impact of health care reform.

So when you add those three impacts together, they make a huge change. I would have to say, as we get on the telephone with State budget directors every other week, what they will tell you is we do not know how to get from here to there, largely on the Medicaid issue.

On the unfunded pension liabilities, the numbers here are always a little bit suspect depending on the discount rate assumption and so on. But clearly, as of the year 2000, I would argue States and municipalities were in pretty good shape. It began to deteriorate. I think we probably have an unfunded liability of about 23 percent of obligations now, so it is significant. On the other side——

Chairman CONRAD. Can I stop you on that point?

Mr. SCHEPPACH. Sure.

Chairman CONRAD. Can you repeat—I want to make sure I understood this last point, the 23 percent.

Mr. SCHEPPACH. Well, that is sort of the unfunded portion of it. So if you are assuming that whatever that commitment is, and the numbers change a little bit depending. If it is a trillion dollars, then you are down $230 billion in terms of the unfunded portion of it. But the pension contributions are generally less than 4 percent of State budgets.

Chairman CONRAD. What is the—can you help us understand, because this became a source of discussion in a previous hearing when we had Chairman Bernanke before the committee. It seems to be concentrated in a relatively small number of States. Is that your understanding? That is, a disproportionate share of the unfunded liability is in a relatively small number of States.

Mr. SCHEPPACH. Yes. It is not four or five, but it is eight or ten, I would say, yes.

Chairman CONRAD. Eight or ten States that are really in——

Mr. SCHEPPACH. Right. And some of those are—I mean, Connecticut is one, for example, Hawaii, or smaller States. But then there is also the New Jerseys, the Illinois, and so on. As I remember, actually, California is better on this issue than in a lot of others.

Chairman CONRAD. My recollection was Illinois was in the most serious shape.

Mr. SCHEPPACH. Correct. I think that is right.

Senator SESSIONS. This shortfall, some of that is tied to the stock market?

Mr. SCHEPPACH. That is correct. There are two things-——

Senator SESSIONS. The market being down, so it is not 23 percent if the market were to continue to go up?

Mr. SCHEPPACH. That is exactly right.

Senator SESSIONS. So it is hard to exactly estimate, but it is dangerous. The numbers are so high that it should raise red flags, that number.

Mr. SCHEPPACH. No, you are right. It is the return in the markets, in bonds, and then it is States did not pay in during this crisis. It is a twofold issue.

But as I said, it is probably less than 4 percent of State budgets. And I will say that we tend to track what is going on in States here and you will find that 30 States have made changes in pensions over the last 5 years and we have 20 States that have made pension changes this year. So they are really beginning to face up to it. What is happening is that they are forcing current employees to pay in more. They are making adjustments on COLAs. They are extending the number of years. So there is a lot of activity in this particular area right now.

Chairman CONRAD. Ray, could we stop you on the point, because Senator Sessions and I were wondering, how could States fail to pay into their pension plans during this period? What legally allowed them not to pay in?

Mr. SCHEPPACH. Well, it differs by State, but some States just do not have requirements on it. In fact, I think some actually borrowed from the fund. So you will find them sometimes borrowing from different trust funds when times, you know, highway trust funds or such.

Chairman CONRAD. We know a lot about that here.

[Laughter.]

Mr. SCHEPPACH. I did not want to say that.

[Laughter.]

Mr. SCHEPPACH. So in terms of what else is going on, I do think, as I said, the shortfall is about $175 billion, and——

Chairman CONRAD. And what period is that over?

Mr. SCHEPPACH. It is really over the next two-and-a-half fiscal years. But I do see a commitment among Governors that they—you know, initially, I think, there was a feeling that they needed to cut, furlough, consolidate, and eventually the economy would come back and sort of save them. I do not think anybody believes that now. I mean, I think the feeling is among Governors that they have to continue to do this to make the long-run sustainability.

In fact, we do not really believe we can cut our way out. We think we have to really redesign State government in terms of how it delivers services. So—but I think this group of Governors are moving on it and I think that I am fairly optimistic that they will work through this problem, including the pension problem.

In terms of things that you can do, I would say the first thing is please do no harm. As you begin to cut budgets, please do not cap the Federal share of Medicaid and shift it to States. I would encourage you to look for things, and there are a number of them where we could both save money, both the Federal Government and States, and so please do not do any harm.

And then the other areas are more around flexibilities on programs. Maintenance of efforts are causing big problems. So to the extent waivers in certain areas, all would be very helpful.

I will reiterate that the Governors are not requesting any additional assistance, financial. They are appreciative of what has happened. But they feel that they need to work their way through it and make these programs sustainable.

The only final comment, again, is that all roads lead back to Medicaid. This is a serious problem. I think that it has to be dealt with, where the Feds and the States sit down and try to make this program much more efficient. Plus, I am not sure States can continue to pay for the long-term care of the dual eligible portion of it as the demographics changes. There is just not the tax base going forward to support it.

With that, thank you very much, Mr. Chairman.

[The prepared statement of Mr. Scheppach follows:]

Statement of
Raymond C. Scheppach

before the

Senate Budget Committee

on

The State Fiscal Situation

on behalf of

The National Governors Association

February 3, 2011

Chairman Conrad, and members of the committee, on behalf of the nation's governors, thank you for the opportunity to appear before you today to discuss the states' fiscal situation.

For 30 years, from 1978-2008, states witnessed average revenue growth of 6.5 percent per year. In fact, only in 1983, were revenues negative – at less than 1 percent. The "Great Recession," which began in December 2008 and was officially declared over in June 2009, was a huge game changer for state governments. Between the last quarter of 2008 and the last quarter of 2009, revenues decreased five consecutive quarters, by 4.0 percent, 12.2 percent, 16.8 percent, 11.5 percent, and 4.0 percent respectively. While revenues for all states have now grown for three consecutive quarters, it has only been by 3 percent on average and would have been flat if it had not been for major tax increases in California and New York. Preliminary early reporting estimates from 41 states did, however, show an increase of 6.9 percent for the last quarter of 2010. In spite of these recent increases, total state revenues are still down about 9 percent in 2010 relative to 2008.[1]

In response to these revenue declines, states cut spending by $75 billion and enacted fee and tax increases of $33 billion over state fiscal years 2008-2010. The cuts would have been much more draconian if the American Recovery and Reinvestment Act and its extensions had not been enacted. Here, the federal government provided states $103 billion in flexible Medicaid funds and $48 billion in education funds. They provided another $10 billion in education funds that passed through states to local school districts. Even with this federal assistance, states are still

[1] The Nelson A. Rockefeller Institute of Government.

looking at shortfalls of about $175 billion over the 2011-2013 period, with a definite cliff the end of state fiscal year 2011, i.e., July 1, 2011, when the enhanced Medicaid funds end.

The Rest of the Decade

Unfortunately, the "Great Recession" was so deep and so broad that it will continue to have impacts on state government throughout this decade in the following three stages.

- The first stage is state fiscal years 2010, 2011 and 2012. Previous economic downturns have shown that the biggest impact on states is the first, second and, at times, the third year after the recession ends. This is because the major decline in revenues and the explosion in the Medicaid rolls come very late in the economic cycle.
- The second stage is the "jobless recovery," which will prevent most states from returning to their 2008 revenue levels until 2013 or 2014 and, in some cases, 2015. This means zero revenue growth over five to six years compared to the previous long-term average of 6.5 percent per year – a huge reduction.
- In the third stage, beyond 2015, states will have to meet many of the needs that were deferred over the preceding six years. While there are many unmet needs—including maintenance on structures, rebuilding "rainy day" funds and upgrading management information systems—the largest need is the retiree pension trust funds that now have significant unfunded liabilities. This is also the period when states should witness a rebound in state revenues, but the revenue path going forward is likely to be lower than the 6.5 percent experienced over the last 30 years. Finally, it is when states will see accelerated Medicaid growth.

The Structural Deficit

States have struggled with structural long-run deficits for some time because of their obsolete tax systems and the double digit growth of Medicaid, which is now 22 percent of state budgets.

However, they were able to make yearly adjustments to spending and revenues to maintain balanced budgets. After the "Great Recession," this structural deficit has become significantly larger and is caused by: 1) a revenue path going forward that will likely grow more slowly than that over the last 30 years; 2) retiree pension and health care unfunded liabilities that have ballooned over the last several years; and 3) state Medicaid spending that will grow rapidly over the next 10 years.

State Revenues – Even if state revenues recover from the "Great Recession" later in this decade, the long-run outlook is likely a lower revenue growth than the 6.5 percent experienced over the last several decades. First, it is doubtful that the U.S. economy will grow as rapidly over the next decade as it has over the previous three decades. This is because of a combination of factors including higher interest rates associated with the huge federal debt, more regulation, higher taxes by all levels of government, diminishing workforce quality relative to U.S. trading partners and more international sovereign debt and currency volatility. Second, states have tax systems that were built for a manufacturing economy of the 1950s, not a high technology, service-oriented, international economy of the 21st century. For example the sales tax, which represents about 40 percent of state revenues generally, only applies to goods, not services, and not to many goods sold over the Internet or downloaded from the Internet. Alternatively stated, new economy outputs are growing but avoiding taxation; old economy goods are not growing yet bearing the tax burden. This low elasticity for the sales tax is a major problem as new economy outputs increasingly erode the tax base. States can fix this problem by reforming taxes, but reform is politically difficult.

Medicaid – Medicaid costs to states in 2008 were about $152 billion or 22 percent of state budgets. Enrollment has increased by 6 million since the recession began and total Medicaid spending growth averaged 8.8 percent in fiscal year 2010 with enrollment growth of 8.5 percent – the highest rates of growth in eight years. States anticipate a spending increase of 7.4 percent in 2011; however, this may be low because state estimates have been low for the last couple of years. According to the 2010 Actuarial Report on the Financial Outlook for Medicaid by the Office of the Actuary of the United States Department of Health and Human Services, the Patient Protection and Affordable Care Act (ACA) is projected to add 11.6 million people to the enrollment in 2014 and almost 20 million by fiscal year 2019. The actuarial report has state spending growing from $133.5 billion in 2010 (which is low because of the enhanced federal match from the Recovery Act) to $224.1 billion in 2014, which is the first year of the Medicaid expansion. This means that the combination of the higher case load growth due to the "Great Recession," the 2012 state fiscal year cliff when the enhanced federal match ends, and the ACA will require states to pay an additional $90 billion between 2010 and 2014. If the actuarial report is correct, states will pay another $100 billion over the five-year period of 2014 to 2019.

Medicaid's growth rate can be brought down in several ways. First, if many of the cost control provisions in the ACA work well. Second, if governors and states work with stakeholders in their states to create more transparency regarding price and quality of all health care in a state and they bring about changes in the current fee-for-service system. Third, if the federal government provides states with more flexibility in administering the program.

Pension Problem – Unfunded liabilities have grown substantially because of both the lower rate of return on investments and the fact that many states did not contribute to the retiree pension and health care trust funds over the last few years. In 2000, state and local pension obligations were essentially fully funded with an assumption of an 8 percent discount rate. By 2009, the unfunded liability was about 15 percent. By 2010, the total unfunded liability for state and local governments had increased to 23 percent of obligations. While this is a significant change, it must be remembered that current employer contributions are only about 3.8 percent of state budgets. If this was increased to 5.0 percent, states could eliminate their unfunded liabilities in pension funds over time.

This level of unfunded pension liabilities is a problem, but states are now making changes to reduce the liability. Between 2005 and 2010, 30 states made pension changes. In 2010, pension actions accelerated with at least 20 states making further changes. Actions states are taking focus on raising length of service requirements, extending the retirement age, increasing employee contribution rates and lowering cost-of-living adjustments (COLAs). Illinois and Missouri, for example, raised the retirement age to 67, and Massachusetts is calling for the same in 2011. Additionally, 11 states made benefit and contribution changes during 2010. For example, Colorado increased the employee contribution rates for fiscal year 2011 by 2.5 percentage points. The contribution changes affect active employees and new employees in seven states, while four states made changes affecting future hires only. Seven states made changes to COLAs. For example, South Dakota removed COLAs for retirees in the first year of retirement, while Rhode Island and Virginia reduced COLA increases for new hires. Other states made significant changes to their defined benefit systems. Michigan and Utah moved from defined benefit plans to hybrid plans during 2010. Utah has closed its defined benefit plan to new workers entirely.

Short-run State Action

Given the fact that states are still looking at shortfalls of $174 billion over the next several years, governors and state legislators understand that they have to continue to downsize and consolidate state government. In fact, it is not enough to just cut budgets, consolidate agencies, and reduce the number of state employees. They also have to redesign the delivery system of all major functions of state government, from prisons to elementary and secondary education to higher education, to make state government more efficient and sustainable over the long run.

While this will be difficult, I think that states will be able to work through these challenges over the next couple of years without any major crisis. States do have larger unfunded pension liabilities, but they have accelerated actions over the last two years and I am optimistic that they will be able to put solutions in place.

This Fiscal Year

Despite states' difficult fiscal conditions, governors are not calling for new one-time help from the federal treasury. In fact, they encouraged the federal government to follow the lead of states and make tough decisions necessary to get its fiscal house in order; federal fiscal stability is critical to the long-term strength of states and the country.

As federal lawmakers work to reduce deficits, reform programs and restore long-term stability, governors call on the Administration and Congress to adhere to the following principles for state-federal deficit reduction:

- **Federal reforms should be designed to produce savings for both the federal government and states.** The shared responsibility for implementing and running state-federal programs should also mean shared savings when reductions or reforms are made at the federal level.

- **Deficit reduction should not be accomplished by merely shifting costs to states or imposing unfunded mandates.** The structural deficit facing federal lawmakers cannot be solved by the states. Good fiscal policy must take into account the effects of federal action on state government to avoid actions that harm the ability of governors to manage state budgets.

- **States should be given increased flexibility to create efficiencies and achieve results.** Decreases in funding should be accompanied by an increase in state authority to manage programs and find savings. For example, states must be allowed to consolidate funds from similar programs to provide better results. Federal mandates, even those that are paid for, fail to encourage state innovation or cost savings that can benefit both states and the federal government.

- **Congress should not impose maintenance of effort (MOE) provisions on states as a condition of funding**. MOE's curtail state authority to control their own budgets and fiscal systems and, over time, discourage investment in state-federal programs.

It is also important to indicate that states are opposed to Congress enacting any legislation that authorizes bankruptcy for states. No governor or state is requesting this authority and it is also true that such authority will likely increase interest rates, raise the cost of state government and create more volatility in financial markets. Governors are strongly opposed to such legislation.

Longer Run

It is up to states to fix their revenue and pension problems. After the next couple of years, however, the projected growth in Medicaid will continue to be a serious funding problem for states as there are three factors coming together during the 2010-2014 period that will accelerate the growth in state Medicaid spending. First, the Medicaid caseload has grown rapidly over the last two years because of the weakness in the economy. Second, states will lose the additional federal aid on July 1, 2011. And third, the ACA will expand the Medicaid program. The federal government will need to work with states to change the Medicaid program to slow its expenditure growth for both levels of government and create a more efficient program, with a more equitable sharing of the costs between the federal government and states consistent with federalism.

Conclusion

Mr. Chairman, there are several conclusions we can reach regarding the state fiscal situation. First, states have already cut $75 billion in spending and raised taxes by $33 billion over the last two years. Governors understand that they have more to do to make state programs sustainable over the long-run. They will be able to close the $175 billion in shortfalls over the next few years unless the economy slows considerably. Therefore, I see no crisis for states regarding pensions or other issues over the next couple of years. Second, governors are not requesting additional one-time fiscal relief, but would like more flexibility on programs and relief from maintenance of effort provisions. Third, after a few years the projected growth in Medicaid will be difficult for states to fund.

Congress needs to focus on this issue and work with governors to change the Medicaid program to slow the growth in spending for both state and federal government, create a more efficient system and create a more equitable sharing of the costs between the federal government and states consistent with federalism.

Mr. Chairman, I would be happy to answer any questions. Thank you.

Chairman CONRAD. Thank you very much.

Mr. Edwards, thank you for your patience and thank you for being here. Dr. Edwards—I am not sure it is Doctor, is it?

Mr. EDWARDS. I am not a doctor.

Chairman CONRAD. But, you know, you have that credibility. You seem like a doctor.

Mr. EDWARDS. I appreciate that very much.

[Laughter.]

Chairman CONRAD. Chris Edwards, Directors of Tax Policies at the Cato Institute. Welcome back.

STATEMENT OF CHRIS EDWARDS, DIRECTOR OF TAX POLICY STUDIES, CATO INSTITUTE

Mr. EDWARDS. Thank you very much, Chairman Conrad and Senator Sessions, for having me here today. I am going to talk a little bit about challenges for Federal spending and then a little bit about challenges for State budgets. federally, we have seen an extraordinary increase in spending over the last decade, from 18 percent under President Clinton's last budget to 25 percent today. I believe the spending explosion really is sucking the life out of the private sector economy, and the real problem I see is that the United States is no longer really a small government country. In my testimony, I have OECD data showing that total Federal, State, local spending in the United States is now 42 percent. We used to be about 10 percentage points smaller than the average OECD country in terms of spending. Over the last decade, that gap has closed to just 5 percent.

So I think, historically, our uniquely high living standards in this country were built partly on our relatively smaller governments and I think we are really risking becoming sort of just another stagnant welfare state in the years ahead, which I think is mainly going to result in less opportunities and higher tax burdens for young people.

So we need to cut spending. Obama's fiscal commission, of course, had lots of great spending cut ideas. I know, Chairman, you have been a real supporter of that report, as I am. I put together all kinds of spending cut ideas at Cato's website, downsizinggovernment.org. And here is the thing that really strikes me, is that other countries have cut spending when they haveten into crisis. We see cuts in the U.K. right now.

And I think Canadian reforms in the mid-1990s are a real model that we can look at. In the mid-1990s, Canadian government spending was up to 53 percent of GDP. Their debt was exploding. Then their liberal government really changed course and they chopped spending from their Federal budget 10 percent in 2 years, which would be like us chopping $370 billion in just 2 years. Then they held spending flat for a number of years after that. The result was dramatic. The Canadian economy——

Chairman CONRAD. What years——

Mr. EDWARDS. Yes?

Chairman CONRAD. And I apologize for stopping you, but——

Mr. EDWARDS. No, that is fine.

Chairman CONRAD [continuing]. This is very interesting to us. We were talking about this actually in the committee yesterday.

Canada, with respect to a VAT, because they imposed a VAT at 7 percent, actually have reduced it to 5 percent——

Mr. EDWARDS. Right.

Chairman CONRAD [continuing]. And during this period, brought their debt as a share of GDP down from over 100 percent, 101 percent of GDP——

Mr. EDWARDS. Right.

Chairman CONRAD [continuing]. Down to 69 percent. So it was this combination of revenue and spending cuts, and the spending cuts were quite tough, were they not?

Mr. EDWARDS. They were, again, 10 percent in 2 years. They brought the VAT in in the late 1980s under a conservative government. Then it was the left-of-center liberal government in the 1990s that dramatically cut spending, as well as they privatized a lot of their government corporations. This was the liberal party, and the liberal party did two rounds of corporate tax cuts. So the politics are really kind of strange up there. But the Canadian economy boomed for 15 years and I think we really need to look at what they did.

Let me switch over to State and local budgets for a couple of minutes, and my views will, I think, contrast pretty sharply with Ray's, I think. There have been a lot of horror stories in the papers over the last couple of years about how States are in a crisis and drastically slashing their budgets, and it is true State general fund budgets have been cut pretty substantially in 2009 and 2010, although they are growing again. But if you look at total State and local spending in Bureau of Economic Analysis data, it was never cut. Total State and local spending, according to the BEA, rose 55 percent between 2000 and 2008. Then it was flat for 2009. Now it is growing again, 2010, 2011. So I do not——

Chairman CONRAD. Does this——

Mr. EDWARDS. Yes?

Chairman CONRAD. I apologize. I just want to make sure I understand. You are talking now all States?

Mr. EDWARDS. Yes, all States and local governments. So, you know, general fund budgets are only about half or so of State budgets. So if you look at total State budgets as well as the local together, it has been a lot more stable than just the State general fund budgets, which as you know, they have to balance every year.

So I think the States can solve their short-term problems. The real challenge, as has already been touched on here, is this long-term problem with debt. State bond debt, State and local bond debt has doubled over the last decade, from about $1.2 trillion to $2.4 trillion.

Unfunded pension liabilities, depending on what the accounting assumptions here, are $3 trillion or so. On top of that, as you probably know, there is the problem of unfunded retiree health plans in the States, which I think is about another $1.5 trillion problem on top of the pension problem.

I agree with these comments, and this is something I think the media often misses. These problems vary dramatically by State. So if you look at bond debt, you get States like Massachusetts that have very high bond debt. Other States, like Nebraska, have virtually no bond debt. I mean, Nebraska——

Chairman CONRAD. Let us talk about North Dakota.

Mr. EDWARDS. You know, I should have brought the North Dakota numbers. I do not know off the top of my head. Maybe you know, but——

Chairman CONRAD. Very low.

Mr. EDWARDS. Right.

Chairman CONRAD. Very low.

Mr. EDWARDS. And so a lot of States, they rely on—their capital budgets rely on pay-as-you-go financing more than issuing debt.

Pension debt, according to figures by economist Andrew Biggs, vary from 11 percent of GDP, again in Nebraska, up to 49 percent in Ohio.

And I would say something else that is interesting is that State worker unionization rates vary dramatically in the States and this affects fiscal policy. So California, New York, two-thirds of State and local workers are unionized. Other States, like Virginia and North Carolina, they do not have unionization in their public sectors. So this affects fiscal policy because I think unions can affect the flexibility of managers to cut costs and make needed reforms.

So I think the upshot here is that the States have taken widely divergent paths, which is OK. We have a Federal system. I wish the poorly managed States would learn more from the well-managed States. But ultimately, I think, the States should be left to solve their own problems. I do not believe in Federal bailouts because I think that is unfair to the frugal States.

But I must say, I also do not favor this idea that has been talked about in the last couple of months about a new Federal statute for State government bankruptcy that some conservatives have been pushing. I think that is interference in State local affairs that we do not really need. I think the States have the tools at their disposal to solve their own problems without that sort of intervention.

So that is all my comments, and thanks again.

[The prepared statement of Mr. Edwards follows:]

Challenges to U.S. Economic Recovery: Federal and State Spending

Statement of Chris Edwards, Director of Tax Policy Studies, Cato Institute,

before the Senate Committee on the Budget

February 3, 2011

Mr. Chairman and members of the committee, thank you for inviting me to testify today regarding challenges to U.S. economic recovery. My comments will focus on the challenge of controlling federal and state government spending in coming years.

Advantages of Federal Spending Cuts

The growth in federal spending over the past decade has been extraordinary. As a share of gross domestic product, spending soared from 18.2 percent in President Clinton's last fiscal year of 2001 to 24.7 percent by fiscal 2011. The causes of this government expansion include the costs of overseas wars, expanded entitlement programs, growing spending on domestic programs such as education, and recent stimulus spending.

Two years after passage of the $800 billion stimulus, that package appears to have been a very expensive failure. Note that the total Keynesian stimulus in recent years included deficit spending of $459 billion in FY2008, $1.4 trillion in FY2009, $1.3 trillion in FY2010, and $1.5 trillion in FY2011. Despite all that deficit spending, the unemployment rate remains stuck above nine percent and this recovery is sluggish compared to prior recoveries.

Whether or not stimulus spending can goose the economy in the short-run, there is no doubt that it comes at the expense of future living standards because of the build-up of debt. Harvard's Robert Barro has calculated that the future damage caused by the 2009 stimulus bill substantially outweighed any short-term benefits it may have had.[1] Thus, to start getting federal spending under control, we first need to abandon the Keynesian approach to budget policy.

Policymakers need to change their focus from short-term fiscal manipulations to long-term spending control. In the long-run, higher government spending reduces economic growth because it transfers resources from the more productive private sector to the less productive government sector. Those transfers impose distortions or "deadweight losses" on the economy, which are further costs of government spending.

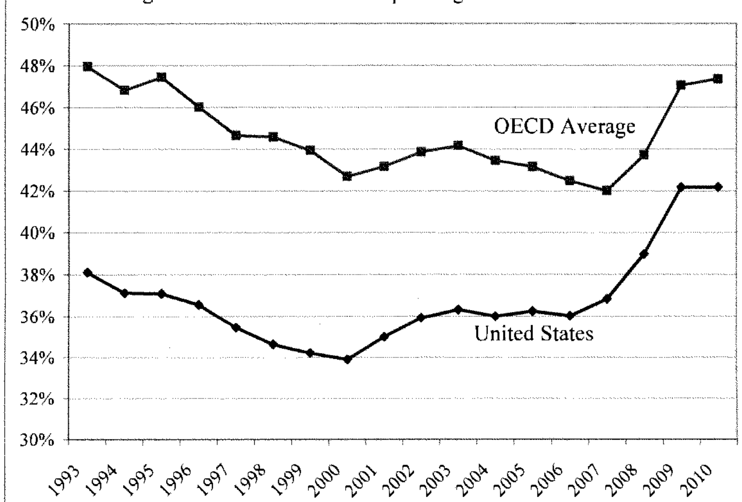
In his State of the Union address, President Obama promoted new government "investment" spending, but given that American governments already consume more than

40 percent of the nation's GDP, it is extremely unlikely that the government could find new projects with sufficiently high returns to make them worthwhile.

Policymakers should reject the idea that added spending is good and beneficial for the economy. It isn't. In recent decades, the federal government has expanded into hundreds of areas that would be better left to state and local governments, businesses, charities, and individuals. That expansion is sucking the life out of the private economy and creating a top-down bureaucratic society. Cutting federal spending would also enhance personal freedoms by dispersing power from Washington.

Policymakers shouldn't think of spending cuts as a necessary evil needed to reduce debt. Rather, the government's fiscal mess is an opportunity to make reforms, such as privatization, that would spur growth. After all, the United States is no longer a small-government nation, as revealed by data from the Organization for Economic Cooperation and Development.[2] The OECD calculates that total federal, state, and local government spending in the United States in 2010 was 42 percent. For many years, America had about a 10 percentage point government size advantage compared to the OECD average, but that advantage has now shrunk to just 5 percentage points, as shown in Figure 1.

Figure 1. Total Government Spending as a Share of GDP



Source: OECD Economic Outlook Database, Annex Table 25.

Historically, America's robust economic growth and high living standards were built on our relatively smaller government than Europe and elsewhere. But if we continue down the current high-spending path, we will become just another sluggish welfare state. Projections by the Congressional Budget Office under its "alternative fiscal scenario," show that federal spending will climb by another 11 percentage points of GDP by 2035 unless we make major reforms.[3] Such a spending expansion would doom young people to unbearable levels of taxation and an economy with few opportunities and little innovation.

We need major federal spending cuts. We should cut entitlements, domestic spending, and defense. The president's fiscal commission had lots of good spending cut ideas, and so do plans by various thinktanks and members of Congress. I've proposed cuts to balance the federal budget by 2020 at www.downsizinggovernment.org. And I've suggested that Congress cap the annual growth in total federal outlays to help force ongoing efforts to find savings.[4]

Some economists argue that spending cuts would hurt the economy. But consider a real-world experiment of substantial budget-cutting—the Canadian reforms of the 1990s.[5] In the early 1990s, overspending had pushed the size of the Canadian government to 53 percent of GDP, and government debt was soaring. The center-left Liberal government then reversed course and began cutting spending in 1995. Over two years, they chopped 10 percent from total federal spending—equivalent to Congress cutting spending about $370 billion in two years. Then the government held spending at roughly the lower level for another three years.

As spending was cut, the Canadian economy did not stagnate—it boomed. Indeed, it boomed for the next 15 years until it was hit by the recent U.S.-caused recession.[6] Canadian government spending has fallen by more than 10 percentage points of GDP and the federal budget was balanced 10 years in a row.[7] At the same time, the government spurred growth with pro-market reforms such as free trade, corporate tax cuts, and privatization. The Canadian model of sharp spending cuts and microeconomic reforms to boost growth is an excellent model for U.S. policymakers to follow.

Current State Budget Woes

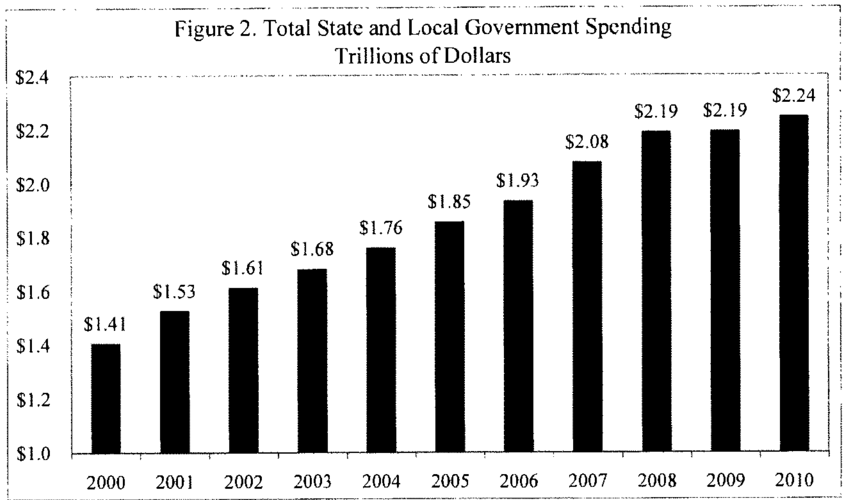
In recent years, we've been deluged with news stories claiming that state governments are radically slashing their budgets and state tax revenues are plummeting. Those concerns led to state bail-out funding in the 2009 stimulus bill, and it is behind continued calls for added state aid.

The reality is that overall state and local government spending has not been slashed. Certainly, governments have had to tighten their belts during the recession, but that is entirely reasonable as families and businesses have had to do the same. Furthermore, recent belt-tightening came after years of robust state spending growth.

Data from the National Association of State Budget Officers (NASBO) show that state general fund spending rose 47 percent between FY2000 and FY2008.[8] Spending then fell 11 percent during FY2009 and FY2010, but spending is now growing again and NASBO expects a 5 percent increase in FY2011.

However, state general fund spending is only part of a broader state budget picture. Figure 2 shows that total state and local government spending rose 55 percent between 2000 to

2008, based on U.S. Bureau of Economic Analysis data.[9] State and local spending leveled out in 2009 at $2.19 trillion, and then it started rising again. In 2010, it was up 2 percent. As a share of GDP, total state and local spending increased over the last decade—from 14.1 percent in 2000 to 15.3 percent in 2010. Thus, despite two recessions during the past decade, state and local spending now consumes a larger share of the U.S. economy.



Source: Bureau of Economic Analysis, National Income and Product Accounts, Table 3.3. Calendar years.

While states have had to trim their general funds, the overall state and local budget situation is not as dire as news reports have suggested. It's true that a number of states, such as California, have dug themselves into deep fiscal holes. But overall state revenues and spending are rising again as the economy expands.

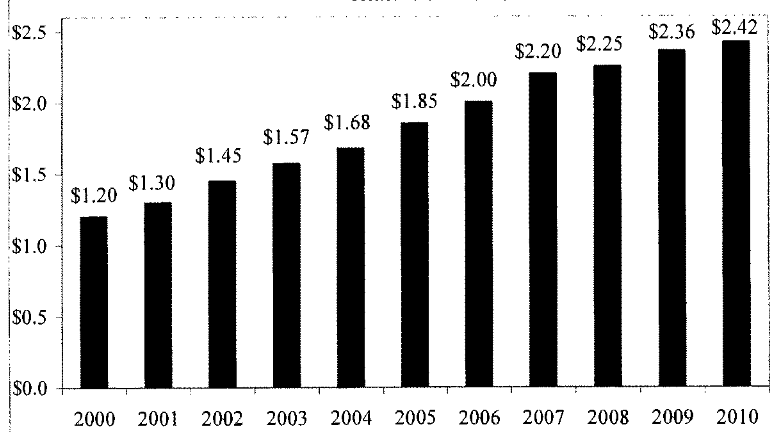
Some pundits are pointing to large "budget gap" figures to suggest that most states are still in a fiscal crisis. The Center on Budget and Policy Priorities, for example, claims that states currently face a $125 billion budget gap.[10] But that is a speculative number, not hard data. If a state expects revenues and spending to rise 7 percent, but then a new forecast shows revenues rising only 3 percent, the state is said to have a 4 percent "gap" or "shortfall." But spending is still rising by 3 percent, which is not a crisis. Budget gap estimates are partly artifacts of faulty economic forecasting and an inability of states to respond flexibly to changing circumstances.

Paul Krugman recently penned a column focusing on CBPP data showing that even conservative Texas has a budget gap as large as California's at up to $25 billion.[11] I was surprised by this, so I looked into it. The latest figures from the Texas state comptroller show general fund revenues at $35.4 billion in FY2010, and a projected $37.0 billion in FY2011 and $37.9 billion in FY2012.[12] Texas revenues are certainly sluggish, but it's not clear where the giant budget gap comes from. Indeed, if the state could simply hold spending flat for a while, there would be no gap or shortfall.

The Real State Budget Crisis

The real state budget crisis is not short-term budget gaps, but the longer-term problem of soaring debt and unfunded obligations in state and local retirement programs. Figure 3 shows that there has been a large increase in state and local government bond debt over the past decade. While state and local debt was fairly stable during the 1990s, it has more than doubled during the last decade from $1.20 trillion to $2.42 trillion, according to the Federal Reserve Board.[13]

Figure 3. State and Local Government Debt Outstanding
Trillions of Dollars



Source: Federal Reserve, Flow of Funds Accounts, Table D.3..

In addition to rising bond debt, state and local governments face huge unfunded costs in their pension and retiree health plans. Defined benefit pension plans have become a unique luxury of the public sector. In 2009, they were available to 84 percent of state and local workers, but to just 21 percent of private workers.[14] Furthermore, public sector plans are generally more generous than the remaining private-sector plans.[15] Recent news articles have highlighted the excesses of public-sector pensions in many cities and states.[16]

Official estimates show that state and local pension plans are underfunded (or overpromised) by about $1 trillion.[17] However, official estimates typically understate the poor shape of pension plans because they rely on optimistic assumptions to value future liabilities. Using more realistic assumptions, a study by Robert Novy-Marx and Joshua Rauh found that state and local pensions have an enormous funding gap of $3.2 trillion.[18]

State and local governments also have large funding gaps in their employee retirement health plans, which likely total more than $1.4 trillion.[19] The combination of funding gaps in state and local pension and health plans amounts to roughly $40,000 for every household in the United States. That is the amount that taxpayers will be on the hook for over future years unless policymakers start cutting excessive benefit levels.

However, an important caveat with regard to debt and unfunded obligations is that the 50 states are in quite different fiscal positions. With respect to bond debt, some states borrow very little, while other states are heavily indebted. A report by Moody's shows that state-level debt varies from more than 8 percent of state GDP in Hawaii and Massachusetts to near zero in Iowa, Wyoming, and Nebraska.[20] Interestingly, those states with smaller union shares in their public sectors have lower per-capita debt loads.[21]

Large differences between the states are also evident in pension funding gaps.[22] Economist Andrew Biggs calculates that the median ratio of pension obligations-to-GDP is 27 percent, but that ratio varies from a low of 11 percent in Nebraska to a high of 49 percent in Ohio.[23]

State policy also varies widely with respect to public sector unionization, which affects state fiscal policy. While some states, such as New York, have more than two-thirds of their state-local workforces unionized, there are about a dozen states that do not allow public sector unionism at all.[24] Virginia, for example, bans collective bargaining in the public sector. Looking ahead, unionization is important because state policymakers need the flexibility to deal with all the fiscal challenges that they face. Unions often resist efforts to cut costs in state and local governments. Optimally, the states would follow Virginia's example and ban collective bargaining in the public sector.

To sum up, some states have been quite frugal, while others seem intent on imposing large costs on future generations. The states have chosen different paths, but they are free to do so in our federal system. Hopefully, the mismanaged states can learn lessons from the better-managed states when it comes to policies such as employee pensions. Certainly we want to avoid federal interventions that would reward the spendthrift states and penalize the frugal states, such as federal bail-outs.

However, I am also skeptical of calls for intervention in the form of a new federal bankruptcy statute for state governments. Such an intervention is not needed because the states already have the power to mend their finances without help from Washington. Supporters of a bankruptcy law are rightly concerned about preventing a future bailout of the states, but I don't see that the political incentives for a bailout would be much changed. The governor of California and other poorly managed states would still rather lobby for a federal bailout than to declare state bankruptcy. Also, I'm uneasy about the idea that the federal government would make it easier for state governments to stiff their bondholders and other creditors.

In sum, the recession has prompted the states to trim their general fund spending, but many states need to make larger reforms in coming years to reduce debt and unfunded obligations.[25] States should cut low-value programs, such as business subsidies. They should privatize government assets, such as highways and airports, and use the proceeds to pay down state debt. They should encourage private financing for new infrastructure, as Virginia has done with the widening of the Capitol Beltway,

State and local governments should put all new workers on defined contribution retirement plans, rather than defined benefit plans. They should change the formulas on current pension plans to make them less lucrative. They should increase employee premiums for pensions and heath care plans. They should reform accounting methods for their pension plans to use lower and more realistic discount rates for future liabilities. And the states with unionized workforces should end collective bargaining to give government managers greater fiscal flexibility. State policymakers have the power to make all these reforms without federal intervention.

Thank you for holding these important hearings. I look forward to working with the committee on these issues.

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[1] Robert J. Barro, "The Stimulus Evidence One Year Later," *Wall Street Journal*, February 23, 2010.
[2] Organization for Economic Cooperation and Development, "Economic Outlook Database," December 2010, Annex Table 25, www.oecd.org/dataoecd/5/51/2483816.xls. For the OECD, I calculated the unweighted average of the countries.
[3] Congressional Budget Office, "The Long-Range Budget Outlook," June 2010, p. 7.
[4] See www.cato-at-liberty.org/swap-debt-limit-for-cut-and-cap.
[5] See www.cato-at-liberty.org/cutting-government-the-canadian-way and www.cato-at-liberty.org/canadas-spending-cuts-and-economic-growth.
[6] See www.oecd.org/dataoecd/6/27/2483806.xls.
[7] See www.oecd.org/dataoecd/5/51/2483816.xls.
[8] National Association of State Budget Officers, *The Fiscal Survey of States*, June 2010.
[9] U.S. Bureau of Economic Analysis, National Income and Product Accounts, Tables 3.3 and 6.2D.
[10] Elizabeth McNichol, Phil Oliff, and Nicholas Johnson, "States Continue to Feel Recession's Impact," Center on Budget and Policy Priorities, January 21, 2011.
[11] See www.nytimes.com/2011/01/07/opinion/07krugman.html.
[12] Texas Comptroller of Public Accounts, "Biennial Revenue Estimate: 2012-2013 Biennium," January 10, 2011, p. 35.
[13] Federal Reserve Board, *Flow of Funds Accounts of the United States* (Washington: Federal Reserve Board of Governors, December 2010), Table D.3.

[14] Chris Edwards, "Employee Compensation in State and Local Governments," Cato Institute Tax and Budget Bulletin no. 59, January 2010.

[15] Pew Center on the States, *Promises with a Price: Public Sector Retirement Benefits* (Philadelphia: The Pew Charitable Trusts, 2007), p. 11.

[16] Chris Edwards, "Employee Compensation in State and Local Governments." Cato Institute Tax and Budget Bulletin no. 59, January 2010.

[17] Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* 23, no. 4 (2009): 191–210.

[18] Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* 23, no. 4 (2009): 191–210.

[19] Chris Edwards and Jagadeesh Gokhale, "Unfunded State and Local Health Costs: $1.4 Trillion," Cato Institute Tax and Budget Bulletin no. 40, October 2006.

[20] Moody's Investors Service, "2010 State Debt Medians Report," May 2010, Table 5.

[21] www.cato-at-liberty.org/unions-and-government-debt.

[22] www.aei.org/docLib/2010RPOno1g.pdf.

[23] www.aei.org/docLib/2010RPOno1g.pdf.

[24] Chris Edwards, "Public Sector Unions," Cato Institute Tax and Budget Bulletin no. 61, March 2010.

[25] I discuss state fiscal reforms in www.cato.org/speeches/chrisedwards-state-fiscal.pdf.

Chairman CONRAD. Thank you. I am going to diverge from typical practice because I have been asking questions as we have gone along here. So we will go to Senator Sessions for his questions, and then we will go to other members of the Committee, and I will withhold my questions until others have had a chance.

Senator SESSIONS. Thank you, Mr. Chairman. It is, I believe, pretty much a truism of State and local and even the Federal Government that financial crises provide the opportunity for improvement of efficiency and productivity. While money is flowing in generously, we just add, we spend more, and we do not focus on the difficult task of productivity.

Forgive a personal story. I was elected Attorney General, and my predecessor mismanaged the finances very badly. That is probably the only reason I could get elected. And it came out he was not able to pay the light bill right before the election. And it turned out to be a $5 million deficit on a $15 million budget. This was 1994, and people were not happy with Government them like they are today. And I did not want to ask the legislature for more money until I had done everything I could.

So we examined the office. We found that one-third of the people had been hired outside the merit system. It was a 200-person offices, and I terminated 70 people and brought on seven new people. We closed offsites. We got rid of automobiles that people were driving home, lawyers were, and we reorganized entirely, and the office today—and that was in 1994—is well below 200 employees today, and I think doing at least as good, or better job of serving the taxpayers.

So I just want to say that State governments are challenged, we are challenged. The idea that we cannot reduce 10 or 15 or 18 percent spending on most of our agencies is not accurate. We will be leaner, more effective, and more productive if the leaders get on board and do what they should do instead of, as the Interior Department does, close down the Smithsonian when you ask them to cut their budget. So this is big-time stuff. So I am not timid about the challenge and opportunity of tight budgets.

Mr. Scheppach, the spending on the States, it has been suggested, has been too often driven by matching funds from the Federal Government, and this has lured the State to commitments that now they are not able to meet, Medicaid I suppose being one of them. I see Governor Christie was having to make the choice about the tunnel, and he was attacked for turning down Federal money. And he said, “Well, I do not have the money to build a tunnel. I do not have the money. I cannot help it if we are turning down money.

In your opinion, have Federal policies seduced or encourage the States to undertake expenditures that they might not otherwise have? Is that part of the problem that we have?

Mr. SCHEPPACH. Yes. It is particularly acute, I think, in the Medicaid area. If you trace Medicaid historically, what happened was the Federal Government would provide options to States, and those States who were a little wealthier than some others would exercise those options. And then you would have 25 or 30 States exercising the option, and then Congress would say, “Well, if it is easy for those 35, let us make a mandatory.”

And so we have been in this iterative process around Medicaid, and now, depending on how you measure it, you have 60 million people in Medicaid, and you are picking up another 20 million. So that is going to be 80 million people in Medicaid. And it is an engagement, and there are very few cost control strategies that States can utilize, and particularly around the long-term care and the dual eligibles.

I mean, you would never build a system from scratch to say if you are in relatively good health and relatively high income, you are in Medicare. Now your health deteriorates and your income deteriorates, and you get half of your services from Medicaid and the other half from Medicare. It makes no sense. People are confused. The incentives are all wrong because we do not do certain things to save money because we end up saving money from Medicare. And you do not do things in Medicare that make sense because the savings come to Medicaid. So you have expanded this program that at its very fundamental basis has huge problems.

Now, we could talk about some of the other areas, you know, discretionary grants. There are like 200 discretionary grants, from the big ones in education and highways right down to a lot of small ones. But it is true that at some point there are some of those that certain States really cannot utilize the money. Moving to broader block grants in areas where States had a lot more flexibility would increase efficiency.

So, you know, I think you are right, but I think Medicaid is the biggest problem.

Mr. EDWARDS. Can I make a comment on that? You know, another example of this is like in transit systems where the Federal Government has traditionally funded the capital costs, the new light rail systems and now new fancy high-speed rail systems. And the problem is that States get induced to build these really expensive systems, but the Federal Government does not fund the operating costs. So these cities and States are going to be left down the road with these very fancy new systems when bus systems would have been cheaper with, you know, lower operating costs, and now they are stuck with all this expensive infrastructure. So there are others areas where this is a problem.

Senator SESSIONS. I would agree, and I might as well be frank about it. I am going to oppose the high-speed rail idea. We do not have the money. I do not believe it is going to be effective. And you cannot pour money into projects that are not going to prove to be effective. We do not have the money. We do not have the money to do things we have to do much less new programs even though they may appear to be popular.

I do want to say, Dr. Scheppach, that many of the Governors are doing great work. If we were running the Federal Government like many of the Governors are running their States, we would be a lot better off. I know Governor Riley in Alabama faced up to his problems. I saw where Haley Barbour in Mississippi reduced spending 9 percent. I see California now, a bit late, but they are stepping up some real reductions, and others are. Governor Christie I mentioned in New Jersey. And that kind of leadership is what we need in Washington, and I do not think we have been getting it.

Dr. Zandi—my time is up—thank you for your work, and I just would say I saw the Case-Shiller housing index predicts another bad year for housing. Are you in agreement with that?

Mr. ZANDI. Yes, I think there will be more house price declines, on the Case-Shiller probably another 5 percent nationally. That would make the peak-to-trough decline in housing values about 35 percent. So it will be another tough year for housing, yes.

Chairman CONRAD. I am going to in my questioning time want to come back to that question, because as I look across the horizon here and we look at potential threats to this economic recovery, housing, the State and local, the European debt situation, and the Middle East, I would put those four at the top of the list. This Committee, we cannot do much about the Middle East. State and local, really I think Ray and Mr. Edwards have described very well the States are really taking on their own challenges. The European debt situation we cannot do a thing about on this Committee. The one thing where we might be able to make a difference is in the housing, and so I want to come back to that.

With that, we will go to Senator Whitehouse. Then it will be Senator Begich, Senator Merkley, Senator Thune on this side. So we will go to Senator Whitehouse, and then come back to Senator Thune.

Senator WHITEHOUSE. Thank you, Mr. Chairman. I would urge the distinguished Ranking Member to at least keep a bit of an open mind as to the potential for high-speed rail. I think if the same approach that he indicated toward high- speed rail had been applied to high-speed road back when we were trying to build the highway system and we were trying to move goods and people around this country on local road, through stoplights, you know, over bumpy surfaces, and through local intersections, you would find that it actually was worth spending that money because it carried follow-on economic effects that were far more than——

Senator SESSIONS. I recognize the Northeast could justify it more than a lot of the places I see it is being projected to go.

Senator WHITEHOUSE. That is all I needed to hear. I appreciate it very, very much.

[Laughter.]

Senator WHITEHOUSE. Mr. Zandi, you have talked a little bit about the housing market, and when I look at the failure of the HAMP program by its own standards, let alone any outside standard, when you look at the foreclosure crisis, when you look at the horrible nature of the short- sale market—I had Rhode Island's realtors in yesterday, and it is completely defective across the country. They come in over and over again with stories about having a short sale ready at a price, the bank cannot get its act together, the short sale disappears; the bank then says, "OK, we are ready." Sorry, buyer gone. So then they come back to the same bank with the same property later. Now it is $100,000 less. They try again. The bank cannot get its act together. Again, they do not get through the process. And finally, you know, here you are with $200,000 in value out of a house, the bank still in the state of confusion.

Wherever you go in this process, whether it is through the HAMP or through foreclosure or through short sale, you see the same thing, which is that no matter who you are, almost no matter who you are, you cannot get a person representing the owner of the mortgage who can make a decision.

I had a witness in the other day in a Judiciary hearing who had been 20 months fighting through the HAMP program and through his bank's modification program to try to get a change, and for 20 months he never once got in touch with somebody who would even give him his last name or you could even call back to.

I mean, if there is something that is sort of basic and American, it is that when you are dealing with somebody else, you ought to be able to get a person on the phone who can make a decision in your case instead of being stuffed into this nightmarish bureaucracy. And for me that is confirmed by what I see at home in Rhode Island, which is that the local banks that held the loans, that have bank officers in the community, are not the problem. We do not have short-sale problems with them. We do not have foreclosure problems with them. All of the problems are in the big banks that sold off these mortgages, and now there is this incredibly complex infrastructure, and there is no way to cut through it. And whether it is you are a person in danger of foreclosure trying to keep your home, your realtor being driven nuts by having to spend 3 or 4 hours on the phone trying to get an answer on a deal that they are beginning to lose faith would ever happen anyway, the HAMP applicant trying to work through the process—they are run, whack, into this same bureaucratic nightmare. And I think it is a little bit like—you know the story about the men who each find an elephant, and one finds a leg and they think that the elephant must be a column, and one finds a trunk and they think the elephant, you know, must be a snake hanging in a tree; the other one finds a tail and thinks it must be a broom. It is all the same elephant.

And I wonder what your thoughts are—you have observed this—on this being a same elephant of a vast and completely unapproachable bureaucratic meltdown, basically, a nightmare that prevents intelligent decisions from being made, that prevents properties from being cleared, that discourages participants, and that is in many ways a vicious cycle, because you are driving property values down when that first buyer cannot get an answer from the bank on the short sale in time. The second buyer is going to be more fed up, and the seller is going to be more discouraged.

So I think we are creating some of our own negative energy by not clearing the fundamental problem of the system, which is that at some point somebody should be able to have a human being with a first and a last name who can make a decision, who they can get in touch with. It seems to me it is as simple as that, and I would love your thoughts.

Mr. ZANDI. Well, I think your characterization of the problem is excellent, very good, and the frustration that you have expressed I have heard many times as well from——

Senator WHITEHOUSE. Every one of us has heard it from our constituents.

Chairman CONRAD. This is how we started the conversation, actually.

Mr. ZANDI. So I completely sympathize with what you were saying, and I agree——

Senator WHITEHOUSE. So how do we fix it?

Mr. ZANDI. I think there are few things that can be done to improve the modification/foreclosure process. I think Senator Merkley has actually done a fair amount of work in this area, and I will mention a few things.

To your point about a point of contact, I think it would be prudent if mortgage servicers who are on the front line with the homeowner are required to have one individual as point of contact for each homeowner so when you call you get that same person. Right now you call, as you say, you can get numerous people, each one in a different part of the elephant, and they do not even understand the elephant. So it makes for a——

Senator WHITEHOUSE. And each telling you to submit the same paperwork you have already submitted four times again.

Mr. ZANDI. And telling you you sent it to the wrong person the last time you did it.

Senator WHITEHOUSE. Right.

Mr. ZANDI. So I think this is a regulatory fix, I think. You can go to the—I do not know if it is legislative, but it is certainly regulatory. Put pressure on the servicers to adopt one point of contact.

Another thing that can be done, I think, to improve the process is end the dual tracking that is going on. Right now a person comes in with a problem; you are put through modification and foreclosure at the same time. So you are talking to someone about trying to get a mod, and then you get a letter in the mail saying you are in default, we are going to take you to a sheriff's sale.

Senator WHITEHOUSE. I met with maybe 14 of our realtors in Rhode Island a couple of months ago. Every single one of them had the experience of a short-sale agreement with the bank pending, and in the middle of it, another part of the bank whacked them with a foreclosure notice, blew up the short sale, and it ended up going into foreclosure inventory for way less than the short sale that the bank had itself agreed to. I mean, it is nutty out there.

Mr. ZANDI. Another fix, you do not dual track; you go through modification. If you fail the modification, then you go through foreclosure. They both do not occur at the same time.

A third thing that could be done is a third-party review. A number of States have adopted this approach. You know, this is a very complex process. Homeowners are ill equipped to navigate through this process. They need help. You know, I think there are TARP funds that are sitting out there that were, at least in theory, allocated for HAMP and HARP that will never be used. They could be redirected to provide some help in this area, and I think it saves everybody a lot of money if, in fact, they——

Senator WHITEHOUSE. Dr. Zandi, I am going to cut you off there out of respect for my colleagues because we have gone over my time. But I am happy to follow the discussion afterwards and appreciate the thought you have given to this.

Mr. Chairman, thank you.

Chairman CONRAD. Thank you, Senator.

Senator Thune.

Senator THUNE. Thank you, Mr. Chairman. I appreciate the testimony of our expert witnesses today, and like many of my colleagues am very concerned about steps we can take to get the economy back on track and to deal with these problems of spending and debt which continue to explode on us; and if we do not start making some of the hard decisions now, I think the decisions will get that much harder.

Mr. Zandi, I would like to ask you a question about how much you believe that the debt and the deficit is currently a drag on our economy. And if you do not believe it is today, when does that effect begin?

Mr. ZANDI. I think the Nation's fiscal challenges are our No. 1 long-term economic challenge, that if we—you—do not address it quickly in a clear and credible way, it will have significant negative implications for financial markets and our economy quickly. I do not think it is this year, but I certainly think by 2012 and certainly 2013, we are going to be seeing the ill effects of inaction.

I would counsel, however, that while it would be very prudent to lay out a clear, credible path to fiscal sustainability—and we can talk about what that means if you would like now—I would not begin that process in 2011; that the recovery is still very fragile. And, in fact, imposing fiscal austerity in 2011, calendar year 2011, would be working at cross purposes with your own actions. The tax cut deal that you came to at the end of last year, in my view, was a very important piece of legislation, very positive, and for me sealed the deal for 2011 and 2012 that the economy is going to do measurably better because of that piece of legislation.

It would also be working at clear cross purposes with the Federal Reserve. The Federal Reserve is maintaining a zero interest rate policy and quantitative easing through the mid-part of this year, at least. So I do not think it would be prudent to begin this process in 2011 but by 2012 and 2013, certainly. And, moreover, to lay out a path for the future to achieve fiscal sustainability in 2011 would be incredibly therapeutic.

Senator THUNE. And you say we can talk about what that means. What does that mean, in your view, path to fiscal sustainability?

Mr. ZANDI. Yes, I believe that your bogey, your target should be to reduce the deficit-to-GDP by 2.5 to 3 percentage points out 5 to 7 years. I will explain how I get there.

The deficit this year, in fiscal year 2011, will wind up being, in my view, somewhere around 9 percent of GDP. When the economy is functioning properly—and I think we are headed in that direction—and functioning reasonably well, the deficit will settle in close to 5 percent of GDP.

The deficit-to-GDP that we can manage—and I am not saying this is what I would espouse, but we can manage—is about 2.5 percent. At 2.5 percent of GDP, our interest payments will not swamp us. We can manage that.

So we have to go from 5 percent in a well-functioning economy to 2.5 percent. You have to close that 2.5-percent gap. You have to close that in the next 5 to 7 years. If you can lay out a clear and credible path to doing that, then you will forestall the consequences that will occur in financial markets and into the broader economy.

We do not solve our problems forever. There is Medicaid and Medicare and health care costs that need to be readdressed, but I think the immediate target should be reducing the deficit by 2.5 percent of GDP.

Senator THUNE. You talked about the potential for sovereign debt crisis in the euro zone. What do you think the potential is for a debt crisis here in the U.S.?

Mr. ZANDI. I think if there are no significant policy changes over the next couple years, certainly over the next couple, 3 years, then those risks would be very, very high and rising quite quickly. So I think we have a window. We have latitude. Our economy is moving in the right direction, but we have 2 to 3 years to get our act together.

Senator THUNE. You mentioned the Fed's policies on quantitative easing. What effect do you believe those are having on both inflation and growth?

Mr. ZANDI. I think the quantitative easing was the appropriate thing to do. I think it is a net positive. There are negatives. You know, obviously it has contributed to higher commodity prices. It complicates the conduct of monetary policy overseas, particularly in emerging economies. But the positives, including lower long-term interest rates, the 10-year Treasury yield is 3.5 percent, fixed mortgage rates are below 5 percent, and the stock market is up significantly, and I think in part because of the QE, the positives trump the negatives in a measurable, meaningful way, and it was the appropriate thing to do.

I do not think we will need—based on what is happening to the economy today and my expectations, I think we do not need any further QE. And I think it would be appropriate for the Federal Reserve to start tightening monetary policy, probably sometime in 2012. But what they have done so far, in my view, has been entirely appropriate.

Senator THUNE. Mr. Edwards, in order for the markets to think that Congress is credible on cutting spending, what do you think those reductions have to be? And when do they have to take effect?

Mr. EDWARDS. Well, I mean, the basic mathematics is we have to get the deficit down to about 3 percent of GDP in order to stabilize debt.

I disagree with Mark really on the timing of this. You know, the view that we have to wait until we start growing again to start cutting spending does not make any sense to me, because, you know, we all assume that—you know, we look at the CBO projections and we all assume that everything is going to be hunky-dory again in a few years because we are going to be growing again. But we might have another recession in 2014, 2015, and, again, folks like Mr. Zandi are going to be coming and saying, oh, no, we need to, you know, spend more money and we cannot cut spending now.

So there is always going to be an excuse for not cutting spending. The longer we wait, the higher Federal debt becomes. It is going to be harder to solve the problem. And I think cutting Federal spending moves resources from the less efficient Government sector to the more efficient private sector. So I think it helps growth.

I talked a few minutes ago about Canada. Canada's experience was that they dramatically cut government as a share of GDP by about 10 percentage points. The economy did not go into recession. It boomed for 15 straight years.

Senator THUNE. What does $4 gasoline or, worse yet, $5 gasoline do the economic recovery?

Mr. ZANDI. I think that would be—if that were to occur now, in the next 6 to 12 months, I think that would be—I do not think $4-a-gallon gasoline would be enough to put us back into a recession, but it would be awfully painful. It is a tax increase, right? If you put more into your gas tank, you have less to spend on everything else. And just for context, every penny increase in a gallon of gasoline costs the American consumer $1.5 billion over a year. So, you know, you add it up, you go from $3 a gallon to $4, that is a $150 billion tax increase in 2011. That would be very difficult, particularly for lower-income households who obviously do not have a lot of latitude. In parts of the country like the South, the hardest-hit group will be low-income households in the South because that is where they drive the most, and a high share of their budget goes to gasoline.

Senator THUNE. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you to all of you for sharing views. It is very helpful.

Dr. Zandi, there was a quote in your testimony which was, "Nothing works well in the economy when house prices are falling." And you placed a lot of emphasis on addressing the housing market, and I appreciate that you are bring that to the forefront. We are still in this period where we have had 300,000 foreclosure filings a month for the last 20 months, and certainly in my home State, every community is affected by this. And it is not just a disaster for the family, but that empty house is helping to further drive down the value of adjacent homes, certainly discouraging consumer confidence, and it is certainly having a broader impact since the construction industry is not going to recover as long as there is a lot of empty homes.

I do appreciate your drawing attention to the several different ways of helping to take on the foreclosure crisis, the single point of contact, and ending the dual track. I want to note that, after talking with a lot of homeowners back in Oregon, it is not simply that the bank cannot complete the last stage, which is the actual foreclosure on the dual track; it is that they suspend all the steps on the dual track during a time period in which they review and conclude up or down whether a modification is going to work. And I assume that that is the—but I wanted to ask if you are talking about suspending the entire track or just the final step.

Mr. ZANDI. Precisely what you say. I think the entire foreclosure process, from default through to sale, should be suspended until it is determined that the borrower cannot qualify for any form of modification, HAMP or private mod.

Senator MERKLEY. And then there were three ideas that I had put out in the paper that you referred to about further intervention, and one was the fire break before foreclosure, mediation, mandatory mediation that you addressed—in other words, an expansion of short refi programs, which you addressed. A third was to revisit the power of bankruptcy judges, at least in a very constrained format with appropriate sideboards on it, maybe take it in a little narrower direction than we did last time Congress took a look at it, primarily not because those judges will exercise that power, because they do not exercise that power much in the other areas that they can modify contracts, but because it gives an incentive to close the deal.

And so since that was one point that I brought forward that you did not address, I just wanted to get your thoughts on that.

Mr. ZANDI. I think that it is a good idea. As you know, right bankruptcy judges can reduce the debt owed for everything but a first mortgage, and that, in my view, should be changed.

Now, there had been some effort in times past during this crisis to make that change on a historical basis, so loans that were already originated, allow bankruptcy judges to change the terms on those loans. At this point, I do not think that is appropriate. But changing the bankruptcy reform law for the future, you know, for future loans, I think that would be entirely appropriate. In fact, I think that would be therapeutic and would make for a better system.

Senator MERKLEY. So let me press that a little bit because the problem seems to be—and we have folks calling our offices every day in Oregon describing how difficult it is to deal with the servicers—is to create a little bit of countervailing incentive for the servicers to close the deal. And, in fact, at this point I want to mention that there seemed to be a number of perverse incentives for the servicers.

I just did a tour of Oregon in four different cities where I did a presentation with homeowners who have been affected, and I heard the same stories we have been hearing in our office, which is, "I called the bank to tell them we had a decrease is income. They said, 'Hey, you are preapproved. Stop making your payments for 3 months.'" And, really, they were calling the servicer, if you will, and not always a bank.

But it turned out that the servicer charged a huge amount of fees once they reduced their payment or stopped making their payments, fees that the servicer would not otherwise have had access to.

Then there was a recent article also noting that servicers make a tremendous amount of money when they put on substitute property insurance, sometimes charging up to 10 times what a homeowner would normally pay, and the servicer gets a huge fee back, hidden to the homeowner in that regard. And so servicers kind of have an incentive to get families into trouble, almost, and I am not sure that has been thoroughly explored. It is certainly a new element to me. I had not come to think that this was part of the challenge with servicers. But any comment on that would be helpful, but, also, that is why I felt lifeline bankruptcy power, even on existing loans, would be helpful because it creates a countervailing incentive to close the deal and help address these problems.

Mr. ZANDI. Well, this is what I would suggest. FDIC Chairwoman Sheila Bair has recently proposed the establishment of a fund financed by the mortgage servicers and mortgage companies designed in the same way as the BP fund. So if you are a homeowner who has been wronged by this process, you can go before this commission and air your grievances, and if it is determine that you have been wronged, then the fund would pay you a fee.

I think this would be an appropriate way of getting the attention of the servicers and the mortgage companies, and it would provide, as you said at the beginning of your comment, the catalyst for getting them to work on this process in a more effective and prudent way.

So that would be my approach as opposed to there are potentially significant unintended consequences from going back and rewriting bankruptcy law on existing mortgages that are—you really have to think that one through. You know, in deep crisis, I was sympathetic to that argument, particularly when the private label securities market was at the heart of the problem. But, increasingly, that is no longer the problem. It is the loans on the books of the banks, at Fannie Mae, Freddie Mac, and the FHA. So I am less sympathetic to that, and I do not think that would be the way I would go.

Senator MERKLEY. I would ask everybody else to weigh in except my time has expired, so thank you very much.

Chairman CONRAD. Thank you very much.

Senator Begich.

Senator BEGICH. Thank you, Mr. Chairman.

I want to followup on——

Chairman CONRAD. Can I just say, for Senator Cardin's benefit, Senator Begich was here earlier.

Senator BEGICH. I apologize. I had to rush out and make a quick call, so thank you, Mr. Chairman.

Let me, if I can, followup on a couple of things. One, Mr. Edwards, I agree with you in regards to States and bankruptcy that we should not go down that path. That would be very—I mean, even the talk of it right now, from what I understand, talking to multiple people who deal in the business of municipal bonds, State bonds, tax-free bonds, it is having an effect on the market, and I know States are probably feeling that, even though they will not say that the rates have been adjusted upwards, but there is some risk now being calculated into what we might do or not do. So even the notion of talking about it, I think, is not very healthy for what we need to get through. So I want to say I agree with you in that regard, that we should not be going down that path.

I would be interested in each one of your quick comments on that. Obviously, Mr. Edwards, you have already made a comment. If each one of you could just quickly comment on the idea of States walking down that path of declaring bankruptcy, which again, I think it would be a huge mistake.

Mr. SCHEPPACH. Senator, I can tell you that we have discussed it and we have—basically, Governors are pretty united in opposition to that legislation. Nobody is asking for it. Nobody wants it. And we agree with you that the mere conversation around it is foreseeing a small risk premium to be built into the bonds. So we are very strongly opposed to it across the board.

Senator BEGICH. I know they call it on the market sometimes headline risk. Go ahead.

Mr. VON WACHTER. So I second the views of Mr. Edwards and Dr. Scheppach. I agree that we should not talk about bailouts. However, there are some areas where there is a close connection between Federal and State funding. When I give an example, it is the unemployment insurance system——

Senator BEGICH. Sure.

Mr. VON WACHTER [continuing]. Where the Federal Government stands in by design of the system after the States run out. And one thing that this administration has already done, has given an impulse to the reform of State-level unemployment insurance systems to funding from the ARRA. And one additional step that could be taken to help the long-term sustainability of these programs and sort of then relieve both State budgets and the Federal budget is to mandate a higher wage base. The wage base——

Senator BEGICH. I do not want to get into the program. I specifically narrowed in on the fact that States could declare bankruptcy. In other words, I understand the program. You are right. There are partnerships and relationships that the Federal Government has.

Mr. VON WACHTER. The UI system is particular because inherent in the system is the States can essentially lend—would borrow from the government——

Senator BEGICH. Sure.

Mr. VON WACHTER [continuing]. Once the trust funds went out, right.

Senator BEGICH. Right.

Mr. VON WACHTER. So there is a typical system where you see them in a small way. So States have not an incentive to buildup sufficient trust funds because they know they can come get more from the government. So this is a system where it is more concrete, but concrete steps could be taken to avoid the behavior that the incentive—the availability to borrow later on creates setting too low a tax base and collecting taxes. So the same thing happens, then, at a broader level, the State budgets. But the possibility to possibly be bailed out. But it probably leads to a pay-as-you-go in situations where you really should be building up funds——

Senator BEGICH. Building up a fund.

Mr. VON WACHTER [continuing]. In good times for bad times, and in many States, you see the opposite. Taxes are low in good times and then they have to rise in bad times. And so talking about bailouts would encourage that and we want to go in the other direction, and UI is a particular example.

Senator BEGICH. Dr. Zandi?

Mr. ZANDI. Yes. I do not think that is a good idea. I think the bankruptcy——

Senator BEGICH. Bankruptcy.

Mr. ZANDI. Yes. I think that the States have all the tools they need and that this would be an error.

Senator BEGICH. And I appreciate that. I just, again, want to kind of put that out there because I think we create a problem by going down the path of discussion when we know Governors are not asking for it. No one is asking for it, really, and it is just a very bad thing.

Let me go into two other areas, but first, I want to give a thought. I, like Senator Sessions, in a different way, I was elected a mayor of a city that walked into a $215 million budget with a $33 million hole in it and we had to resolve it. We had a three-prong attack. One was spending issues. One was revenue. One was also investment in basic core infrastructure—water, sewer, roads, so forth. I have turned down—when I was mayor, I turned down the Federal resources when offered for the simple reason we do not have the money, and so you cannot do it, and also sustainability of those resources.

I guess I want to—Senator Sessions brought up a good point, and you are right, there is kind of this addiction, and the reality is, it is really up to the Governors and, I would say, mayors, which have actually a larger amount of the debt out there than States do in the sense of what is out there, but they have just got to say no. It is about leadership. For them just to say, well, maybe I will get 10 percent from the Feds, there are many times I just said no. And what we did, we actually changed our policy. We never used one-time resources for ongoing expenses. That was—I had to tell the local city council, which was hard for them to get off of that gravy train. Once we did that, we created stability, and that is—I mean, Governors, mayors—mayors, and I am biased, I am a former mayor, I am not a Governor, never have been—we have to do it because otherwise we will get yelled at at the grocery store. So we do not get really a choice. There is no more hiding us.

So I guess part of it is this gap of sometimes leadership just to say no, even when your constituents may think it is a wise thing, but getting off these one-time moneys are, to me, the right way to deal with budget, even from the Federal end. You know, we use one-time moneys to kind of solve a problem and then hope it all works out next year. That is very dangerous.

But one thing I want to mention and make sure I heard you right, because I think I heard the same statistic, the pension issue—and our State had to deal with it. We dealt with it. Cities dealt with it. We are more sound than ever before. But really, when you figure it all out, it is about 4 percent or whatever the percent is. It is a small percentage of the overall budget and I want to echo and make sure I heard what you said.

States are managing their way kind of through it painfully. But should there be a more consistent rules of the game on how they do this, because each State does it differently. And you are right. It is very convoluted, and especially to the bond markets, to understand how stable is that State, how stable—can you give some thoughts on that? I am not suggesting more regulation, but I am just trying to figure out, how do you get some more uniformity here so the financial markets can respond the right way when crediting and scoring States for their bonds as well as cities.

Mr. SCHEPPACH. The problem is that the pension things are pretty much considered to be legal contracts——

Senator BEGICH. Correct.

Mr. SCHEPPACH [continuing]. And each State——

Senator BEGICH. Ours is actually vested in our Constitution.

Mr. SCHEPPACH. OK. Yes, you are right.

Senator BEGICH. That is how legal it is.

Mr. SCHEPPACH. But sometimes it includes issues. A lot of times, for example, the COLA is not in the contract, so you have a lot of flexibility there. Or it may be that the age is not in it and other components of it.

So I think they are working through it. As I say, we had 30 States in the last 5 years and we have ten now, and they have moved from sort of these small incremental to bigger. The basic problem, though, is that they still have defined benefit as opposed to defined contribution——

Senator BEGICH. Right.

Mr. SCHEPPACH [continuing]. Although some, like Utah, are beginning to move at least hybrid types of systems.

Senator BEGICH. That is what we have done.

Mr. SCHEPPACH. So, I mean, I think the rating agencies are able to look at the liabilities there and the liabilities on bonds and make informed decisions. So I do not know that uniformity is really necessary. I am pretty confident in this area that there is serious focus on this right now.

Senator BEGICH. And I will end on this, because my time has expired, but I know there are always these headlines about the crisis in the States. But really, what you are stating, and I want to make sure I am hearing you right, the majority of the States have really started to deal with this because they recognize the ongoing cost is not millions, but billions. Is that a fair statement?

Mr. SCHEPPACH. Yes, I think it is, and it is—I think States should be given some credit. They have cut spending by $75 billion over the last two years. That is not from what I would argue is CBO's sort of inflated baseline. That is against actuals.

Senator BEGICH. That is real dollars.

Mr. SCHEPPACH. That is pretty tough stuff. And I think they understand that they have a lot more to do, but I think they are prepared to do it.

Senator BEGICH. Very good. Thank you.

Thank you, Mr. Chairman. I know my time is up.

Chairman CONRAD. I thank the Senator.

Senator Cardin.

Senator CARDIN. Thank you, Mr. Chairman. Let me thank you for the series of hearings that we have held on the national deficit, and I want to thank this panel.

Dr. Scheppach, I want to followup on Senator Begich's point because we have talked about the States, but I do not think we have talked enough about the risk factors of municipal and county governments. And if you are a Governor, you have proprietary interest to avoid a problem with a county or a municipality within your State. Today, our State governments have limited capacity as to how they can respond. They have to take care of their own budgets. So they are not as well prepared as perhaps they would need to be to avoid a consequence in their State that could have impact not just on that town or on that county, but could have impact on the entire State, in fact, could have impact well beyond the borders of one State.

So I just want to get your assessment as to how much attention the Governors are paying to the problems of municipal and county governments, as they are obviously in a more difficult position.

Mr. SCHEPPACH. I hate to say this. In a sense, they are into survival for themselves, to some extent, focusing on their own problems. There are some States, like Pennsylvania, who actually had laws that did not necessarily require but allowed them to help municipalities and so on, but a lot of States do not have that. So I think that they are not focusing on that issue a lot, although personally, I think, because I looked at it to some extent relative to the States, it is a bigger problem. But again, I think if there are some that go into default, my sense is that they are going to be fairly small, that, again, you look historically and there has not been a lot of defaults in this particular area. So particularly if we begin to get some positive revenue growth, I think they will be able to work through this, as well.

Senator CARDIN. I think that is a pretty direct, honest answer, and I appreciate that. We are all in a mode right now of survival, and that is true at the national level, also. But I would just like to remind my colleagues of the concept of federalism, that the Federal Government has responsibility as it relates to the States, working with the States. But I also believe that our municipalities and counties, which are creatures of our State, the State has a responsibility to work with our municipal governments. They have no other place to go.

A lot of Governors are now—at the national level, we are clearly going to be providing less resources to our States. There is no question. At the State level, you are going to be providing less resources to the counties. The counties are going to be providing less help to municipalities. The municipalities do not have anywhere else to go.

So I think we all need to understand, as we look for this credible plan to deal with our national debt, that it is the same people who live in municipalities, counties, States, and the Federal Government and that it does not do a person in Baltimore City any good if the plan is credible at the national level but dumps its problems to the taxpayers of Baltimore City and the people who live in Baltimore City and they have no chance of survival under the policies taken by the Federal Government and the State government.

So I like the language that our Chairman has used, and I think this is worth repeating. The Chairman said that we need a credible plan. It does not have to be a radical change overnight. We need a credible plan that gets us to the numbers that, Mr. Edwards, you were referring to. We want to get to those numbers. So I think we need to be mindful that we do not want to see the people of our nation harmed because we have taken care of our own problem at the national level, but we have dumped everything off on the States, or the States have dumped it off on local governments.

Dr. Zandi, I want to get back to the mortgage issue because it is still a huge problem in our community and all communities, and your exchange with Senator Merkley. Do we have a structure in place that could implement the policy that you are suggesting? That is, do we have a credible way of being able to determine whether a potential person who is subject to foreclosure quickly could determine whether they are entitled to some form of help?

Mr. ZANDI. No. I do not think we have a mechanism in place that is appropriate and is helpful enough. Some States have been more aggressive than others. I think the State of Connecticut, New York, I think probably New Jersey put in processes with third parties involved to try to facilitate this for homeowners, but it is not something that is being done nationwide or in parts of the country where the foreclosure problem is particularly acute. It is a problem coast to coast, but in some places, it is obviously very acute. So, no, I do not think that we have addressed that adequately enough.

Senator CARDIN. So if we were just to put in a moratorium without having a process in place, is that really going to help the situation or not?

Mr. ZANDI. No. I am not advocating that we have a moratorium. I am advocating that we, through the regulatory process, require some changes in the way the mortgage services conduct their business. So one point of contact, no dual tracking, a third-party review, a fund established to compensate homeowners that are shown to be wronged in the process. I think if you do those things, and I do not think—it is going to be very difficult to do this legislatively, but through the regulatory process, I think that that would be helpful and make a difference in facilitating the foreclosure modification process.

I think we are at a point now where we have some tools. We have just got to make them better. We need to work through this process as fast as we can. We need to get on the other side of this so that the housing market can begin to function properly and house prices start to rise. And we need to work through the foreclosure modifications.

Senator CARDIN. Well, I agree. We are still in a very, very difficult position on these issues, and there is uncertainty in the marketplace, also, which is not helpful. So the further we could clarify this, and I agree with you, I think we have enough tools out there. We just need to make sure that they are used and that the regulators do their jobs.

Thank you, Mr. Chairman.

Chairman CONRAD. Let me—I had deferred my questioning time, because we were late because of the prayer breakfast this morning, to members being here, so I kind of asked questions as we went along, but I want to come back to some of the fundamental questions I wanted to ask.

As I see it, in terms of the work of this committee, one of the most important things we can do is contribute to getting on a more sustainable course. How serious a threat do you believe it is to our long-term economic strength to having deficits of 10 percent of GDP this year and being on a course to a debt that would be 233 percent of GDP, according to CBO, if we stay on the current trend line? Dr. Zandi, how big a threat do you see that to our long-term economic security?

Mr. ZANDI. It is lethal. I mean, I think if you do not make changes to change those forecasts in a substantive way, our nation's economy will be—and our living standards will be diminished for generations to come. So I think it absolutely, positively has to change.

Chairman CONRAD. Well, that is about as clear as it can be. Lethal is pretty strong. And, frankly, I agree with it. I believe that.

So then the question becomes a matter of timing. I personally believe, and the commissions, all of the bipartisan commissions have come to roughly the same conclusion, that is, do not make big changes right now, but put in place a plan that makes big changes over this decade. In the case of the Fiscal Commission, we reached a determination we needed to reduce the deficit $4 trillion over that period of time—four trillion. That is real money. What do you say with respect to timing and size of the changes that are required?

Mr. ZANDI. I think the Fiscal Commission laid out a very good road map for you. There are two commissions, and both roughly came to the same place and laid out roughly the same path, and I think we should move in the direction that they have laid out for us.

So the deficit-to-GDP, let us call it nine, 10 percent this fiscal year. If we can get that down to two to 3 percent of GDP by the end of the decade and do that in a way that everyone believes we are going to do that—and we do not have to do it in 1 year. We can do it over that period.

And we do not have to begin now, and we should not. We should start that process when the economy is moving forward in a clear and definitive way, and my benchmark for that would be a falling unemployment rate. As soon as the unemployment rate is definitively moving south, I think at that point we can conclude that we are off and running and we need to then refocus and start imposing real fiscal discipline and austerity. Before that point in time, I think it would be—we will probably make our way through, but it would be, I think, a risk that we should not take.

And so, therefore, in 2011, I think you have done what you need to do. I think we are in good shape. I would not change fiscal policy, the thrust of fiscal policy for calendar year 2011. But beginning in 2012 and through the end of the decade, I think at that point, we need to very, very disciplined with respect to reducing those deficits, get it down to 2 percent of GDP.

Chairman CONRAD. So in dollar terms, what size of package would be required?

Mr. ZANDI. So if you meet my, sort of the numbers I gave you earlier, and your bogey is two-and-a-half percent of GDP, that is $375 billion a year in today's dollars, right. So to get that down to zero, that $375 billion to zero in five to 7 years, that is $50 billion a year in today's dollars. Obviously, it is more dollars in the future, but that is roughly what you need to do. It has to be very clearly done.

Chairman CONRAD. It has to be credible that it is going to be done.

Mr. ZANDI. Credible, and I think there are many elements of credibility. I mean, one is, and again, I am hearkening back to the commission——

Chairman CONRAD. So we are talking—just in dollar terms of the total package, you are very close to the kind of $4 trillion number that the commission came up with.

Mr. ZANDI. Yes. Exactly.

Chairman CONRAD. Dr. Scheppach?

Mr. SCHEPPACH. The only point I would make is that, let us face it, 95 percent of our problem is health care costs. We kind of know what to do in Social Security when we get the political will. So I think the structure of the package is also very, very important. Again, you can cut domestic discretionary and get the generated savings there, but I suspect you are not going to get the impact on financial markets if it is a package of domestic discretionary. It seems to me it has to be health care, and that is a problem because I do not think we know how to do that and we have some more experimentation. But I think 90 percent of that problem is health care.

Chairman CONRAD. You know, let me just say this. All roads lead to health care, but what the commission concluded, and I think correctly so, everything has to be on the table. You have to do revenue. You have to do domestic discretionary spending on both the defense and non-defense side. I will tell you, testimony before the commission on some of the things that are happening at the Department of Defense was startling in terms of cost. You have to do the entitlements. And obviously, the biggest entitlement, the place where we have the biggest unfunded liability is in the health care accounts.

Now, I know I do not want to reopen the health care debate, but I would say this to my colleagues. I was deeply involved in that effort, however imperfect it is. We took every idea, virtually every idea for reducing health care expenditure that analysts gave us from whatever perspective.

So the best analysts—in fact, Senator Gregg and I wrote a letter to CBO and asked them, what are the things that we could do that would give us the biggest bang for the buck at reducing health care expenditure? CBO came back and told us, No. 1, you have to change the tax treatment of health care, and economists from almost every philosophical perspective said that is the case because you are encouraging over-utilization.

No. 2, they told us, you have to change the payment methodology. You have to quit paying for procedures and you have to move to paying for health care outcomes.

Third, they told us, you have to put in place some ongoing mechanism to get the ideas that work in terms of bringing down costs, getting them implemented. And so we put in place this whole new institution to try new things, and if they work, to implement them nationally.

I am sorry. Did you want to add a point to that?

Mr. SCHEPPACH. Well, the only point I would mention, and this is not a position of the organization, but having spent a fair amount of time on this, I almost think one thing that you ought to look at is to—because we now have all-payer data systems in a bunch of States which means we have a much better sense of what is driving the cost of health care, and it has to be done for everybody. One of the things I am concerned about, if you cut Medicare or Medicaid, it just gets shifted to the ERISA firms and so on.

I almost think it has to be done State by State now, and one thing that may be worth looking at is you provide some incentives to States if, in fact, they begin to reduce the rate of increase in health care costs for everybody in the State, because I think it has to be addressed across the board. Some States may want to regulate. Others may want to do transparency. But I think it is an approach that may be worth looking at.

Chairman CONRAD. All right. Senator Portman has joined us. Welcome. Why do you not take your time. And let me just indicate that Dr. Zandi needs to leave here at right about noon, so why do you not proceed, Senator Portman.

Senator PORTMAN. Thank you, Mr. Chairman, I appreciate it, and thank you for allowing me to come and speak. I have not figured out how to be at three hearings at once yet, so I apologize I did not get to hear all of your testimony, but I really wanted to come by and have the opportunity to speak briefly and hear from you.

I love the fact we are talking about health care, and I think, Ray, you just mentioned the 95 percent figure. I am not sure that is accurate, but you should know that at this very table last week, Dr. Elmendorf said that health care is the No. 1 fiscal concern he has, and that is not a surprise because it is and it does drive the cost of Medicare and Medicaid, of course.

I have a more sort of fundamental question for you about the impact of current deficits on our economic growth. There is all sorts of data out there about the future impact of the enormous debts that we are building up, and the CBO projections are sobering, to say the least. But what is the impact today? What we do not talk about enough, I think, and maybe you can correct me on this, but I believe that we are crowding out private investment. I believe that with a $1.5 trillion debt this year projected, or deficit this year projected and a debt that is on track to double in the next 10 years, that we are impacting our ability to get out from under the difficult economic conditions we have been in over the last couple of years.

I just wonder if you could comment on that. I have heard people say that with a $1.5 trillion deficit, building on the $1.3 trillion and $1.4 trillion the last couple years, that there is maybe a point or point-and-a-half off of GDP. Do you agree with that? And if you could take it to the next level for me in terms of its impact on the economy, which would be the impact on jobs. What does that mean in terms of job growth in this country as we are struggling to deal with this exorbitantly high unemployment number even as the economy is beginning to grow?

So I would start with Dr. Zandi, if it is OK, and then if we could work down the panel.

Mr. ZANDI. I do not think the current budget deficit is crowding out private investment. I do not see evidence of that. The 10-year Treasury yield is 3.5 percent. B-double-A corporate borrowing yields are incredibly low. Even junk corporate bond yields are very low by historical standards. I do not think the cost of financing is an issue for companies.

In fact, I think the large budget deficit is helpful in that it is supporting demand. For example, the tax cut deal that you came to at the end of last year, I think, has a very important provision that will cost money but will be very important to supporting investment in 2011, and that is expensing of any investment, and I think that is a very under-appreciated aspect of that deal that will provide a lot of investment and actually will add a lot of jobs. Businesses will go out and buy an airplane and they have to fill it, or they buy a piece of machinery and they have to install it and they have to man it. So I think that was very appropriate and very good policy.

Now, having said all of that, I think I would entirely agree that we need to reduce these budget deficits moving forward when the economy is clearly off and running, and I think we are very close.

If everything sticks to my script, by next year, we should be in a measurably better place and the fiscal austerity that I think is important should begin at that point and we should engage in the kind of discipline necessary to ensure that we do not crowd out private investment because we will if the Federal Government does not pull back quickly once the economy is moving forward.

Senator PORTMAN. Dr. von Wachter?

Mr. VON WACHTER. So I agree with what Dr. Zandi said earlier, that we should be ready, or put mechanisms in place today to gain fiscal stability conditional on the unemployment rate falling. We should not start tightening our belts at a moment when we may need to do important investments, for example, support unemployed workers and help them when the time is coming, when their businesses are starting to hire to help them get out in the labor market.

For example, we were talking earlier about the housing market. The difficulty, the regulatory difficulties in the housing market may take longer to fix. So if job growth is picking up beforehand, we want to be ready to, for example, give people unemployment insurance mobility bonuses to take up jobs in other regions. So we have to be able to spend and invest in areas that allow us to grow, to get out of the current situation, to then achieve fiscal sustainability when the unemployment rate is down.

Senator PORTMAN. Dr. Scheppach?

Mr. SCHEPPACH. Yes. I would probably agree with Mark, but I do think the faster you can enact the changes, the better, even if they are not going to go into effect really for a year or a year and a half. So to the extent that you can put together a package now and do it, I think that is very, very positive.

Senator PORTMAN. Mr. Edwards?

Mr. EDWARDS. I think the way—you know, I agree with Mark that the usual way economists think about crowding out is through interest rates. The government borrows more. Real interest rates go up. Less investment flowing to the private sector. But you can also think about it—and I agree that you do not really see that now.

But Federal spending crowds out real resources in the private sector. You can think about it this way. If the Department of Defense is—the procurement budget is going way up or the size of our force structure is rising, you are taking very high-skilled and talented people out of producing stuff for the private sector for private markets and they are producing in the government sector. So the spending crowds out real resources, even as a separate sort of a mechanism from interest rates.

I would say, in going back to the previous question on when we need to make these cuts, we should not think about this in terms of one big change, one big giant reform. We obviously have to do incremental stuff over time. This year, Congress can cut some defense. Next year, we can raise the Social Security retirement age, and on and on. I do not envy the job of House and Senate members over the next few years. It is going to be very painful to be a Member of Congress because you are going to have to cut every year. There is no more getting elected and just promising all kinds of goodies. That is all going away, I think, for——

Senator SESSIONS. Well, as for paying and not cutting, as the past election showed, some people got shellacked in the past election——

Mr. EDWARDS. Right.

Senator SESSIONS [continuing]. And a lot of that was because we spent too much. So the myth that somehow it is harder to cut than it is to spend——

Mr. EDWARDS. Right.

Senator SESSIONS. I should not have interrupted. Excuse me, Mr. Chairman.

Mr. EDWARDS. So one——

Chairman CONRAD. No, I think that is a very important point, because, frankly, we have—one thing Senator Sessions and I absolutely agree on is the need to put in place a credible plan as soon as possible. A place where we may have a difference is the timing and the make-up of the plan. We do not have a difference on the absolute essential need to put in place a plan that is serious and credible.

Now, the place where I might differ from what I just heard you say is I think you need to have a plan that takes a series of votes now that makes these changes over time. That is, I do not want to see us in a situation where we do a little bit here and then we hope somehow that there is going to be a little more done, because my experience around here is you had better act while you have the window of opportunity and you had better put in place a multiple-year plan that has real discipline associated with it. This operating year by year around here is, I think, one of the things that gets us into trouble.

Mr. EDWARDS. Yes. I mean, I sort of partly agree with that, and I think you can think about mechanisms you can put in place to kind of force changes. I think David Malpass might have testified here the other day that he is proposing an idea that he puts sort of a cap on public debt as a share of GDP which would force sort of constant annual changes to get under that limit.

I proposed the idea in my testimony of putting a cap on the growth in total annual outlays. You pick a number, three or 4 percent, put it into a statute. Congress has to make sure outlays do not rise more than that every year, which would sort of be like the 1990 BEA, except it would be the overall budget. And again, that would force change, force Congress to focus on discipline every year.

Chairman CONRAD. We need to shut down because we had promised witnesses that they would be out by about noon, and I apologize we are a little beyond that. But I want to thank this panel, just outstanding and we very much appreciate your taking the time and energy to present to us here this morning. Thank you.

The committee is adjourned.

[Whereupon, at 12:06 p.m., the committee was adjourned.]

THE PRESIDENT'S FISCAL YEAR 2012 BUDGET PROPOSAL

TUESDAY, FEBRUARY 15, 2011

U.S. SENATE,
COMMITTEE ON THE BUDGET,

The committee met, pursuant to notice, at 2 p.m., in room 608, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Murray, Wyden, Stabenow, Cardin, Whitehouse, Merkley, Begich, Coons, Sessions, Enzi, Crapo, Ensign, Cornyn, Graham, Thune, Portman, Toomey, and Johnson.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I want to say for my colleagues, there will be a full turnout of the committee for this hearing, but we have a series of things going on simultaneously. The Tuesday caucuses of both parties are still underway. There is an event at the White House that has members. The Finance Committee is meeting with the Secretary of Health on the President's budget simultaneously. And we have a vote scheduled at 2:35.

Senator SESSIONS. But you are minding the store.

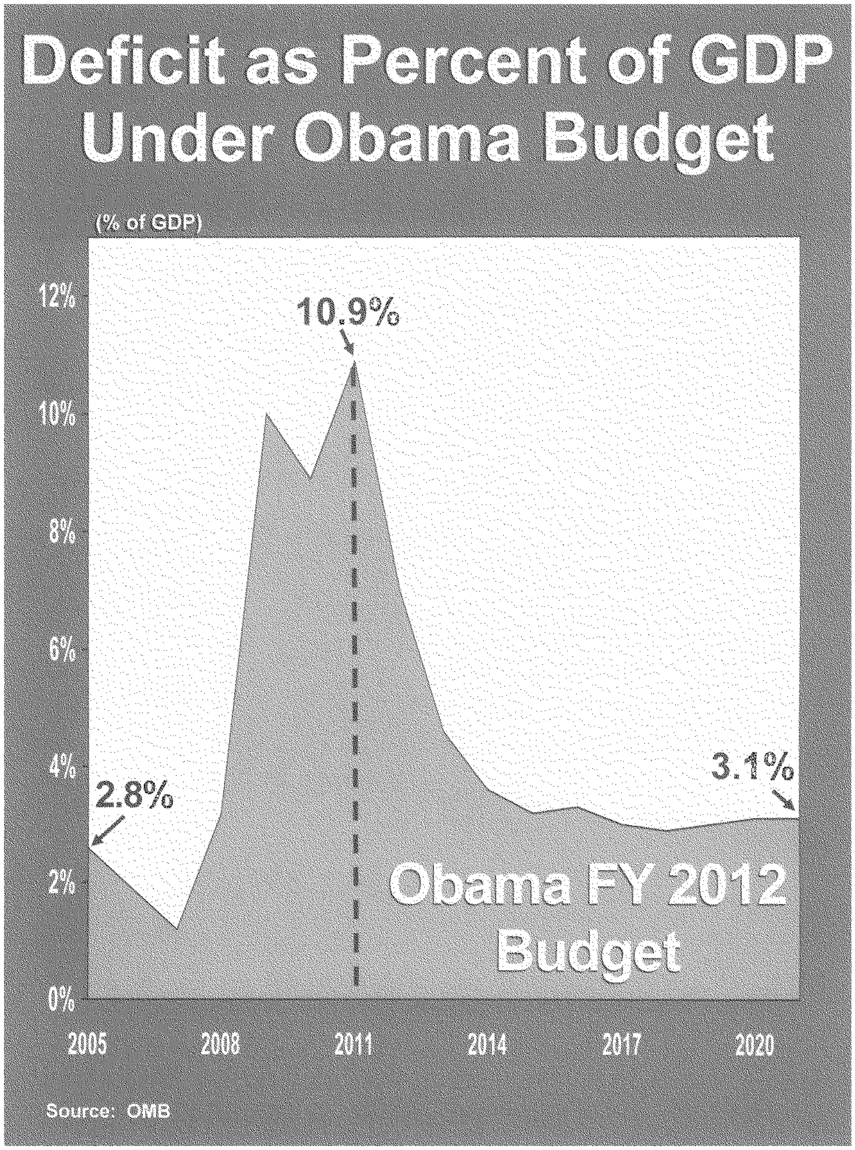
Chairman CONRAD. We are minding the store, Senator Sessions.

I want to indicate that because of the kind of turnout we are anticipating and because of the interruption for the vote, my intention will be to do 5-minute rounds, and then if we get a chance, we will go deeper, have a second round. But with all these hurdles, I think that is the only way we can get through this afternoon.

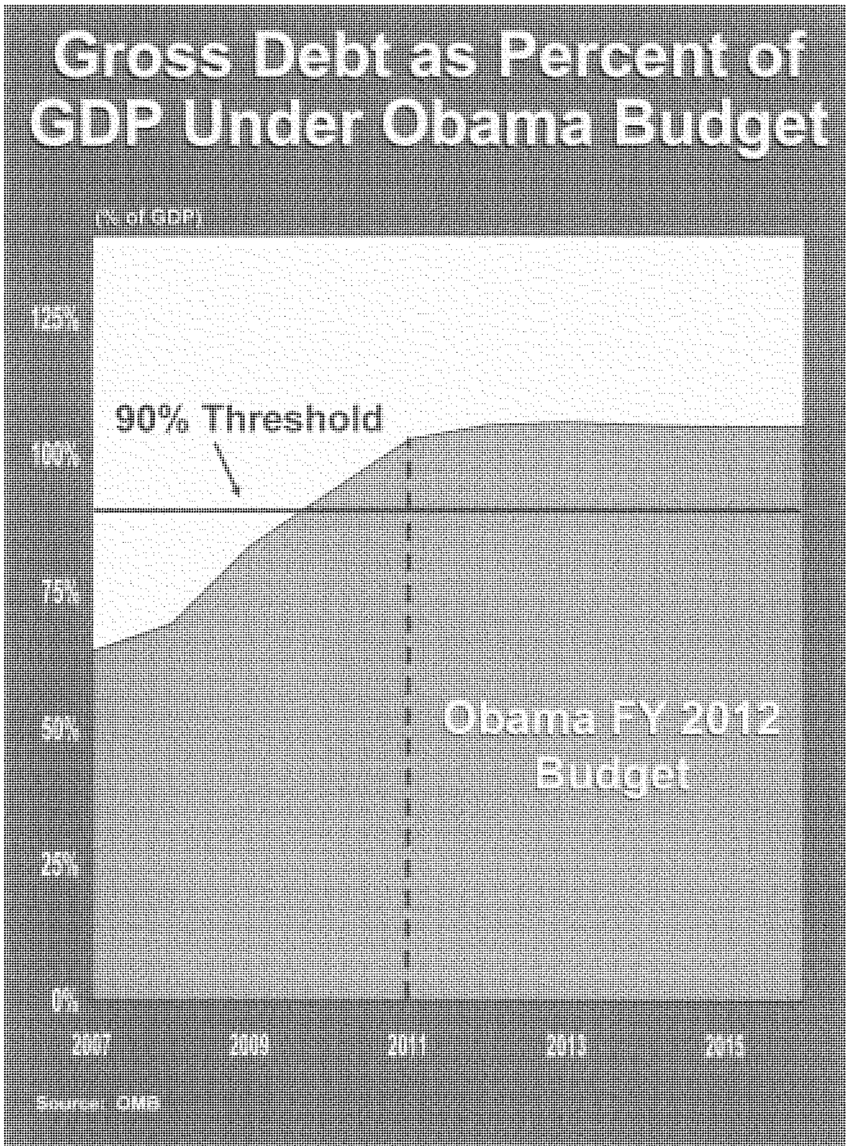
I want to welcome everybody. Today's hearing focuses on the President's budget proposal for 2012. Our witness today is the OMB Director, Jack Lew. Welcome back to the committee, Jack. You are no stranger here. Thank you again for agreeing to take on this very challenging task at this difficult time. I am sure when you finished your first term, you never imagined you would be serving again and that it would be at a time when the Nation faces a 1-year deficit of over $1.5 trillion. When you last left, you left a balanced budget. In fact, you left surpluses, and I think you can be forever proud of your legacy.

This is a challenging time for the country and the budget certainly reminds us of that fact. I have said consistently over the last 2 years that during the financial crisis and economic downturn, I think the administration acted quickly and decisively to make decisions that rescued us from a financial collapse. And I would credit the ending days of the previous administration for starting to put in place those policies to prevent what I believe would have been a financial collapse.

At the same time, I have been critical about the need for similarly decisive action now to pivot to dealing with our long-term debt threat. Make no mistake, we are at a critical juncture. We are borrowing 40 cents of every dollar we spend. Spending is at the highest level of a share of our economy in more than 60 years and revenue is at its lowest level as a share of the economy in over 60 years. Not surprisingly, we are seeing deficits, then, at record levels. Deficits are now projected to be over 10 percent of GDP this year.



This next chart depicts the gross Federal debt as a percent of the economy under the President's 2012 budget. It shows the debt reaching 100 percent of GDP this year and rising slightly throughout the remaining budget window. It is important to remember that many economists regard anything above 90 percent as the danger zone. And let me repeat what I have said at every meeting. The findings of economists Carmen Reinhart and Ken Rogoff in their book about 200 years of financial crisEs, and I quote, "We examine 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, 90 percent and above, are associated with notably lower growth outcomes."



So, look, these deficits and debt are not just numbers on a page. They are the fundamentals that have a lot to say about our future economic prospects. What is the economic opportunity going to be for our people? What are the job creation opportunities going to be? What is the economic position of our nation going to be?

Economists Reinhart and Rogoff on Danger of Gross Debt Above 90 Percent of GDP Threshold

"We examine 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 / GDP levels (90 percent and above) are associated with notably lower growth outcomes."

–Carmen M. Reinhart and Kenneth S. Rogoff
"Growth in a Time of Debt," American Economic Review: Papers & Proceedings
May 2010

And unfortunately, as disturbing as the current situation is, the long-term outlook is even more dire. It is this deteriorating long-term outlook that is the biggest threat to this nation's future economic strength and security.

Now, let me give credit where credit is due. The President's budget does include modest steps for addressing the fiscal situation. Here are a few key savings that I have identified in the President's budget.

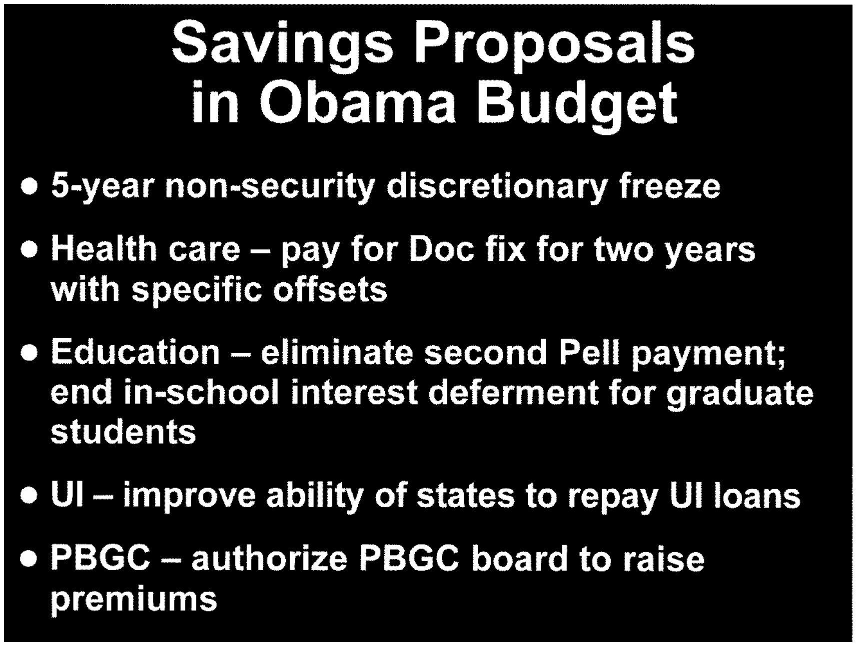
No. 1, a 5-year non-security discretionary freeze with estimated savings of $400 billion. That is not insignificant and I praise the administration for it.

They also have paid for the doc fix for 2 years with specific offsets. That, too, is an advance.

Third, they have advocated significant changes to the Pell Grant program, eliminating the second Pell Grant payment and ending in-school interest deferment for graduate students.

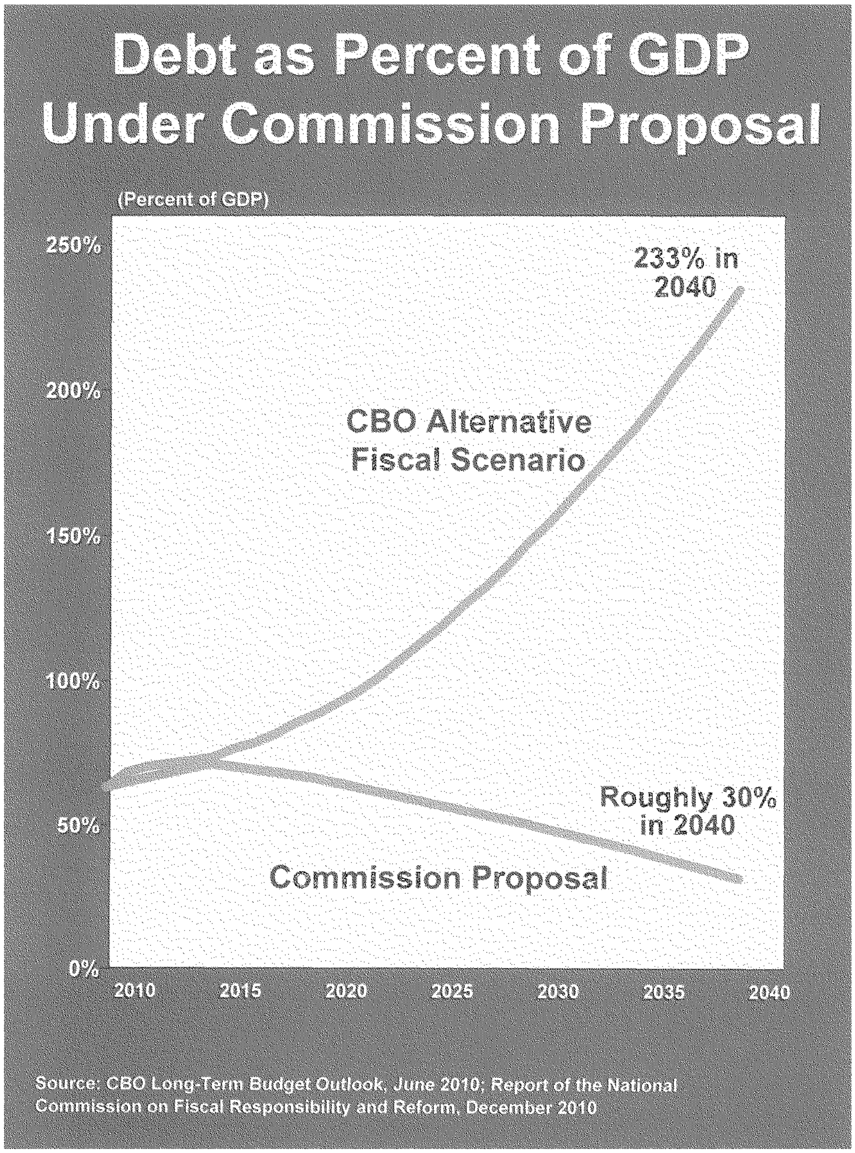
Fourth, they have improved the ability of States to repay the unemployment insurance fund.

And five, they have authorized the Pension Benefit Guaranty Corporation to raise premiums to better ensure the program's long-term solvency.

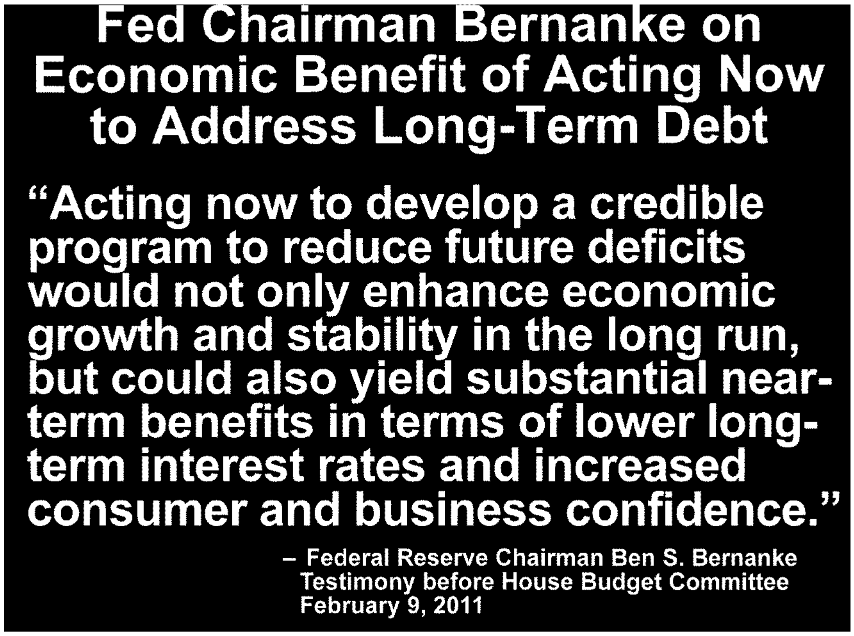


Critically important steps. I applaud the President for those proposals. I wish there had been even more. I supported the deficit and debt reduction plan assembled by the President's Fiscal Commission, and while not perfect, continue to believe that it provides a better way forward beyond the next 2 years. I give the President good marks for the next 18 months to 2 years. What I am concerned about is the longer term, and over the next decade, I believe we need a package of debt reduction approaching what the Fiscal Commission laid out of some $4 trillion.

What we need, I believe, is an entire package with everything on the table that deals with fundamental reform of our tax system, and we have to address the entitlements, because with a doubling of people eligible over the next coming years, we are on an unsustainable course. I believe what is needed is bipartisan recognition that we have to face up to the budget realities. Both sides have to be willing to move off their fixed position and find common ground, and that means we must look beyond the mere 12 percent of the budget that is being focused on when we look at just non-security discretionary spending. That is only 12 percent of the budget. That cannot carry the full load of facing up to the debt threat. You cannot solve this problem by looking at just 12 percent of the budget. This problem is too large and too important.



Let me conclude by citing recent testimony from Federal Reserve Chairman Bernanke in which he cites the benefits of acting now. Specifically, he stated, "Acting now to develop a credible program to reduce future deficits would not only enhance economic growth and stability in the long run, but could also yield substantial near-term benefits in terms of lower long-term interest rates and increased consumer and business confidence."



I hope people are listening. I hope my colleagues are listening. We cannot afford to wait until markets collapse, and I say to my colleagues, that is the course that we are on. I believe it without question, that we are on a course that will lead to a financial disaster, and it is our responsibility to bring the country back from the brink. It is our obligation and it has to start here.

With that, we will turn to Senator Sessions for his opening statement, and I want to at this point thank Senator Sessions and his team for the courtesy that they have given us in working out the scheduling of hearings going forward. It has been a very positive and constructive working relationship. I want to thank Senator Sessions and your entire team for the cooperation.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you. Thank you. We have a lot to do and you have had a lot of hearings and a lot of work. We have no choice but to support you in that and we will continue to do so.

Mr. Lew, thank you for joining us at this hearing, and it is an important one at a critical point in history.

Yesterday, the President submitted his formal budget to the Congress, as law requires. It is the President's third budget and the last budget that will cover a full year of his current term in office. It was one of his last chances to put forward a serious proposal to address our growing financial crisis.

Our crushing debt undermines confidence in our economy, weakens our standing in the world, and results in devastating job losses to Americans. A recent study showed that our debt may already be costing us a million jobs a year. Nearly every expert that has testified before this committee has sounded the warning call. So, too, has the International Monetary Fund, Moody's, our own Federal Reserve. All have cautioned us to turn back from the abyss of runaway spending and debt.

And yet the President has submitted a budget yesterday that fails to change course. It was a very un-serious response to a very serious problem. The President's budget would increase spending every single year, doubling the nation's debt by the end of his first term and tripling it by the end of his budget. It would also impose $1.6 trillion in new taxes on families and businesses, a further barrier to jobs and growth.

Erskine Bowles, the Democratic Co-Chair of the President's own Fiscal Commission did not mince words Sunday. Speaking to the Washington Post, Mr. Bowles said that the budget goes, quote, "nowhere near where they will have to go to resolve our fiscal nightmare."

Across the nation, editorials rebuked the President for not rising to the occasion. The Washington Post said the President punted. The Los Angeles Times said the budget landed with a thud. USA Today said the budget was a shame and economically risky. The Wall Street Journal said it was transparently cynical. The New York Times said the budget is most definitely not a blueprint for dealing with the real long-term problems that feed the budget deficit. Investors Business Daily said the President's plan, quote, "will lead inevitably to a weaker economy and perhaps even default."

My goal here is not to excoriate the President, but for me, it is a point of sadness, not satisfaction, that we have seen such a weak response. A historic opportunity has been lost. Maybe it can be recovered, but at this moment, it has been lost. Like when President Nixon went to China or President Clinton signed welfare reform, this could have been the President's moment to rally diverse political factions behind a common cause. I believe the country is ready.

Our nation is confronted with a defining challenge. Our financial future hangs in the balance, but the President has suggested he is waiting for Congress to put forward a serious proposal first. That is not leadership. It is going to be hard for Congress to fulfill that role without Presidential leadership.

Did Winston Churchill say he was waiting for Parliament to come up with a plan to win the war? When a nation is faced with any threat, great or small, financial or military, it is the job of the nation's chief executive to step forward with a plan. But not only has the President failed to lead, but his administration, sad to say, has consistently attacked Republicans when they do step up and put forward bold ideas to reduce spending or address our spiraling debt.

In recent days, it seems the White House has been more interested in spend than in honest conversation about the serious challenges we face. What the President does not seem to realize is that the fight over our budget is about much more than politics. It is about economic survival.

But while I am deeply disappointed, my confidence in the future is not diminished. If Washington does not change direction, the American people will change the direction of Washington. We see Governors like Governor Christie and Governor Cuomo in New York gaining popularity and strength from making tough choices.

Significant spending reductions may not be easy; they are, indeed, not. But they will make us stronger and more prosperous. It is a tough road, but it is the right road. It is the road which leads to a better future. It is the road we have to be on, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Sessions.

Now we will turn to Director Lew for his opening statement. Then we are going to go to questions.

I would say to my colleagues, again, because we face a vote at 2:35 and because of the notice by our colleagues that all of them intend to be here, we are going to do five-minute rounds and we will try to get to a second round.

Director Lew, please proceed. And again, welcome back to the committee.

STATEMENT OF HONORABLE JACOB J. LEW, DIRECTOR, U.S. OFFICE OF MANAGEMENT AND BUDGET

Mr. LEW. Thank you, Mr. Chairman, Senator Sessions. Thank you both for the kind words personally about me. It is good to be back here. I remember very fondly my last testimony as Director on the last day I was in office and I had a chart that projected a surplus of $5.6 trillion over the next 10 years. How far away that seems, and that is what we are going to be talking about today, how we can turn the tide.

After emerging from the worst recession in generations, we face another historic challenge. We need to demonstrate to the American people that we can live within our means and invest in the future. We need to work our way out of the deficits that are driving up our debt and at the same time make tough choices to out-educate, out-build, and out-innovate so that we can compete with our rivals around the world. This is what it is going to take to return to robust economic growth and job creation in the future.

This is the seventh budget that I have worked on at the Office of Management and Budget and it is the most difficult. It includes more than $1 trillion of savings from policy, two-thirds from lower spending, and it puts the Nation on a path toward what we are going to call for the moment fiscal sustainability. That means that by the middle of the decade, the government will no longer be adding to our debt as a share of the economy. Clearly, it is not far enough. We all agree there is more work to do. But in order to start bringing down the debt, we have to stop adding to it, and this budget would get us there.

By the middle of the decade, we will be able to pay for our current bills and remain in what is called primary balance for many years after that. The President has called this budget a downpayment because there is still going to be work to do to deal with our debt and to address the long-term challenges. But we cannot start to pay down the debt until we stop adding to it.

The budget lays out a strategy for significant deficit reduction. It is the most significant deficit reduction in a comparable period since the end of World War II. It will bring our deficit into the range of 3 percent of the economy by the middle of the decade and stay there for the rest of our budget window.

Changing this trajectory of our fiscal path is a significant accomplishment, but to do it, it will take tough choices and I would like to just highlight a few of them.

The budget, as you have noted, includes a 5-year freeze on nonsecurity discretionary spending. This will save $400 billion over the next decade and it will bring spending for this part of the budget down to the level it was at when President Eisenhower was in the Oval Office. To achieve savings of this magnitude, it is going to require more than just cutting waste and fraud and abuse and duplicative programs. We clearly need to start there, but we will not get the job done if that is all we do.

We are going to need to make cuts in places where, if we were not facing the kinds of difficult fiscal challenges that we face, we would not be making cuts, places like the Low Income Home Energy Assistance Program and Community Development Grants for cities and counties.

In national security, where we are not freezing the budget, we are also making real cuts. Defense spending over the past decade has been growing faster than inflation and we can no longer afford to sustain that. This budget will cut $78 billion from the Pentagon spending plan over 5 years, which will bring defense spending down to zero real growth. This is a level that the Secretary and the military leadership believe we can do without harming our national security, but it will require reductions, and reductions in weapons programs that we do not need and we cannot afford.

We also have additional savings that come from bringing our troops home. The troops coming home from Iraq will mean that the spending on overseas contingency operations will go down, and when you look overall at our defense spending, that means they will be 5 percent—more than 5 percent below the request level last year.

As has been noted before and I think we hopefully all agree is the case, just cutting discretionary spending will not solve our fiscal problems, and this budget deals with many other issues and it deals with mandatory spending and revenue to help deal with our fiscal challenges.

I would like to use two examples of what we are doing in this budget to confront these fiscal challenges. For the past number of years, there are two areas where Congress has year after year taken legislative action for reasons that have bipartisan support. I think there is, for good reason, bipartisan support that we should not see Medicare reimbursement rates for doctors go down by 30 percent and we should not see middle-class families be pushed into the Alternative Minimum Tax. The problem is that the legislation to deal with that has not been paid for, and until last December when, frankly, there was a very good and right decision to pay for the doc fix, it had not been paid for.

This budget says we have to stop that. We have to start paying for this. And we have specific savings proposals, as the Chairman noted, that would pay for the doc fix for the next 2 years. That means $62 billion of savings in mandatory programs, dozens of specific program changes so that we can have a $62 billion offset to pay for 2 years of the doc fix, so between action taken last year and that, we will be able to have time to work toward a new sustainable set of reimbursement policies.

In the case of the Alternative Minimum Tax, it has not been paid for in the past. This budget proposes to pay for it and it proposes to do so by putting into the tax code a provision that would limit the value of itemized deductions for the top taxpayers, that is families of $250,000 and above, so that they would get the same benefit for their itemized deductions that the bracket just below them gets. This would return the value of deductions to where it was in the Reagan administration. It would be a step toward doing something that the Commission proposed, which is that we start to control spending in the tax code. These are both downpayments on long-term reform to reduce the deficit further and the administration looks forward to working with the Congress.

The President has in the State of Union and the budget made clear that we are going to need to work together to solve a number of additional problems. In the State of the Union and the budget, the President called for deficit-neutral corporate tax reform so that we can simplify the system, eliminate special interest loopholes, level the playing field, and importantly, lower the corporate tax rate for the first time in 25 years so that American businesses will be more competitive.

And while it does not contribute to our deficits in the short- or medium-term, the President has laid out his principles to strengthen Social Security and he has called on Congress to work in a bipartisan fashion to address this compact for future generations.

As we take these steps to live within our means, we also invest in areas critical to the future economic growth and jobs creation. We invest in education, innovation, clean energy, and infrastructure. But even in those areas, we have had to make tough tradeoffs in order to fund our high-priority programs.

As the Chairman noted in his opening remarks, we worked hard to maintain the Pell Grant levels that we worked together to put in place so that nine million students can get a Pell Grant of $5,550 a year. We pay for it in this budget with $100 billion in savings, primarily from ending the summer school Pell Grant and by changing the way we treat interest when graduate students have loans while they are in school.

In the area of innovation, we support $48 billion in research and development, which includes $32 billion for the National Institutes of Health and it meets visionary goals to bring a new clean energy economy into place. To help pay for these investments, lower-priority programs are cut, and we do eliminate 12 tax breaks for the oil, gas, and coal companies that will raise $46 billion over 10 years.

And to build the infrastructure that we need to compete, the budget includes a proposal for a $556 billion Surface Transportation Reauthorization bill, and the plan consolidates over 60 duplicative programs which have often been earmarked into five, which demand more competition for funds, and we insist that it be paid for, because we cannot afford to do this if we do not pay for it.

Mr. Chairman, I have no illusions, and we have very difficult challenges ahead. We need to make tough choices if we are going to put our country back on a sustainable fiscal path. As we make these choices, it is important that we not cut the areas that are critical to helping our economy grow and make a difference in families and businesses.

Finally, cutting spending and cutting our deficits is going to require that we put our political differences aside and that we work together. I look forward to working with you as we craft a set of policies so that we can live within our means and invest in the future.

I thank you and look forward to answering your questions.

[The prepared statement of Mr. Lew follows:]

TESTIMONY OF
JACOB J. LEW
DIRECTOR
OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE
SENATE COMMITTEE ON THE BUDGET

February 15, 2011

Chairman Conrad, Ranking Member Sessions, and Members of the Committee, thank you for inviting me to testify this afternoon about the President's Fiscal Year 2012 Budget.

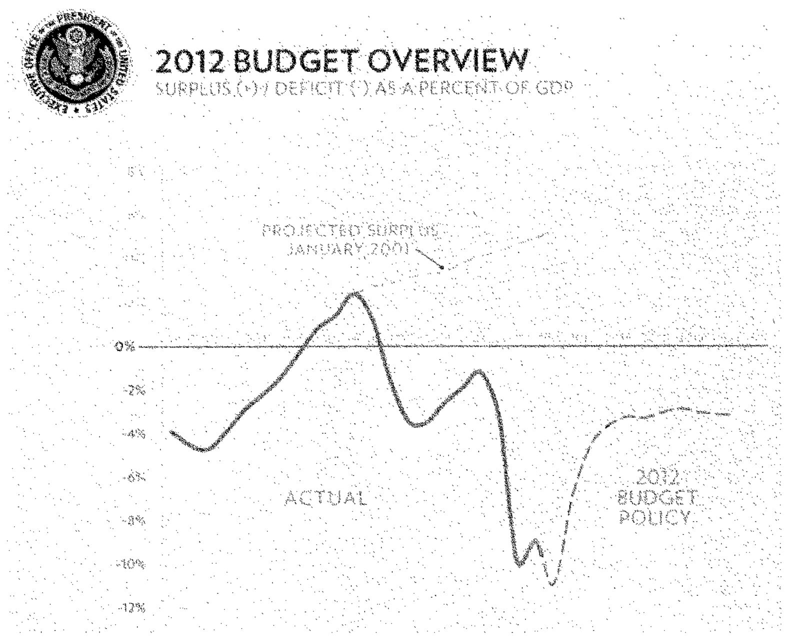
As the President has said, now that the country is back from the brink of a potential economic collapse, our goal is to win the future by out-educating, out-building and out-innovating our competitors so that we can return to robust economic and job growth. But to make room for the investments we need to foster growth, we have to cut what we cannot afford. We have to reduce the burden placed on our economy by years of deficits and debt.

This is the seventh budget I have worked on at OMB and the most difficult. It is a budget of shared sacrifice across the Federal government. It is a budget that makes tough choices to begin to tackle our major fiscal challenges. It is a budget that transitions from rescuing the economy to investing in our future. It is a budget that lives within our means in order to compete effectively in the world economy.

THEN AND NOW

The world has changed since I last served at OMB. When I left OMB in January 2001, we had balanced the budget and projected a surplus of $5.6 trillion over the next decade. In fact, we projected that the U.S. would effectively be debt-free by 2013. Unprecedented economic growth was certainly a key driver of budget surpluses. But in a virtuous cycle, a commitment by the President and the Congress to maintain a surplus reinforced expectation of Federal fiscal responsibility, which had a positive impact on interest rates and further helped to spur economic growth. This surplus was the result of year after year of fiscal discipline including budget agreements in 1990, 1993 and 1997. Presidents and congressional majorities from both parties reached across the aisle to make tough policy choices.

When I returned as OMB Director last November to a projected deficit of $10.4 trillion—a sixteen trillion dollar swing in just over ten years—the fiscal picture could not have been more different. Large deficits were driven by two main factors: first, the worst economic downturn in a generation and policy response necessary to rescue the economy, and second, the decision in prior years to give two large tax cuts without offsetting them and to create a Medicare prescription drug benefit without paying for it.



Clearly, the challenges we face today are very different than those we faced more than a decade ago, when many of us worked together to balance the budget.

Our Record

Bringing the Economy Back from the Brink

It is useful to begin by reviewing the state of our economy, because it shows how far we have come but also how far we need to go.

When the President took office the economy was in freefall. Real gross domestic product (GDP) was dropping at an annual rate of 4.9 percent after falling at an annual rate of 6.8 percent the previous quarter. The economy was losing an average of 783,000 private sector jobs per month. A steep decline in the stock market combined with falling home prices led to a significant loss of household wealth. Between the third quarter of 2007 and the first quarter of 2009, the real net worth of American households declined by 28 percent – the equivalent of one year's GDP.

In the last year, we have seen some encouraging signs that the trajectory has changed and that a recovery is beginning to take hold. An economy that had been shrinking for nearly a year is now growing again—over the past six quarters, through the first quarter of FY 2011, real GDP has grown at an average rate of 3.2 percent. After nearly two years of job losses, more than one million private sector jobs were added to the economy in 2010. Capital and credit markets are functioning and gaining strength. And after teetering on the brink of liquidation just two years ago, America's auto industry is posting healthy gains and returning money to the taxpayers who helped it through a period of turmoil.

What changed?

Just 28 days after taking office, the President signed into law the Recovery Act to create and save jobs and to invest in an economy able to compete in the 21st century. Approximately one-third, or $288 billion, of the Act's funds went to tax cuts for small businesses and 95 percent of working families. Another third, or $224 billion, was used for emergency relief for individuals and state and local governments. The final third was invested in projects to create jobs, spur economic activity, and lay the foundation for future sustained growth.

This investment had a powerful impact. The White House Council of Economic Advisers (CEA) estimates that the Recovery Act raised the level of GDP as of the third quarter of 2010 by 2.7 percentage points, relative to what it would have been absent intervention, and raised employment relative to what it otherwise would have been by between 2.7 and 3.7 million jobs in the same time frame.

And we have acted together to build on this growth. In March 2010, the President signed the Hiring Incentives to Restore Employment (HIRE) Act that provided subsidies for firms that hired workers who were unemployed for at least two months and other job creation incentives. In August, he signed into law $10 billion in additional aid to States to prevent the dismissal of 160,000 of teachers, police officers, and firefighters nationwide. In September, the President signed the Small Business Jobs Act. At the end of 2010, the President signed into law a bipartisan agreement on taxes that prevented a tax increase for middle-class families, extended unemployment insurance benefits for millions of Americans hardest hit by the recession, provided powerful incentives for business investment and job creation, and temporarily reduced the payroll tax which also would help spur macroeconomic demand. Economists from across the political spectrum agree that this bill will boost economic growth in 2011 by 0.5 to 1.2 percentage points.

From the Recovery Act to our financial stabilization plan, the President's tough choices over the past two years have helped to save the economy from a second Great Depression. But we are keenly aware that the recovery is not happening fast enough for the millions of Americans who are still looking for jobs, and our immediate task is to accelerate economic growth and job creation to get our fellow Americans back to work. That is why the President has proposed an up-front investment of $50 billion in building new roads, rails, and runways to upgrade our infrastructure and create new jobs. It is why the President is making key investments in innovation, clean energy, and education that will create jobs and make our workforce more competitive. And that is why the President laid out a commonsense approach to regulation that is pragmatic and evidence-based, and that will protect our health and safety and help lay the groundwork for economic growth and job creation.

Restoring a Sound Fiscal Policy

While taking steps to rescue the economy, the President has also worked to restore accountability and fiscal responsibility. In his first Budget, the President confronted directly the fiscal situation we inherited, eliminating trillions of dollars in budget gimmicks. He made a commitment to restoring fiscal responsibility, while recognizing that increasing the deficit in the short term was necessary to arrest the economic freefall. The President pledged to cut the deficit he inherited in half as a share of the economy by the end of his first term, a commitment this Budget keeps. He signed into law pay-as-you-go (PAYGO) legislation that returned the tough budget rules of the 1990s to Washington. The principle behind PAYGO is simple: all new, non-emergency entitlement spending and revenue losses must be offset by savings or revenue increases, with no exception for new tax cuts.

In addition, the President signed into law the landmark Affordable Care Act (ACA), enacting comprehensive health insurance reforms that will hold insurance companies more accountable, lower health care costs, guarantee more health care choices, and enhance the quality of health care for all Americans while reducing the deficit. According to CBO analysis, the Affordable Care Act will save more than $200 billion over the next ten years and will reduce the deficit by more than $1 trillion over the second decade. This is more deficit reduction than in any legislation since the 1990s. At the same time, the ACA's savings provisions tackle the single biggest contributor of our nation's long-term deficits—rising health care costs.

While taking major steps to bring down our deficits, the President also demanded that the Government spend every taxpayer dollar with as much care as taxpayers spend their own dollars. The President proposed legislation to create an expedited rescission authority so that unnecessary spending can be struck swiftly and constitutionally. Through his Accountable Government Initiative, the Administration has launched a host of initiatives to streamline what works, cut what does not, and eliminate wasteful spending. These initiatives include focusing agencies on identifying and delivering on their top priorities, a comprehensive strategy to reform Government contracting that will save $40 billion by the end of 2011, an initiative to reduce the amount of improper payments made by the Government by $50 billion, a review and reform of information technology use and procurement, an initiative to reduce administrative overhead by billions and improve performance, and an effort to dispose of billions of dollars of unneeded and under-utilized real property assets.

Each year since entering office, President has asked his Administration to go line-by-line through the Budget to identify programs that are outdated, ineffective, or duplicative. In his first two Budgets, the President identified more than 120 terminations, reductions, and savings, totaling approximately $20 billion in each year. These terminations ranged from a radio navigation system for ships made obsolete by GPS to new F-22 fighter jets. While recent administrations have seen between 15 and 20 percent of their proposed discretionary cuts approved by the Congress, the Administration saw 60 percent of its proposed discretionary cuts become law for 2010.

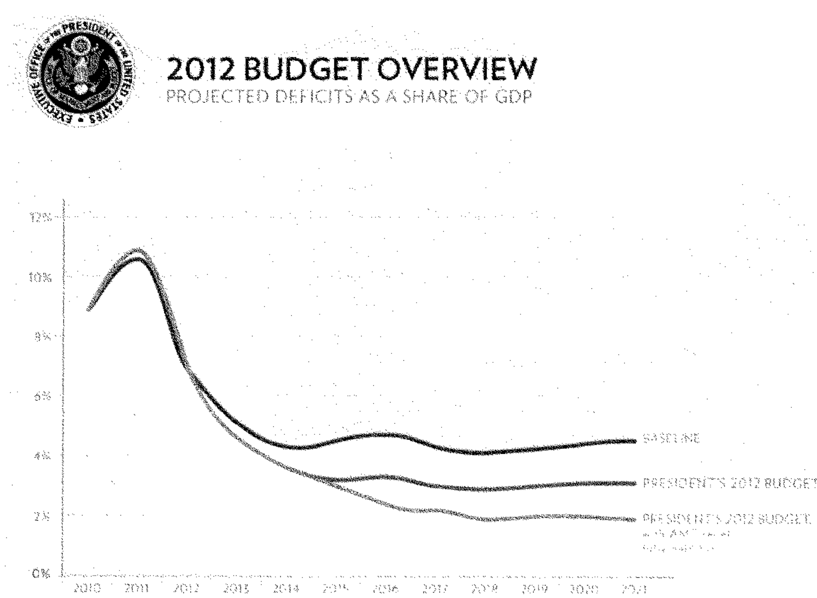
Finally, in April 2010, the President created the bipartisan National Commission on Fiscal Responsibility and Reform, and charged the Commission with identifying policies to improve the fiscal situation in the medium term and to achieve long-term fiscal sustainability. The

Commission made an important contribution, beginning the process of building a bi-partisan consensus on the nature of the challenge we face and expanding the debate to include a broader range of options. While the Administration doesn't agree with every recommendation in the report, there are many areas of this budget that reflect the work of the Commission.

LIVING WITHIN OUR MEANS AND INVESTING IN THE FUTURE

Now that the country is back from the brink of a potential economic collapse, our goal is to win the future. But we cannot do so if we are saddled with increasingly growing deficits. This Budget builds on recent progress and lays out a comprehensive and responsible plan that will put us on a path toward fiscal sustainability for the rest of the decade—a down payment that will build a strong foundation to tackle our long-term challenges.

The projected deficit this year is nearly 11 percent of GDP, the highest level since World War II, reflecting the severity of the recession and our temporary measures to generate jobs and growth. The Budget lays out a path of rapid deficit reduction—the most deficit reduction in a comparable period since World War II. In the second half of the decade and beyond, debt is no longer growing as a share of GDP—a key indicator of fiscal sustainability. Redirecting our fiscal path on this downward slope is a significant accomplishment, one which will take tough choices and



shared sacrifice—and is essential for the long-term competitiveness of the American economy.

The first step to reducing our deficit is maintaining a strong economy, which is a key priority for the Budget. As the baseline projections show, with economic growth we begin to make substantial progress at reducing the deficit even before we make additional policy changes. However, even with a sustained recovery, simply continuing current policies does not get the job done – it would leave us with deficits of between 4 and 5 percent of GDP—with debt growing at an unsustainable rate through the end of the decade and beyond.

To stay on a path towards sustainable deficits on the order of 3 percent of GDP, we make tough choices across all areas of the Budget to identify more than $1 trillion in savings – two thirds from spending reductions. This requires decisions beyond just separating the good programs from the bad. It means broadly sharing sacrifices in all areas of the Budget in order to make critical investments in areas most important to growth and competitiveness. And it means reducing spending in areas where we continue believe there is still important work to do. It cannot be achieved by simply looking at discretionary spending – we need to look at mandatory and revenue policies as well. An overview of key decisions in the FY 2012 Budget is as follows:

- *Non-security discretionary.* The Budget proposes to freeze non-security discretionary spending for five years, which saves more than $400 billion over the next decade and brings this category of spending to its lowest level as a share of the economy since Dwight Eisenhower was in office.

- *Security discretionary.* The Budget reflects tough decisions in areas outside of the non-security freeze—bringing Defense spending down from a long period of significant real growth to zero real growth, saving $78 billion over the next five years relative to last year's plan. Reflecting the winding down of military operations in Iraq, the Overseas Contingency Operations (OCO) budget for DOD in 2012 will be about 26 percent lower than levels in the President's 2011 request. As a result, the overall defense budget, including OCO, will be down by 5.2 percent from last year's request.

- *Health care.* The Budget fully pays for a two-year extension of current Medicare physician payment rates with $62 billion in health care savings, preventing a payment cut of over 25 percent. The Budget also proposes incentives for States to implement medical malpractice reforms to further reduce the growth of health care costs.

- *Revenues.* The Budget pays for three years of AMT relief by cutting the value of tax expenditures for high-income taxpayers by 30 percent. The Budget also opposes any further extension of the unaffordable upper-income tax cuts to two years.

- *Fiscal stewardship.* The Budget includes several proposals to reduce the risk of future liabilities. These include giving the Pension Benefit Guaranty Corporation (PBGC) the ability to adjust premiums to reflect all risks facing the pension insurance system and proposing reforms to encourage State responsibility and improve the solvency of the Unemployment Insurance Trust Fund.

Shared Sacrifices, Hard Choices

To be competitive in the 21st Century, the United States cannot be weighed down by crippling budget deficits, ineffective programs that waste tax dollars, and a government that is not accountable to the American people.

Five-year non-security freeze. It would be short-sighted to cut spending across the board and shortchange critical areas for growth and competitiveness – such as education, innovation, and infrastructure – or carelessly slash programs that protect the most vulnerable. This means that some cuts must be deeper to make room for key investments. In his 2011 Budget request, the President proposed a three-year, non-security discretionary freeze. As the economic recovery takes hold, the President believes that it is important to go further and is now proposing a five-year, non-security discretionary freeze. This is an extension of the freeze proposed last year, based on 2010 enacted levels. This freeze would be the most aggressive effort to restrain discretionary spending in 30 years and, by 2015, would lower non-security discretionary funding as a share of the economy to the lowest level since Dwight D. Eisenhower was president. Over the decade, the five-year freeze saves more than $400 billion.

Program terminations, reductions, and savings. In part to meet this freeze, the Budget includes over 200 terminations, reductions, and savings totaling more than $33 billion in savings for 2012 alone. On their own, these cuts will not solve our fiscal problems, but they are a critical step to creating a more responsible and accountable Government and a key component of a comprehensive deficit reduction strategy. It is never easy to end or cut programs; they all have advocates. Some programs are duplicative, outdated and ineffective. But we also had to choose programs that, absent the fiscal situation, we would not cut:

- **Low-Income Housing Energy Assistance Program (LIHEAP).** The Budget cuts LIHEAP by more than $2 billion, returning LIHEAP funding to 2008 levels, prior to the energy price spikes. However, in this difficult fiscal environment, we cannot afford to maintain the expansion to the program.

- **Community Services Block Grant (CSBG).** CSBG has helped to support community action organizations in cities and towns across the country. These are grassroots groups working in poor communities, dedicated to empowering those living there and helping them with some of life's basic necessities. These are the kinds of programs that President Obama worked with when he was a community organizer, so this cut is not easy for him. Yet for the past 30 years, these grants have been allocated to virtually the same organizations, using a formula that does not consider how good a job the recipients are doing. The Budget proposes to cut financing for this grant program in half, saving $350 million, and to reform the remaining half into a competitive grant program, so that funds are spent to give communities the most effective help.

- **Grants-in-Aid for Airports.** The Budget lowers funding for the airport grants program to $2.4 billion, a reduction of $1.1 billion, by eliminating guaranteed funding for large and medium hub airports. The Budget focuses the traditional Federal grants to support smaller commercial and general aviation airports that do not have access to additional revenue or other outside sources of capital. At the same time, the Budget would allow larger airports greater flexibility to generate revenue with increased non-Federal passenger facility charges.

These cuts are not limited to a few agencies. Rather, these cuts reflect shared sacrifice across the Federal government—even for agencies that are central to out-competing, out-building, and out-educating in the 21st century. For example, the Department of Education has made difficult decisions in order to maintain historic increases for Pell Grants, which are critical to creating future generations that are well-educated and globally-competitive. The Administration would put Pell Grants on firm financial footing through steps that include eliminating the in-school interest subsidy for loans to graduate students and ending the new year-round Pell Grant, which offers students a second Pell Grant in one year, but has cost ten times more than anticipated. The Budget also eliminates 13 discretionary programs at the Department of Education and consolidates 38 K-12 programs into 11 new programs that emphasize using competition to allocate funds.

Federal civilian employee pay freeze. Federal workers are patriots who work for the Nation often at great personal sacrifice. They deserve our respect and gratitude. But just as families and businesses across the country are tightening their belts, so too must the Federal government. On his first day in office, the President froze salaries for all senior political appointees at the White House. In his Budget last year, the President proposed extending that freeze to other political appointees, and he eliminated bonuses for all political appointees across the Administration. Starting in 2011, the President has proposed and Congress enacted a two-year pay freeze for all civilian Federal workers. This will save $2 billion over the remainder of 2011, $28 billion over the next five years, and more than $60 billion over the next 10 years.

Savings in discretionary security programs. The President's Budget also demands cuts and savings in security programs. DOD, in particular, has seen an average increase to its base budget of 7.4 percent a year over the past decade. Moving forward, DOD is pursuing a variety of strategies to set the course for zero real growth in defense spending, and saving $78 billion in its base budget (including $13 billion in FY 2012) relative to FY 2011's request for the next five years. Secretary Gates will oversee a package of terminations, consolidations, and efficiencies in operations to slow this growth, and these savings will be used to fund programs and efforts critical to the armed forces and the security of the Nation. Reflecting the winding down of military operations in Iraq, the Overseas Contingency Operations (OCO) budget for DOD in 2012 will be about 26 percent lower than levels in the President's FY 2011's request. As a result, the overall defense budget, including OCO, will be down by 5.2 percent from last year's request.

Administrative savings. Allowing waste is never right, and it is especially intolerable in a time of tightening belts and tough decisions. Continuing the President's Accountable Government Initiative, the Budget cuts $2 billion in administrative overhead like travel, printing, supplies, and advisory contract services; establishes a process to quickly sell excess and under-utilized Federal real estate; and embraces competitive grant programs based on the Race to the Top model. This model is applied to programs from early childhood education through college; to allocate grants for transportation; to bring innovation to workforce training; and to encourage both commercial building efficiency and electric vehicle deployment.

Reorganize government. We live and do business in a global economy, but the organization of our government has not kept pace with the private sector advancements of the 21st century. Many of our government organizations have strayed from their original or core missions, evolving out of inertia rather than in response to the changing needs of the groups they serve. This has resulted in duplicative and ineffective programs that persist and grow over time, and an organization of functions that doesn't always make sense. For example, as the President stated in his State of the Union address, there are twelve different agencies that deal with exports. Americans deserve a streamlined, efficient and well-functioning Federal government that is responsive to the needs of its citizens and of the private sector.

The Budget reflects the President's commitment to reorganizing the Federal government to ensure that our resources are being used effectively and efficiently, with a particular focus on making the U.S. more competitive. In the coming months we will be working to identify where we can merge, consolidate and cut in order to better facilitate the needs of all American companies, entrepreneurs, and innovators and give these engines of economic growth a leg up in the global economy. The President plans to submit a proposal to Congress to enact the changes necessary to reorganize the Federal government in a way that best serves the goal of a more competitive America.

INVESTMENTS IN OUR FUTURE

The best antidote to a growing deficit is a growing economy, which spurs expanded employment, higher revenue collection, and lower demand for spending on safety net programs like unemployment insurance nutrition assistance. Putting the Nation on a sustainable fiscal path and getting our deficits under control are critical to making the United States competitive in the global economy, and the Budget lays out a strategy to do this. At the same time, it also recognizes that we cannot cut back on investments that will fuel future economic growth particularly since sustained and robust economic growth plays a very significant, long-term role in reducing deficits. While the Budget identifies cuts and savings and asks for shared sacrifices across the government, it also invests in areas critical to helping America win the race for the jobs and industry of the future.

We must target scarce Federal resources to the areas critical to winning the future: education, innovation, clean energy, and infrastructure.

Educate a competitive future workforce. In an era where most new jobs will require some kind of higher education, we have to keep investing in the skills of our workers and the education of our children. This Budget continues to support the President's commitment to once again have the highest proportion of college graduates in the world by 2020, and continues the reform agenda not just by devoting significant resources to where they are needed, but also by ensuring that those funds are being invested in programs that deliver results efficiently and effectively. This Budget calls for:

- Maintaining the Pell Grant maximum award at $5,550. Since 2008, the Administration has increased the maximum Pell Grant by $819, ensuring access to postsecondary education for over 9 million students from low-income families.

- Supporting reform of K-12 education with expanded Race to the Top and other innovative, evidence-based programs that encourage innovation and reward success, and expands the Race to the Top concept to early childhood education with $350 million to establish a new, competitive Early Learning Challenge Fund for States.

- Establishing a Workforce Innovation Fund that will encourage States and localities to break down barriers among programs, test new ideas, and replicate proven strategies for delivering better employment and education results at a lower cost per outcome.

Investment in R&D and transformational technologies. To compete in the 21st century economy, we need to create an environment where invention, innovation, and industry can flourish. That starts with continuing investment in the basic science and engineering research and technology development from which new products, new businesses, and even new industries are formed. We must focus in areas that show the greatest promise for job creation to position ourselves to get ahead of our competitors and be a leader in emerging industries. This Budget makes significant investments in clean energy technology and research and development to nurture the United States as a world leader in innovation. To meet these goals, the Budget calls for:

- Providing $148 billion for research and development. This level of funding continues the effort to double investments in basic research at the National Science Foundation, Department of Energy Office of Science, and the National Institute for Standards and Technology (NIST); provides robust investment in biomedical research at National Institutes of Health (NIH); and doubles energy efficiency research and development.

- Making the Research and Experimentation (R&E) tax credit permanent to give businesses the certainty they need to make these important investments. In addition, the Administration proposes to expand the credit by about 20 percent, the largest increase in the credit's history, and simplify it so that it is easier for firms to take this credit and make the investments our economy needs to compete.

- Bolstering economic rejuvenation in hard-hit areas of our country with new Growth Zone program. Growth Zones will deliver expanded tax incentives for investment and employment and a more streamlined access to government assistance to 20 new areas facing economic distress as well as growth potential.

- Providing $8.7 billion for clean energy technology research, development, demonstration, and deployment. This includes more than doubling energy efficiency investments and increasing renewable energy investments by over 70 percent. The Budget seeks to reinforce new approaches to energy research by adding three new energy innovation hubs and expanding investment in the Advanced Research Projects Agency – Energy (ARPA-E). In addition, the budget provides $5 billion for Section 48C tax credits for renewable energy manufacturing facilities.

Build a 21st century infrastructure. To compete in the 21st century, we need an infrastructure that keeps pace with the times and outpaces our rivals, and for too long we have neglected our Nation's infrastructure, its roads, bridges, levees, waterways, communications networks, and transit systems. In the Recovery Act, the Administration made the largest one-time investment in our Nation's infrastructure since President Eisenhower called for the creation of a national highway system. We need to continue to build on those efforts –and to do so responsibly by paying for what we build. We cannot strengthen our economy with a modern infrastructure if at the same time it weakens our fiscal standing. To give America the world-class infrastructure our economy needs, the Budget:

- Proposes a six-year surface transportation reauthorization that increases average annual investment by $35 billion per year, in real terms, over the previous six year authorization plus passenger rail funding in those years; this represents a total inflation-adjusted increase of sixty percent over the life of the bill. To bring the trust fund under budget enforcement mechanisms, the Budget proposes to reclassify trust fund spending on surface transportation as mandatory, subjecting it to PAYGO rules and closing score-keeping loopholes.

- Provides $1.2 billion for the Next Generation Air Transportation System, the Federal Aviation Administration's multi-year effort to improve the efficiency, safety, and capacity of the aviation system.

- Invests in smart, energy-efficient, and reliable electricity delivery infrastructure. The Budget continues to support the modernization of the Nation's electrical grid by investing in research, development, and demonstration of smart-grid technologies to spur the transition to a smarter, more efficient, secure and reliable electrical system.

- Builds next-generation wireless broadband network to provide access to 98 percent of the population, creates a Wireless Innovation Fund, and establishes an interoperable broadband network for public safety. These proposals will be fully paid for with proceeds from proposed "voluntary incentive auctions" of underused spectrum and other spectrum management measures, which will generate more than $27 billion over the next decade. In addition to funding the programs above, nearly $10 billion of these proceeds will be dedicated to deficit reduction.

BUILDING ON OUR PROGRESS

Now that the recovery is beginning to take hold, taking further steps to ensure responsibility has to be a priority—not because fiscal austerity in and of itself is virtuous, but because there is no way that we can compete and win in the world economy if we are borrowing without an end in sight.

The President's Budget is a down payment. It puts the government on a path to reach sustainable deficits over the next ten years. This means that for the first time in 10 years, the government will again be fully paying for all of its programs and the debt will stabilize as a share of GDP. This is an important milestone—but not the finish line—on the path to a balanced budget.

We cannot achieve sustainable levels with ever deeper cuts in non-security discretionary spending, which is simply not a large enough share of the picture either to cause or to solve the whole problem. The President has been clear that we must work on a bipartisan basis to find long-term solutions across all areas of the Budget, including Medicare, Medicaid, and tax reform.

Continue efforts to restrain the growth of health costs. Health care comprises one-quarter of non-interest Federal spending, and it is the key driver of future deficit growth. According to CBO analysis, the Affordable Care Act will save more than $200 billion over the next ten years and will reduce the deficit by more than $1 trillion over the second decade. This is a pivotal achievement, and the President is resolutely committed to implementing the ACA fairly, efficiently, and swiftly. But the job is not yet done. The Budget builds on the ACA with additional proposals to contain health care cost growth:

- The ACA made important advances in the area of program integrity, but there are other important opportunities to reduce fraud, waste, and abuse in Medicare and Medicaid. The Budget includes ideas pulled from external sources, including recommendations from the President's Fiscal Commission and from legislation that has received bipartisan support. The $62 billion in health savings in the Budget focus on increasing program integrity, efficiency, and accountability—not reducing beneficiary access or benefits. For example, the Budget extends efficiencies from Medicare competitive bidding for durable medical equipment to Medicaid, and prohibits brand and generic drug companies from delaying the availability of new generic drugs ("pay-for-delay").

- At the same time, these health savings pay for two years of relief from the Sustainable Growth Rate (SGR) formula—preventing a decrease of nearly 30 percent in physician payments that would hurt Medicare. This paid-for extension is on top of the three previous paid-for extensions of the SGR fix, including the one-year extension enacted in December, establishing a pattern of practice that we hope to continue as we work with Congress to achieve a permanent fix.

- Fully implementing the Affordable Care Act achieves cost savings and promotes efficient care, including reimbursing doctors and hospitals as Accountable Care Organizations, and adjusting payments to hospitals with high readmissions or hospital-acquired conditions. Implementing the Act also has the potential to fundamentally transform our health system into one that delivers better care at lower cost—a potential that is not fully captured in the ACA savings estimates. In particular, the Act incorporates the most promising ideas from economists and leaders from across the political spectrum to control health care costs.

- The President's Budget includes $250 million in grants to States to reform their laws on medical malpractice through various approaches such as health courts, safe harbors, early disclosure and offer programs, or other legal reforms. These grants would be awarded and administered by the Bureau of Justice Assistance (BJA) in consultation with the Department of Health and Human Services. The goal of any reform would be to fairly compensate patients who are harmed by negligence, reduce providers' insurance premiums, weed out frivolous lawsuits, improve the quality of health care, and reduce medical costs associated with "defensive medicine." This proposal is in line with the Fiscal commission's recommendation for "an aggressive set of reforms to the tort system."

Make a Down Payment on Tax Reform. To foster a competitive economy, we must have sensible and affordable tax policy that is consistent with our overall objectives of deficit reduction and economic growth. Since the last comprehensive overhaul nearly three decades ago, the tax code has been weighed down with revenue-side spending in the form of special deductions, credits, and other tax expenditures that do little for middle income families, and burdened with generous upper income tax cuts and more generous estate tax cuts for families making more than $250,000 a year. To compete and win in the world economy, we cannot sustain a tax code burdened with these unaffordable benefits. This is why the President has called on the Congress to undertake a fundamental reform of our tax system. As progress towards this goal, the Budget calls for:

- Allowing the 2001 and 2003 High-Income and Estate Tax Cuts to Expire. The Administration remains opposed to the permanent extension of these high-income tax cuts past 2012, as now scheduled, and supports the return of estate tax to 2009 rates and exemption levels. These policies save nearly a trillion dollars over the decade including interest effects. We cannot afford these unpaid-for tax breaks for the wealthiest Americans and we are committed to limiting the current extension to two years.

- Beginning the Process of Corporate Tax Reform. The United States has the highest corporate tax rate in the world. Part of the reason for this is the proliferation of tax breaks and loopholes written to benefit a particular company or industry. The result is a tax code that makes our businesses and our economy less competitive as a whole. The President is calling on Congress to work with the Administration on corporate tax reform that would simplify the system, eliminate these special interest loopholes, level the playing field, and use the savings to lower the corporate tax rate for the first time in 25 years -- and do so without adding a dime to our deficit.

- Paying for the Alternative Minimum Tax (AMT). This Budget provides for a three year extension of AMT relief, and is offset by an across-the-board 30 percent reduction in itemized deductions for high-income taxpayers. This is the first time an extension of AMT relief has been fully paid for. While our base projections do not assume that we continue to pay for AMT relief after 2014, the President is committed to working with Congress to fully pay for AMT relief beyond this window. Doing so reduces the deficit by an additional 1 percent of GDP by the end of the decade relative to the deficit reduction in the Budget.

Take Steps Now to Reduce Future Liabilities. Looming debts and unfunded liabilities can put taxpayers on the line for bailing out programs in the future. The Budget promotes fiscal stewardship by restoring responsibility to key areas. First, the Budget proposes to give the Pension Benefit Guaranty Corporation (PBGC) Board the ability to adjust premiums and directs PBGC to take into account the risks that different sponsors pose to their retirees and to PBGC. This will both encourage companies to fully fund their pension benefits and give the PBGC the tools to improve its financial soundness without over-burdening the companies it ensures, saving $16 billion over next decade. Second, the 2012 Budget provides short-term relief to States by providing a two-year suspension of State interest payments on their debt and automatic increases in Federal unemployment insurance (UI) taxes. At the same time, the Budget proposes steps to encourage States to put their UI systems on firmer financial footing and pay back what they owe to the Federal government. Beginning in 2014, the Budget increases the minimum wages states can subject to unemployment taxes to $15,000. Finally, the Budget proposes to gradually reduce the loan portfolios and eligible loan sizes of Fannie Mae and Freddie Mac and end the conservatorship of these companies, scaling back government support in a way that allows private capital to return without undermining the housing market recovery.

Begin a Dialogue on Social Security Solvency. The President considers Social Security to be one of our most successful programs, and indispensable to workers, people with disabilities, seniors, and survivors. The President has been clear that we need to strengthen Social Security to make sure that Social Security is sound and reliable for the American people, now and in the future. The Budget lays out the President's principles: Reform should strengthen the program and its protections for the most vulnerable, without putting at risk current retirees and people with disabilities, without slashing benefits for future generations, and without subjecting American's guaranteed retirement income to the whims of the stock market. The President believes that the best way forward is for leaders of both parties to come together to discuss the way forward on a bipartisan basis.

Social Security is not contributing to our deficit any time soon. Our goal is to make sure that current and future generations are assured that the system will remain sound for the long term as well – to provide the peace of mind that is one of the important benefits of insurance.

A WAY FORWARD

There has been a vibrant national conversation on fiscal responsibility over the past several months. The President's Fiscal Commission made important progress in launching a serious bipartisan discussion last year, and I commend them for resetting the debate on further deficit reduction. While the President has not embraced all of their proposals, many of them are included in this year's Budget. Federal employee pay freezes, medical malpractice reform, a call for government reorganization, and the elimination of in-school subsidies for graduate student loans are just a few examples. Our Terminations, Reductions, and Savings volume includes numerous proposals that were also recommended for termination or reduction by the Fiscal Commission. And like the Commission, we make proposals to improve budget discipline, including subjecting the Transportation Trust Fund to PAYGO rules and providing for program integrity cap adjustments. We must take serious steps to both cut spending and cut deficits. We must address these issues in a bipartisan way. And we must do so in a way that is consistent with our core values.

The Fiscal Commission was clear that that the only way to tackle our deficit is to cut excessive spending wherever we find it – in domestic spending, defense spending, health care spending, and spending through tax breaks and loopholes. Now that the worst of the recession is over, we have to confront the fact that our government spends more than it takes in. That is not sustainable and we need a comprehensive approach

The five year non-security freeze achieves significant savings with a dramatic reduction in discretionary spending over the coming decade, and it will require commitment from both the Administration and Congress to live within that framework. But we have to remember that this category of spending represents a little more than 12 percent of our Budget. To make further progress, we cannot pretend that cutting this kind of spending alone will be enough. Looking forward, we will have to make hard decisions to further reduce health care costs, including programs like Medicare and Medicaid, which are the single biggest contributor to our long-term deficit. Health insurance reform will slow these rising costs, which is part of why nonpartisan economists have said that repealing the health care law would add a quarter of a trillion dollars to our deficit. Still, we need to look at other ideas to bring down costs, and the proposals in this year's Budget are a first step. And we cannot afford a permanent extension of the tax cuts for the wealthiest two percent of Americans if we are committed to achieving a sustainable deficit.

This Budget builds on the work of the last two years, and makes a down payment on a strong American future. Much work remains to be done. We need to take steps to reduce our future liabilities. And we need to work to shape our government into one that is more affordable, more effective, and more efficient.

I look forward to working with both houses of Congress in the coming months as we work to put our fiscal path back on a sustainable course.

Chairman CONRAD. Thank you, Director Lew.

Let me start with what I see as the best news in the proposal of the President, and that is that he brings down the deficit as a share of the Gross Domestic Product quite sharply, from almost 11 percent of GDP down to just over 3 percent of GDP during the 10-years. That is critically important because that does stabilize the debt.

But let me go to the question of the level of our gross debt, because as I see the President's proposal, we get to a gross debt of over 100 percent of our GDP and just stay stuck there. So it is true the debt is stabilized, but it is stabilized at a level that is too high. Why do I say 100 percent of GDP is too high? Because the best information we have available to us, the Reinhart-Rogoff study of 200 years of fiscal history and 44 countries say when your gross debt is over 90 percent of GDP, the chances increase that your future economic growth will be substantially reduced.

And this is what we see in terms of the gross debt as a share of GDP the 10-years of the President's budget. It is over 100 percent the entire time. That, to me, is just not wise. It is not acceptable. It is not a fiscal strategy that the country should embrace.

I understand that the President's budget is an opening bid. We all know there is a negotiation that will have to ensue. It will have to involve both houses of Congress, both parties and the President.

The question that I would have for you is how does that serious conversation get started? We have a budget, but a budget resolution, as you know, is purely a Congressional document. It never goes to the President for his signature or veto. So the question I have for you and the question I think many of us are struggling with is how do we get to the serious discussion of getting not only the debt stabilized—I will grant you, you do that. To me, that is not enough, because the second step is we have to work this debt down, and just stabilizing it for 10 years at a level that is too high, that cannot be the answer. At least, to me it cannot be the answer. So how do we get, in your judgment, this more serious negotiation started?

Mr. LEW. Senator, I think that, first, stabilizing the debt is not something that we can take for granted. There are a lot of hard decisions that we are going to need to make in order to bring the deficit down to 3 percent of GDP. If we do not take the tough actions that are laid out in this budget, we will be closer to 5 percent of GDP, not 3 percent of GDP.

So I think as a first matter, it is not just a question of building confidence. It is kind of like you have to walk before you run. We have to do this in order to get to the next step. So I think that when we describe this—when the President has described this budget as a down payment, I think it is important to note that getting that down payment is in and of itself going to be a hard accomplishment and it is something we are going to need to work together on, because I know there are a lot of things in our budget that will not be immediately accepted and we are going to have to work toward a set of policies that get us there.

In terms of the long term, you know, I think the process always begins with the President putting a budget on the table. The President has a comprehensive responsible budget. That is the first, not the last, step in the process. The President has worked very hard to try in the State of the Union, in his budget, in his remarks today, to establish an atmosphere where we could start to build trust that builds on the success we had at the end of last year where I think there was a process of beginning to learn how to work together across party lines.

I have worked on bipartisan agreements from both ends of Washington, from the Congress when I was in the Speaker's Office in the Democratic Congress and a Republican White House, and from a Democratic President's White House working with a Republican Congress. Developing that relationship of trust is the key to there being success. And I think that we have tried very hard in everything we have done in this budget to put things on the table to expand the range of things that can be discussed, but it is not always the case that putting a specific proposal out there advances things most quickly. I personally believe that if you look at the last 20, 30 years, sometimes putting out a proposal slowed things down because it polarized the sides and they dug in. We need to figure out a way to have a conversation that gets the parties talking together.

So I cannot give you a date or a time. I think that we have put a budget forward. We have a lot of immediate issues facing us in terms of the funding of the government after March 4, the extension of the debt ceiling in the spring, the budget resolution that Congress has to pass. I would say that one of the things I believe is that we have to separate these issues. We should do the things that we have to do to keep our business going. And we have to figure out how to engage on this as different plans are put down and we see what the differences are and look toward working together toward the middle where we can agree.

Chairman CONRAD. Let me just say this to you, because I am going to try to follow 5-minute rounds. You know, I have enormous respect for you. I know what you did. I know the role you played in getting us back on track previously. In that answer, I do not hear a plan for how we get to a serious discussion. I hear the reasons for doing the budget proposal that is out there. I understand that. I might even accept it. But I cannot accept that if I do not hear a way forward that gets us to the discussion we have to have because it cannot be the answer that we are going to have a debt over 100 percent of GDP throughout the next decade. That cannot be the answer for this country's fiscal future.

Senator Sessions?

Senator SESSIONS. Thank you, Mr. Chairman. I agree with you 100 percent. This idea that you are balancing the budget somehow when you are not is the Washington theory that got us into this fix, and stabilizing the debt is so dangerous because we are at the upper limit already and we could have an economic shock at any time. Another recession is not projected in your budget that I know of. It is not in there. So it is a high-risk thing, and as leaders, I agree with the Chairman, we have to take the steps that we know need to be taken today to protect our people from danger in the future.

Have you, Mr. Lew, explained the budget to the President an do you think he fully understands the choices of the decisions and direction it undertakes?

Mr. LEW. Senator, this is the President's budget. I have the honor of presenting his budget. So he understands and has made the decisions to drive this budget.

Senator SESSIONS. Well, in his radio address to the Nation Saturday, he said, so after a decade of rising deficits, this budget asks Washington to live within its means, and that is what our country has to do. That is what families do. Does this budget say that we are going to live within our means at any single year in the 10-year plan you have set forth?

Mr. LEW. Senator, this budget would get us to the point where in the middle of the decade, we will be paying for our current expenses and we will be in what is called primary balance. That means that the only thing that is putting us into deficit is payments of interest on the national debt. And if I could put it in terms that—a family's terms, it is like saying we are going to cut the credit card, not add to the balance, and then we will work on paying down the old bill.

Senator SESSIONS. But we are adding to the balance and we are not cutting up the credit card. That is just the fact. Do you believe that the American people who heard the President on his radio address Saturday say that this budget calls on Washington to live within its means, do you think that it is misleading in the sense not in the lowest deficit year of the ten, by your own budget, the deficit will be over $600 billion that year?

Mr. LEW. Senator, having sat in this chair and presented three budgets with surpluses, I know the difference between a surplus and a deficit. We are not going to get to a surplus until we can pay down the debt because of the interest payments.

Senator SESSIONS. Oh, you mean reducing the debt is paying down the debt? Is that Washington-speak?

Mr. LEW. What I said was we are going to stop adding to the debt. Our spending will not add to the debt.

Senator SESSIONS. Well, what year can you say that under your budget it gets below $600 billion a year in added debt?

Mr. LEW. Senator, I understand the arithmetic of paying interest on our national debt. We have accumulated a lot of debt. This has been a very deep recession. We have had an enormous number of decisions made that have caused the deficit to grow. We are going to have to work together to reverse that, but we cannot——

Senator SESSIONS. Are you just saying that——

Mr. LEW [continuing]. We cannot make the debt go away and we have to pay the interest on it until we start reducing it.

Senator SESSIONS. Well, I know there is some idea that somehow you can say you are in balance when you do not pay your interest, you do not count the interest payment, which is obviously not a legitimate way to analyze it. There is no dispute that I can see that your budget costs for not a single year in which we add less than $600 billion to the debt, and you said in your interview Sunday with Candy Crowley, our budget will get us over the next several years to the point where we can look the American people in the eye and say we are not adding to the debt any more. We are spending money that we have each year and then we can work on bringing down the national debt. Was that an accurate or misleading statement to the American people Sunday?

Mr. LEW. Senator, I think it is an accurate statement that our current spending will not be increasing the debt. We do have interest payments. It is going to take us a while to work down those interest payments and——

Senator SESSIONS. Well, you did not say that. You said that we will be bringing down the debt during the period of this budget and that we can look them in the eye and say we are not adding to the debt any more.

Mr. LEW. And that——

Senator SESSIONS. That is not accurate, is it?

Mr. LEW. No, I believe it is accurate. Our current programs, the things we are doing that we are making decisions on, we have stopped spending money that we do not have. We cannot just wish the national debt away.

Senator SESSIONS. Well, I think the American people——

Mr. LEW. They are going to have to make hard decisions——

Senator SESSIONS [continuing]. Heard it and——

Mr. LEW. It is going to take hard decisions to bring that down.

Senator SESSIONS. My time is up, and Mr. Chairman, I would just add one comment, that the budget says it will save a trillion dollars over 10 years. The way the budget is scored by your own analysis, that means we will reduce the total debt added to the American people over that 10 years from $14 trillion to $13 trillion, which is an insignificant amount in the scheme of that number and does not get off the trajectory we are on, which is toward a financial abyss.

Chairman CONRAD. I thank the Senator.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Director Lew, to drive the deficit down dramatically, we need more economic growth, and you have talked about corporate tax reform. I am certainly in favor of taking tax breaks away for companies that are doing business offshore and using that money to dramatically lower rates for companies that do business here. But what troubles me is that your comments mean that there will not be real tax relief for 80 percent of American businesses that are organized as sole proprietorships or partnerships, or the typically hardware store, the electronics firm. And, in fact, my concern is the approach that you are going without trying to get these small businesses that pay taxes as individuals is going to create more complexity and more uncertainty for those small businesses that are a vital part of the economic engine we need for growth.

What is the plan to make sure that we have broader tax reform and particularly pick up the 80 percent of business entities that pay taxes as individuals?

Mr. LEW. Senator Wyden, I think when the President put the proposal for corporate tax reform out there, he did not mean for that to be the end of the conversation. We have to start somewhere. We have a corporate tax system where it has been a long time since we have gone through and taken away the special provisions, where in order to lower the rates without increasing the deficit, we are going to need to broaden the base. And that is going to be a hard process.

He has also said that he wants to work together on a broader basis to deal with the tax system, but we do have to start somewhere, and the corporate tax reform proposal is the first place.

Senator WYDEN. We should not start in a place that is going to further distort the code and make it more complicated. Dr. Bernanke said you have to recognize the interactions between the individual portions of the code and the corporate portions of the code. I just hope—you talk about the conversation. Right now small business is getting short shrift in the conversation. That is not right, and we cannot generate the economic growth that the President wants to see and you want to see.

Let me ask you about a Pacific Northwest matter, and that is timber payments. We are glad that it is in the budget, but it falls dramatically short of the historic obligation. In fact, let me tell you what the President said during the campaign in 2008. He said, with respect to county payments, "I completely agree it is an obligation we have to meet. I think we are not meeting it well right now because we are doing it piecemeal year after year by year."

That is exactly what you are proposing again. You are talking about giving us one more year, then having a study, and in effect putting in place the uncertainty that the President correctly said in the campaign that we ought to move away from to get these rural communities—and there are hundreds of them around the country—off the fiscal rollercoaster.

So what can we tell our folks in the Pacific Northwest is the plan to really provide a way to meet the historic obligation and get these rural communities off the rollercoaster?

Mr. LEW. Senator Wyden, we have had many discussions about this provision, and I hope you can see the impact of those discussions on this proposal. What we have done is we have tried to put in a funding level that would meet the immediate need. We proposed different things that we have discussed in the past which create economic alternatives so that there would be real economic vitality in the areas and ultimately not as much of a need for the payments. And we have indicated an openness to being flexible in terms of working through doing it either as a discretionary or mandatory program.

So we think we have put together something that is a very solid starting point. It is a proposal. And it is obviously going to be something we have to work with Congress on over the coming year, and I look forward to working with you on it.

Senator WYDEN. We are glad it is in the budget, Director Lew. I just want you to know that if you are talking about the historic obligation—and we recognize that times have changed. We are trying to get into new areas, biomass opportunities for the private sector. I am concerned that with the proposal that you are offering now in the rural West we are going to see rural counties go bankrupt. And we have to do better than that. We will work with you. It will be a bipartisan effort. I am glad it is in the budget. We have a long way to go.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, and thanks for respecting the time. Thanks to all colleagues for respecting the time with the number of colleagues here.

Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

Director Lew, I have to join in what a number have said. As I reviewed the President's budget when it came out, I was discouraged. I felt the President took a pass. And, frankly, as one of those who served on the Fiscal Commission and voted for the recommendations that the President's Fiscal Commission made, I saw very little of the recommendations in the budget, and, frankly, when comparing the numbers that we see in the budget to what I think are going to be the reality, it appears to me that the budget that is proposed does not even go as far as it has claimed to. And I want to get into a couple of aspects of that with you.

First, you use the term "primary balance," and I think we all understand that here in Washington in the Budget Committees and so forth. But when the American people hear that, I am not sure they quite understand what it is we are saying.

Is it not accurate to say that when you use the words "the budget comes into primary balance," is means that if you do not pay any interest on the national debt, you can say that you are covering the ongoing expenditures?

Mr. LEW. Yes. It means that the only deficit is coming from paying the debt.

Senator CRAPO. And is that the entire budget, including mandatory spending?

Mr. LEW. That is the entire budget.

Senator CRAPO. And can you tell us what the amount of interest adding to the debt is throughout the totality of the 10 years?

Mr. LEW. I would have to look up the number. I can get back to you with the number.

Senator CRAPO. Well, I have what I think are some of your charts here. Would it be fair to say that the gross debt of the United States over the 10 years of this budget will grow from about $13.5 trillion to $26.3 trillion?

Mr. LEW. That would be the total debt, not the debt held by the public.

Senator CRAPO. Understood.

Mr. LEW. The debt held by the public is a lower——

Senator CRAPO. That is the gross debt. And the debt held by the public would grow from about $9 trillion to about $19 trillion. Is that not correct?

Mr. LEW. Correct.

Senator CRAPO. So I think it is just important that, as we talk about this, you understand the reason for the frustration that many of us have is that this does not change the course that we have been on. Our debt, whether you count the public debt or the gross debt, is going to double in the next 10 years under this budget, and that is not sufficient. As I think the Chairman said, this may be a good opening bid, but we should not be in a bidding process here. We should be engaged with solid leadership from the White House, and we should, as Congress, be engaged heavily in that process as well.

A couple of other aspects of the report that I would like to highlight, if I can. As I look at the budget report as we have analyzed it so far, you are projecting about a $1.7 trillion increase in revenue relative to the same baseline that the Congressional Budget Office projected in January, as I analyzed the two differences there. Can you tell me why the difference?

Mr. LEW. Over what period are you——

Senator CRAPO. I understand that to be over the period of the budget.

Mr. LEW. There are differences in our budget because, first of all, we have policy proposals, but there are also some differences because of economic assumptions. And I can tell you what the impact of the policy proposals are in our budget, and I can also tell you what the impact of the economic is. But——

Senator CRAPO. Would it be fair to say the policy proposals you are talking about assume over $1 trillion in new taxes? Is that correct?

Mr. LEW. Well, I apologize for being a little bit complicated, but we consider the baseline to leave the tax rates from the top bracket where they will be when the 2-year extension expires. So we are not counting the savings that come from leaving that provision in place as savings. That would be, you know, roughly speaking, $700 billion of savings. We are not counting it as savings because it is in the baseline.

Senator CRAPO. Understood.

Mr. LEW. We have $368 billion of net additional revenues in our budget.

Senator CRAPO. But aren't you signaling that you want to see those taxes——

Mr. LEW. Oh, yes. No, our policy position is they should be allowed to expire.

Senator CRAPO. All right.

Mr. LEW. But we do not count them in our $1.1 trillion of deficit reduction because they are in the baseline.

Senator CRAPO. All right. And because of time, I want to go on here. I know there are other policy matters we could—in fact, I would like to get into. I would love to, but also with regard to your economic projections, it appears to me that you are projecting a significantly increased economic performance over what either the private sector in, say, the blue chip reviews show or CBO's projections that came out in January. Is that not——

Mr. LEW. I am not sure I would agree that they are substantially, but they are somewhat more optimistic. The assumptions that we have are in the middle range of what the Federal Reserve looks at when it looks at economics, and it is consistent with the recovery from past financially led recessions. In fact, it is a little bit slower in getting to recovery. The basic difference between the two is that we assume that over a longer period of time we will get back to the economic growth we had before the recession.

The other assumptions assume that we are permanently going to be lower. We think that our assumption there is right. The trajectory may or may not be right. We may be year-to-year—you know, it is hard to hit these things on a bull's eye. But conceptually I think we have the right assumption.

Senator CRAPO. Thank you. Again, I would love to go deeper, but I am out of time. Thank you.

Chairman CONRAD. I thank the Senator for respecting the time.

Senator Coons.

Senator COONS. Thank you, Mr. Chairman.

Director Lew, thank you for your presentation so far today. I am hopeful that this budget—that this conversation at this Committee and elsewhere will serve as a catalytic event, that the members of this Committee who are expressing disappointment at the failure to sort of grasp the larger challenges in front of us in this budget will be able to work in a bipartisan way to find a path forward.

I do find there are some things in this budget about which I am encouraged. R&D tax, credit permanence is something I have championed, and the domestic spending freeze, and the willingness to make differing cuts, deep cuts in some areas, but still sustain innovation, education, and infrastructure investments I think is wise, and being willing to pay for the doc fix and the AMT fix I think are good moves, and there are a number of things I would love to get into—the pay-for-success bonds, the race-to-the-top methodology, and Federal property disposition—if we have time later.

But your written testimony and the comments of two Senators before me really focus on the Commission. The written testimony you submitted says that while the administration does not agree with every recommendation in the Commission's report, there are many areas of this budget that reflect the work of the Commission. I would be interested—I think the Bowles-Simpson Commission laid out the kind of strong, broad vision that we need to take on to tackle not just the deficit but, as was mentioned before, the debt for the long term.

Where does the administration differ with the Commission's proposals? And where do you see them incorporated in this budget? Because I think in large part, the strongest, toughest work of the Commission is absent from this budget.

Mr. LEW. Well, let me give you a few examples of ideas from the Commission that are in the budget: the move toward reforming medical malpractice policies so that we can deal with the impact that that has on health care costs; the approach to the corporate tax reform issue; our pay freeze for the Federal work force; the approach to tax expenditures. The way we are paying for the alternative minimum tax is essentially scaling back on spending on the tax side in a way that is consistent with the report.

You know, I think if you look at the——

Chairman CONRAD. Could I stop you for a minute? Just to alert colleagues, a vote has started, and we are going to continue the operations of the Committee. Senator Murray has gone to vote. So I would recommend, looking at the line-up here, Senators Toomey and Johnson might want to go vote now so that you could come back and be in line. It might work best. I think others, you know, can stay because Senator Graham is next on this side, and on our side Senator Whitehouse is next. But I do think it would be wise for the two gentlemen to go vote now so they do not lose out on time.

Senator SESSIONS. We need the official to add some time to the game clock here.

Mr. LEW. Now I have to remember where I was in answering your question.

Senator COONS. You had gotten to tax reform as being an approach for paying for——

Mr. LEW. So, you know, I think if you look at what the charge to the Commission was, the charge to the Commission was to come up with a plan that would reduce the deficit to 3 percent of GDP, not because we believe that that is an endpoint, but because we believe in order to get beyond that to do deficit—debt reduction, you have to first get to the place where you get to what we are calling primary balance.

I think that, you know, there has been a lot of debate about Social Security, a lot of debate about Medicare. Let me say a word about Social Security.

The President has indicated very clearly that he would like to work on a bipartisan basis to deal with Social Security, but not because it is contributing to the deficit in the short term. It is not contributing to the deficit in the next 5, 10 years. The Social Security Trust Fund is in surplus until 2037. A lot of the expenses in the budget are driven by Social Security. As more of the baby boomers retire, they are going on to the Social Security program, as they have a right to and should, and that is driving spending up. And we have to be sure that we are funding Social Security so that it can keep that promise for this generation and the next generation. But it would not affect the window of this 5 to 10 years, and we need to keep them separate. The President would like very much to work together on a bipartisan basis to be able to deal with that.

Senator COONS. So, Director, my question to you was which of the recommendations of the Commission has the administration rejected or differed with and unwilling to accept as we get going with the broader conversation about how to tackle not just sustainable deficits but what is a sustainable national debt.

Mr. LEW. And I have to respond that you have heard a reticence to say what is unacceptable because it is important to leave ideas on the table. It is important that if we are going to have the serious bipartisan conversation, we not take hard lines on either side of an issue and that we allow the conversation to continue. I actually think that that is part of leadership in terms of how do you prepare the environment for the kinds of discussions that I hear so many people in this room—and we ourselves agree—believe need to happen.

The easiest thing to do in Washington is to take an idea that is controversial and to kill it. The hardest thing to do is to create an environment where it is safe to have conversations and look for middle ground where reasonable people can agree.

Chairman CONRAD. I thank the Senator.

Senator GRAHAM IS NEXT.

Senator GRAHAM. Thank you, Mr. Chairman. And before I start, I would like to congratulate you and Senator Crapo and all the others who participated in the bipartisan Commission to kind of get us out of this mess. I really appreciate what you did.

Mr. Lew, I want to pick up on your comments about Social Security. You sort of made an invitation on behalf of the President to see if we can find some common ground in saving Social Security from—I do not know if "bankruptcy" is the right word, but certainly a collapse down the road. Am I hearing you right, you would like us to work together?

Mr. LEW. I can only point to the President's word in the State of the Union.

Senator GRAHAM. OK. Well, I am going to take you up on it right here in front of the whole country, anybody who is watching C–SPAN, cannot sleep. I really do believe that this is the year for Social Security reform and that the age adjustment from 65 to 67 was accomplished by Tip O'Neill and Ronald Reagan working together.

Do you believe that adjusting the age for Social Security is something the President would be interested in if it was in a bipartisan fashion?

Mr. LEW. Senator, I had the honor of working for Speaker O'Neill in 1983, advising him on Social Security, and I think the reason they were able to reach an agreement in 1983 was that for a prolonged period of time there were conversations going on where ideas were thought through and developed where, after a very, very bruising political battle in 1981, some trust was built up and there was the exploration of middle ground. I think that is what we need to do now. I do not think this is the time for——

Senator GRAHAM. Are we there yet for the middle ground, like means testing? You know, when I speak about this back home, I talk about my personal situation. When I was in college, my Mom died and then 15 months later my Dad died, and my sister was 13, my family owned a restaurant and a liquor store, and if it were not for survivor benefits coming into our family from Social Security, it would have been very difficult for us to make it. That check mattered. Well, I am 55, no kids, not married. When my time comes to retire, I could accept less benefits than those promised. I think a lot of people would probably do what I just said. Do you think the administration is open to talking about a means test in some realistic way?

Mr. LEW. Well, I am going to be reluctant to address positions because I do not think it would be helpful to the process.

Senator GRAHAM. OK.

Mr. LEW. But I would say this about 1983: The reason there could be an agreement in 1983 was that there was a provision that had not been law before which subjected Social Security benefits to income taxation. That was essentially saying that if you had other income and it put you in a place where you did not need the benefit as much, it was subject to taxation. One side considered it a tax increase. The other side considered it a benefit cut.

Senator GRAHAM. I understand the idea.

Mr. LEW. It took a lot of work to get to that point.

Senator GRAHAM. Sure. What do we need to do to get to that point?

Mr. LEW. I think having the kinds of conversations that we are having, continuing it. There will be——

Senator GRAHAM. Well, we are having a good conversation, but, you know, every time I put something on the table, you say we have to talk about—we need to talk about it behind closed doors. That makes sense. But you had a Commission—get back to me because I have only got a minute left and tell me where I need to go and who I need to meet with about finding a way to save Social Security from what I think is an unacceptable demise.

Very quickly, to the President, this is the year—there are a lot of Republicans who understand entitlements have to be put on the table. We are reluctant to go by ourselves because, you know, this issue is easily demagogued. So I am just suggesting to you that there is a moment in time in 2011, before we get into the 2012 cycle too deeply, to find a way to do something meaningful on Social Security that would help our long-term indebtedness. Do not let that opportunity pass.

Now we are going to go to a different issue right quick. Are you familiar that in 2014 the Panama Canal is going to be widened and deepened to allow sort of super cargo tankers to come through the canal?

Mr. LEW. I will confess that I am not familiar with the current policy on the Panama Canal.

Senator GRAHAM. Well, I understand that, but there is a new way of shipping goods coming, and harbors on the east coast have to be deepened to accept these ships. The Charleston harbor needs $400,000 for the Corps of Engineers to study how deep the harbor will be. There is no money in the President's budget for that harbor. Only one million out of a hundred and something million dollars was spent on east coast harbors in the President's budget to get these harbors ready for the super tanker. Could you please study this and get back with me? Because if we do not deepen the Charleston port, that is the economic engine for the State of South Carolina and for the Southeast. These ships are coming. I want to make sure America is a place for them to dock. So could you get back with me about a plan to make sure we can service these ships coming through the Panama Canal?

Mr. LEW. I am happy to look at it, and I do know that in terms of our general policy, we were very constrained because of the savings that we were looking for in the discretionary budget, and there are things that would be good policy and things we would like to do that we just did not have the resources to do. So not knowing that particular project, I suspect we did not put enough money into the category and, therefore, a good project could not get funded. But I will get back to you.

Senator GRAHAM. I look forward to working with you.

Mr. LEW. Likewise.

Senator MURRAY [presiding]. Senator Whitehouse.

Senator WHITEHOUSE. To followup quickly on Senator Graham, would you mind including me in his report as well? Because we have the port at Quoset Point and the port of Providence that are also in a similar situation.

Mr. LEW. Sure.

Senator WHITEHOUSE. On the question of Social Security, when you were working for Speaker O'Neill back in 1983 on that compromise, the perils facing Social Security were imminent, were they not?

Mr. LEW. They were imminent. There was——

Senator WHITEHOUSE. And now Social Security is sound at least until what year?

Mr. LEW. 2037.

Senator WHITEHOUSE. 2037, OK. I want to shift to the question of the revenue and tax side, and I want you to imagine a hospital orderly who is pushing a trolley late at night down the halls of Rhode Island Hospital and is earning $29,100 a year, which is the average pay for a hospital orderly in the Providence area. That person will pay about 16.7 percent of their income in total Federal taxes. At the same time, the IRS just reported, based on the most recent information available, that the 400 top income earners in the United States of America who earned on average $344 million each that year, more than a third of a billion dollars each that year, actually paid taxes to the Federal Government at the rate of 16.6 percent; i.e., the hospital orderly pushing the trolley down the halls of the hospital at 2 in the morning is paying a higher tax rate right now in this country than the 400 top income earners who are bringing home a third of a billion dollars a year.

Now, I have nothing against people making a third of a billion dollars a year. That is America and this is wonderful. But does it make sense for the hospital orderly to be paying a higher Federal income tax rate all in than they do?

Mr. LEW. Is that a question you want me to answer?

Senator WHITEHOUSE. Yes.

Mr. LEW. I think you have put your finger on something that is a real issue, that we have a tax system that is very lopsided, and the proposals that are in this budget to let the rate cut for the highest earners, the top bracket, not remain at the lower level but to revert. The proposal we have to limit the value of itemized deductions in the top bracket would do something to kind of rebalance the system.

I do not know what it would do to that specific comparison. I would have to go and look. But it certainly would affect it.

Senator WHITEHOUSE. And if you look at corporate taxes and take a sort of long view through history, if you go back to 1935, for every dollar that an American chipped in to fund the Federal Government, an American corporation chipped in a dollar to fund the Federal Government. By 1948, for every dollar that an American chipped in, an American corporation was only chipping in 50 cents. It was two bucks in individual revenue for every one dollar in corporate revenue. In 1971, it got to $3 in individual revenue for every dollar in corporate revenue. In 1981, it got to $4 in individually paid—regular Americans paying taxes, revenue, for every $1 that corporations paid. And in 2009, we hit 6:1. So for every dollar that an American pays in, a corporation only pays one-sixth of a dollar. Or otherwise said, for every dollar that an American corporation pays in revenue to support the Government, American human beings have to pay $6.

There is a pretty clear trajectory on this. Where do you think that trajectory should end? And if you could put that in the context of the $123 billion in corporate tax loopholes that the Joint Committee on Taxation calculated in the 2010 fiscal year 2009, I would appreciate it.

Mr. LEW. Senator, this budget does a number of things. First, it has a number of proposals that would limit certain corporate deductions, things like in the fossil fuel area that I mentioned in my opening remarks, some of the provisions with regard to companies that move jobs overseas. So it would have an effect on the margin of shifting that balance. I do not know that it would shift it materially because there are, as I say, individual proposals.

At the core of what this budget says on corporate taxes is that we need to do corporate tax reform so that we can be more competitive and can create jobs in the future. And to us, what that means is that we have to in a revenue-neutral way—we cannot increase the imbalance. We have to broaden the base by reducing the deductions, the special interest provisions, and lower the rates.

That is something that we think is critical to our economic future and to our competitiveness, and that is why the President spoke to it both in the State of the Union and the budget.

Senator WHITEHOUSE. Thanks, Mr. Lew. My time has expired.

Thank you, Chairman.

Senator MURRAY. Senator Ensign.

Senator ENSIGN. Thank you and, Director Lew, thanks for being here. I, too, want to compliment you for your service in the past, and we all have a great deal of respect for you and understand you are working within the constraints of an administration.

We have talked about this, and many of us have said that these votes that we are going to take politically are going to be very, very difficult votes. It is much easier to get re-elected when you are giving money away, basically. When you are creating new programs, new initiatives, you go back home and you tout those. Those are much easier to get re-elected. And I realize the President is very concerned about his re-election, as all Presidents going toward a second term are. But this is not a time in our country where we can afford to worry about our elections nearly as much as we can the country. And I actually—this was not a time for, in my opinion, political cowardice. I believe that this budget misses the mark dramatically because the ideas, the cuts, there are no entitlement reforms in this bill, and we are still adding massive amounts of debt.

You said we are living within our means. Now, let me just try to ask you, if you were a family—you used the family credit card as the example. OK? And you said that, well, we first—and I agree with you. We first have to tear up the credit cards. But tearing up the credit cards means you are not increasing spending. OK? You are not increasing spending. Does this—not as a percentage of the economy, does this bill increase spending?

Mr. LEW. If I could just use the example again, if you stop adding to the balance on your credit card, you still add interest while you are paying it down.

Senator ENSIGN. That is right. So——

Mr. LEW. The analogy is the same.

Senator ENSIGN. It is correct, and so we are getting further in debt because of our interest rates.

Mr. LEW. Yes.

Senator ENSIGN. Every family knows that. So this bill, because the spending cuts are not enough, allows the interest rates to take us further into debt is the point. Is that correct?

Mr. LEW. I do not disagree with that.

Senator ENSIGN. OK. I just wanted to make sure because some of the other stuff to me is double talk because we are still going further into debt massively.

Mr. LEW. The terminology that we use in Washington of primary balance is a little confusing, but——

Senator ENSIGN. Well, it is because I believe it is dishonest. It is the way politicians, Republicans, Democrats, for years have talked about things in order to not have to make the tough votes. It is critical, I believe, because the debt that we are facing and the interest payments on the debt—the CBO Director sat there and said it is unsustainable. He has said Government spending is actually crowding out private sector investment to create jobs.

The report that the Chairman talked about in his opening statement, or maybe it was in his questions, he said that when gross debt equals 90 percent of a country's economy, which is where we are today, that is a decrease, a net decrease of 1 percent of GDP, which translates into about a million jobs in America. So we are hurting future prosperity of Americans because of this overspending that we have, and that is why I said we are willing to join the President on entitlement reform. Republicans are standing ready for the President's leadership. I hope you take that message back to him. We will make the tough votes. We will take—but we cannot do it alone. Republicans are in the minority in the U.S. Senate. We need to join with Democrats to do this. I think the Chairman has shown leadership on this. But we need desperately White House leadership, and this budget, this State of the Union address, did not do it. We have two more chances this year—we have the CR and we have the debt ceiling—to show Presidential leadership where we are going to be serious about spending. And I hope that you will take that message back to the President that we are willing to join him so that neither side is taking as much political heat as would normally be taken in a situation like this, so we can both show the political courage to do what is right for the country.

Mr. LEW. Senator, if I may, you know, I think that in order for there to be bipartisan agreement at any point, you need bicameral and bipartisan participation. I think there are different kinds of conversations happening in different places, and that is not unusual that you do not just get to the point where you have an agreement. You have to work your way to it.

I have to take issue with your characterize of the budget. I do not agree that it is a budget that has the flaws you describe.

Senator ENSIGN. Then answer me this: What percentage of total spending over the 10 years did you decrease? What percentage of total spending did you decrease in this budget?

Mr. LEW. I mean, obviously there is a lot of different categories of spending and——

Senator ENSIGN. Total spending. Just total spending.

Mr. LEW. The reason I am resisting just accepting the framing of your question——

Senator ENSIGN. How about it is less than one penny out of every dollar?

Mr. LEW. But it is important to unpack what is driving spending.

Senator ENSIGN. I asked the CBO Director that question, and that is what he said. It is less than one penny.

Mr. LEW. But if I may just take 1 minute to answer?

Chairman CONRAD [presiding]. Let me just say that the Senator's time has expired, but you can answer this question, and then we have to go.

Mr. LEW. Thank you, Mr. Chairman.

The spending that we control on an annual basis is coming down quite dramatically. The $400 billion that we save in the non-security discretionary part of the budget would bring spending in that category down to its lowest level as a percentage of the economy since the 1950s. There is continuing growth of spending in programs like Social Security and Medicare because the baby boom is retiring, people are taking the benefits that they have paid for, and there is nothing wrong with that. So spending will go up during this period even while we are taking action to cut spending that we control. And I think we just have to be careful to separate those issues.

I do not think that the solution to spending as a percentage of the economy going down is simply to put an arbitrary number in there because what that would have the effect of doing, it would mean that you would say that people turn 65 or 67 and they cannot get their benefits. And that is not what anyone means.

Chairman CONRAD. Senator Murray.

Senator MURRAY. Thank you very much, Mr. Chairman, and thank you, Director Lew, for your experience and credibility on bringing this budget to us.

I wanted to just mention on the Veterans Affairs funding, I see that the President has requested an increase of $2.7 billion over the current year, and that appears on my first review to be sufficient. I did want to say, as Chair of the Veterans Committee I believe construction money does have to follow a vision on health care spending. And I am going to be talking with Secretary Shinseki over the coming few weeks about the mental health and women veterans' issues and making sure that some of the cost-saving proposals do not affect the quality of VA care.

I did want to ask you specifically while you are here a real immediate concern that I do have on the veterans caregivers benefits. As you might know, VA's implementation plan for that bill that we passed here in Congress without one negative vote was overdue, and once the VA did submit it, it veered dramatically from the bill that we cleared here in the House and Senate. Rather than following Congress' intent, the administration set some overly stringent hurdles that are really going to deny help to caregivers that we intended that bill to be for. We are talking about a very small population of wounded warriors, and I cannot think of any reason why the administration would err on the side of diminishing that benefit. And I wanted to ask you while you were here if you would commit to taking another look at the VA's plan, compare it to the law that we passed, and remove some of those unnecessary benefits.

Mr. LEW. Senator, I am familiar in general with the provision. I have to apologize. In the 8 weeks I have been at OMB, I have followed this issue some. I know there are conversations going on now that I frankly have not been able to participate in because of my work on putting the budget out. But I will get back into that conversation.

Senator MURRAY. OK, and I think I said "benefits." I meant eliminate the barriers. If you could look back at that and come back to me within 30 days, I would really appreciate it. There are families out there waiting for this benefit that passed, and we want to make sure it is implemented accurately.

I did want to ask you about the work force section of your budget. There are about 14 million people today in this country that are unemployed. More than 40 percent of them have been without a job for 6 months. So I am very concerned that the administration is choosing to cut funding for job training programs. I was at home recently and talked to a small business owner who serves on a local work force investment board, and he was telling me about a recent hire that he did make through a one-stop career center, and the success of that, particularly because it was a veteran that he hired through that. And it just seems to me at this time when we are trying to match skills and get people with the skills that they need with an unemployment this high that job training is really a critical part of our investments. So I wanted to ask you if you can give us the administration's rationale for cuts when jobs and economic recovery should be our central focus.

Mr. LEW. Senator, we have had obviously many difficult decisions to make in this budget to live within the spending restraints, and one of the things we have done is consolidated programs in areas where there was duplication. We have looked to try and fund programs that were high- performing programs, and this is a case where, you know, we have training and employment services funded at roughly the level they were at in 2010. It is a little bit higher.

In general, we looked at 2010 as kind of the base because we do not know what 2011 is with the appropriations still undecided for the year. So we looked to put together a program that was overall balanced and investing in the programs that work and consolidating, and I would be happy to get back to you with more detail.

Senator MURRAY. OK. I would appreciate that. I just think it is really important that we do not leave that out when that is what is getting people jobs today.

And real quickly in just my last minute, I really wanted to tell you thank you for the EM budget. I know it is something you and I have talked about for a long time, and I think the administration recognizes it has legal obligations when it comes to that funding. And I really appreciate the effort you put into that.

I think we still have work to do moving forward. I see that the administration is committed to modernizing our nuclear weapons facilities in the coming years. I notice that OMB has said it will ensure that future allocations to that effort are going to occur in the required amounts, and that is something that is unusual for OMB to commit to. So like I have been saying for a long time, it is exactly where we need to go with the EM budgets for fundamental legal reasons and because there is also massive amounts of human and monetary capital wasted when EM does not have a stable budget. We have to make sure that those budgets are effectively done right for the long term. So that is something I am going to keep working with you on, but I wanted to thank you for your commitment in this budget.

Mr. LEW. Thank you, Senator.

Chairman CONRAD. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman.

Director Lew, thank you very much for being with us today. I have to share the concern and disappointment that several of my colleagues have already expressed about what I see as a real lack of leadership here, a lack of taking this critical moment to seize the opportunity. I really think the American people want us to make the big, tough decisions that assure us that it will restore a fiscally sustainable path. And I do not think this budget does that.

By your numbers, the total debt held by the public levels off somewhere in the mid to high 70s as a percentage of GDP, I guess around 76 percent or thereabouts. It starts to move up toward the end of your 10-year outlook. My suspicion is it is on a trajectory that continues to rise higher after that.

But what really concerns me is I think there is a significant likelihood that the numbers are actually considerably worse than what we are looking at here, and three things come to mind. I want to make sure that I have these things factually correct, though.

The first is the way you are dealing with the AMT. My understanding is that for a limited period of time, I think 3 years, the assumption is that the AMT will not capture the new group of people that it would otherwise capture. There are offsets to that. But, thereafter, the assumption implicit in these numbers is that the AMT will not be patched anymore and that there will be this revenue coming in to the Government as it goes unfixed in subsequent years. Do I have that right?

Mr. LEW. Not exactly, Senator. What we have done is we have paid for 3 years of the so-called patch so that the AMT will not cover middle-class families. We have said we think it should be paid for permanently. We have not taken the credit for that, so our deficit projections assume that it is fixed and not paid for. Were we to pay for it, which is what we would like to do on a bipartisan basis, it would reduce the deficit by an additional 1 percent of GDP.

Senator TOOMEY. OK.

Mr. LEW. So there is a substantial upside if we can do the right thing on the AMT.

Senator TOOMEY. If we did. So your numbers assume that no middle-class family is ever captured by the AMT.

Mr. LEW. It assumes the patch continues, but it is only paid for for 3 years.

Senator TOOMEY. OK.

Mr. LEW. We thought it was a bit of a heroic assumption to assume we paid for it over the whole period.

Senator TOOMEY. Right. I would agree.

Mr. LEW. We put in the offsets for the first three.

Senator TOOMEY. Right. With respect to the doc fix, my understanding is that there is a period of time—I think it is 2 years—for which the assumption is that the doctors would not experience a draconian cut in reimbursement rates. After that 2-year period, is it implicit in these numbers to assume that the doctors will, in fact, have that cut?

Mr. LEW. So the doc fix is a little bit different. In the case of the doc fix, first, Congress last year paid for it. So we have, unlike the

AMT, a first case of Congress saying even though the budget rules did not require it to be paid for, the right thing to do was to pay for it, and I applaud the Congress for doing that. We worked with the committees to make that happen.

We have now put in $62 billion of specific offsets to pay for two more years of the doc fix, and what we have said beyond that is that we need to work together to come up with a reimbursement system that does not have to be patched from year to year. And we think that the pattern and practice of paying for the doc fix last year, delineating specific offsets for the next 2 years, and working together to reform the reimbursement system and pay for it, we do not—we assume that it is fixed going forward.

Senator TOOMEY. I am not sure I understood your answer, because the question—my question fundamentally is do these numbers assume that the doctors take the cut in reimbursements that is currently projected in law but the Congress has always postponed.

Mr. LEW. What it assumes is that we fix the system so we do not have to cut the rates.

Senator TOOMEY. So does it assume the savings to the government——

Mr. LEW. Well, it assumes net zero because it assumes we would work together to fix it and pay for it.

Senator TOOMEY. Although we have not figured out how we are going to do that.

Mr. LEW. We now have 3 years to do it if we get this.

Senator TOOMEY. I think that is quite an assumption to make given the circumstances.

The other concern that I have is the assumptions that go into calculating our interest expenses, our projections on interest expenses. My understanding is, right now, the average cost of servicing our debt is something less than 3 percent, is the average weighted cost of our Treasury securities.

Mr. LEW. Right. Our current rates are lower than that——

Senator TOOMEY. Closer to two, in fact, right?

Mr. LEW. Yes.

Senator TOOMEY. The average rate that you assume in these numbers is a little bit higher than that, right?

Mr. LEW. Umm——

Senator TOOMEY. I think it is on the order of a little over 4 percent.

Mr. LEW. I think so, yes.

Senator TOOMEY. I think, historically, over the last 20 years, it has averaged closer to 6 percent. My point is——

Mr. LEW. I have to confess, the economic assumptions were locked while I was awaiting confirmation, so I am not quite as familiar with them as I otherwise would be.

Senator TOOMEY. Here is my concern. We are at a time where we are accumulating an unprecedented amount of debt. We have a Federal Reserve that is pursuing a policy of unprecedented easy money. They are creating a staggering amount of money. We have a huge growth in the money supply. We have a spike in commodity prices. And it is, I think, extremely optimistic to think that we are not going to have at least a reversion to the historical average of interest rates and a distinct risk that it would be much higher.

I understand you have to pick a number and you have to make an assumption, but my point is that I think there is a very, very dangerously high risk that our interest expense ends up being much, much higher than these numbers.

Mr. LEW. You know, obviously, the economic assumptions are based on a number of factors. We think they are in the middle range in terms of being reasonable assumptions. There is one aspect of our assumptions on the growth side where there is a conceptual difference, but on the interest rate assumptions, I think they are in the mainstream, and we can get back to you with details.

Senator TOOMEY. Thank you. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Stabenow.

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

First, I would followup on my colleagues, Director Lew. I would just answer, as the person who had the legislation to completely fix the doc fix, or what has been called the sustainable growth rate problem, which does not work at all. I would say I am going to assume, and you can assume, that doctors are never going to get that cut because I cannot imagine that happening. So we have to get that fixed, and I appreciate that you at least put in a 2-year fix going forward.

There are a number of things that I would like to ask. I will focus on a couple, but first start by saying that I appreciate the work that has been done. I know that cutting discretionary spending back to the percentage of GDP under President Eisenhower is no small thing, and so I appreciate very much what you are focusing on. It is tough. There are things that we know we need to do. Every family has to cut their budget, has to tighten their belt, and we do at the Federal level, as well, and so we have to start from that premise but also be smart about it. And so I think those are the challenges for us, as to what we need to strategically invest in.

The first point goes to something specific to the Great Lakes. The President cares about the Great Lakes. I care about the Great Lakes. We have had a significant investment in Great Lakes restoration in this budget that is cut. My question is whether or not you believe that there are the resources available to protect the Great Lakes from Asian carp coming into the Great Lakes. This is, as you know, a serious issue that would undermine our tourism and boating industries and cost us jobs and would have a tremendous impact, the fact that these fish are coming up through the Mississippi River and are dangerously close to the Great Lakes. And so whether it is Great Lakes restoration or the Army Corps of Engineers, I need to know that there are sufficient resources available to make sure that stopping the Asian carp is a top priority for the administration.

Mr. LEW. Senator, the funding level for the Great Lakes Initiative obviously is reduced, but it is not eliminated. We continue with the initiative. I would have to go back and check on exactly what the status of preventing the carp from swimming upstream, as it were, is. I am happy to check and get back to you.

Senator STABENOW. Thank you. Let me turn now to the other important piece of this and that is the fact that we have a serious deficit. I was proud in 1997 to cast a vote with many of my colleagues to balance the budget for the first time in 30 years under President Clinton and very dismayed that we are right back in a worse position now and we will dig our way out of it again. We have to.

But we also know that we are never going to get out of deficit with more than 15 million people out of work.

Mr. LEW. Absolutely.

Senator STABENOW. And so that is why we have to focus on jobs, as well. Andrew Liveris, who is the CEO of Dow Chemical Company, based in Michigan, is the author of a new book called Make It In America, which I would recommend you taking a look at. In his book, he says, at a time when U.S. companies run by patriotic people are moving offshore at the fastest rate in history, we should, at a minimum, recognize that the model we are relying on is not working. It is time to recognize that if we do not act soon, if we continue to let markets rule in every instance, we will become the global economy's biggest bystander and potentially its biggest drain. Our U.S. companies are competing with countries that are subsidizing entire industries. As Mr. Liveris says in his book, we need to get into the game and play to win.

I believe that the budget makes some important steps in that direction, focusing on smart investments like clean energy technology and advanced manufacturing, education, work force development. So I am wondering, Director Lew, if you could please explain how the administration analyzed the various programs in the budget and how you determined which programs to invest in to strengthen our competitiveness and to create jobs making things in America.

Mr. LEW. Thank you, Senator. I think if you look at the investments in this budget, in education, in innovation, in building our infrastructure, they are all tied to answering that question. When you talk to CEOs, as I have over the last months, one of the things they say is they need to get high school and college graduates who have the skills in science, math, engineering, technology to do the work. It is becoming more of a challenge. So that is something that our education system, we can do that.

Innovation, we know that in innovation, America has been the leader in the world and it is drive by a great partnership between Federal funding, government funding of basic science and innovation in the private sector, adapting it and taking it to commercial application.

And in terms of infrastructure, we have to have both the ports and roads that make it possible to be connected to the world, but also the electronic connections so that we can communicate and create virtual hubs in any part of our country, and the budget invests in all those things.

Senator STABENOW. Thank you.

Chairman CONRAD. Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman.

Director Lew, nice to meet you.

Mr. LEW. Nice to meet you, Senator.

Senator JOHNSON. I am hoping you are hearing, at least from our side of the aisle, that there is a real readiness here to seriously address these problems, and I guess I agree with my colleagues that we are not seeing real leadership being presented by the President here and it is disappointing. So if the President is willing to show real leadership, I think you have an awful lot of people on this side that are really willing to work with him and take the hard votes.

As the new kid on the block here, I might have some nuts and bolts questions that I would like to ask. First of all——

Mr. LEW. That usually precedes the hardest questions.

Senator JOHNSON. Oh, I do not think so. These should be easy. I am looking at your proposed budget spreadsheet form here and I am seeing numbers that go from a deficit of $1.645 trillion out to $774 trillion. That adds up to $8.9 trillion cumulative deficit over that 11-year period. But the gross debt is growing by $12.9 trillion, or $12.8 trillion. Can you explain that $3.9 trillion difference to me?

Mr. LEW. Well, the gross debt includes both debt held by the public and the trust fund debt, so—and from now until 2025, the Social Security Trust Fund will be building up balances, and then it will only be actually in deficit after 2025. So from now until 2025, we have additional Social Security balances being built up. I do not know if it explains the whole amount, because there are other trust funds, but that is probably the phenomenon.

Senator JOHNSON. How realistic is that, though, because have we not for the first time slipped into deficit imbalance in terms of Social Security payments versus payouts?

Mr. LEW. Social Security is drawing on the trust fund, but it is not in deficit, no.

Senator JOHNSON. OK. So again, that 3.9, you are saying, is probably—most of that would probably be Social Security Trust Fund.

Mr. LEW. Yes.

Senator JOHNSON. What is the rationale for even——

Mr. LEW. I can get back to you and check.

Senator JOHNSON. OK. What is the rationale of even talking about a primary balance?

Mr. LEW. So primary balance is a term I did not invent, and I can say after today it is probably not the most artful turn of phrase. The concept is a sound one. The concept is that we need to have spending and revenue policies such that our current obligations, not counting interest, are all paid for. And then you have your built-up debt and you have to start paying down your debt. Until you pay down your debt, it still accrues interest. So primary balance means you are at the point where the only reason you have a deficit is that your built-up debt is still earning interest, paying interest.

Senator JOHNSON. Yes, but you have to pay the interest——

Mr. LEW. You have to pay the interest, yes. Yes.

Senator JOHNSON. So it seems kind of silly to me to even talk about it because——

Mr. LEW. Well, it is——

Senator JOHNSON [continuing]. We are obligated to pay those interest payments, correct?

Mr. LEW. Yes, but it is a very meaningful—if you think of a road that we have to be on where our goal is ultimately to pay down the debt, where ultimately to get to balance and then surplus, we have to cross through the point of stopping spending more on real expenses now and being in the place where we can freeze the principal, and if the interest is compounding, start to pay it down so it can be reduced.

Senator JOHNSON. Well, again, we are a long ways from that because we are——

Mr. LEW. A long ways.

Senator JOHNSON [continuing]. We are not getting serious about it.

Let me—in business, when you are putting together a budget, generally, you kind of look at worst-case scenario. I mean, you do not put in the most rosy scenario. From my standpoint, this is maybe not totally rosy, but certainly not the worst case scenario. I look at three areas of pretty primary risk here: Interest payment on the debt, the health care law—I believe you are probably still assuming that that will actually decrease the deficit, and then just your growth assumptions. What do you, of those three, which one do you think is the greatest risk in terms of not actually coming to fruition?

Mr. LEW. You know, I think with any long-term economic assumptions, there are risks on both sides. In our budget documents and in our analytical perspectives volume, we show the risks, positive or negative. I cannot actually tell you—none of us know whether we are going to be above or below in a lot of these areas. We have tried to come in in each of the cases with middle-of-the-line assumptions.

In the one case that I described before, we have a conceptual difference and I think ours is right. We believe that the economy will return to where it was before the recession. It is just a question of how long it takes to get there. If you assume the economy will forever be reduced because of the recession, that will be the first time that we did not have a full recovery from a recession.

On the others, I would be reluctant to hazard a kind of higher or lower than risk. We have tried to use middle-of-the-range assumptions so that they can balance each other out.

Senator JOHNSON. One quick question. Do you really believe the health care bill will reduce the deficit? Do you really believe that?

Mr. LEW. Yes, I do.

Senator JOHNSON. OK.

Mr. LEW. So does the Congressional Budget Office.

Chairman CONRAD. Senator Nelson.

Senator NELSON. Good afternoon.

Chairman CONRAD. Oh, I am sorry. Senator Cardin is back. Senator Cardin is—I apologize, Senator Nelson. Senator Cardin is back.

Senator CARDIN. Thank you, Mr. Chairman. Senator Nelson and I both serve on the other committee that we were balancing back and forth, but I promise I will not take very long.

First, Director Lew, I want to ask the question following up on the confirmation hearings dealing with the Title 17 Loan Guaranty Program Senator Crapo and I both asked about during your confirmation hearings and that is the scoring the OMB does for these loan guarantees. And I will ask that you get back to me and ask whether you can handle this administratively or whether legislation is going to be needed in order for us to be able to move forward with these loan guaranty programs so that we can advance on the nuclear power front. So would you get back to me on that?

Mr. LEW. I will get back to you, Senator. I mean, we have worked—in the brief time I have been back at OMB, we have worked on all these loan guaranty programs trying to get to a place where it is more transparent what is going on, and the responsiveness is clear, and if you have questions, I would be happy to respond.

Senator CARDIN. Well, we believe—it is really causing a problem, the way that the scoring has been done, and discriminates against certain States over others based upon their regulatory structure. That was never our intent. So I would ask that you would take a look at this again——

Mr. LEW. I will take a look at it.

Senator CARDIN [continuing]. So that we can move forward. Thank you.

I want to sort of get to the overall thoughts. Unfortunately, your budget is being released at the same time we are dealing with the Continuing Resolution in the House, and we will have to deal with that also in the Senate, and there is a lot of focus right now on discretionary spending because of the Continuing Resolution that needs to be passed. Now, I think you have come in with a rather aggressive approach for discretionary spending. The $400 billion savings, to me, is a significant part of the overall strategy to bring the deficit under control. A freeze is a freeze. It is going to cause us to make some very painful judgments. And we saw in your budget that you made some painful suggestions. I disagree with some of those and I am hoping that we can adjust the priorities. But I think the overall goal that you have set is attainable and can be done without disruption to our economy and to our programs.

But at the same time, you need to look at the other major factors, whether it is entitlement spending or the revenue side and tax reform. It is interesting that your budget extends a lot of the tax policies, whether it is AMT or the rates for under $250,000. Do you have a dollar amount associated with how much the extension of those tax provisions will cost over the next 10 years so we can try to put this in proper perspective as to what we are doing with the budget deficit?

Mr. LEW. Senator, do you mean the AMT pay for or——

Senator CARDIN. The AMT pay for. You also extend some of the other tax provisions, particularly for those under $250,000 income——

Mr. LEW. The AMT is $321 billion over 10 years, and the others, I would have to—I can look them up.

Senator CARDIN. But they are substantial.

Mr. LEW. Oh, yes, yes, yes——

Senator CARDIN. I mean, they are going to be——

Mr. LEW. They are substantial.

Senator CARDIN. We are getting into the trillion dollar range, if not higher than that.

Mr. LEW. The extension of the middle-class tax cut that is in the baseline is very substantial——

Senator CARDIN. Substantial—trillions.

Mr. LEW [continuing]. And were we to extend the upper-income tax cut, which we do not, it is very substantial, as well.

Senator CARDIN. I think that was about $700 billion——

Mr. LEW. Seven-hundred-and-nine billion.

Senator CARDIN. Yes, if I remember correctly.

Mr. LEW. And the additional cost of the estate tax provision that was enacted in December for 2 years compared to the 2009 policy is another $98 billion. We assume that it goes back to the 2009 policy.

Senator CARDIN. And the reason I mention that is that we are getting into this debate on the discretionary spending side, and I think the proposal that you brought forward is one that is going to cause some really difficult choices to be made, but it is the right policy for us to achieve. But if we do not achieve that by also reforming our tax code, we are never going to get to the type of results that are going to be fair for the American people in balancing the budget but also balancing our priorities.

And I think that we need to know how much money we are spending, for example, on tax expenditures. We do not exercise anywhere near the same discipline on tax expenditures as we do on discretionary spending. So if we are going to be able to have a credible plan for the deficit, we cannot just talk about the discretionary spending side. We really need to get beyond that.

Mr. LEW. I totally agree, Senator, and the reason that we have put forward as a way to pay for the Alternative Minimum Tax, limiting the deductions in the top bracket, is because it begins to get at that question of tax expenditures and curtailing how much we are spending on the tax side. It is obviously not the last word on the subject, but it is an important step.

Senator CARDIN. We need tax reform, and we desperately need it. We are going to need leadership from the White House and we are going to need bipartisan leadership here in Congress in order to be able to achieve that.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Portman.

Senator PORTMAN. Thank you, Mr. Chairman, and Director Lew, having been in your shoes 4 years ago, I remember this being a very hectic week. You seem more relaxed than I was at the time, probably because you have been through it before.

You probably heard some of the commentary from my colleagues today and from me about this budget. I am very disappointed because I do not think it rises to the challenge that you yourself have set out or the President had set out, and I wish I could say otherwise. By the way, I think there are some opportunities, and Senator Cardin just talked about one, and the Chairman has talked about this, as well, which is tax reform that is not in the budget that would help in terms of creating the economic growth that enabled us 4 years ago to be able to propose a balanced budget over 5 years because we had substantial revenues coming in and a deficit that was roughly one-ninth of today's deficit.

So at the risk of doing sort of the specific critiques that used to drive me crazy, let me give you some critiques that I see in this budget and get your response, because I may be misreading it. As I look at it, getting into some of the details, I see about $960 billion in what I would call either imaginary or unspecified savings, in one case wishful savings, and we have talked about some of them today, but not all of them.

The doc fix we have talked about, and Senator Stabenow said she was pleased to see that you covered the doc fix through 2013, I look at that very differently. I see about $62 billion in savings, but those are 10-year savings, and actually on an annual basis over those years it covers only about 8 percent of the costs for those two fiscal years and I wonder how that is considered a doc fix. If you look at the $315 billion in unspecified savings that you have for the doc fix, I am not sure where that comes from.

You look at the trust fund for transportation, it is called the Bipartisan Financing for Transportation Trust Fund—I guess that means Democrats and Republicans are both going to pay higher taxes—but I am not sure what that means. I have been told it is a gas tax hike, but that is not what it says in the budget, and I have been told by others it is not a gas tax hike, so it seems to me that is unspecified.

And last, of course, the AMT relief. We have talked about that. I guess you have clarified today for me that it is a reduction in tax expenditures related to limiting deductions on high-income individuals. That has always been considered a dead-on-arrival proposal, as it was last year in the budget, so I think that may not be imaginary or unspecified but may be wishful.

If you add all these up, you get to a deficit that would be higher by about $964 billion, almost $1 trillion. Of course, that virtually eliminates the, I think, $1.1 trillion savings that you all are claiming in the budget. So I am just—I am concerned about the overall budget and the big picture we have talked about today because it does not address the fundamental issues. It does increase the debt substantially, doubles it over the 10-years. But also, even the savings here, I wonder if you could tell me why you think these are real savings.

Mr. LEW. Senator, I am happy to. You know, I think if you take these items individually, the offsets that we use to pay for the 2-years of the so-called doc fix are very real savings. There is in the program integrity area 16 specific line item proposal. We have policy behind each of them.

I think the notion of pay-as-you-go rules are that you can take savings over 10 years and apply them to spending within the 10-years and that is how we pay for it. So it is consistent with pay-as-you-go scoring and I think that is a very solid set of proposals.

Senator PORTMAN. These are Medicare savings over 10 years——

Mr. LEW. It is a combination of Medicare, Medicaid, Federal Employee Health Benefit Program. It is a variety of very specific policies.

Senator PORTMAN. You pay for the 2-years——

Mr. LEW. I would say that on the surface transportation bill, we are very clear in the budget that if we can work together on the policy for the investments, we need to also work together on the policies of paying for it because we do not get one without the other. So I do not think that—it does not increase the deficit. It just increases the risk of whether or not we can fund the surface transportation priorities. There are a lot of different ways that one could fund them, and in the past there has been—it has been an area where there has been the ability to work together on a bipartisan basis. We may have disagreements on the priorities. It may not be that the program is one where we all agree.

Senator PORTMAN. No, I think—let us assume we agree on that, but there is——

Mr. LEW. The pay-fors will have to follow or we do not get the investment.

Senator PORTMAN. This is a budget that claims the pay for and you are just out there that the pay for, we will figure out.

Mr. LEW. On the AMT, we do not count savings beyond the provision I have described. And on the doctor fix in the out years, you know, it is—there is going to need to be a debate on what to do to resolve this so that we do not have to deal with it on an annual basis, so we have a reasonable policy on reimbursement and we do not keep going back to something that everyone agrees cannot happen. And that is what we are proposing that we work together to do in this 3-year window that we pay for.

Senator PORTMAN. Mr. Chairman, I do not know how much time you are allotting us. It went down to zero and back up to 3 seconds——

Chairman CONRAD. No, that means you are 32 seconds over.

[Laughter.]

Senator PORTMAN. OK. All right. Well, I have a number of other questions. Again, thanks for being with us today, Director Lew, and I hope we will have a chance for a second round.

Chairman CONRAD. Senator Nelson.

Senator NELSON. Thank you for your public service. Putting this together has been tough for you. It is a good first step, but we have a long way to go.

And one of the President's stated goals is to expand the economy by expanding exports through our trade, and it was raised earlier and I want to underscore it. With the Panama Canal being expanded so that it can accommodate the very largest of the cargo ships coming from Asia so they do not have to dock in California and then incur the cost of taking the cargo off and putting it on rail or trucks and sending it to the East Coast, these large ships are going to be able to come right through the Panama Canal and come to East Coast ports and that is going to increase a good bit of activity both coming in and going out, a lot of economic activity.

But most of the ports on the East Coast cannot receive the new large cargo ships because you have to get the channels dredged deeper. There are just about three ports on the East Coast that can accommodate the deep ships and there are others that want this, and yet there was no, despite pleas and begging on my knees for a de minimis new start, which we can match local and State funds for deepening channels, there are none in here. So this has already been addressed. I want to add my comment and you are to get back to us and I would appreciate it if you would get back to me, as well as to the other Senators who raised the issue. Thank you.

OK. Now, you go through and you make up a budget. These are the President's priorities. In the case where there is an authorization for appropriations, what is the guidance that the President gives you in following an authorization?

Mr. LEW. Senator, the—in general, the policy is to look at each program and each department and to look to what the right policy for the next year is. An authorization in some cases is going to be the upper limit. In some cases, you propose than more it. In other cases, you propose lower than it. Senator, the President's budget often proposes policy. If there is a specific program that you are asking about, as I suspect there is, I would be happy to address it.

Senator NELSON. Well, for example, the President signed the NASA authorization bill last September and yet the budget does not necessarily follow the authorization bill. I am not talking about the overall level of funding. I am talking about the allocation of the dollars within the agency. Do you want to comment on——

Mr. LEW. Well, I think that, in general, we did try and fund programs in a manner consistent with the authorization. There is a general tightness in this budget where we did not have as much money to allocate as——

Senator NELSON. That is not what I am talking about.

Mr. LEW. I understand, and we have tried to reflect the policy in the authorization and the budget. If there are specific areas where we have not, I am happy to discuss them with you.

Senator NELSON. Yes. For example, in the authorized budget for the new heavy-lift rocket, you all in fiscal year 2012 have cut it over a billion dollars. You cannot build a rocket cutting it a billion dollars. And I am talking about the capsule, as well. But, on the other hand, when we put this delicate balance together between the heavy-lift and also the commercial rockets, which we support, and Senator Cornyn's colleague from Texas is the one that helped me put this thing together, the fact is that you all decided, well, the commercial rockets ought to have more money than was authorized, and I am just wondering why you are not following the law.

Mr. LEW. Well, I think the President's budget is an opportunity to propose funding levels that are consistent with the policy requirements. We looked at the authorization and tried to track it. We had lower total funding levels. We saw there as being real need for the commercial satellite. We tried to hit the right balance. I understand that that may be something that we have some different views on and I look forward to working with you on it.

Senator NELSON. OK. And the law is the law, and the good news is, Mr. Chairman, the President proposes and the Congress disposes.

I know my time is up. I am going to submit a question for the record about the difference in the budget that you assume the cost of acquiring the takeover of Fannie and Freddie, and that is much different from the Congressional Budget Office estimate, and so I will submit that for the record. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you. Thanks for your respecting the time.

Senator Thune is actually next.

Senator THUNE. I see everybody is really happy about that.

[Laughter.]

Chairman CONRAD. Let me just say this for colleagues. I am not going to be able to do a second round. I have to stop at 4. So we have three left and we are going to have to press ahead.

Senator SESSIONS. Mr. Chairman, I know you do have a very serious schedule problem, but I had hoped that we would have a second round. I do not think we have begun to sufficiently inquire into this budget at this critical point in time. Perhaps if you cannot extend it, could you extend the time by which we could file written questions?

Chairman CONRAD. Yes, I would be glad to do that, and I apologize. Normally, it is my practice here to go as long as people want to go. Today, I cannot do it, so we have to close at 4. Obviously, we are not going to quite meet that.

Senator Thune.

Senator THUNE. Thank you, Mr. Chairman, and Director Lew, thank you for being here today. I know that—I do not want to rehash a lot of the old ground because everybody has been very critical of the budget proposal, and forgive me if I ask questions that have been asked already. I have not been in the room when some of the others have asked.

But it does seem like everybody knows this entitlement thing is just a time bomb waiting to blow up and that there would be some proposal, particularly given the fact that there was a debt commission that made a number of recommendations, at least on Social Security reform. I understand that the Medicare-Medicaid aspect of that which is health care attributable is a more difficult nut to crack. No less, we need to get after that, as well. But why is there not any attempt to deal with these long-term problems? I mean, you have a budget which literally goes from $13 trillion in gross debt, or $14 trillion in gross debt, which is where we are today, to $26.3 trillion in gross debt.

Mr. LEW. Senator—and I apologize if I repeat for others what I said in response to an earlier question—the Social Security issue is a very complicated one, but I think it is important to understand that it is not contributing in the short run to the deficit problem. And I just want to correct something I said before, because I may have used a number incorrectly.

The Social Security Trust Funds will not be exhausted until 2037. You know, they do not—they continue to grow because of both the balances that have been built up and the interest that is paid on those balances until 2025. And it is something that we ought to deal with because it is the right thing to do. We ought to be able to tell our children and our grandchildren that they can rely on Social Security just like our parents could. We need to separate it from the short-term deficit discussion. I actually think that will be the only way that we can have the kind of serious bipartisan conversation, because it is not contributing to the problem in this window.

The President said in the State of the Union that he wants to work on a bipartisan basis to do it. He laid out some principles there. Those principles are repeated in the budget.

It is a challenge to have a conversation about Social Security in a bipartisan way. I have worked on the issue for 30 years. It has always been a challenge. The easiest thing in the world to do is to polarize the debate over Social Security. The President has worked very hard to extend a hand to have a conversation, and I think that is leadership. I think it is leadership to say we need to have that kind of adult conversation.

Now, we have to figure out how to do it. I understand that, you know, there is an impatience to get on with it. But we ought to look at when the problem really hits. If you have a problem where the trust fund will be exhausted in 2037 and we are saying in 2011 that we want to have a conversation about it now, we think we are taking a pretty long look, and I hope we can work together on it.

Senator THUNE. Well, we are putting IOUs, like we do all the time, into these trust funds. I mean, it is operating at a balance with less coming in and more going out. But I guess that was my point.

Mr. LEW. I would just take issue with the IOU description because they are Treasury bonds and the Federal Government has always honored bonds.

Senator THUNE. But it is debt. But my point, though, is this: I understand, OK, so Social Security, let us say that that is not as big of a factor as perhaps the other two are. Why would you wait? I mean, the adult conversation occurred during the Debt Commission. The Debt Commission made recommendations. The President appointed this debt Commission. You have all the experts who got together and said this is what we need to do, and to me, saying we need to have a conversation somewhere down the road about this, that is not leadership. And why would you—if Social Security—if your perception is that it is not a problem until some point in the future, what about Medicare and Medicaid? I mean, we all know that this is 60 percent, and growing, of the budget all the time.

Mr. LEW. The administration has done quite a lot in the area of health care in the first 2 years. There may be different views about the merits of what we have done, but the Congressional Budget Office agrees with us that we save hundreds of billions of dollars in the first 10 years and $1 trillion in the second 10 years. In addition to that, in this budget we have $62 billion of additional savings in health programs. So we have put quite a lot forward in health programs.

We are open to new ideas. The President made it clear; he does not think that we have a monopoly on good ideas. He wants to work together to move forward in this conversation. But I do not think it is fair to say that the President has not taken leadership on health care. He has taken a lot of leadership.

Senator THUNE. Well, I think we disagree about that question, but quickly——

Mr. LEW. We may disagree on the policy. I do not think we can disagree that he has taken leadership.

Senator THUNE. On a technical point, the economic assumptions about growth that you come up with are at least a point higher annually than are those that come up—that the CBO came out with. How do you come that far apart? That is a significant amount.

Mr. LEW. Our assumptions are in the middle range of the Federal Reserve Board's analysis. The basic difference between the Congressional Budget Office assumptions and ours is that we believe that, consistent with past history, we will recover from this recession, and as in all financially led recessions, we will ultimately get back to the level of economic growth that existed before the recession.

CBO assumes that we will permanently have a loss of economic capacity. We disagree with that assumption. One can disagree about the trajectory, and, you know, we may be right or wrong on how many years it gets there. But we believe strongly that we will get back to that rate of growth.

Senator THUNE. Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

Senator SANDERS.

Senator SANDERS. Thank you, Mr. Chairman. I apologize for being late. I was chairing a hearing.

Mr. Lew, the President has proposed in his budget to let the Bush tax cuts for the wealthiest 2 percent of Americans expire at the end of 2012.

Mr. LEW. Correct.

Senator SANDERS. Now, a few months ago, when the Democrats controlled the House, when Democrats had a larger majority in the Senate, the President conceded that point to the Republicans and extended the tax breaks for 2 years. Why do you have any belief whatsoever—and maybe my Republican colleagues would like to chime in on this—that, in fact, these tax breaks will be terminated when Republicans, who are adamantly for these tax breaks, are in power in the Senate?

Mr. LEW. Senator, when we worked on the tax bill in December, the President made it very clear that his position had not changed, that he believes that these tax rates should not be extended permanently. In the context of trying to work together to do something that was very immediate so that we would have economic growth this year and not have a tax increase this year, we had a 2-year extension. This is consistent with the position he took then, and we are going to——

Senator SANDERS. But I asked you a question. Given the dynamics of politics, when Democrats controlled both bodies, I do not think any of my Republican friends would disagree, it ain't going to happen.

Mr. LEW. But I think there were very few who predicted that the tax agreement would happen, so I think in the area of predictions, lots of times——

Senator SANDERS. Well, many people did not predict that that tax agreement, which gave hundreds of billions of dollars in tax breaks to the top 2 percent, would have happened. Many of us wish it did not happen.

Let us talk about Social Security. When the President ran for office, he was very clear in saying that Social Security has been an absolute success for the last 75 years, it is vital to the well-being of the working people of this country, and campaigned and saying that he wanted to extend the life of Social Security and its financial solvency by lifting the cap on taxable income coming from people who made more than $250,000 a year. He saw that as the solution. He saw that as fair. I happen to agree with him. Is that still his position?

Mr. LEW. You know, Senator, I think that what the President said is that he thinks we ought to work together on a bipartisan basis——

Senator SANDERS. No, I asked you a question. Is that still his position?

Mr. LEW. I think his position, as he stated it then, that there is room to raise the cap and that will help extend solvency remains true.

Senator SANDERS. That will extend it. That will solve the problem.

Mr. LEW. The challenge we are going to have to work together for a bipartisan solution is going to be to find something we can all agree on. And I think he has tried to indicate that it is not necessary to cut benefits for current retirees or to——

Senator SANDERS. For current retirees.

Mr. LEW [continuing]. Benefits in the future. And that is a framework for a conversation.

Senator SANDERS. A framework for a conversation. Let us stay on that point a little bit. Is the framework for a conversation cutting benefits for younger workers?

Mr. LEW. I do not want to address hypothetical provisions. I think that the issue of Social Security is one that ought to cross party lines. I think we——

Senator SANDERS. What position are the Republicans stating that you feel that we can work with them on?

Mr. LEW. I think that there is going to be a need for us to look at options where——

Senator SANDERS. What options?

Mr. LEW. Senator, it is premature for me to address the specific——

Senator SANDERS. Are we going to cut benefits for workers?

Mr. LEW. The President said clearly that we are not going to cut benefits for current retirees, and we are not going to slash benefits for future retirees.

Senator SANDERS. "Slash" is a big word. What does "slash" mean?

Mr. LEW. I am going to stick with the words the President used.

Senator SANDERS. Slash? Or we can cut. You can cut but not slash. Well, let me ask you this question——

Mr. LEW. Senator, I really——

Senator SANDERS [continuing]. About Social Security.

Mr. LEW. I really think I should leave the President's words to say it.

Senator SANDERS. All right. Let me ask this question. Has Social Security, which is funded by the payroll tax, contributed one nickel to the deficit of this country?

Mr. LEW. Social Security is fully funded through 2037.

Senator SANDERS. Has it contributed one nickel to the deficit?

Mr. LEW. No, it has actually been helping with——

Senator SANDERS. That is right.

Mr. LEW. Yes.

Senator SANDERS. If Social Security has not contributed one nickel to the deficit, why are we looking at it within the context of deficit reduction?

Mr. LEW. I agree. Senator, I have said four times at this hearing it should not be looked at in that context.

Senator SANDERS. OK. How many years will Social Security pay out every benefit to every eligible American?

Mr. LEW. If we take no action, the trust fund is exhausted in 2037.

Senator SANDERS. So that is another twenty—and there are varying opinions, 23, 24 years. Some say longer.

Mr. LEW. These numbers——

Senator SANDERS. Some say——

Mr. LEW. When the trustees do new estimates, the numbers could change.

Senator SANDERS. Right. Exactly. At which point it would pay out about 75 or 80 percent of all benefits. How does——

Mr. LEW. Because current revenue will fund benefits, correct.

Senator SANDERS. Right. How does that issue of paying out every nickel owed to every eligible American for the next 23, 25 years, whatever it may be, compare to the fact that in real terms unemployment today in terms of official plus people who have given up looking for work, people who are working part time who want to work full time, is at 16 percent? I mean, is that more of a crisis than worrying——

Mr. LEW. Mr. Chairman, should I——

Chairman CONRAD. For you to answer the question——

Mr. LEW. Mr. Chairman, I am looking for direction as to whether I should go on.

Chairman CONRAD. Answer the Senator.

Mr. LEW. Senator, the President has made clear that he views getting the economy moving and creating jobs is an immediate priority. This whole budget is built around the premise that we need to build an economy for today and for the future to create jobs. We have to be able to handle multiple challenges, and we are not comparing the immediacy. The fact that Social Security is important and we should look at it as a long-term issue, we should not wait until it is on the eve of crisis, shows a real concern that we have a compact across generations that we need to keep. It is not a deficit reduction question, and we have not tried to suggest that it has that kind of urgency. It does have that importance, though.

Chairman CONRAD. Senator Cornyn.

Senator CORNYN. Mr. Lew, assuming the Federal Government spends $3.7 trillion but only receives $2.2 trillion in revenue, that leaves an annual deficit of $1.5 trillion, correct?

Mr. LEW. That would be the arithmetic.

Senator CORNYN. Well, that is about as sophisticated as I get when it comes to arithmetic, so bear with me. But the cumulative effect of that annual deficit represents the debt, which is currently roughly $14 trillion. Isn't that right?

Mr. LEW. Right.

Senator CORNYN. So here is my question, and it is not a trick question, I assure you. We are talking about cutting spending—and I agree with my colleagues that I am disappointed that the President's proposed budget does not do a better job, and I trust that the House and the Senate will do a better job. In fact, from 2008 levels this budget represents a 33-percent increase in discretionary spending, leaving out emergency and the Department of Defense spending. But, really, I do not want to talk to you so much about the cuts, in other words, what that top line should be. I want to talk to you about what do we do to grow that bottom line, because that is the gap we need to close, right, both within sensible cuts or limits in Federal spending but also how do we get the economy growing again to bring that bottom line up? Would you agree with me?

Mr. LEW. If you look at our projections over the next 10 years, the most important single thing is getting the economy moving. If we do not get the economy moving, there is no way for us to make enough policy to close the gap. So——

Senator CORNYN. Thank you. You and I agree——

Mr. LEW. Which is why this budget is built around keeping the economy moving.

Senator CORNYN. Well, you and I may disagree about that.

Mr. LEW. I thought we might.

Senator CORNYN. You project the unemployment rate or assume the unemployment rate next year will be 8.6 percent, right? In other words, it is still going to be stubbornly high. Would you agree?

Mr. LEW. Yes, the unemployment rate is higher than we want it to be now, and it remains too high for too long.

Senator CORNYN. And that is because the private sector is not creating jobs adequate to hire enough people to bring that number down. Wouldn't you agree?

Mr. LEW. It is because we are recovering from the deepest recession in a generation, and historically the recovery period and the job creation after financially led recessions is longer. So we are on a path, but we are doing everything we can to push that path harder.

Senator CORNYN. But with all due respect, you are not answering my question. My question is: The reason why unemployment rates are high is because the economy is not growing faster in a way that would create those jobs and bring unemployment rates down, correct?

Mr. LEW. To be clear, the economy is now in recovery. We are growing at rates that are, you know, 3 to 4 percent. That is not good enough. But we see a return to growth rates in this immediate forecast period that starts to get back on our feet.

Senator CORNYN. Well, I would say that most Americans would believe that 8.6 percent unemployment next year is unacceptably high, and we need——

Mr. LEW. And we agree with that.

Senator CORNYN. And we need to find ways to grow the economy, primarily by encouraging the private sector to invest and to expand businesses and create jobs.

I want to ask you, how in the world is the private sector supposed to do that when this budget assumes tax increases of $1.6 trillion?

Mr. LEW. You know, I think if you look at the tax policies in this budget, they are consistent with the tax policies that were in place when we had the longest period of uninterrupted growth in our Nation's history.

Senator CORNYN. And that is not my question. How is economic growth consistent with the tax increase of $1.6 trillion? Are you going to say the economy is going to grow in spite of that anti-stimulus effect of increased taxes or because of it?

Mr. LEW. The challenge we have is coming out of a deep recession, dealing with a structural deficit that was caused by a series of a policy decisions that were made to have tax cuts and spending increases and not pay for them. We are now paying that price, and we have to work together to close that gap, and we have to do it by having everything on the table. We cannot do it by just cutting, as people said, the 12 percent of the budget that goes to annual appropriations.

Senator CORNYN. But you are not saying, are you, that a $1.6 trillion tax increase will stimulate that economic recovery? Are you saying that?

Mr. LEW. I am saying that we have tax policies in this budget that are consistent with economic growth. We have tax incentives to encourage economic growth. We have spending policies to encourage economic growth. We may disagree on some of the composition. We do not disagree on the goal, and I hope we can work together on working through the differences—

Senator CORNYN. I agree we disagree that this budget does encourage economic growth, and indeed I think it discourages it. But let me ask you my last question since we have just a short time together.

You project in this budget that interest on the debt will over a 10-year period of time total $5.7 trillion. I wonder if you would comment on a Bloomberg article that reports a Treasury Department meeting with a 13-member committee of bond dealers and investors where they say that interest expense on the debt will rise to 3.1 percent of gross domestic product by 2016 from 1.3 percent in 2010 with the Government forecast to run cumulative deficits, so forth and so on. My question is: We are right no seeing relatively low interest rates because the Fed is trying to help with the recovery. But if interest rates double or triple, the assumptions that you make on the debt service, the interest that is paid on that debt could well—will double and triple along with that, correct?

Mr. LEW. And our economic assumptions do assume an increase in interest rates over the period consistent with the economic growth that we forecast.

Chairman CONRAD. I thank the Senator.

Senator ENZI.

Senator ENZI. Thank you, Mr. Chairman, and thank you, Director Lew. I was a strong—I was a cosponsor of the Deficit Commission, the Conrad-Gregg Deficit Commission, and I voted for it. And I was pleased that the President picked up the reins on that and appointed a committee. And I was pleased with almost everything that they proposed and think that probably all of them could be passed if they were done in steps rather than as one lump sum. I think the opposition—but I noticed in the budget that there are provisions for repealing a bunch of the oil and gas tax expenditures, and that was a proposal of the Deficit Commission, but it was in exchange for lowering the corporate rate so that we could be more competitive internationally. Instead, we are taking that money and utilizing it as a pay-for, and we are going to drive up the cost of energy. Can you explain to me why we are stealing it from there instead of doing what the Deficit Commission suggested?

Mr. LEW. Senator, we do have policies in this budget to undertake corporate tax reforms that will be deficit neutral, broaden the base, and lower the rates. We also have policies in the budget that we think make sense on their own, and these oil, gas, and tax provisions are a part of them. I think that as we engage in the conversation, we are going to have to work through these issues together and see if they should be treated together or apart. But I——

Senator ENZI. If the expenditure has already been made, then it cannot be used to do the other piece there. I noticed there was a piece in there about LIFO, too, and I do not think they realize the impact that that will have on small business having to put cash up front to pay for the things there, just as the small oil and gas companies would have to put cash up front to do what has been proposed in this.

When I talked to the Commission, primarily the two co- chairs, I suggested that any of these provisions were done had to be done over a period of time for the businesses to be able to adjust. The cash up front is not available for anybody right now. So it looks like it would put a lot of people out of business and raise prices. So we will be getting a little more information on that, too.

I have a whole series of questions. I will not ask them all. I do want to mention that in 2006 we reauthorized the Abandoned Mine Land Trust Fund. That was done over a point of order because it was mandatory spending. That is a trust fund like the Social Security Trust Fund. If we default on that debt, I think we are saying something about how valuable our trust funds are.

One of the things that we passed just recently was a Form 1099 reporting under health care, and that covered both the $600 in a calendar year for corporations and for property. And I noticed in the budget that you only did the part that applied to corporations. Why is the administration rejecting the Senate amendment and offering a proposal—and it is an amendment that has come up before and had very substantial support—offering a proposal that only gets half the job done?

Mr. LEW. Senator, we support addressing the 1099 provision and look forward to working together on that. This budget was put together before the Senate provision that recently was passed, and I would have to go back and study the two to understand the difference.

Senator ENZI. Well, the President in his State of the Union speech even promised that the 1099 would be gone, but only half of it is going to be gone. I appreciate the question that Senator Wyden asked about the effect the budget is going to have on the 750,000 small businesses. And I know we are in a hurry, so I will submit the rest of my in written form.

Chairman CONRAD. I thank the Senator for his courtesy.

Senator MERKLEY.

Senator MERKLEY. Thank you, Mr. Chair, and thank you for your testimony. And I wanted to start with the county payments, and

I know from the conversations that we have had and other Senators have had with you that you understand the basic framework in which BLM lands were set aside to produce timber and to produce revenues for the counties. The Federal Government has come along and said, well, we are going to put some restrictions on this, but we will compensate for those restrictions. And now the Federal Government has come along and said, well, maybe we will not compensate you for those restrictions.

I do want to applaud the fact that you have this in your budget for 2012. We are still trying to understand exactly what that number is. There is a little bit of a cryptic nature to it. But it also appears that it has been moved from the mandatory funding into the discretionary funding, which is an item of tremendous concern. It has always been a mandatory funding because it was a contract between the Federal Government and the timber counties. And so I just wanted to ask that question of you and try to get some sense of whether we are reading this correctly, that it has been moved to discretionary, and if so, why.

Mr. LEW. Senator, we did fund it on the discretionary side, but we also indicated an openness to working with Congress to resolve the matter in the course of the legislative process and did not take a firm position that it had to be discretionary versus mandatory. We thought that fitting it within the tight caps, given the pressures, saving $400 billion over 10 years, was a way to make a real commitment to the funding request. And we look forward to working with you and Senator Wyden and others as we go forward.

Senator MERKLEY. Thank you. Then for now I will just register that that is of significant concern because it suggests that it is not being viewed as a contract as it has been in the past. And, of course, we are calling upon the Federal Government to honor its contract with the counties.

I wanted to turn to the President's support for renewable energy and energy efficiency and clean energy technology in the budget request, and there are several pieces in there I am delighted to see. One of them is related to the funding of low-cost loans for energy renovations. Another is related to electric vehicles. And I am coming at this from the point of view of trying to think of our economy the way you would think about positioning a company. And if we are in a world where we are importing $1 billion a day of oil and sending that money overseas, there are national security issues associated with that. There is certainly the fact that those dollars do not stay in our grocery stores and our retail outlets and create additional jobs for Americans. And then there is the fact that as we substitute for oil, we can also produce less carbon dioxide and read some of our goals for addressing global warming.

So I would like to see all of that, and I just want to know if you know of any potential barriers, either in budgeting or in procurement procedures, that would be problematic as we attempt to undertake one piece of that, which is electrifying the Government fleets.

Mr. LEW. Senator, we have put in a broad range of proposals from research and development to incentives for commercialization to try and get the United States into the leadership position we should be in, both in terms of developing and producing these technologies and in using them.

I am happy to take a look at the provisions regarding the Government fleet. That is not a provision I off the top of my head remember the details of, but I am happy to get back to you.

Senator MERKLEY. Well, I have really come to this point of view of applauding the administration of taking this seriously. We have had administrations in the past that have talked about attacking our dependence on foreign oil and our addiction to oil in general. And we have not been able to follow through with coherent American policies to end this. I think we can simply look at the turmoil of these last few weeks in the Middle East and recognize that not only are we sending a ton of money to governments abroad, but many of those governments are governments that do not always share our national interests and end up funneling some of that money into groups that we are actually in opposition to around the world.

So for a whole host of reasons——

Mr. LEW. We win in three ways if we succeed in this policy.

Senator MERKLEY. Absolutely.

Mr. LEW. We reduce our dependence on foreign oil, we create American jobs, and we have environmental benefits. That is why we think it is so important to do it.

Senator MERKLEY. And thank you so much for your effort in the budget to take on that area.

In the 6 seconds I have left, community development block grants, I just want to express a lot of concern about the cuts that are there. Many of these benefit low-income people through affordable housing projects and many other projects within communities. We are still facing a situation with 300,000 foreclosure filings a month across America, and I look forward to working with you all to make sure that we do not balance this budget on the backs of those who are struggling in their community and are hardest hit by this recession, which was caused by the deregulatory policies of the Bush administration, with predatory lending and runaway Wall Street gambling, and we should not solve this problem by further kicking those who have been hurt by this economy.

Chairman CONRAD. That will have to be the last word. Let me just thank Director Lew. I thank all colleagues. Because of the inability to get to a second round given the number of colleagues who participated today, instead of closing out questions at the end of today, we will extend that until noon tomorrow, give colleagues a chance——

Senator SESSIONS. How about all day tomorrow, Mr. Chairman?

Chairman CONRAD. Would you prefer that we do it until the end of tomorrow?

Senator SESSIONS. Yes, if you would, at least.

Chairman CONRAD. All right. We will do that. So, Director Lew, I would ask you to take up those questions expeditiously.

Mr. LEW. I would be happy to.

Chairman CONRAD. Senator Sessions.

Senator SESSIONS. Briefly, Mr. Lew, I want to stress again my displeasure with your statement that our budget will get us over the next several years to the point where we can look the American people in the eye and say we are not adding to the debt anymore, we are spending money we have each year, and then we can work on bringing down the national debt. I believe that is inaccurate. I believe any American that heard that would believe that this budget balances. It does not come close to do so. And this chart up here, I know it is on this primary balance theory that does not count the interest, but under your plan, the President's plan, at the end of your 10-year budget the interest will be $844 billion in 1 year, dwarfing all of these other agencies and departments and expenditures—something which we have never seen before in our country, and it threatens our debt structure and our economy.

Mr. LEW. Senator, I do not disagree that we have to take on the debt and we have to pay down the debt and reduce the interest payments. The only thing I take issue with——

Senator SESSIONS. Does this budget do it?

Mr. LEW. I think we get to the point where we——

Senator SESSIONS. Does it do it?

Mr. LEW. It gets us to the point where we stop adding to the problem with our new spending, and that is——

Senator SESSIONS. The debt goes up every year, and the deficit is—the debt has increased—doubled over this period.

Mr. LEW. I just think that if we are going to have the kind of conversation we need to have to resolve this, we have to have it in a way where we respect each other, and I respect your position, Senator.

Senator SESSIONS. Well, I cannot respect a position that suggests this budget reduces the debt. If you take that position, we are talking beyond each other. The Wall Street Journal said about this budget——

Mr. LEW. I said we stop adding to the——

Senator SESSIONS [continuing]. That it is as detached from reality as——

Mr. LEW. No, we stop adding to the debt——

Senator SESSIONS. —Mr. Mubarak.

Mr. LEW [continuing]. With our new spending. We do have interest payments. We have to control those interest payments in the future. This is a downpayment. We have to finish the job.

Senator SESSIONS. Forgive me, Mr. Chairman, but this is a—I do not think it is a matter of opinion. I believe, Mr. Lew, it is flatly in error, and it cannot continue. And I hope the President and he never repeats that this budget balances at any point in the 10 years.

Chairman CONRAD. Director Lew, do you want to respond?

Mr. LEW. No, I mean, I really do not mean to be argumentative about this. I think there is a very complicated idea here that we are trying to work through together. You know, in order for us to get to the point of reducing the debt, there are several things that have to happen. We have to have taxes and revenues that cover our current spending, and then we lock in an amount of the debt that will continue to have interest. That interest compounds until we pay down the debt. We have to then reduce the principal of the debt so the interest stops compounding. I think we agree on that in principle, and if the language of Federal budgeting is confusing, I apologize for that. I did not invent the language. And I would like- -I really would like to work together, because I do not disagree with you in the core principle that we have not solved the problem until we have really brought down the debt. And I think what we have put on the table is a huge step to put us in a place where we have the kind of stability to then go forward and take the next step.

Chairman CONRAD. Let me just conclude on my own. Senator Sessions has expressed himself clearly. Let me express myself clearly. I believe in the near term this budget has it about right. I believe as passionately as Senator Sessions does that for the long term we are going to have to do a whole lot more. I do not believe it will happen next year in an election year. I personally believe we have to have a long-term plan agreed to this year. I believe it has to be on the range of what the Commission proposed, which is $4 trillion of debt reduction over the 10 years. The administration's description of its plan is $1 trillion. We will see what CBO says when they do a re-estimate.

But, honestly, we have a responsibility to this country that is sober and somber and serious, and I believe history will condemn us all. I believe history will condemn us all if we do not do substantially more for the decade than is in this budget. I believe it fundamentally puts at risk the economic security of the country. And I believe that. I believe the evidence is quite strong that the risks that are being run are unacceptable risks.

So I give you good grades for a beginning. Somehow—somehow— we have to find a way—and the administration has a big responsibility here—to help us understand their vision of how this process comes together. And, you know, we do not have a whole lot more time. Sometime very soon there is going to have to be a negotiation that involves the leadership of the House and the Senate, Republicans and Democrats, and the White House. And, honestly, I think the seriousness of this to the country cannot be overstated.

With that, we will adjourn the hearing.

[Whereupon, at 4:22 p.m., the Committee was adjourned.]

FY 2012 Budget QFRs – Senate Budget Committee

Sen. Sessions

To justify your statement that this budget is "not adding to the debt anymore," you said the primary deficit is balanced in the medium term. Does that mean that you are able to claim a balanced budget without having to account for our interest cost?

The 2012 Budget reaches primary balance in 2017. This would be the first year since 2007 that the Government is able to pay for its current programs with its current revenues. It is important to note that reaching primary balance does not mean that the budget is balanced or that the debt has stopped growing in dollar terms. A budget in primary balance still requires borrowing for interest costs, which causes the debt to increase, although at a slower pace than when the budget is in primary deficit. This is analogous to a credit card balance, which rises even without any new purchases, because of interest charges for prior purchases. However, primary balance is a necessary step on the path to restoring fiscal responsibility. That is why the President has called this Budget a down payment, but not a complete solution. We still have work to do to pay down the debt and address the country's long-term fiscal challenges.

Sen. Sessions

In your interview on CNN on February 13, you said, "Our budget will get us, over the next several years, to the point where we can look the American people in the eye and say we're not adding to the debt anymore; we're spending money that we have each year, and then we can work on bringing down our national debt." I would like to ask how you think that statement would be interpreted by an average member of the viewing audience.

1. Do you think that most people would interpret "we're not adding to the debt anymore" to mean that outlays other than net interest spending is not greater than total receipts?

2. Or, do you think that most people would interpret that as simply meaning that the debt is not increasing and that the budget is balanced?

3. Is your responsibility as OMB Director to present statistics and facts to the public in a fair and unbiased way, or is it to advance the political interests of the President?

The President's budget outlines policies that are projected to decrease annual deficits (including consideration of net interest payments) to around 3% of GDP over the next several years. The budget makes clear that reaching primary (non-interest) balance in the shorter term is an important first step toward putting the Nation on the longer term course of bringing down our national debt, in light of the $1.3 trillion annual deficit coupled with the substantial economic downturn that the President faced upon taking office. The President has been very clear that his Budget is a down payment on our long-term fiscal challenges. With respect to preparation and submission of the President's budget, the responsibility of the OMB Director is to assist the President in providing the information specified by law, reflecting the budget priorities established by the President.

Sen. Sessions

In your testimony, you said that "the terminology that we use in Washington of primary balance is a little confusing."

1. Why did you choose not to use this term or attempt to explain it in your interview on CNN?

2. To your knowledge, is the "primary balance" concept used, to any significant extent, by anyone other than a small group of public finance economists?

3. In a 1986 report on economic fallacies, a senior analyst for the Government of Canada's Depository Services Program wrote, "The greatest threat to fiscal stability comes from the use of the primary deficit as the relevant fiscal concept." Please explain why you disagree.

1. The term "primary balance" and its related concepts are technical in nature, and are most appropriate for discussion among budget and public finance experts such as members of the Senate Budget Committee. I always try in public appearances to avoid jargon that obscures the real meaning of these technical concepts. Examples like a household credit card bill are a way to communicate more clearly and convey the critical concepts that underlie technical budget terminology.

2. The concept of primary balance is relevant and well understood by budget analysts concerned with long-range sustainability of fiscal policy. It is not the only measure of fiscal sustainability, but it is an important one because it highlights the key principle that budgets which are in persistent primary deficit -- that is, budgets which are borrowing to pay for current programs as well as to pay interest on past borrowing -- lead to debt rising faster than GDP, which makes fiscal policy unsustainable by definition. Running a primary surplus is necessary to stabilize the ratio of debt to GDP, which is a key first step to achieving fiscal sustainability.

3. I am not familiar with the 1986 report that you refer to. I agree that primary balance is not a sufficient method to assess sound government fiscal policy and should not be used as the sole benchmark to achieve that goal. This is exactly why the President has called this Budget a down payment, and that even after passing the threshold of primary balance we still have work to do to pay down the debt and address our long-term fiscal challenges.

Sen. Sessions

I have noticed similarities in much of the language employed by you and President Obama in recent days, including phrases like "living within our means," "making tough choices," and "will not be adding to the national debt," as well as analogies involving credit card balances.

1. Did President Obama direct you to use these terms when talking about his budget?

2. Did you ever participate in any meetings at which rhetorical strategies were discussed?

> **a. If so, what members of the White House press office or communications office attended?**
>
> **b. Did political advisors participate in these meetings?**
>
> **c. Were any concerns ever raised that these terms might be misleading?**

To the extent that my statements may employ language similar to that reflected in the President's budget, or his State of the Union message, or in other Presidential statements concerning this year's proposed budget, they reflect my efforts to highlight the policies of the President outlined therein. It would not be appropriate for me to disclose deliberative communications with the President and his advisors concerning the formulation of budget policy, or concerning the preparation or presentation of the budget.

Sen. Sessions

Subsequent to your testimony and President Obama's press conference on the budget, various organizations—including PolitiFact, McClatchy, and the Concord Coalition, as well as reporters from ABC News, Reuters, and CNN—have said the claim that the budget "will not be adding more to the national debt" is either false or misleading.

1. **In light of this, what efforts will you make to ensure that you are accurate in your characterization of the debt impact of the president's budget?**
2. **Please describe what steps you will take, if any, to ensure that President Obama is accurate in his characterization of the debt impact of the budget.**

I believe that the President's proposed budget submitted to Congress on February 14, 2011, fully and accurately reflects the relationship between that proposal and the debt, which is discussed in great detail, particularly in the "Long Term Budget Outlook" and "Federal Borrowing and Debt" sections of the volume entitled "Fiscal Year 2012, Analytical Perspectives."

Sen. Sessions

My understanding is that the budget treats Fannie Mae and Freddie Mac as separate from the federal government, recording only the cash transactions between the government and the mortgage GSEs. The Appendix to the budget states, on the one hand (p.1319), that the GSEs " ... are not included in the Federal Budget because they are private companies, and their securities are not backed by the full faith and credit of the Federal Government." On the other hand, the budget says (p. 25) that the administration " ... will continue to ensure that the GSEs have sufficient capital to honor any guarantees issued now or in the future and the ability to meet any of their debt obligations ... "

1. Why does the administration refuse to account for impacts on the budget of the government-run housing GSEs, Fannie and Freddie, in the way that the Congressional Budget Office argues is appropriate?

2. Are debt obligations and other securities issued by Fannie and Freddie backed by the full faith and credit of the federal government?

3. The administration has proposed to wind down the portfolios and allowable loan limits of Fannie and Freddie. How is this proposal reflected in the budget?

1. The Administration presents the budget impact of the housing GSEs as their estimated transactions with Treasury under the Senior Preferred Stock Purchase Agreements (PSPAs). The Budget maintains the existing non-budgetary presentation for Fannie Mae and Freddie Mac, as it does for the other GSEs. This is consistent with financial accounting standards that do not require consolidation of an entity if ownership control is temporary.

2. The obligations of Fannie Mae and Freddie Mac are not explicitly backed by the full faith and credit of the Federal Government, but the PSPAs effectively ensure there will be sufficient capital for Fannie Mae and Freddie Mac to be able to honor agency senior debt, agency subordinated debt, or guaranteed mortgage backed securities guaranteed in all cases, whenever issued. The structure of the PSPAs provides a substantial margin of solvency for Fannie Mae and Freddie Mac that would allow them to meet their obligations even in substantially more adverse economic scenarios than the Budget forecasts.

3. Reflecting the Administration's wind-down proposal, the budget projections of Treasury's PSPA investments are consistent with the Department of Treasury's 2010 financial statement, and GSE net income projections take into account that the allowable investment portfolios of Fannie Mae and Freddie Mac will be reduced by 10 percent each year, as specified in the their PSPA agreements with Treasury, and that the temporary conforming loan limits of up to $729,750 will expire at the end of fiscal year 2011. The Budget does not assume or pre-judge any specific changes to operating assumptions on their single family guarantee business (such as future pricing increases or legislative changes).

Sen. Sessions

In the long-term budget outlook discussed in Chapter 5 of Analytical Perspectives, the projections appear to suggest that the President's budget would reduce the fiscal gap to 1.8% of GDP over the period through 2085. However, these projections rely on some unrealistic assumptions. In particular, many would take issue with your assumptions regarding "excess cost growth" (or the average annual growth rate for health spending above GDP growth).

1. For Medicaid, your long-run budget projections assume growth in spending per enrollee exceeds growth in GDP per capita by 0.65 percentage points (GDP + .65%). However, according to the Congressional Budget Office the historical rate of excess cost growth in Medicaid is GDP + 2.0% (measured over the period from 1975 to 2008). Given that the Chief Actuary at CMS projects "aggregate Medicaid costs will increase significantly as a result of the Affordable Care Act, due to the very large number of additional enrollees starting in 2014 and that Medicaid expenditures will increase at an average annual rate of 8.3% over the next 10 years, how do you defend using a Medicaid excess cost growth assumption of GDP + .65% beyond the ten year window? Why did you not adopt the standard GDP+1 % assumption used for long-run health spending projections?

2. For Medicare, your long-run budget projections assume growth in spending per enrollee is 0.3 percentage points per year above the growth in GDP per capita (GDP + .3%). However, according to the Congressional Budget Office the historical rate of excess cost growth in Medicare is GDP + 2.5% (measured over the period from 1975 to 2008). Your assumption significantly departs from the standard GDP+1 % methodology used for long-run health spending projections. It is also lower than the overall cap on health spending growth recommended by the President's Fiscal Commission. Given that the Chief Actuary at CMS has said that "there is a strong likelihood that certain of these changes [in ACA] will not be viable in the long range," and that financial projections in the 2010 Medicare trustees report "do not represent a reasonable expectation for actual program operations in either the short range or the long range," why would you rely on such an unrealistic assumption in your long-term budget projections?

3. Page 51 of the FY 2012 Analytical Perspectives includes a table labeled "Table 5-1 Long-Run Budget Projections." Can you produce a similar table and provide it to my staff for the alternative scenario in which health spending per capita continues its historical trend of growing 2 percentage points faster than GDP per capita?

1. The cost-reduction mechanisms in the ACA significantly reduce projected budget deficits in the long run and slow future growth in medical costs. CBO estimates that the ACA will save more than $200 billion over the next 10 years and more than $1 trillion over the second 10 years, but in the near term there is an expansion of total health care costs because of the increased coverage for those who previously lacked health insurance. This is reflected in higher near term costs for Medicaid. The 2012 Budget projects that Federal Medicaid costs will increase by an average of 8.8% per year for the period beginning in 2008 and ending in 2021. This is the similar to the 2010 Actuarial Report for Medicaid.

The excess cost growth in the Medicaid program in the long run is projected to average 0.65 percentage points. CBO in its 2010 long-run projections assumed Medicaid cost growth over the same period would average 0.8 percentage points; in 2009 they projected excess cost growth of 0.6 percentage points for Medicaid. Thus, our projections are in the same range as CBO's, and all these projections imply a marked slowdown compared with previous trends in Medicaid costs. Many provisions of the ACA are expected to constrain future growth of health system costs including those for the Medicaid program. For example, the ACA includes an array of delivery system reforms, including incentives for accountable care organizations and payment reform demonstrations that have the potential to re-orient the medical system toward providing higher quality care, not just more care, while reducing future cost growth.

2. The 2010 Medicare Trustees Report projections imply that average long range annual growth in Medicare spending per enrollee will be 0.3 percentage points per year above the growth in GDP per capita, and the same assumption was used in the long-run Medicare projections in Analytical Perspectives. This assumption accounts for the impact of the ACA, including the new payment rules for hospitals and other providers in the ACA as calculated by the Medicare actuaries as well as an array of delivery system reforms. Because of the payment provisions which apply to Medicare and not to private health spending or Medicaid, the slowdown in future Medicare costs is projected to be larger than the slowdown in future private health care costs or future Medicaid costs. In addition to the reforms that apply mainly to Medicare, there are many other reforms in the ACA that can be expected to lower future health care cost growth affecting private health and Medicaid as well as Medicare. The long-run budget projections in Analytical Perspectives have always been based on the Administration's budget policy, and the current policy assumes compliance with the ACA now and in the future.

3. An alternative version of Table 5-1 is attached which shows the projections for the budget on an assumption that excess cost growth is 2% per year for Medicare, Medicaid, and private health insurance.

Attachment: Long-Run Bud Proj. Health Cost.pdf

Table 5-1. Long-Run Budget Projections, Excess Health Cost Grows =2%
(Receipts, Outlays, Surplus, or Deficit, and Debt as a Percent of GDP)

	1980	1990	2000	2010	2020	2030	2040	2050	2060	2070	2080	2085
Receipts	19.0	18.0	20.6	14.9	19.9	19.8	20.2	20.8	21.3	21.9	22.5	22.9
Outlays:												
Discretionary	10.1	8.7	6.3	9.0	5.7	5.5	5.5	5.5	5.5	5.5	5.5	5.5
Mandatory:												
Social security	4.3	4.3	4.1	4.8	5.1	5.7	5.7	5.5	5.4	5.4	5.3	5.2
Medicare	1.1	1.7	2.0	3.1	3.3	4.7	6.0	7.3	9.2	11.5	14.4	16.2
Medicaid	0.5	0.7	1.2	1.9	2.4	2.8	3.4	4.1	5.0	6.1	7.5	8.3
Other	3.7	3.2	2.4	3.7	3.2	3.0	2.8	2.9	2.9	3.0	3.1	3.3
Subtotal, Mandatory	9.6	9.9	9.7	13.5	13.9	16.3	18.0	19.9	22.4	25.9	30.3	33.0
Net interest	1.9	3.2	2.3	1.4	3.4	4.2	5.8	8.1	11.2	15.8	22.3	26.4
Total outlays	21.7	21.9	18.2	23.8	23.0	25.9	29.2	33.4	39.1	47.2	58.1	64.8
Surplus or Deficit (-)	-2.7	-3.9	2.4	-8.9	-3.1	-6.1	-9.0	-12.6	-17.8	-25.3	-35.5	-41.9
Primary Surplus/Deficit(-)	-0.8	-0.6	4.7	-7.6	0.2	-2.0	-3.2	-4.6	-6.6	-9.5	-13.2	-15.6
Federal Debt Held by the public, End of Period	26.1	42.1	34.7	62.2	76.7	92.8	128.7	179.2	249.5	351.0	494.6	586.0

Note: The figures shown in this table beyond 2020 are the product of a long-range forecasting model maintained by the Office of Management and Budget. This model is separate from the models and capabilities that produce detailed programmatic estimates in the Budget. It was designed to produce long-range projections based on additional assumptions regarding growth in the economy, the long-range evolution of specific programs, and the demographic and economic forces affecting those programs. The model, its assumptions, and sensitivity testing of those assumptions are presented in this chapter.

Sen. Sessions

The new health care law increased the balance of Medicare's Hospital Insurance (HI) trust fund by almost $400 billion over ten years. Balances in the HI trust fund are generally held in the form of government debt. The new law would increase government debt by a similar amount. According to CBO, the new health care law would "increase debt held by government accounts more than it would decrease debt held by the public, and would thus increase gross federal debt."

1. Do you agree with CBO that the new law increases our gross federal debt?

2. Will the new health care law cause us to reach the debt limit sooner than we would without the law?

According to CBO's most recent estimate, the Affordable Care Act (ACA) will reduce the deficit by more than $200 billion in the first decade and more than $1 trillion in the second decade. This means that the ACA reduces the deficit more than any other legislation in over a decade.

The Affordable Care Act will both improve the overall financial position of the federal government and extend the life of the Medicare Hospital Insurance (HI) trust fund by twelve years, as estimated in the Medicare Trustees Report. These are distinct accomplishments, which are accounted for through different mechanisms. Both accomplishments help enable the federal government to honor its commitment to Medicare beneficiaries now and in the future.

The health reform legislation reduces the deficit and extends the life of the HI trust fund, since Medicare HI savings, as a matter of trust fund accounting, are credited toward the trust fund. These are each worthy--though distinct--ends. Reducing the deficit improves the financial position of the federal 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. This has been the standard method of accounting used in budgeting and in assessing the HI Trust fund for decades.

The Administration has not projected the effect of the ACA on gross Federal debt, but I believe it is more important to focus on debt held by the public. As CBO noted in its letter on the impact of ACA on the debt, the concept of gross Federal debt "conveys little about the federal government's future financial burdens and has little economic meaning." The ACA reduces the deficit by over $200 billion in the first decade and more than $1 trillion in the second decade; this means more than a $1 trillion less debt held by the public incurred over the next two decades and reduced future interest payments on that debt as a result.

In response to the second part of the question, the Treasury Department has estimated that we will reach the debt limit between April 15 and May 31. I defer to Secretary Geithner on more specific estimates regarding debt subject to limit.

Sen. Sessions

Under the "Delivering High-Performance Government" section of the Analytical Prospective document, the budget discusses President Kennedy's 1961 call to put a man on the moon by the end of the decade as an outcome-oriented goal and integral to government success.

1. In 1961 how much of NASA's budget was devoted to science and how much was devoted to exploration?

2. What is the primary outcome-oriented goal NASA is pursuing?

1. In 1961, NASA received an annual appropriation of $964 million. Of this, approximately half (51%) was devoted to "spaceflight development and operations," which roughly parallels the Exploration Systems and Space Operations Mission Directorates of today. Aeronautical and space research, which conducted more of the science-related activities, accounted for approximately 47% of the budget in that year.

2. The NASA Authorization Act of 2010 states: "The National Aeronautics and Space Administration is and should remain a multi-mission agency with a balanced and robust suite of core missions in science, aeronautics, and human space flight and exploration." Over the past decade NASA has had successes in many different mission areas, including completing construction of the International Space Station, making major scientific discoveries with the Hubble Space Telescope and other space observatories, exploring the solar system with robots, and greatly expanding our knowledge of the Earth's weather and climate.

NASA is striving to ensure that all of its programs have clear outcome-oriented goals. The agency's FY 2012 Performance Plan includes 6 strategic goals and numerous annual performance goals to be accomplished by the end of FY 2012 in support of these strategic goals.

For example, in the area of human spaceflight NASA's strategic goal is to "extend and sustain human activities across the solar system." The FY 2012 Performance Plan lists 18 annual performance goals (APGs) for this goal alone, including: completing at least two flights to the Space Station by U.S. developed cargo delivery systems and completing testing of the Multi-Purpose Crew Vehicle Ground Test Article.

Attachment: NASA FY12 Performance Plan.pdf

Management and Performance

FY 2012 Performance Plan Narrative

NASA's updated strategic goals are reflected below. Each is clearly defined and supported by multi-year Outcomes, Objectives, and Performance Goals. These in turn are supported by annual performance goals (APGs) that enhance NASA's ability to measure and report on the Agency's progress in achieving its strategic goals.

To better communicate the contribution of NASA's mission support elements, those performance measures are now structured as function-based, rather than Theme-based. Performance measures that were previously listed under Cross-Agency Support, including Education, information technology services, construction of facilities, human capital management, safety and mission assurance, launch services, and space communications have now been incorporated into the appropriate strategic goal.

The following table provides a summary of all of the Agency commitments identified in the preceding sections of this document.

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
Strategic Goal 1	Extend and sustain human activities across the solar system.		
[illegible]			
Objective 1.1 [illegible]	[illegible] ISS		
[illegible]			
APG 1.1.1.1: ISS-12-1	In concert with the International Partners, maintain a continuous crew presence on the ISS by coordinating and managing resources, logistics, systems, and operational procedures.	International Space Station Program	International Space Station
[illegible]			
APG 1.1.1.2: SSP-12-1	Ensure the Space Shuttle Endeavour is ready for transport to its final display location.	Space Shuttle Program	Space Shuttle
[illegible]			
APG 1.1.1.3: ISS-12-2	Fly the ISS spares, logistics, and utilization hardware as agreed to by the International Partners in the ISS transportation plan	International Space Station Program	International Space Station
APG 1.1.1.3: ISS-12-3	Complete at least two flights to the ISS by U.S. developed cargo delivery systems.	International Space Station Program	International Space Station
[illegible]			
APG 1.1.1.4: ISS-12-4	Provide 100 percent of planned on-orbit resources (including power, data, crew time, logistics, and accommodations) needed to support research.	International Space Station Program	International Space Station

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
APG 1.1.1.4: ISS-12-5	Achieve zero Type-A (damage to property at least $1 million or death) or Type-B (damage to property at least $250 thousand or permanent disability or hospitalization of three or more persons) mishaps.	International Space Station Program.	International Space Station
[illegible]	[illegible]		
[illegible]			
APG 1.1.2.1: ISS-12-6	Accomplish a minimum of 90 percent of the on-orbit research objectives as established one month prior to a given increment, as sponsored by NASA, baselined for FY 2012.	International Space Station Program	International Space Station
[illegible]			
APG 1.1.2.2: ERD-12-1	Conduct flight definition review for at least five flight experiments in fundamental space biology that were selected through the 2010 International Space Life Sciences Research Announcement.	Advanced Explorations Systems	Exploration Research and Development
APG 1.1.2.2: ERD-12-2	Deliver at least four physical sciences payloads for launch to the ISS.	Advanced Explorations Systems	Exploration Research and Development
APG 1.1.2.2: ERD-12-3	Conduct at least six experiments in combustion, fluids, or materials sciences on the ISS.	Advanced Explorations Systems	Exploration Research and Development
[illegible]			
[illegible]	[illegible]		
[illegible]			
APG 1.2.1.1: CS-12-1	Conclude the commercial crew transportation systems (CCDev2) agreements and make initial selections for the design, development, and demonstration of commercial crew transportation systems.	Commercial Crew	Commercial Spaceflight
[illegible]			
APG 1.2.1.2: CS-12-2	Begin evaluation and certification of integrated commercial crew transportation system.	Commercial Crew	Commercial Spaceflight

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
[illegible]	[illegible]		
[illegible]	[illegible]		
APG 1.3.1.1: HEC-12-1	Successfully complete Space Launch System's (SLS) Systems Requirements Review (SRR).	Space Launch System	Human Exploration Capabilities
[illegible]	[illegible]		
APG 1.3.1.2: HEC-12-2	Complete testing of Multi-Purpose Crew Vehicle (MPCV) Ground Test Article (GTA).	Multi-Purpose Crew Vehicle	Human Exploration Capabilities
[illegible]	[illegible]		
[illegible]	[illegible]		
APG 1.3.2.1: ERD-12-4	Develop and release two NASA Research Announcements that solicit from the external biomedical research community the highest quality proposals to mitigate space human health risks.	Human Research	Exploration Research and Development
[illegible]	[illegible]		
APG 1.3.2.2: ERD-12-5	Release Acute Radiation Risk Model Version 2 to assess effects of solar particle events during exploration missions.	Human Research	Exploration Research and Development
[illegible]	[illegible]		
APG 1.3.2.3: ERD-12-6	Deliver the next-generation space biomedical ultrasound device to enhance the Human Research Facility capability on the ISS through 2020.	Human Research	Exploration Research and Development
[illegible]	[illegible]		
[illegible]	[illegible]		
APG 1.3.3.1: ERD-12-7	In collaboration with the Planetary Science Division, develop a plan to return data that will support the selection of destinations and reduce risk for future human space exploration missions.	Advanced Explorations Systems	Exploration Research and Development

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
Strategic Goal 2	Expand scientific understanding of the Earth and the universe in which we live.		
Objective 2.1 [illegible]	[illegible]		
APG 2.1.1.1: ES-12-1	Demonstrate planned progress in understanding and improving predictive capability for changes in the ozone layer, climate forcing, and air quality associated with changes in atmospheric composition. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Earth Science
APG 2.1.1.2: ES-12-2	Complete the Orbiting Carbon Observatory-2 (OCO-2) Systems Integration Review.	Earth System Science Pathfinder	Earth Science
APG 2.1.1.2: ES-12-3	Complete the Earth Venture 1 (EV-1) Investigation Readiness Reviews (IRR) and begin initial field campaigns.	Earth System Science Pathfinder	Earth Science
Objective 2.1.2 [illegible]	[illegible]		
APG 2.1.2.1: ES-12-4	Demonstrate planned progress in enabling improved predictive capability for weather and extreme weather events. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Earth Science
APG 2.1.2.2 ES-12-5	Complete the Global Precipitation Mission (GPM) Pre-Environmental Review.	Earth Systematic Missions	Earth Science
APG 2.1.2.2: ES-12-3	Complete the EV-1 Investigation Readiness Reviews (IRR) and begin initial field campaigns.	Earth System Science Pathfinder	Earth Science

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
[illegible]	[illegible]		
APG 2.1.3.1 ES-12-6	Demonstrate planned progress in quantifying, understanding, and predicting changes in Earth's ecosystems and biogeochemical cycles, including the global carbon cycle, land cover, and biodiversity. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Earth Science
APG 2.1.3.2 ES-12-7	Complete the Landsat Data Continuity Mission (LDCM) Systems Integration Review.	Earth Systematic Missions	Earth Science
APG 2.1.3.2: ES-12-2	Complete the Orbiting Carbon Observatory-2 (OCO-2) Systems Integration Review.	Earth System Science Pathfinder	Earth Science
APG 2.1.3.2: ES-12-3	Complete the Earth Venture 1 (EV-1) Investigation Readiness Reviews (IRR) and begin initial field campaigns	Earth System Science Pathfinder	Earth Science
[illegible]	[illegible]		
APG 2.1.4.1: ES-12-8	Demonstrate planned progress in quantifying the key reservoirs and fluxes in the global water cycle and assessing water cycle change and water quality. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Earth Science
APG 2.1.4.2: ES-12-5	Complete the Global Precipitation Mission (GPM) Pre-Environmental Review.	Earth Systematic Missions	Earth Science
APG 2.1.4.2: ES-12-9	Successfully complete the Soil Moisture Active-Passive (SMAP) Critical Design Review.	Earth Systematic Missions	Earth Science

Measure #	Description	Contributing Program (s)	Contributing Theme
[illegible]	[illegible]		
[illegible]			
APG 2.1.5.1: ES-12-10	Demonstrate planned progress in understanding the roles of ocean, atmosphere, land, and ice in the climate system and improving predictive capability for future evolution. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Earth Science
APG 2.1.5.1: ES-12-11	Achieve mission success criteria for the Ocean Surface Topography Mission (OSTM).	Earth Systematic Missions	Earth Science
[illegible]			
APG 2.1.5.2: ES-12-12	Launch the National Polar-orbiting Operational Environmental Satellite System (NPOESS) Preparatory Project (NPP).	Earth Systematic Missions	Earth Science
[illegible]			
APG 2.1.5.3: ES-12-13	Complete the ICESat 2 Preliminary Design Review.	Earth System Science Pathfinder	Earth Science
APG 2.1.5.3: ES-12-2	Complete the Orbiting Carbon Observatory-2 (OCO-2) Systems Integration Review.	Earth System Science Pathfinder	Earth Science
[illegible]	[illegible]		
[illegible]			
APG 2.1.6.1: ES-12-14	Demonstrate planned progress in characterizing the dynamics of Earth's surface and interior and forming the scientific basis for the assessment and mitigation of natural hazards and response to rare and extreme events. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Earth Science
[illegible]			
APG 2.1.6.2: ES-12-7	Complete the Landsat Data Continuity Mission (LDCM) Systems Integration Review.	Earth Systematic Missions	Earth Science

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
Objective [illegible]	[illegible]		
[illegible]			
APG 2.1.7.1: ES-12-15	Advance at least 25 percent of decision-support projects at least one Applications Readiness Level	Applied Sciences	Earth Science
APG 2.1.7.1: ES-12-16	Increase the number of science data products delivered to Earth Observing System Data and Information System (EOSDIS) users.	Earth Science Research	Earth Science
APG 2.1.7.1: ES-12-17	Maintain a high level of customer satisfaction, as measured by exceeding the most recently available federal government average rating of the Customer Satisfaction Index.	Earth Science Research	Earth Science
[illegible]			
Objective [illegible]	[illegible]		
[illegible]			
APG 2.2.1.1: HE-12-1	Demonstrate planned progress in understanding the fundamental physical processes of the space environment from the Sun to Earth, to other planets, and beyond to the interstellar medium. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Heliophysics
[illegible]			
APG 2.2.1.2: HE-12-2	Complete the Magnetospheric MultiScale (MMS) Systems Integration Review.	Solar Terrestrial Probes	Heliophysics
APG 2.2.1.2: HE-12-3	Complete the Geospace Radiation Belt Storm Probes Launch Readiness Review.	Living with a Star	Heliophysics
Objective 2.2.2	[illegible]		
[illegible]			
APG 2.2.2.1: HE-12-4	Demonstrate planned progress in understanding how human society, technological systems, and the habitability of planets are affected by solar variability interacting with planetary magnetic fields and atmospheres. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Heliophysics

Management and Performance

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
APG 2.2.2.2: HE-12-2	Complete the Magnetospheric MultiScale (MMS) Systems Integration Review.	Solar Terrestrial Probes	Heliophysics
APG 2.2.2.2: HE-12-3	Complete the Geospace Radiation Belt Storm Probes Launch Readiness Review.	Living with a Star	Heliophysics
Objective 2.2.3	Maximize the safety and productivity of human and robotic explorers by developing the capability to predict the extreme and dynamic conditions in space.		
APG 2.2.3.1: HE-12-5	Demonstrate planned progress in maximizing the safety and productivity of human and robotic explorers by developing the capability to predict the extreme and dynamic conditions in space. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review	Multiple Programs	Heliophysics
APG 2.2.3.2: HE-12-3	Complete the Geospace Radiation Belt Storm Probes Launch Readiness Review.	Living with a Star	Heliophysics
Objective 2.3	Inventory solar system objects and identify the processes active in and among them.		
APG 2.3.1.1: PS-12-1	Demonstrate planned progress in inventorying solar system objects and identifying the processes active in and among them. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Planetary Science
APG 2.3.1.2: PS-12-2	Complete the New Frontiers 3 Preliminary Design Review.	New Frontiers	Planetary Science
APG 2.3.1.2: PS-12-3	Complete the Discovery 12 mission concept studies.	Discovery	Planetary Science

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
[illegible]	[illegible]		
APG 2.3.2.1: PS-12-4	Demonstrate planned progress in understanding how the Sun's family of planets, satellites, and minor bodies originated and evolved. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Planetary Science
APG 2.3.2.1: PS-12-5	Complete MESSENGER mission success criteria.	Discovery	Planetary Science
APG 2.3.2.2. PS-12-2	Complete the New Frontiers 3 Preliminary Design Review.	New Frontiers	Planetary Science
APG 2.3.2.2 PS-12-6	Complete the Lunar Atmosphere and Dust Environment Explorer (LADEE) Systems Integration Review	Lunar Quest Program	Planetary Science
[illegible]	[illegible]		
APG 2.3.3.1 : PS-12-7	Demonstrate planned progress in understanding the processes that determine the history and future of habitability of environments on Mars and other solar system bodies. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Planetary Science
APG 2.3.3.2: PS-12-10	Complete the Mars 16 Mission Confirmation Review.	Mars Exploration	Planetary Science
APG 2.3.3.2: PS-12-8	Complete the Mars Science Laboratory (MSL) Launch Readiness Review.	Mars Exploration	Planetary Science
APG 2.3.3.2: PS-12-9	Complete the Mars Atmosphere and Volatile EvolutioN Mission (MAVEN) Systems Integration Review.	Mars Exploration	Planetary Science

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
[illegible]	[illegible]		
APG 2.3.4.1: PS-12-11	Demonstrate planned progress in understanding the origin and evolution of life on Earth and throughout the biosphere to determine if there is or ever has been life elsewhere in the universe. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Planetary Science
Objective 2.3.5	[illegible]		
APG 2.3.5.1: PS-12-12	Demonstrate planned progress in identifying and characterizing small bodies and the properties of planetary environments that pose a threat to terrestrial life or exploration or provide potentially exploitable resources. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Planetary Science
APG 2.3.5.2: PS-12-13	Demonstrate planned progress in characterizing potentially hazardous objects that are possible destinations for future human space exploration.	Multiple Programs	Planetary Science
[illegible]	[illegible]		
APG 2.4.1.1: AS-12-1	Demonstrate planned progress in understanding the origin and destiny of the universe, and the nature of black holes, dark energy, dark matter, and gravity. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Astrophysics

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
APG 2.4.1.2: AS-12-2	Complete the Nuclear Spectroscopic Telescope Array (NuSTAR) Launch Readiness Review.	Astrophysics Explorer	Astrophysics
Objective 2.4.2	Improve understanding of the many phenomena and processes associated with galaxy, stellar, and planetary system formation and evolution from the earliest epochs to today.		
APG 2.4.2.1: AS-12-3	Demonstrate planned progress in understanding the many phenomena and processes associated with galaxy, stellar, and planetary system formation and evolution from the earliest epochs to today. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review.	Multiple Programs	Astrophysics
APG 2.4.2.2: JWST-12-1	Begin integration of James Webb Space Telescope (JWST) flight optics into Optical Telescope Element (OTE).	James Webb Space Telescope	James Webb Space Telescope
APG 2.4.2.3. AS-12-4	Initiate the Stratospheric Observatory for Infrared Astronomy (SOFIA) Segment 3 Aircraft modifications and upgrades.	Cosmic Origins	Astrophysics
Objective 2.4.3	Generate a census of extra-solar planets and measure their properties.		
APG 2.4.3.1: AS-12-5	Demonstrate planned progress in generating a census of extra-solar planets and measuring their properties. Progress relative to the objectives in NASA's 2010 Science Plan will be evaluated by external expert review	Multiple Programs	Astrophysics

Management and Performance

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Measure #	Description	Contributing Program (s)	Contributing Theme
Strategic Goal 3	Create the innovative new space technologies for our exploration, science, and economic future.		
[illegible]	[illegible]	[illegible]	[illegible]
Objective [illegible]	[illegible]		
[illegible]	[illegible]	[illegible]	[illegible]
APG 3.1.1.1: ST-12-1	Initiate Phase II studies to further develop two of the most promising prior (FY 2011 and predecessor NASA Institute for Advanced Concepts (NIAC)) Phase I concepts.	Crosscutting Space Technology Development	Space Technology
[illegible]	[illegible]	[illegible]	[illegible]
APG 3.1.1.2: ST-12-2	Conduct at least three Centennial Challenges competitions	Crosscutting Space Technology Development	Space Technology
[illegible]	[illegible]	[illegible]	[illegible]
APG 3.1.1.3: ST-12-3	Twenty innovative projects will be initiated across the NASA Centers.	Crosscutting Space Technology Development	Space Technology
[illegible]	[illegible]	[illegible]	[illegible]
APG 3.1.1.4: ST-12-4	At least 25 percent of the Small Business Innovation Research and Small Business Technology Transfer (SBIR/STTR) Phase II technology projects awarded between 2007-2011 will be infused into NASA programs and projects.	SBIR and STTR	Space Technology

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
APG 3.1.1.5: ST-12-5	At least 40 of the Small Business Innovation Research and Small Business Technology Transfer (SBIR/STTR) technologies will be advanced to Phase III (received non-SBIR/STTR funding).	SBIR and STTR	Space Technology
APG 3.1.1.6: ST-12-6	Complete 100 research plans.	Crosscutting Space Technology Development	Space Technology
[illegible]	[illegible]		
APG 3.2.1.1: ST-12-7	Initiate five game changing technology projects.	Crosscutting Space Technology Development	Space Technology
[illegible]	[illegible]		
APG 3.2.2.1: ST-12-8	Initiate development of at least two new technologies with game changing potential for small satellites.	Crosscutting Space Technology Development	Space Technology
[illegible]	[illegible]		
APG 3.2.3.1: ST-12-9	Initiate at least one new small satellite mission that will demonstrate game changing or crosscutting technologies in space.	Crosscutting Space Technology Development	Space Technology

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Measure #	Description	Contributing Program (s)	Contributing Theme
Objective 3.2.4	Demonstrate new space technologies and infuse them into missions.		
[redacted]			
APG 3.2.4.1: ST-12-10	Complete preliminary design of at least two system-level technologies for flight or relevant environment demonstration.	Crosscutting Space Technology Development	Space Technology
Objective 3.2.5	Provide flight opportunities and relevant environments to demonstrate new space technologies.		
[redacted]			
APG 3.2.5.1: ST-12-11	Select and fly technology payloads from NASA, other government agencies, industry, and academia using flight services procured from at least three commercial reusable suborbital and parabolic platform providers.	Crosscutting Space Technology Development	Space Technology
[redacted]			
Objective 3.3.1	Demonstrate telepresent operations of robotic assistants working with crew.		
[redacted]			
APG 3.3.1.1: ERD-12-8	Demonstrate Robonaut 2 assisting the crew to perform tasks inside the ISS.	Exploration Technology Development	Space Technology
Objective 3.3.2	Develop and demonstrate critical technologies for safe and affordable cargo and human space exploration missions beyond low Earth orbit.		
[redacted]			
APG 3.3.2.1: ERD-12-9	Initiate tests of Extra-Vehicular Activity (EVA) Portable Life Support System (PLSS) technologies in a vacuum chamber environment.	Advanced Exploration Systems	Exploration Research and Development

Management and Performance

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
APG 3.3.2.1: ST-12-12	Test automated fluid couplings for cryogenic propellant transfer to support Cryogenic Propellant Storage And Transfer (CRYOSTAT) systems requirements.	Exploration Technology Development	Space Technology
Objective 3.4.1	Promote and develop innovative technology partnerships among NASA, U.S. industry, and other sectors for the benefit of Agency programs and projects.		
APG 3.4.1.1: ST-12-13	Establish at least 12 technology-related significant partnerships during FY 2012.	Partnership Development and Strategic Integration	Space Technology
APG 3.4.1.2: ST-12-14	Complete at least 30 technology transfer agreements during FY 2012.	Partnership Development and Strategic Integration	Space Technology
APG 3.4.1.3: ST-12-15	Greater than 35 percent of the Phase II Small Business Innovation Research and Small Business Technology Transfer (SBIR/STTR) technology projects awarded between 2007-2011 will be transferred into commercial products or services.	SBIR and STTR	Space Technology

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
[redacted]			
APG 3.4.1.4: ST-12-16	Document at least 40 notable technology transfer successes in NASA's Spinoff publication.	Partnership Development and Strategic Integration	Space Technology
[redacted]			
APG 3.4.1.5: ST-12-17	Ensure that 75 percent of all NASA technology projects are recorded in the portfolio database and are analyzed against the prioritizations in the space technology roadmaps.	Partnership Development and Strategic Integration	Space Technology
Strategic Goal 4	**Advance aeronautics research for societal benefit.**		
[redacted]			
Objective 4.1.1	**Develop advanced technologies to improve the overall safety of the future air transportation system.**		
[redacted]			
APG 4.1.1.1: AR-12-1	Develop first generation engine icing performance degradation parametric simulation capability.	Aviation Safety	Aeronautics
APG 4.1.1.1: AR-12-2	Provide static code analysis techniques for certification.	Aviation Safety	Aeronautics
APG 4.1.1.1: AR-12-3	Develop concept of operations for an integrated vehicle health assurance system.	Aviation Safety	Aeronautics
APG 4.1.1.1: AR-12-4	Demonstrate algorithm to predict at least three anomalies in massive datasets.	Aviation Safety	Aeronautics
Objective 4.1.2	**Develop innovative solutions and technologies to meet future capacity and mobility requirements of the Next Generation Air Transportation System (NextGen).**		
[redacted]			
APG 4.1.2.1: AR-12-5	Develop Initial Weather Translation Models.	Airspace Systems	Aeronautics
APG 4.1.2.1: AR-12-6	Demonstrate safe Interval Management Procedures to a Single Airport with dependent parallel runways.	Airspace Systems	Aeronautics

Management and Performance

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
APG 4.1.2.1: AR-12-7	NASA will provide the results of the human-in-the-loop (HITL) simulations and the field trial to the Federal Aviation Administration (FAA) as they are completed, with the final report being provided in September 2012. (HPPG milestone)	Airspace Systems	Aeronautics
Objective 4.1.3	Develop tools, technologies, and knowledge that enable significantly improved performance and new capabilities for future air vehicles.		
[redacted]			
APG 4.1.3.1: AR-12-10	Validate the effectiveness of Micro-array Flow Control devices for improving performance and flow quality in low-boom supersonic propulsion inlets.	Fundamental Aeronautics	Aeronautics
APG 4.1.3.1: AR-12-11	Demonstrate First Generation Integrated Multidisciplinary Simulation Tool for Analysis and Design of Reusable Air-Breathing Launch Vehicles.	Fundamental Aeronautics	Aeronautics
APG 4.1.3.1: AR-12-8	Characterize gaseous and particulate emissions of hydro treated renewable jet fuel as a potential carbon dioxide (CO_2) neutral aviation fuel.	Fundamental Aeronautics	Aeronautics
APG 4.1.3.1: AR-12-9	Demonstrate drag reduction benefits of active flow control for a representative rotorcraft fuselage configuration.	Fundamental Aeronautics	Aeronautics
[redacted]			
Objective 4.2.1	Develop advanced tools and technologies that reduce the technical risk associated with system-level integration of promising aeronautical concepts.		
[redacted]			
APG 4.2.1.1: AR-12-12	Demonstrate low-weight, damage-tolerant stitched composite structural concept on curved panel subjected to combined tension and internal pressure loads.	Integrated Systems Research	Aeronautics
APG 4.2.1.1: AR-12-13	Develop integrated Human Systems Integration, Communications, and Separation Assurance subproject test concept and Phase 2 test objectives necessary to achieve human-in-the-loop simulation and flight test series milestones supporting the Unmanned Aircraft Systems (UAS) Integration in the National Airspace System (NAS) Project.	Integrated Systems Research	Aeronautics

Management and Performance

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Measure #	Description	Contributing Program (s)	Contributing Theme
Strategic Goal 5	**Enable program and institutional capabilities to conduct NASA's aeronautics and space activities.**		
[redacted]			
Objective 5.1.1	**Establish and maintain a workforce that possesses state-of-the-art technical and business management competencies.**		
[redacted]			
APG 5.1.1.1: AMO-12-1	Ninety percent of Shuttle workforce is assigned to follow-on work by FY 2012 year-end.	Agency Management	Agency Management and Operations
APG 5.1.1.1: AMO-12-2	Twenty percent or more of annual recruitments will be through the early career hiring initiatives.	Agency Management	Agency Management and Operations
[redacted]			
APG 5.1.1.2: AMO-12-3	Install an Agency-wide mentoring program that includes an automated system for matching mentors and mentees.	Agency Management	Agency Management and Operations
APG 5.1.1.2: AMO-12-4	Eighty percent of the Agency's leadership training and development programs include "leading through transformation" content.	Agency Management	Agency Management and Operations
[redacted]			
APG 5.1.1.3: AMO-12-5	Identify and address at least three significant labor-management challenges identified during the year during periodic Agency-led Labor Management Forums.	Agency Management	Agency Management and Operations
[redacted]			
APG 5.1.1.4: AMO-12-6	Seventy-five percent of NASA's primary installations implement improvement initiatives derived from the Federal Employee Viewpoint Survey.	Agency Management	Agency Management and Operations
[redacted]			
APG 5.1.1.5: AMO-12-7	Complete all FY 2012 actions described in the NASA Model Equal Employment Opportunity (EEO) Agency Plan.	Agency Management	Agency Management and Operations

Management and Performance

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
APG 5.1.1.6: AMO-12-8	Adopt diversity improvement targets derived from the results of the Agency-wide diversity-inclusion survey and other relevant workforce and U.S. population data.	Agency Management	Agency Management and Operations
Objective 5.1.2	**Provide opportunities and support systems that recruit, retain, and develop undergraduate and graduate students in STEM-related disciplines.**		
APG 5.1.2.1: ED-12-1	Achieve 40 percent participation of underserved and underrepresented (in race and/or ethnicity) in NASA higher education projects.	STEM Education and Accountability	Education
APG 5.1.2.1: ED-12-2	Achieve 45 percent participation of women in NASA higher education projects.	STEM Education and Accountability	Education
Objective 5.2.1	**Achieve mission success by factoring safety, quality, risk, reliability, and maintainability as integral features of programs, projects, technologies, operations, and facilities.**		
APG 5.2.1.1: AMO-12-9	Assure zero fatalities or permanent disabling injuries to the public resulting from NASA activities during the fiscal year.	Safety and Mission Success	Agency Management and Operations
APG 5.2.1.2: AMO-12-10	Reduce Total Case Rate and Lost Time Case Rate by one percent, in accordance with the President's Protecting Our Workers and Ensuring Reemployment (POWER) initiative.	Safety and Mission Success	Agency Management and Operations
APG 5.2.1.3: AMO-12-11	Reduce damage to NASA assets by two percent per fiscal year, based on a five-year running average.	Safety and Mission Success	Agency Management and Operations

Management and Performance

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Measure #	Description	Contributing Program (s)	Contributing Theme
Objective 5.2.2	Provide information technology that advances NASA space and research program results and promotes open dissemination through efficient, innovative, reliable, and responsive services that are appropriately secure and valued by stakeholders and the public.		
[redacted]			
APG 5.2.2.1: AMO-12-12	Achieve Initial Operating Capability (IOC) for one Service Office (NASA Enterprise Data Center) and FOC for the initial five Service Offices as part of the NASA Information Technology Infrastructure Integration Program (I3P).	Agency IT Services (AITS)	Agency Management and Operations
[redacted]			
APG 5.2.2.2: AMO-12-13	Implement intrusion detection sensors monitored by the NASA Security Operations Center (SOC) on 75 percent of NASA institutional network monitoring sites.	Agency IT Services (AITS)	Agency Management and Operations
[redacted]			
APG 5.2.2.3: AMO-12-14	Migrate or retire all administrative systems from the Agency Administrative mainframe computer.	Agency IT Services (AITS)	Agency Management and Operations
[redacted]			
APG 5.2.2.4: AMO-12-15	Reduce the number of NASA data centers by 10 percent.	Agency IT Services (AITS)	Agency Management and Operations
[redacted]			
APG 5.2.2.5: AMO-12-16	Implement a Communications and Collaboration Lab that conducts five evaluations to assess new approaches for the dissemination of information, and real-time, multi-participant knowledge creation and management.	Agency IT Services (AITS)	Agency Management and Operations

FY 2012 Performance Plan

Measure #	Description	Contributing Program (s)	Contributing Theme
Objective 5.2.3	[illegible]		
[illegible]			
APG 5.2.3.1: AMO-12-17	Finalize remaining Center Master Plans into the Agency Integrated Master Plan.	Agency Management	Agency Management and Operations
APG 5.2.3.1: COF-12-1	Initiate facilities demolition process for five significant Agency facilities in addition to demolition processes initiated in FY 2011.	Institutional CoF	Construction of Facilities
[illegible]			
APG 5.2.3.2: ECR-12-1	Reduce energy intensity use annually by three percent from an FY 2003 baseline.	Environmental Compliance and Restoration	Environmental Compliance and Restoration
APG 5.2.3.2: ECR-12-2	Reduce potable water use annually by two percent from an FY 2007 baseline.	Environmental Compliance and Restoration	Environmental Compliance and Restoration
APG 5.2.3.2: ECR-12-3	Reduce fleet vehicle energy use annually by two percent of petroleum products from an FY 2005 baseline.	Environmental Compliance and Restoration	Environmental Compliance and Restoration
[illegible]			
Objective 5.3.1	[illegible] National Rocket Propulsion Test Alliance [illegible]		
[illegible]			
APG 5.3.1.1: SFS-12-1	Meet Rocket Propulsion Test (RPT) Master Plan requirements for year one.	Rocket Propulsion Test	Space and Flight Support (SFS)
Objective 5.3.2	[illegible]		
[illegible]			
APG 5.3.2.1: AR-12-14	Achieve ratings greater than 86 percent for overall quality and timeliness of Aeronautics Test Program (ATP) facility operations.	Aeronautics Test	Aeronautics

Management and Performance

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Measure #	Description	Contributing Program (s)	Contributing Theme
[illegible]			
Objective 5.4.1	[illegible]		
[illegible]			
APG 5.4.1.1: SFS-12-2	Sustain 100 percent success rate with the successful launch of NASA-managed expendable launches as identified on the Launch Services Flight Planning Board manifest.	Launch Services	Space and Flight Support (SFS)
[illegible]			
APG 5.4.1.2: SFS-12-3	Incorporate information sharing processes into programmatic policies and incorporate into crew demonstration activities and future crew transportation service contracts.	Launch Services	Space and Flight Support (SFS)
Objective 5.4.2	[illegible]		
[illegible]			
APG 5.4.2.1: SFS-12-4	Implement FY 2012 milestones within the 21st Century Space Launch Complex (21st CSLC) plan.	21st Century Space Launch Complex	Space and Flight Support (SFS)
Objective 5.4.3	[illegible]		
[illegible]			
APG 5.4.3.1: SFS-12-5	Complete Tracking and Data Relay Satellite (TDRS) K Pre-ship review.	Space Communications and Navigation	Space and Flight Support (SFS)

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Measure #	Description	Contributing Program (s)	Contributing Theme
APG 5.4.3.2: SFS-12-6	Complete the Space Network Ground Segment Sustainment (SGSS) Preliminary Design Review (PDR).	Space Communications and Navigation	Space and Flight Support (SFS)
APG 5.4.3.3: SFS-12-7	Complete Deep Space Station-35 (DSS-35) antenna fabrication at vendor.	Space Communications and Navigation	Space and Flight Support (SFS)
Objective 5.5.1	Facilitate the use of the ISS as a National Laboratory [illegible]		
APG 5.5.1.1: ISS-12-7	Facilitate non-profit organization (NPO) implementation of its initial grants solicitation process.	International Space Station Program	International Space Station
Objective 5.5.2	Enhance international and interagency partnerships through increased use of [illegible] interagency coordination [illegible]		
APG 5.5.2.1: AMO-12-18	Establish an internal Interagency Partnerships Working Group (IPWG) led by the Office of International and Interagency Relations (OIIR) to improve Agency-wide coordination of interagency partnerships and related interagency working groups.	Agency Management	Agency Management and Operations

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Measure #	Description	Contributing Program (s)	Contributing Theme
Strategic Goal 6	Share NASA with the public, educators, and students to provide opportunities to participate in our Mission, foster innovation and contribute to a strong national economy.		
[illegible]			
Objective 6.1.1	[illegible]		
[illegible]			
APG 6.1.1.1: ED-12-3	100,000 educators participate in NASA education programs.	STEM Education and Accountability	Education
Objective 6.1.2	[illegible]		
[illegible]			
APG 6.1.2.1: ED-12-4	25,000 undergraduate and graduate students participate in NASA education opportunities.	STEM Education and Accountability	Education
[illegible]			
APG 6.1.2.2: ED-12-5	600,000 elementary and secondary students participate in NASA instructional and enrichment activities.	STEM Education and Accountability	Education
APG 6.1.2.2: ED-12-6	85 percent of elementary and secondary students express interest in STEM careers following their involvement in NASA education programs.	STEM Education and Accountability	Education
Objective 6.1.3	[illegible]		
[illegible]			
APG 6.1.3.1: AMO-12-19	Equal opportunity (EO) assessment and technical assistance provided, or onsite compliance assessment performed, on-location at five STEM or STEM-related programs that receive NASA funding.	Agency Management	Agency Management and Operations

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Measure #	Description	Contributing Program (s)	Contributing Theme
Objective 6.2.1	[illegible]		
[illegible]			
APG 6.2.1.1: ED-12-7	5,000 educators use NASA resources in their curricula after participating in NASA professional development.	STEM Education and Accountability	Education
[illegible]			
APG 6.2.1.2: ED-12-8	Provide expertise to support the development of integrated science and engineering standards.	STEM Education and Accountability	Education
[illegible]			
Objective 6.3.1	[illegible]		
[illegible]			
APG 6.3.1.1: AMO-12-20	Issue a competitive opportunity to engage the public in NASA's activities.	Agency Management	Agency Management and Operations
[illegible]			
Objective 6.4.1	[illegible]		
[illegible]			
APG 6.4.1.1: ED-12-9	450 museums and science centers across the country actively engage the public in major NASA events.	STEM Education and Accountability	Education

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Measure #	Description	Contributing Program (s)	Contributing Theme
Objective 6.4.2	Provide clear, accurate, timely, and consistent information that is easily accessible and suitable for a diverse audience.		
[illegible]			
APG 6.4.2.1: AMO-12-21	Evaluate communication tools for impact and establish Agency best practices.	Agency Management	Agency Management and Operations
Objective 6.4.3	Provide the communications infrastructure to enable NASA's commitment to make government more open, transparent, and participatory.		
[illegible]			
APG 6.4.3.1: AMO-12-22	Finalize NASA Freedom of Information Act (FOIA) regulations."	Agency Management	Agency Management and Operations

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Uniform and Efficiency Measures

Measure #	Description
International Space Station Theme	
APG EFF 1.1.1.4: ISS-12-3	Provide 100 percent of planned on-orbit resources (including power, data, crew time, logistics, and accommodations) needed to support research.
APG EFF 1.1.2.1: ISS-12-6	Accomplish a minimum of 90 percent of the on-orbit research objectives as established one month prior to a given increment, as sponsored by NASA, baselined for FY 2012.
Earth Science Theme	
APG EFF 2.1.7.1: ES-12-16	Increase the number of science data products delivered to Earth Observing System Data and Information System (EOSDIS) users.
APG EFF 2.1.7.1: ES-12-17	Maintain a high level of customer satisfaction, as measured by exceeding the most recently available federal government average rating of the Customer Satisfaction Index.
APG EFF: ES-12-20	Complete all development projects within 110 percent of the cost and schedule baseline.
APG EFF: ES-12-21	Deliver at least 90 percent of scheduled operating hours for all operations and research facilities.
APG EFF: ES-12-22	Peer-review and competitively award at least 90 percent, by budget, of research projects.
APG EFF: ES-12-23	Reduce time within which 80 percent of NASA Research Announcement (NRA) grants are awarded, from proposal due date to selection, by four percent per year, with a goal of 180 days.
Space Technology Theme	
APG EFF 3.4.1.5: ST-12-17	Ensure that 75 percent of all NASA technology projects are recorded in the portfolio database and are analyzed against the prioritizations in the space technology roadmaps.
Agency Management and Operations Theme	
APG EFF 5.2.1.2: AMO-12-10	Reduce Total Case Rate and Lost Time Case Rate by one percent, in accordance with the President's Protecting Our Workers and Ensuring Reemployment (POWER) initiative.
APG EFF 5.2.1.3: AMO-12-11	Reduce damage to NASA assets by two percent per fiscal year, based on a five-year running average.
APG EFF: AMO-12-20	Maintain system execution time during the year-end close process at FY 2010 baseline.
Environmental Compliance and Restoration Theme	
APG EFF 5.2.3.2: ECR-12-1	Reduce energy intensity use annually by three percent from an FY 2003 baseline.
APG EFF 5.2.3.2: ECR-12-2	Reduce potable water use annually by two percent from an FY 2007 baseline.
APG EFF 5.2.3.2: ECR-12-3	Reduce fleet vehicle energy use annually by two percent of petroleum products from an FY 2005 baseline.
Aeronautics Theme	
APG EFF: AR-12-16	Deliver at least 86 percent of on-time availability for operations and research facilities.
Astrophysics Theme	
APG EFF: AS-12-6	Complete all development projects within 110 percent of the cost and schedule baseline.

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Uniform and Efficiency Measures

Measure #	Description
APG EFF: AS-12-7	Deliver at least 90 percent of scheduled operating hours for all operations and research facilities.
APG EFF: AS-12-8	Peer-review and competitively award at least 95 percent, by budget, of research projects.
APG EFF: AS-12-9	Reduce time within which 80 percent of NASA Research Announcement (NRA) grants are awarded, from proposal due date to selection, by four percent per year, with a goal of 180 days.
Heliophysics Theme	
APG EFF: HE-12-6	Complete all development projects within 110 percent of the cost and schedule baseline.
APG EFF: HE-12-7	Deliver at least 90 percent of scheduled operating hours for all operations and research facilities.
APG EFF: HE-12-8	Peer-review and competitively award at least 90 percent, by budget, of research projects.
APG EFF: HE-12-9	Reduce time within which 80 percent of NASA Research Announcement (NRA) grants are awarded, from proposal due date to selection, by four percent per year, with a goal of 180 days.
Planetary Science Theme	
APG EFF: PS-12-14	Complete all development projects within 110 percent of the cost and schedule baseline.
APG EFF: PS-12-15	Deliver at least 90 percent of scheduled operating hours for all operations and research facilities.
APG EFF: PS-12-16	Peer-review and competitively award at least 95 percent, by budget, of research projects.
APG EFF: PS-12-17	Reduce time within which 80 percent of NASA Research Announcement (NRA) grants are awarded, from proposal due date to selection, by four percent per year, with a goal of 180 days.

Multi-Year Ratings Trends

Under NASA's previous performance framework (based on NASA's 2006 Strategic Plan), NASA provided performance measure trend data at the multi-year outcome level. To provide continued performance trend information, a separate table is included below to reflect trend information at the objective level in NASA's new performance framework, which most closely tracks to the previous multi-year outcome level in the previous framework. In several cases, multiple outcomes relate to a single objective. For more information on previous years' performance ratings and measures from FY 2006 to FY 2010, please visit http://www.nasa.gov/news/budget/index.html.

NASA previously rated multiyear outcomes based on the following definitions:

Green: NASA achieved most APGs under this outcome and is on-track to achieve or exceed this outcome.

Yellow: NASA made significant progress toward this outcome, however, the Agency may not achieve this outcome as stated.

Red: NASA failed to achieve most of the APGs under this outcome and does not expect to achieve this outcome as stated.

White: This outcome was cancelled by management directive or is no longer applicable based on management changes to the APGs.

None: The stated outcome did not exist in the years indicated.

2011 Strategic Plan Objectives		FY 2010	FY 2009	FY 2008	FY 2007
1.1.1	Maintain resources (on-orbit and on the ground) to operate and utilize the ISS.	2.2 Green	2.2 Green	2.2 Green	2.2 Green
1.1.2	Advance engineering, technology, and research capabilities on the ISS.	2.1 Green	2.1 Green	2.1 Green	2.1 Green
		2.3 Green	2.3 Green	2.3 Green	None
1.2.1	Enable the commercial sector to provide cargo and crew services to the International Space Station (ISS).	5.2 Yellow	5.2 Green	5.2 Green	5.2 Green
1.3.1	Execute development of an integrated architecture to conduct human space exploration missions beyond low Earth orbit.	6.4 White	6.5 Green	6.5 Green	None
1.3.2	Develop a robust biomedical research portfolio to mitigate space human health risks.	2.3 Green	2.3 Green	2.3 Green	None
1.3.3	Identify hazards, opportunities and potential destinations, to support future safe and successful human space exploration missions.	3B.3 Green	3B.3 Green	3B.3 Green	3B.3 Green
		3C.3 Green	3C.3 Green	3C.3 Green	3C.3 Green
		3C.4 Green	3C.4 Green	3C.4 Green	3C.4 Green
		6.4 White	6.5 Green	6.5 Green	None
2.1.1	Improve understanding of and improve the predictive capability for changes in the ozone layer, climate forcing, and air quality associated with changes in atmospheric composition.	3A.1 Green	3A.1 Green	3A.1 Green	3A.1 Green
2.1.2	Enable improved predictive capability for weather and extreme weather events.	3A.2 Green	3A.2 Green	3A.2 Green	3A.2 Green
2.1.3	Quantify, understand, and predict changes in Earth's ecosystems and biogeochemical cycles, including the global carbon cycle, land cover, and biodiversity.	3A.3 Green	3A.3 Green	3A.3 Green	3A.3 Green
2.1.4	Quantify the key reservoirs and fluxes in the global water cycle and assess water cycle change and water quality.	3A.4 Green	3A.4 Green	3A.4 Green	3A.4 Green
2.1.5	Improve understanding of the roles of the ocean, atmosphere, land and ice in the climate system and improve predictive capability for its future evolution.	3A.5 Green	3A.5 Green	3A.5 Yellow	3A.5 Yellow
2.1.6	Characterize the dynamics of Earth's surface and interior and form the scientific basis for the assessment and mitigation of natural hazards and response to rare and extreme events.	3A.6 Green	3A.6 Green	3A.6 Green	3A.6 Green
		3A.2 Green	3A.2 Green	3A.2 Green	3A.2 Green
2.1.7	Enable the broad use of Earth system science observations and results in decision-making activities for societal benefits.	3A.7 Green	3A.7 Green	3A.7 Green	3A.7 Green

2011 Strategic Plan Objectives		FY 2010	FY 2009	FY 2008	FY 2007
2.2.1	Improve understanding of the fundamental physical processes of the space environment from the Sun to Earth, to other planets, and beyond to the interstellar medium.	3B.1 Green	3B.1 Green	3B.1 Green	3B.1 Green
2.2.2	Improve understanding of how human society, technological systems, and the habitability of planets are affected by solar variability interacting with planetary magnetic fields and atmospheres.	3B.2 Green	3B.2 Green	3B.2 Green	3B.2 Green
2.2.3	Maximize the safety and productivity of human and robotic explorers by developing the capability to predict extreme and dynamic conditions in space.	3B.3 Green	3B.3 Green	3B.3 Green	3B.3 Green
2.3.1	Inventory solar system objects and identify the processes active in and among them.	3C.2 Green	3C.2 Green	3C.2 Green	3C.2 Green
2.3.2	Improve understanding of how the Sun's family of planets, satellites, and minor bodies originated and evolved.	3C.1 Green	3C.1 Green	3C.1 Green	3C.1 Green
2.3.3	Improve understanding of the processes that determine the history and future of habitability of environments on Mars and other solar system bodies.	3C.3 Green	3C.3 Green	3C.3 Green	3C.3 Green
2.3.4	Improve understanding of the origin and evolution of Earth's life and biosphere to determine if there is or ever has been life elsewhere in the universe.	3C.2Green	3C.2Green	3C.2Green	3C.2Green
2.3.5	Identify and characterize small bodies and the properties of planetary environments that pose a threat to terrestrial life or exploration or provide potentially exploitable resources.	3B.3 Green 3C.4 Green	3B.3 Green 3C.4 Green	3B.3 Green 3C.4 Green	3B.3 Green 3C.4 Green
2.4.1	Improve understanding of the origin and destiny of the universe, and the nature of black holes, dark energy, dark matter, and gravity.	3D.1 Green	3D.1 Green	3D.1 Green	3D.1 Green
2.4.2	Improve understanding of the many phenomena and processes associated with galaxy, stellar, and planetary system formation and evolution from the earliest epochs to today.	3D.2 Green	3D.2 Green	3D.2 Green	3D.2 Green
2.4.3	Generate a census of extra-solar planets and measure their properties.	3D.4 Green	3D.4 Green	3D.4 Green	3D.4 Yellow
3.1.1	Create a pipeline of new low Technology Readiness Levels (TRL) innovative concepts and technologies for future NASA missions and national needs.	None	None	None	None
3.2.1	Prove the technical feasibility of potentially disruptive new space technologies for future missions.	None	None	None	None
3.2.2	Spur the development of routine, low-cost access to space through small payloads and satellites.	None	None	None	None
3.2.3	Demonstrate new space technologies and infuse them into future science and exploration small satellite missions and/or commercial use.	None	None	None	None
3.2.4	Demonstrate new space technologies and infuse them into missions.	5.3 Green	None	5.3 Green	5.3 Green

2011 Strategic Plan Objectives		FY 2010	FY 2009	FY 2008	FY 2007
3.2.5	Provide flight opportunities and relevant environments to demonstrate new space technologies.	5.1 Green	5.1 Green	5.1 Green	5.1 Green
3.3.1	Demonstrate in-space operations of robotic assistants working with crew.	None	None	None	None
3.3.2	Develop and demonstrate critical technologies for safe and affordable cargo and human space exploration missions beyond low Earth orbit.	6.2 Green	6.2 Green	6.2 Green	6.2 Green
		6.3 Green	6.3 Green	6.3 Green	None
3.4.1	Promote and develop innovative technology partnerships among NASA, U.S. industry, and other sectors for the benefit of Agency programs and projects and national interests.	5.3 Green	None	5.3 Green	5.3 Green
4.1.1	Develop advanced technologies to improve the overall safety of the future air transportation system.	3E.1 Green	3E.1 Green	3E.1 Green	3E.1 Green
4.1.2	Develop innovative solutions and technologies to meet future capacity and mobility requirements of the Next Generation Air Transportation System (NextGen).	3E.2 Green	3E.2 Green	3E.2 Green	3E.2 Green
4.1.3	Develop tools, technologies, and knowledge that enable significantly improved performance and new capabilities for future air vehicles.	3E.3 Green	3E.3 Green	3E.3 Green	3E.3 Green
4.2.1	Develop advanced tools and technologies that reduce the technical risk associated with system-level integration of promising aeronautical concepts.	3E.5 Yellow	3E.5 Yellow	3E.5 Yellow	3E.5 Yellow
5.1.1	Establish and maintain a workforce that possesses state-of-the-art technical and business management competencies.	AS.2 Green	None	None	None
5.1.2	Provide opportunities and support systems that recruit, retain, and develop undergraduate and graduate students in STEM-related disciplines.	ED.1 Green	ED.1 Green	ED.1 Green	ED.1 Green
		ED.2 Green	ED.2 Green	ED.2 Green	None
5.2.1	Achieve mission success by factoring safety, quality, risk, reliability and maintainability as integral features of programs, projects, technologies, operations, and facilities.	AS.4 Green	None	None	None
5.2.2	Provide information technology that advances NASA space and research program results and promotes open dissemination through efficient, innovative, reliable, and responsive services that are appropriately secure and valued by stakeholders and the public.	AS.1 Green	None	None	None
5.2.3	Develop and implement long-range infrastructure plans that address institutional capabilities and critical assets, directly link to mission needs, ensure the leveraging of external capabilities, and provide a framework for Agency infrastructure decision-making.	AS.3 Green	None	None	None
5.3.1	Work with the National Rocket Propulsion Test Alliance to identify NASA, Department of Defense	AS.5 Green	6.4 Green	6.4 Green	6.4 Green

2011 Strategic Plan Objectives		FY 2010	FY 2009	FY 2008	FY 2007
	and commercial capabilities and requirements.	5.1 Green	5.1 Green	5.1 Green	5.1 Green
5.3.2	Ensure that Aeronautics Test Program (ATP) facilities are available and capable of supporting research, development, test and evaluation goals and objectives for NASA and national aerospace programs.	3E.4 Green	3E.4 Green	3E.4 Green	3E.4 Green
5.4.1	Ensure reliable and cost-effective access to space for missions critical to achieving the National Space Policy of the United States of America.	AS.5 Green	6.4 Green	6.4 Green	6.4 Green
		5.1 Green	5.1 Green	5.1 Green	5.1 Green
5.4.2	Transform the Florida launch and range complex to provide a robust launch and range infrastructure for future users.	AS.5 Green	6.4 Green	6.4 Green	6.4 Green
5.4.3	Build and maintain a scalable, integrated, mission support infrastructure that can readily evolve to accommodate new and changing technologies, while providing integrated, comprehensive, robust, and cost-effective space communications services at order-of-magnitude higher data rates to enable NASA's science and exploration missions.	AS.5 Green	6.4 Green	6.4 Green	6.4 Green
5.5.1	Facilitate the use of the ISS as a National Laboratory for cooperative research, technology development, and education.	None	None	None	None
5.5.2	Enhance international and interagency partnerships through increased use of international and interagency coordination mechanisms.	6.4 White	6.5 Green	6.5 Green	None
6.1.1	Provide quality STEM curricular support resources and materials.	ED.2 Green	ED.2 Green	ED.2 Green	None
6.1.2	Provide NASA experiences that inspire student interest and achievement in STEM disciplines.	ED.2 Green	ED.2 Green	ED.2 Green	None
6.1.3	Assess grant recipient institutions throughout the education pipeline to ensure that grant recipients demonstrate a consistent commitment to civil rights compliance.	ED.1 Green	ED.1 Green	ED.1 Green	ED.1 Green
6.2.1	Develop NASA's leadership role in national STEM improvement efforts, as demonstrated by provision of meaningful educator professional development and student experiences, adoption of education technologies, and contributions to STEM education policies and strategies.	ED.1 Green	ED.1 Green	ED.1 Green	ED.1 Green
6.3.1	Extend the reach of participatory engagement across NASA.	None	None	None	None
6.4.1	Use strategic partnerships with formal and informal educational organizations to provide NASA content to promote interest in STEM.	ED.3 Green	ED.3 Green	ED.3 Green	ED.3 Green
6.4.2	Provide clear, accurate, timely, and consistent information that is readily available and suitable for a diverse audience.	None	None	None	None

2011 Strategic Plan Objectives		FY 2010	FY 2009	FY 2008	FY 2007
6.4.3	Provide the communications infrastructure to enable NASA's commitment to make government more open, transparent, and participatory.	None	None	None	None

Sen. 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 U.S. Will the U.S. fall behind the Chinese in space supremacy and will that inspire fewer young Americans go into the sciences?

The President has spoken of how the space program inspired him personally, and the Administration strongly believes in the power of the space program to spark passions and launch careers. By almost any indicator, U.S. capabilities in space far surpass those of China, and the President's Budget will continue to guarantee the Nation's leading position in space.

The President is firmly committed to moving U.S. students from the middle to the top of the pack in math and science achievement over the next decade. The 2012 Budget invests $3.4 billion in programs across the federal government to address the need to improve our science, technology, engineering, and math (STEM) education.

As part of the effort to out-educate other nations in STEM subjects, the President called for a new effort to prepare 100,000 STEM teachers with strong teaching skills and deep content knowledge over the next decade. As a crucial component of achieving this goal, the 2012 Budget proposes an investment of $100 million through the Department of Education and the National Science Foundation to prepare effective STEM teachers for the classroom.

Sen. Sessions

The President proposes to resurrect the Build America Bonds (BAB) program, increasing entitlement spending by almost $60 billion over ten years, offset by increased taxes from the phaseout of the existing interest exclusion for tax exempt state and local bonds. The BAB program provides a subsidy to state and local governments to defray slightly more than a third of the interest cost of issuing bonds.

1. If the Federal Government has a debt problem, how is it responsible for the this government to subsidize and encourage state and local governments to incur more debt with Build America Bonds?

2. Do you think the federal subsidy will cause states to take on more debt than they normally should simply to get the benefit of the Build America Bonds program?

The Administration proposes to make the successful Build America Bond (BAB) program permanent at a reduced subsidy level designed to be approximately revenue neutral in comparison to the Federal tax losses from traditional tax-exempt bonds. This would entail reducing the subsidy rate from 35 percent, provided under the American Recovery and Reinvestment Act, to 28 percent. The proposal would also expand the eligible uses for BABs beyond new investments in governmental capital projects to include certain additional program uses for which State and local governments may use tax-exempt bonds under current law.

With a reduced subsidy rate, State and local governments will not have an incentive to incur more debt than they would with traditional tax-exempt bonds, since their cost of debt service after the subsidy will be about the same.

Sen. Sessions

The President created the Fiscal Commission in February of last year. The Commission issued its debt. Over the past year, when the President has been asked about his plan to reduce the deficit, he claimed that he was waiting for the Fiscal Commission to finish its work.

1. Why did the President set out certain goals for the Fiscal Commission, and then produce a budget that did not meet those goals?

2. How does this budget embrace the recommendations of the Fiscal Commission?

3. Where specifically does the President disagree with the Fiscal Commission recommendations?

The Fiscal Commission was charged with "identifying policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run," and "balancing the budget excluding interest payments on the debt by 2015," with the result of "stabiliz[ing] the debt-to-GDP ratio at an acceptable level once the economy recovers." The President's Budget reduces the deficit significantly starting in 2013 and achieves primary balance by 2017. It also takes a number of steps to put the budget on a more sustainable long-term trajectory. For example, the Budget proposes policies that would pay for relief from scheduled cuts in Medicare physician payments under the Sustainable Growth Rate system (SGR) and scheduled increases in the Alternative Minimum Tax (AMT), two areas for which relief has often not been paid for in the past. The budget also includes principles for ensuring the long-term solvency of Social Security and tax code simplification. With both significant savings in discretionary and mandatory programs and sensible revenue proposals, this budget represents a comprehensive approach to deficit reduction in line with the Commission goals.

The President's Budget benefitted significantly from the hard work done by the Fiscal Commission. The Budget adopts the Fiscal Commission's approach to corporate tax reform and treatment of the Transportation Trust Fund, and it includes consequential proposals like PBGC reform, government reorganization, and medical malpractice reform. It includes more than a dozen specific spending cuts from the Commission's report, including the federal pay freeze, and it takes the first step towards significant long-term challenges highlighted in the Commission report, including paying for SGR and AMT relief with specific offsets.

Like the Fiscal Commission report, the President's Budget includes a tough, disciplined proposal for the discretionary budget. The President's budget saves $400 billion over ten years with a five-year freeze on non-security discretionary spending and puts non-security discretionary on a path to zero real growth. The Commission report front-loads significant discretionary savings with an up-front cut on both non-security and security discretionary spending, followed by a controlled growth rate through the end of the budget window.

Sen. Sessions

The President tasked OMB with looking for ways to reduce the duplication of federal programs. The federal government currently provides extra financial assistance to:

"Empowerment Zones"; "Renewal Communities"; "Enterprise Communities"; and "Historically Underutilized Business Zones."

Your budget proposes creating a new "Growth Zone" program for "areas facing economic distress." Shouldn't we be consolidating these programs before we create a new one?

Growth Zones would promote job creation and investment in economically distressed areas that have demonstrated potential for future growth and diversification into new industries. While current law provides some regionally targeted benefits to numerous areas, most of these incentives have expired or are due to expire soon and some of these designations have been in effect over 16 years. In particular, Empowerment Zones are due to expire at the end of 2011 and would be replaced by Growth Zones. The Administration desires to target resources to areas where they would provide the most benefit on a going-forward basis. The national competition for Growth Zone status would drive regional economic growth. Growth Zones are designed to build on the success of Empowerment Zones while making improvements to ensure federal dollars are being spent effectively to generate the most impact on the ground.

Renewal Communities and Enterprise Communities have expired. The HUBZone program is still in effect, but has no tax incentives that affect the budget, and is administered by the SBA to channel procurement contracts to small businesses in designated areas.

Sen. Sessions

Please provide a table that shows -- by account, amount (BA and Outlays) and year -- the changes in the baseline that result from reclassifications proposed in the budget.

OMB provided this table to committee staff on 3/9/2011, and is also provided below.

Attachment: DOT_proposed reclassifications.pdf

Proposed BEA Category Reclassifications in the 2012 Budget Adjusted Baseline
(Changes from the 2012 Budget Adjusted Baseline, in millions of dollars)

Account	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
National Infrastructure Investments (021-04-0143):												
Discretionary:												
BA............	-600	-600	-609	-619	-631	-643	-654	-667	-680	-693	-706	-720
OL............	---	-138	-336	-458	-523	-573	-613	-636	-647	-659	-672	-684
Mandatory:												
BA............	600	600	609	619	631	643	654	667	680	693	706	720
OL............	---	138	336	458	523	573	613	636	647	659	671	684
Federal-aid Highways (021-15-8083):												
Discretionary:												
OL............	-30,112	-34,490	-39,296	-35,439	-43,531	-44,526	-45,274	-46,761	-48,948	-50,121	-50,826	-51,318
Mandatory:												
BA............	---	---	-1,196	-621	46	766	1,499	2,243	3,045	3,861	4,692	5,538
OL............	30,112	34,490	39,296	35,439	43,531	44,526	45,274	46,761	48,948	50,121	50,826	51,318
Motor Carrier Safety Grants (021-17-8158):												
Discretionary:												
OL............	-275	-449	-311	-315	-321	-326	-332	-338	-343	-350	-356	-363
Mandatory:												
BA............	---	---	3	7	12	18	23	29	35	41	47	54
OL............	275	449	311	315	321	326	332	338	343	350	356	363
Motor Carrier Safety Operations and Programs (021-17-8159):												
Discretionary:												
OL............	-237	-299	-245	-253	-260	-268	-276	-285	-294	-303	-312	-322
Mandatory:												
BA............	---	-5	2	9	16	25	33	42	50	60	70	80
OL............	237	299	245	253	259	268	276	285	294	303	313	323
Operations and Research (021-18-0650):												
Discretionary:												
BA............	-140	-140	-143	-148	-151	-156	-160	-165	-170	-175	-180	-185
OL............	-131	-136	-121	-139	-149	-153	-158	-162	-166	-171	-176	-183
Mandatory:												
BA............	140	140	143	148	151	156	160	165	170	175	180	185
OL............	131	136	121	139	149	153	158	162	167	172	177	182
Operations and Research (Transportation Trust Fund) (021-18-8016):												
Discretionary:												
OL............	-125	-118	-121	-116	-118	-121	-124	-126	-129	-133	-136	-139
Mandatory:												
BA............	---	---	---	2	5	7	11	13	16	20	23	26
OL............	125	118	121	116	118	121	124	126	130	133	136	139

Proposed BEA Category Reclassifications in the 2012 Budget Adjusted Baseline
(Changes from the 2012 Budget Adjusted Baseline, in millions of dollars)

Account	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Highway Traffic Safety Grants (021-18-8020):												
Discretionary:												
OL............	-566	-709	-711	-631	-641	-651	-663	-674	-687	-700	-713	-726
Mandatory:												
BA............	---	---	---	9	19	30	42	54	66	79	91	105
OL............	566	709	711	631	641	651	663	675	688	700	712	726
Operating Subsidy Grants to the National Railroad Passenger Corp (021-27-0121):												
Discretionary:												
BA............	-563	-563	-571	-580	-590	-600	-610	-621	-632	-644	-655	-667
OL............	-563	-563	-571	-580	-590	-600	-610	-621	-632	-644	-655	-667
Mandatory:												
BA............	563	563	571	580	590	600	610	621	632	644	655	667
OL............	563	563	571	580	590	600	610	621	632	644	655	667
Capital and Debt Service Grants to the National Railroad Passeng. (021-27-0125):												
Discretionary:												
BA............	-1,002	-1,002	-1,016	-1,032	-1,050	-1,068	-1,086	-1,105	-1,125	-1,146	-1,166	-1,187
OL............	-918	-1,090	-1,016	-1,032	-1,050	-1,068	-1,086	-1,105	-1,125	-1,146	-1,166	-1,187
Mandatory:												
BA............	1,002	1,002	1,016	1,032	1,050	1,068	1,086	1,105	1,125	1,146	1,166	1,187
OL............	918	1,090	1,016	1,032	1,050	1,068	1,086	1,105	1,125	1,146	1,166	1,187
Capital Assistance for High Speed Rail Corridors and Intercity P. (021-27-0719):												
Discretionary:												
BA............	-2,500	-2,500	-2,535	-2,576	-2,619	-2,664	-2,709	-2,758	-2,808	-2,858	-2,910	-2,962
OL............	---	-23	-115	-329	-627	-963	-1,367	-1,847	-2,289	-2,537	-2,622	-2,665
Mandatory:												
BA............	2,500	2,500	2,535	2,576	2,619	2,664	2,709	2,758	2,808	2,858	2,910	2,962
OL............	---	23	115	329	627	963	1,367	1,847	2,288	2,536	2,622	2,665
Administrative Expenses (021-36-1120):												
Discretionary:												
BA............	-99	-99	-102	-106	-110	-114	-119	-123	-128	-132	-138	-145
OL............	-96	-102	-102	-106	-110	-114	-118	-123	-127	-133	-137	-143
Mandatory:												
BA............	99	99	102	106	110	114	119	123	128	132	138	145
OL............	96	102	102	105	110	114	118	123	127	132	137	145
Grants for Energy Efficiency and Greenhouse Gas Reductions (021-36-1131):												
Discretionary:												
BA............	-75	-75	-76	-77	-79	-80	-81	-83	-84	-86	-87	-89
OL............	---	-8	-27	-38	-61	-70	-77	-83	-80	-81	-82	-84
Mandatory:												
BA............	75	75	76	77	79	80	81	83	84	86	87	89
OL............	---	8	28	38	61	70	77	83	80	81	83	84

Proposed BEA Category Reclassifications in the 2012 Budget Adjusted Baseline
(Changes from the 2012 Budget Adjusted Baseline, in millions of dollars)

Account	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Capital Investment Grants (021-36-1134):												
Discretionary:												
BA............	-1,998	-1,998	-2,026	-2,058	-2,093	-2,129	-2,165	-2,204	-2,244	-2,284	-2,325	-2,367
OL............	-1,197	-1,337	-1,585	-1,815	-1,996	-2,148	-2,039	-2,118	-2,154	-2,192	-2,231	-2,271
Mandatory:												
BA............	1,998	1,998	2,026	2,058	2,093	2,129	2,165	2,204	2,244	2,284	2,325	2,367
OL............	1,197	1,337	1,585	1,815	1,996	2,147	2,039	2,118	2,154	2,192	2,231	2,271
Research and University Research Centers (021-36-1137):												
Discretionary:												
BA............	-66	-66	-67	-68	-69	-70	-72	-73	-74	-75	-77	-78
OL............	-53	-57	-73	-77	-74	-74	-69	-71	-72	-73	-74	-76
Mandatory:												
BA............	66	66	67	68	69	70	72	73	74	75	77	78
OL............	53	57	73	77	74	74	69	71	72	73	74	76
Discretionary Grants (Transportation Trust Fund, Mass Transit Acct) (021-36-8191):												
Discretionary:												
OL............	-17	-13	-13	-13	-13	---	---	---	---	---	---	---
Mandatory:												
OL............	17	13	13	13	13	---	---	---	---	---	---	---
Transit Formula Grants (021-36-8350):												
Discretionary:												
OL............	-7,346	-7,644	-9,641	-9,535	-9,671	-9,304	-8,789	-8,939	-9,096	-9,257	-9,423	-9,593
Mandatory:												
BA............	---	---	-18	99	234	380	529	680	843	1,009	1,177	1,348
OL............	7,346	7,644	9,641	9,534	9,671	9,304	8,790	8,940	9,096	9,257	9,423	9,592
Totals												
Discretionary:												
BA............	-7,043	-7,043	-7,145	-7,264	-7,392	-7,524	-7,656	-7,799	-7,945	-8,093	-8,244	-8,400
OL............	-41,636	-47,176	-54,284	-50,876	-59,735	-60,959	-61,595	-63,889	-66,789	-68,500	-69,581	-70,421
Mandatory:												
BA............	7,043	7,038	5,936	6,769	7,724	8,750	9,793	10,860	12,000	13,163	14,344	15,551
OL............	41,636	47,176	54,285	50,874	59,734	60,958	61,596	63,891	66,791	68,499	69,582	70,422
Net												
BA............	---	-5	-1,209	-495	332	1,226	2,137	3,061	4,055	5,070	6,100	7,151
OL............	---	---	1	-2	-1	-1	1	2	2	-1	1	1

Sen. Warner

The Performance and Management section of the budget highlights the progress that has been made with the Performance.gov website - which hosts all the progress agencies are making on the high priority performance goals included in the FY11 Budget. When will this site be public and updates on the goals be available?

OMB is developing Performance.gov to track progress on Priority Goals and cross-cutting management efforts. This information will primarily be used within the Executive Branch to help drive progress on these priorities. A test version of the site is currently in use by Federal agencies to support internal management reviews. In addition to its use for internal management, the website will communicate a clear, concise picture of progress to the Congress, the public, and others. With the passage of the GPRA Modernization Act of 2010, this website is required to be available to the public before October 1, 2012. We are working now to make the website meet the requirements of the law, and plan to make it available before the statutory deadline. We are currently revising our project plans to address the necessary changes and the current uncertainty over project funding levels for the Electronic Government fund at GSA, which funds development of the site. We will update the committee as the revised project plans are finalized.

Sen. Warner

Last year, we passed the Government Performance and Results Modernization Act of 2010 to improve the information used for decision making. Can you give me an update on the implementation at OMB? What do you see as the key challenges to implementation?

OMB has begun working with agency leaders in the President's Management Council, Performance Improvement Council, other management councils, and other offices in the EOP to implement the law. I anticipate that OMB will issue initial guidance to agencies in early spring. A key implementation challenge will be bringing about a lasting cultural change where government agencies, Congress, and other partners' recognize the value of performance information and see goals, measurement, and analyses as tools to improve performance and reduce costs and risks. Past government efforts in this area have led to a focus on compliance and one-size-fits all approaches that produced reams of plans and reports that no one read, but little diagnostic analysis that helped agencies make smarter decisions and improve performance. We intend to work closely with agencies to ensure that the goal-setting, measurement, and data-driven reviews required by the new law are powerful tools that aid decision makers in headquarters, in the field, and in the government and private organizations that work with the Federal government to improve the quality of American lives.

Sen. Warner

This year, you asked agencies to identify "low priority" programs in their budget submissions. How did you use this information in the budget development?

The Administration asked agencies to engage senior leaders to set near-term Priority Goals and identify low-priority agency programs which informed the priority-setting so essential to the FY 2012 Budget process. Many of the programs agencies identified through this process are included in the Terminations and Reductions volume or reprioritized in the 2012 Budget.

Sen. Enzi

You noted in your answers to questions that the Social Security Trust Funds are solvent until 2037. Currently, money collected from taxpayers for the social security trust funds are invested in interest-bearing Treasury securities. Is it true that the federal government does not set aside financial assets to cover its liabilities associated with these securities (rather, the funds are used by the U.S. Treasury for general government purposes), so that as the trust funds are depleted and the securities are redeemed, the federal government must finance repayment through more public borrowing, repaying less debt, raising taxes, or cutting other spending?

It is true that amounts collected by Social Security in excess of benefit payments are invested in interest-bearing securities that constitute legal claims on the Treasury, similar to interest-bearing securities held by the public. It is also true that the securities held by Social Security are reported as assets by the Social Security Administration and liabilities by the Treasury, which cancel each other out for the Government as a whole.

When Social Security redeems securities for benefits, the Treasury will finance the benefit payments in the same way as it finances any other Federal expenditure. It will use current receipts if the unified budget is in surplus or it will borrow from the public if the budget is in deficit. The need to finance these future expenditures for Social Security and other important programs requires that the Government work today to ensure that it is in a position to fulfill these obligations, which, as all Treasury bonds, are backed by the full faith and credit of the United States, when they come due. The 2012 Budget provides a roadmap to putting the Government on a fiscally sustainable path so that the Government will be able to fulfill its commitments.

Sen. Enzi

The FY 2012 budget includes a provision to terminate Abandoned Mine Land payments to certified states.

I was one of the lead authors on a carefully constructed compromise that reauthorized the Abandoned Mine Lands Trust Fund in 2006. That trust fund continued the tax on coal companies for each ton of coal they mine. The compromise legislation included Democrats and Republicans. The coal industry and the United Mine Workers of America supported the bill. Members from certified states like Wyoming supported the compromise as did members from uncertified states like Pennsylvania and West Virginia. As a Senator, President Obama voted in favor of the legislation that included this compromise.

Why is the Administration backtracking on the agreement between Democrats and Republicans on an issue that was supported by then-Senator Obama?

The Administration proposes to reform DOI's abandoned mine lands program to focus the available reclamation funds on cleaning up the highest priority sites. The Budget proposes to terminate unrestricted mandatory payments from the Treasury to States and Tribes that have finished restoring their abandoned coal mines, because these payments do not contribute to the goal of addressing abandoned mine hazards. This proposal would also competitively allocate the remaining funds to reclaim the Nation's highest priority abandoned coal mine sites.

Sen. Enzi

The President issued Executive Order 13563 titled, Improving Regulation and Regulatory Reviews. I was pleased to see the President acknowledge some regulations have gotten out of balance, placing unreasonable burdens on business - burdens that have stifled innovation and have had a chilling effect on growth and jobs." On its face, this is an initiative both sides of the aisle can support.

According to the Government Accountability Office 43 major rules imposing new costs on the private sector were adopted during the last fiscal year. These rules imposed $28 billion in new costs to Americans, including many small businesses that can't afford increased costs.

It is my understanding that section 7 of the Executive Order exempts independent agencies from this review. One of those independent agencies, the National Labor Relations Board (NLRB), is charged with administering the National Labor Relations Act in more than six million workplaces in the country, including many small businesses. NLRB Chairman Wilma Liebman said rulemaking will be an area of emphasis in 2011. Do you agree that including independent agencies in the regulatory review would be the first major step towards actually lessening the regulatory burden on small businesses? If so, how will you ensure these independent agencies, including the NLRB, conduct reviews of their regulations?

Please provide a status update on the government-wide review of current regulations and the timeline for completion of the review. In addition, please describe how OMB will quantify the economic consequences of the regulations you review.

Following the practice set by previous Executive Orders on regulatory review, dating back to President Reagan, Executive Order 13563 does not apply to or bind independent agencies. But in recent guidance, OMB/OIRA has explicitly encouraged such agencies to give consideration to all of its provisions, consistent with their legal authority. In particular, such agencies are encouraged to consider undertaking, on a voluntary basis, retrospective analysis of existing rules. Executive Order 13563, as well as guidance we have issued pursuant to it, calls for agencies to engage in a "periodic review" of their regulations in order to maintain a "consistent culture" of retrospective review and analysis throughout the executive branch. To facilitate this ongoing process of review, the E.O. states that each agency shall develop and submit a plan for revising its regulations "[w]ithin 120 days of the date of this order," or May 18, 2011. On February 2, OMB issued guidance on implementation of EO 13563. That guidance, among other things, asks agencies to solicit the public for comments and also to rely on cost-benefit analyses to evaluate the economic consequences of their rules. Agencies are now actively engaged in the process of producing their preliminary plans and of analyzing existing rules. Among other things, the Environmental Protection Agency, the Department of Transportation, the Social Security Administration, and the Department of Energy have asked the public for comments. In connection with our 2011 Draft Report to Congress on the Benefits and Costs of Federal Regulations, OMB is requesting comments on conceptual, empirical, and methodological issues associated with retrospective review.

Sen. Enzi

Recently, the Occupational Safety and Health Administration (OSHA) "temporarily" halted two proposals. One of the proposals was a "re-interpretation "of a workplace noise standard. The second was a proposed rule on musculoskeletal disorder recordkeeping requirements. Upon withdrawing the two proposals, the Department of Labor announced that it planned outreach to the small businesses and stakeholders on both issues. I am curious why the Department did not conduct any of this outreach prior to making proposals? Halting the proposed rule after DOL has already put employee time and money into the effort, only to be told "start over" does not seem to be an efficient, nor competent way to do business. Wouldn't it be a good idea for the Administration to initiate a Small Business Regulatory Enforcement Fairness Act (SBREFA) advisory panel on such proposals? What do you suggest can be done so that agencies like OSHA follow SBREFA?

OSHA is required to initiate an advisory Small Business Regulatory Enforcement Fairness Act (SBREFA) panel when a proposed rule is expected to have a significant impact on a substantial number of small entities. The Agency has conducted SBREFA panels on a number of important regulatory issues that meet this criterion. Most recently, for example, OSHA has held a SBREFA panel to address issues associated with the prospective regulation of diacetyl; the Agency has also indicated plans to initiate SBREFA panels on injury and illness prevention programs and combustible dust. This Administration is firmly committed to eliminating excessive and unjustified burdens on small businesses, and to ensuring that regulations are designed with careful consideration of their effects, including their cumulative effects, on small businesses, as indicated in the January 2011 Presidential Memorandum "Regulatory Flexibility, Small Business, and Job Creation."

Sen. Enzi

Under current law, the Centers of Medicare and Medicaid Services (CMS) is allowed to use Medicare Trust Fund dollars for specified activities relating to quality improvement and fraud and abuse prevention.

Concerns have been raised that CMS could use this so-called apportionment authority to fund some of the implementation activities associated with the new health care law. Any diversion of these funds would represent a serious breach of faith with the Medicare beneficiaries who have contributed to the Medicare Trust Fund through their Medicare payroll taxes.

Will you commit that OMB will block any effort to divert Medicare Trust Fund dollars to any purpose other than providing care for Medicare beneficiaries and funding the existing Medicare quality and fraud prevention programs?

The Social Security Act explicitly provides authority to CMS to use Hospital Insurance Trust Fund and Supplementary Medical Insurance Trust Fund dollars to support program administrative costs, including quality improvement and fraud and abuse prevention activities. This has been true since the inception of the Medicare program. This principle, which is also true for Social Security, is to ensure that the total costs of the program are reflected in the Trust Funds.

The Affordable Care Act (ACA) builds on existing authorities within the Social Security Act to improve program quality and reduce fraud waste and abuse. The ACA extends authorities that have always been funded through the Trust Funds and use of Trust Fund dollars to support these activities is appropriate and explicitly authorized by law.

We appreciate your concerns about inappropriate use of funds. The President's Budget includes a number of provisions to reduce inappropriate and wasteful spending in the Medicare and Medicaid programs. The Office of Management and Budget keeps a watchful eye to make sure that all Federal dollars are spent for appropriate purposes. We can ensure you that Trust Fund dollars will not be diverted for inappropriate purposes.

I would also point out that the enactment of the ACA significantly improved the status of the Medicare Hospital Insurance Trust Fund. In the aggregate CBO estimated that the changes made by the Affordable Care Act will save $230 billion over ten years and by $1 trillion over the next ten years. Both CBO and CMS's Office of the Actuary project that the ACA will also extend the insolvency date of the Hospital Insurance Trust Fund.

Sen. Enzi

Despite numerous requests, Congress has not been given a schedule of when additional health care reform regulations will be published. Can you please provide a schedule of when you expect upcoming health care regulations will be published?

Also, senior Administration staff have previously indicated that many of the interim final rules will be reissued as final rules. Is this your understanding? If so, please include the dates you expect the interim final rules will be reissued as final rules as part of the schedule mentioned above.

The Departments of Health and Human Services, Labor, and Treasury have been working to meet the schedule for implementing the Affordable Care Act according to the deadlines provided in the Act. We expect the agencies to issue final rules, responding to comment, in a timely fashion. For information on planned regulatory actions, the Unified Agenda published on December 20, 2010 contains information on regulatory activities, including timelines. Agencies are in the process of developing the 2011 Spring Agenda, which will update this information.

Sen. Enzi

Within nine months of the new health care bill becoming law, OMB helped to publish 18 regulations. Twelve of the 18 regulations were issued as interim final rules. This means that two thirds of the health care regulations were issued without an opportunity for the public to comment on them. This is unacceptable and Americans are suffering the consequences as these rules are being rushed through by this Administration.

For example, parents in at least 19 states cannot buy health insurance for their children because of the way one of the regulations was drafted. The Administrative Procedure Act establishes the basic requirements for the rulemaking process, and generally requires that federal agencies publish a notice of proposed rulemaking in the Federal Register, give "interested persons" an opportunity to comment on the proposed rule, and after considering the public comments, publish a final rule.

Can you make a commitment to me that your office will insist that federal agencies publish a notice of proposed rulemaking in the Federal Register, and give the public at least a 30 day opportunity to comment on all the regulations issued implementing the new health care law?

I share your support for public participation in the federal rulemaking process. Executive Order 13563 specifically directs agencies, where feasible and permitted by law, to provide the public with ample time to comment on regulatory actions. EO 13563 states, "To the extent feasible and permitted by law, each agency shall afford the public a meaningful opportunity to comment through the Internet on any proposed regulation, with a comment period that should generally be at least 60 days." However, statutory or judicial deadlines can affect an agency's ability to issue a notice of proposed rulemaking. The Affordable Care Act regulations are examples of situations where the rulemaking agency faced a statutory deadline. We will continue to work with agencies to encourage the use of notices of proposed rulemaking and other means of advancing public participation.

Sen. Enzi

Once again, the Administration's FY2012 budget calls for the expiration of the 2001 and 2003 tax cuts for so-called "high-income earners" upon their expiration in 2012. Based on the discussions that this administration had with business owners and executives over the past several months regarding tax reform, I am surprised that the administration has not recognized the impact of not allowing those tax rates to continue for small businesses that operate in pass-through form, the business income from which is taxed at individual income tax rates. Pursuant to this proposal, half of all small business income would be subject to higher taxes, and nearly 750,000 small businesses would face higher taxes. Is this proposal the Administration's idea of a good non-corporate tax reform effort - raise taxes on small businesses and small business owners in Wyoming and around the country? Does the Administration believe that it can separate tax reform into corporate and non-corporate tax reform? If so, why has the Administration not taken into account the proliferation of businesses in Wyoming and throughout the United States that operate as partnerships, limited liability companies, or S-corporations, all of whose business income is subject to individual income tax rates?

Most of the pass-through income goes to a small percentage of taxpayers. Over 95 percent of small-business owners will be unaffected by the expiration of the tax cuts for high-income earners, since most have net income that is below the $250,000 income threshold at which the higher tax rates would be increased if the 2001/2003 tax cuts expire.

The Administration supports revenue-neutral corporate tax reform that would lower corporate tax rates and increase the tax base by eliminating loopholes and other tax preferences. Also, as the President said in the State of the Union address, the best thing we could do on taxes for all Americans is to simplify the individual tax code, and the Administration is ready to work in a bipartisan effort to do that.

The Administration has fully supported tax provisions that have benefited small business in the Small Business Jobs Act of 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and in the FY12 Budget. The December bipartisan agreement expanded and temporarily increased the annual expensing and investment limits for small businesses, and also extended a temporary increase in the exclusion of tax on capital gains realizations on certain small business stock. The Administration proposes to permanently extend the 100 percent exclusion of capital gains realizations of small businesses.

Sen. Enzi

Just a few weeks ago, an overwhelming majority in the Senate voted to approve an amendment to an aviation bill that would repeal the onerous Form 1099 reporting provisions that were included in the health care reform law. As I pointed out when I asked you the question, the Administration's budget suggests that this bipartisan agreement is not the right answer - that, in fact, a portion of the provision should remain in the law. You told me that you would get back to me with the Administration's position, given that it was recent Senate action.

Does the Administration stand by its proposal that a business be required to file an information return for payments for services or for gains aggregating to $600 or more in a calendar year to a corporation (except a tax-exempt corporation) and information returns would not be required for payments for property?

We support a modification that would alleviate the burden of this requirement on small business and will work with Congress to accomplish this goal. The Budget proposes to repeal the additional reporting requirements imposed by the Affordable Care Act. The proposal also would require businesses to file an information return for payments aggregating to $600 or more in a year to a corporation. Regulatory authority would be provided to make appropriate exceptions where reporting would be especially burdensome. Information returns would not be required for payments for property. We believe these provisions will alleviate the reporting burden at a much lower cost than simply repealing the ACA provisions. While we have concerns with pending offsets, we look forward to working with the Congress to ensure a fully paid-for repeal of the 1099 provision becomes law.

Sen. Enzi

The budget proposes a 25 percent decrease in the Job Corps construction account. How does this proposal impact the Job Corps Center that is scheduled to be built in Riverton, Wyoming?

Funding for this Center, along with the Centers in Iowa and New Hampshire was walled off when they were awarded in 2007. Since that time, the Centers in Wyoming and New Hampshire have been delayed. When does the Administration plan to release the bid solicitation for the Job Corps Center in Wyoming?

The 2012 Budget's proposal to reduce Job Corps Construction would not affect the program's ability to finance construction of the Wyoming center. However, the pending FY 2011 appropriations bill, H.R. 1, would not fund new facilities, considering significant cuts to Job Corps unobligated balances and new 2011 funding. Pending resolution of the FY 2011 appropriations process, the bid solicitation processes for Wyoming and New Hampshire are on hold.

Sen. Enzi

Community Living Assistance Services and Supports Act (CLASS Act):

The CLASS Act was passed as part of the Patient Protection and Affordable Care Act of 2010. On January 5, Secretary Sebelius sent a letter to Congress stating that the CLASS Act programs would be moved to the Administration on Aging (AoA). The following questions concern that move and the overall implementation of the CLASS Act.

1. The Administration is utilizing nearly $1 billion in funds from the Patient Protection and Affordable Care Act of 2010. Will you please provide a breakdown of how these monies are being spent and by the agencies spending the money? How much money is being used to implement the CLASS Act?

Of the $1 billion appropriated in the Health Reform Implementation Fund, $128 million was obligated in FY 2010. This includes $107 million for the Department of Health and Human Services and $21 million for the Internal Revenue Service. The FY 2012 President's Budget includes $120 million for CLASS. The obligated funds have primarily supported salaries, benefits, contracts, and infrastructure for health reform initiatives.

Sen. Enzi

2. Is the Administration on Aging (AoA) receiving funds to administer the program? Are federal funds being transferred from other previously appropriated programs, such as Own Your Future and the National Long-Term Care Clearinghouse, to finance the administrative costs of the CLASS Act? What percentage of AoA monies are being used for the CLASS Act implementation? Please list any programs whose funding has been shifted to implement the CLASS Act, and for each fiscal year. Please specify whether these are mandatory or discretionary funds. Please also list the statutory authority for the use of these funds for the implementation of the CLASS Act.

The President's FY 2012 Budget requests $120 million in administrative funding for the CLASS program, including significant investments for the development of a national IT system and education and outreach to potential participants and employers.

FY 2012 will be the first year that CLASS will receive a discretionary appropriation. CLASS requires funds from a discretionary appropriation in FY 2012 to bridge the period between FY 2011 when funding is covered under Section 1005 of P.L. 111-152 and the point at which administrative funding can be drawn statutorily from premiums received.

For FY 2010 and FY 2011, no AoA funding is being used to administer CLASS. The program's expenses are being funded entirely by the Health Reform Implementation Fund.

Sen. Enzi

3. Is there expected to be an advertising and/or outreach campaign for the CLASS Act programs? If so, what is the ten year budget for the advertising/outreach campaigns? How will the monies be spent? Where will the Department of Health and Human Services (HHS) find the money for the campaign? Please specify whether these are mandatory or discretionary funds. Please also list the statutory authority for the use of these funds for the implementation of the CLASS Act

The CLASS Act is geared to help Americans protect their independence if they require long-term care services in the future. The CLASS program is required by law to maintain solvency over 20 and 75 years. The Department of Health and Human Services (HHS) will develop CLASS to meet these important requirements, and no taxpayer funds will be used for payment of benefits. Outreach and education will be crucial components of achieving the goals of the CLASS program. HHS will provide additional detail regarding implementation of outreach efforts for the CLASS program.

Sen. Enzi

4. Recently, I was informed that HHS intends to contract with outside to groups, Knowledge Networks and Thompson Reuters, to conduct a study and surveys on who is purchasing long-term care insurance and related products. Were these contracts put out for competitive bid? Will you please supply copies of the contracts?

The Department of Health and Human Services (HHS) will develop CLASS to meet important statutory requirements for solvency over 20 and 75 years, and no taxpayer funds will be used for payment of benefits. HHS will provide additional detail regarding contracts required to implement the CLASS Act.

Sen. Enzi

5. If surveys were used by these outside groups on behalf of a study undertaken for HHS, federal law requires that the surveys of more than ten individuals must be approved by the Office of Management and Budget. Please supply copies of the OMB approval of these surveys and copies of all surveys used.

All information collection requests (ICRs) submitted by agencies for OMB approval under the Paperwork Reduction Act (PRA) can be found at http://www.reginfo.gov/public/do/PRASearch. OMB has reviewed and approved one survey that contained questions related to the CLASS Act. These questions added to HHS/CDC's National Health Interview Survey (approved by OMB on December 13, 2010) can be found at: http://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=201009-0920-002.

Sen. Enzi

6. In adhering to the President's commitment to transparency and abiding by government contract regulations, please list all studies that have been submitted to OMB for approval in the last 180 days. Include the estimated cost of the study, the source of the funding, as well as the organization in charge of its administration.

Between August 22, 2010 and February 18, 2011, OMB received 321 information collection requests (ICRs) that employ statistical methods for OMB approval under the Paperwork Reduction Act (PRA). The supporting statement for each ICR contains information such as the agency conducting or sponsoring the study and cost to the federal government. Copies of the ICR package (including the supporting statement) submitted for OMB approval can be found at: http://www.reginfo.gov/public/do/PRASearch. The source of the funding can be obtained from the agency conducting or sponsoring the study.

Sen. Enzi

7. Has the Department of AoA hired an actuary for the CLASS Act? Pursuant to Section 3203 of the CLASS Act, you shall develop at least three actuarially sound benefit plans as alternatives for the CLASS Independence Benefit Plan. Have you consulted with the three actuaries, and if so, who are the actuaries? Is the actuary for the Centers of Medicare and Medicaid Services (CMS) one of the three actuaries? When will the three alternatives be shared with Congressional oversight Committees? When will the final decision be made with respect to which actuarial plan alternative will be the basis for the CLASS Act implementation? Will you require that each of the actuarial analyses contain a 75-year analysis?

Robust actuarial estimates will be crucial components of achieving the goals of the CLASS program. HHS will provide additional detail regarding implementation of the actuarial work for the CLASS program.

Sen. Enzi

8. What will OMB do to ensure the fiscal solvency of the CLASS Act programs? Will OMB use an independent actuary to review calculations used by HHS in establishing premiums and benefits under the CLASS Act programs?

HHS is utilizing expertise throughout the Administration, including OMB, during the planning for CLASS. In addition, the CLASS actuary will operate under the same longstanding approach of the Medicare and Social Security actuaries— with strong independence supported by the best available information and analytic tools.

Sen. Enzi

9. When will the first premiums be collected pursuant to the CLASS Act programs? Will the collection of premiums begin prior to the establishment of the CLASS Independence Benefit Plan? Will the collection of premiums begin prior to the establishment of enrollment mechanisms for all entities and individuals? What regulations need to be finalized before premiums collection commences?

HHS will provide additional detail regarding collection of premiums for the CLASS program.

Sen. Enzi

10. Recently, Secretary Sebelius gave a speech to the Kaiser Family Foundation concerning the CLASS Act. She claimed that the CLASS Act has loopholes and that it only offers two options for setting premiums and "[n]either of these options is appealing." What loopholes need to be fixed? Will these require legislative changes? What other options are you considering for premiums? Will these premium issues require legislative changes?

HHS will provide additional detail regarding premium frameworks being considered for the CLASS program.

Sen. Enzi

11. In recent years, the federal government's own long-term care insurance programs experienced a serious spike in cost of premiums to those enrolling in the program. How can you ensure that no premium spikes will occur with those enrolling in CLASS Act programs? Will enrollees in CLASS Act programs be given the opportunity to receive a refund if premium spikes are too high?

HHS will provide additional detail regarding premium frameworks being considered for the CLASS program.

Sen. Enzi

Regulatory Flexibility Act:

12. What will OMB do to ensure that federal agencies comply with E.O. 12866 and the Regulatory Flexibility Act and to provide for sound economic analyses for all proposed, interim and final regulations? Will there be any additional OMB oversight of regulations promulgated pursuant to the Patient Protection and Affordable Care Act of 2010 and the Dodd-Frank Wall Street Reform and Consumer Protection Act? Will OMB require additional outreach to the small business community to ensure that the economic analyses cover all effected entities?

On January 18th, the President issued Executive Order 13563, entitled "Improving Regulation and Regulatory Review," as well as a memorandum entitled "Regulatory Flexibility, Small Business, and Job Creation," both of which emphasize the importance of reducing regulatory and paperwork burdens (including those burdens on small businesses). In the memorandum, the President specifically directed executive departments and agencies (and requested independent agencies) to give serious consideration to whether and how it is appropriate to reduce regulatory burdens on small businesses through increased flexibility (including, for example, delayed compliance dates, simplified reporting requirements, and partial or total exemptions). The President also directed that whenever an executive agency chooses not to provide such flexibility in a rule that is likely to have a significant economic impact on a substantial number of small entities (for reasons other than legal limitations), it should explicitly justify its decision. Recently OMB requested that agencies submit burden reduction initiatives, with particular emphasis on reducing paperwork and reporting burdens on small business.

As part of the regulatory review process, OMB will evaluate agency compliance with Executive Order 13563 and with the Presidential memorandum on "Regulatory Flexibility, Small Business, and Job Creation." OMB will also work with the U.S. Small Business Administration Office of Advocacy on Regulatory Flexibility Act compliance for regulations that have an impact on small businesses. Such work will include the Affordable Care Act and Dodd-Frank Wall Street Reform and Consumer Protection Act regulations that are subject to E.O. 12866 and 13563 review. (It is important to note, however, that independent agency regulatory actions are not subject to these E.O.s, although independent agencies are encouraged to give consideration to all of its provisions, consistent with their legal authority.)

Sen. Enzi

The President's FY2012 budget proposes moving the Senior Community Service Employment Program (SCSEP) from the Department of Labor (DOL) to the Administration on Aging (AoA). The Government Accountability Office's (GAO) job training report released February 8, 2011 found while administered by DOL, SCSEP appeared to be meeting its training and employment objectives. Given DOL's experience and existing resources in administering job training programs, could you please describe how AoA is better equipped to oversee SCSEP? Please explain AoA's level of experience in administering job training and employment programs. Does AoA currently employ any staff dedicated to handling older adult workforce issues, and if so, how many?

The Senior Community Service Employment Program (SCSEP) has three goals: to foster individual economic self-sufficiency, promote useful opportunities in community service, and increase the participation of low-income seniors in unsubsidized employment. Transferring SCSEP to the Administration on Aging (AoA) will strengthen SCSEP's capacity to meet these goals by fostering better coordination between SCSEP and other senior-serving programs, improving SCSEP's focus on the comprehensive well-being of seniors, and expanding opportunities for SCSEP participants to contribute to their communities through service to other seniors. Closely integrated with other programs serving low-income seniors, SCSEP could better support not only employment, but also health, wellness and independence for seniors. Because of its expertise in senior issues, AoA is well-positioned to provide strong support and technical assistance to SCSEP grantees. Over two-thirds of the state and territorial grantees already house their SCSEP programs within offices on aging, senior services or health and human services departments - departments that AoA already works with. A move to AoA will consolidate federal oversight of the OAA under one department, streamlining operations and putting federal administration of SCSEP in alignment with operations in the field. Additionally, AoA will continue to work with the Department of Labor to expand job opportunities for aging workers and ensure that the employment and training needs of SCSEP participants are met.

Sen. Enzi

With the Older Americans Act up for reauthorization this year, why should transitioning SCSEP from DOL to AoA be completed using budgetary procedures instead of through the regular legislative process? Has DOL or AoA solicited comments from outside stakeholders and the older adult community, and if so, what has been the reaction to the proposed transition?

In anticipation of reauthorization, AoA convened three national listening sessions, held one joint session with the Department of Labor, and participated in hundreds of national, state and local sessions convened by stakeholders and involving all states and area agencies. As a result, the critical internal and external stakeholders representing thousands of older individuals and their caregivers were engaged in providing input and recommendations for the next reauthorization. Representatives indicated that SCSEP participants could benefit from a greater degree of alignment between the networks that administer the programs. AoA anticipates working closely with SCSEP grantees at the national, state, and local levels to enhance coordination and create better alignment with other Older Americans Act programs and services as well as with the Workforce Investment Act system. The Administration looks forward to working with Congress on ways to strengthen the Senior Community Service Employment Program (SCSEP) and other programs providing critical supports to seniors through reauthorization of the Older Americans Act.

Sen. Toomey

Since the Social Security trust fund contains Certificates of Indebtedness and Special Issue Obligations that can only be redeemed through the Treasury Department, the federal government will have to cover any cash deficit in Social Security through one of three methods- tax increases, reduced spending in other areas, or increased deficits, or some combination thereof.

How does Pres. Obama assume these cash deficits will be covered? What form of tax increases and spending cuts will be implemented to cover this cash deficit? How much additional debt, above what is already projected, will be taken out to pay for this?

The operations of the Social Security trust funds are fully reflected in the President's Budget. The Budget proposes to reduce the overall budget deficit to 3 percent of GDP by 2017, thereby achieving primary balance. The deficit is reduced to levels that keep the debt from increasing as a share of GDP even earlier, starting in 2013.

The Budget includes all of the transactions of the Social Security trust funds under current law, and proposes no change to their structure or financing. Therefore, there is no additional debt beyond what is projected in the Budget to cover the transactions of the Social Security trust funds.

Sen. Toomey

In December 2010, President Obama signed into law a tax compromise. As part of this compromise, he lowered the employee share of the Social Security payroll tax by two percentage points. The tax cut compromise is slated to expire at the end of FY 2012.

a) Does the OMB budget baseline assume that the employee share of the payroll tax reverts back to 6.2%?

b) How much additional revenue will this bring in than if the employee share stayed at 4.2% through 2021?

The budget assumes that the reduction in the Social Security employee payroll tax rate from 6.2 percent to 4.2 percent, which applies to taxable wages received after December 31, 2010, and before January 1, 2012, expires with respect to wages received after December 31, 2011, as scheduled under current law. Extending the 2% payroll tax holiday through 2021 would reduce payroll tax revenues by $1.4 trillion over the ten year period.

Sen. Toomey

If all other factors in the OMB budget remain the same, what would the federal government's annual interest payments be if borrowing costs on US debt returned to the average level they were at during the Clinton Administration by the beginning of FY 2013? What would be the overall impact on the deficits and debt?

During the Clinton Administration, Treasury 91-day interest rates were on average 0.81 percent higher than the Budget assumptions for 2013-2021, and 10-year rates averaged 1.17 percent higher. The sensitivity to economic assumptions table in the Budget projects the effects of a 1 percentage point increase in interest rates, a similar scenario. The table shows the impact of higher rates starting in 2011; when the increase is delayed to 2013 there is a $714 billion increase in the debt over the Budget window.

Sen. Toomey

Regarding the AMT fix in the OMB budget, how much of the offset for this fix is present in the first three years?

a) What is the present value of the remaining offset through 2021?

The Budget pays for the $316 billion cost of a three-year extension of AMT relief with an offset of $321 billion from limiting the value of certain tax expenditures. $51 billion of the offset is over the three years for which the extension of AMT relief reduces revenues. The remaining portion of the offset for the AMT fix is $270 billion over the last seven years of the ten-year budget window. OMB does not calculate present value amounts in the budget other than for Federal credit programs, which use present value to measure the subsidy cost of loans and loan guarantees according to the Federal Credit Reform Act.

Sen. Toomey

Regarding the SGR "doc-fix" in the OMB budget, how much of the offset for this is present during the first two years?

a) What is the present value of the remaining offset through 2021?

The Budget pays for the $54 billion cost of two years of Medicare physician payment relief from the SGR formula with an offset of $62 billion from savings in Medicare, Medicaid, and other health programs. $6 billion of the offset is over the three years that the SGR fix increases outlays. The remaining portion of the offset for the SGR fix is $56 billion over the last seven years of the ten-year budget window. OMB does not calculate present value amounts in the budget other than for Federal credit programs, which use present value to measure the subsidy cost of loans and loan guarantees according to the Federal Credit Reform Act.

Sen. Toomey

The President's Budget includes a policy called "Pay-for-Delay" that limits the ability of brand and generic drug firms to settle their patent lawsuits. The effect on the budget deficit of this policy, as outlined on Page 196 (Table S-8), is listed as reducing the deficit by almost $8.8 billion dollars from now until 2021. However, the CBO estimates that this change in policy will only generate $2.6 billion in that same time frame. Could you please justify this discrepancy?

The Budget estimate was developed by the independent CMS Office of the Actuary. The estimate is generally based on the methodology reported by the Federal Trade Commission (FTC) in its January 2010 report, "Pay-for-Delay: How Drug Company Pay-Offs Cost Consumers Billions," applied to a base of Medicare and Medicaid spending. However, the CMS estimate assumes average consumer savings of 45 percent, compared to 77 percent assumed by FTC. We do not have detailed information about CBO's scoring assumptions and methodology. Potential factors that may contribute to the difference in savings estimates include variable assumptions about the baseline against which savings were estimated, different assumptions about the impact of the proposal over time, and assumptions about behavioral changes that could be produced by the proposal.

Sen. Toomey

Total spending for Medicare in the OMB budget from 2010 to 2021 is estimated to be about $1.5 trillion less than what the CBO predicted in their January forecast for the same time frame. Could you please account for this significant discrepancy?

The difference of about $1.5 trillion between CBO and OMB's Medicare baselines is because CBO's projection is for gross Medicare spending but the Budget's estimate is net Medicare outlays. Gross spending includes Medicare expenditures that are covered by premiums and other offsetting receipts such as Part D State payments to the federal government. Net outlays subtract these offsetting receipts to show net Federal spending on the program. When comparing apples to apples, that is, comparing CBO and the Budget's projections of net Medicare spending between 2010 and 2021, the difference shrinks to about $354 billion from 2010 to 2021, which represents about 5 percent of Medicare net outlays. This difference is well within the range of historical differences between CBO and OMB's estimates. Since the FY 2000 Budget, OMB and CBO's Medicare baseline estimates have differed by as much as 10.3 percent and as little as 0.1 percent. Differences between CBO and the Administration's estimates are due to differences in technical and economic assumptions.

Sen. Graham

With one of President Obama's initiatives being to double exports over the next five years and 94% of the nation's overseas commerce being carried on federally maintained channels, I fail to see this priority reflected in the budget request for Army Corps, which is responsible for the getting our ports ready to handle the big ships carrying these job-creating exports. What type of priorities went into developing the Corps' budget, and why was such a limited amount of resources allocated to establishing a South East deepwater capable harbor?

The President's Budget provides $4.6 billion for the Army Corps of Engineers civil works program (Corps). The Budget does not allocate these funds on a regional basis or to give exports a preference. Rather, it strives to produce as much value as possible for the Nation from this funding, with emphasis on the three main missions of the Corps, one of which is commercial navigation. (The other two are flood and storm damage reduction, and aquatic ecosystem restoration.)

The proposed budget for the Corps commercial navigation program is $1.6 billion, roughly 34 percent of the $4.6 billion provided for the Corps. In allocating this $1.6 billion, the Corps gave priority to maintaining major coastal harbors and their channels, maintaining the inland waterways with the most commercial use, constructing inland and coastal navigation projects with high economic returns, and completing four ongoing feasibility studies. Most of this funding reduces transportation costs for commercial goods moved by water, including exports.

The budget for the Corps is consistent with the Administration's export initiative. In the short-term, it maintains spending for work financed from the Harbor Maintenance Trust Fund at the FY 2010 enacted level, in a year in which the overall budget for the Corps is 15 percent lower. In the long-term, the President's Budget proposes to reform the way that Federal navigation investments are funded. These reforms, which affect both the Harbor Maintenance Trust Fund and the Inland Waterways Trust Fund, will support investments that contribute to the strength of the American economy.

As noted above, the proposed budget for the Corps does not establish priorities on a regional basis. However, it does include $162 million in support of several dozen navigation projects from Virginia to Florida, roughly 10 percent of the total funding for the Corps commercial navigation program nationwide.

The Corps has constructed the main navigation channel in three southeast harbors to a depth of 45 feet or more: Morehead City, NC (45 feet); Charleston, SC (45 feet); and Hampton Roads, Norfolk, and Newport News Harbors, VA (50 feet). The Budget provides $59 million for the Corps in support of commercial navigation at these three ports, nearly 37 percent of the Corps funding for all southeast ports. This illustrates how major coastal ports are a priority for the Corps and our ongoing investment in infrastructure.

Sen. Graham

For the FY 2012 International Affairs request, the Administration has asked for two pots of funding for the State Department and United States Agency for International Development (USAID): (1) a base request of $47 billion for operations and programs and (2) Overseas Contingency Operations (OCO) totaling $8.7 billion funding for the "temporary and extraordinary" costs associated with Iraq, Afghanistan and Pakistan. Can you please clarify: when the Administration asserts that the International Affairs request is in our national security interests - and should be considered national security spending - are you only talking about OCO, or both the base and OCO requests? What specifically are those interests?

The Administration's International Affairs request, both base and OCO, advances the national security interests of the United States, just as military base and OCO budgets are both considered part of our national security budget.

The International Affairs request supports the President's National Security Strategy across a broad range of international programs and activities. Each program in the base and OCO contributes to advancement of our national security objectives of security, prosperity, respect for universal values, and a just and sustainable international order.

The distinction between base and OCO focuses on those costs that are extraordinary and temporary rather than enduring in nature. OCO supports programs closely tied to Department of Defense activities in the front-line states of Iraq, Afghanistan, and Pakistan, but the base request also supports enduring operations and assistance programs in each country necessary to sustain a long-term diplomatic, development, and security relationship.

Sen. Graham

The House of Representatives will act on a Continuing Resolution (CR) that provides $44.9 billion for the State, Foreign Operations, which is $3.8 billion below the FY 2010 enacted level and $11.7 billion below the FY 2011 budget request. How will the House CR impact the operations and programs of the State Department and USAID?

The House bill (H.R. 1) would cut State Department funding by 18 percent from the President's FY 2011 Budget request. A cut of this magnitude would force reductions that would have an adverse impact on civilian efforts critical to success in Iraq, Afghanistan, and Pakistan, and our ability to promote U.S. national security and foreign policy interests.

The House bill would cut the President's Budget request for State and USAID global health programs by $1.5 billion nearly 18 percent. A cut of this magnitude would put millions of lives at risk by leaving over 10 million persons at risk of malaria without preventive or treatment services, and scaling back life-saving interventions to protect mothers and newborns, such as immunizations and training of skilled birth attendants, resulting in over 275,000 additional preventable deaths.

The House bill would reduce Development Assistance and the Economic Support Fund (ESF) by $3.3 billion compared to the FY 2011 request, a reduction of nearly 31 percent. The bill would not allow the Administration to fund all of its priorities in Afghanistan and Pakistan. The cut to the ESF could limit infrastructure and governance initiatives in Afghanistan and bring the Pakistan non-military assistance level below the Kerry-Lugar-Berman authorization bill.

The House bill cuts about $600 million (-33 percent) from the FY 2011 President's Budget for humanitarian assistance to refugees (MRA) and over $400 million (-50 percent) for International Disaster Assistance (IDA). The cuts would leave millions of people affected by conflict and disasters without access to shelter, clean water, food and other critical needs and, for refugees, would likely significantly reduce admissions to the United States.

The House bill would reduce Food for Peace Title II food aid by over 40 percent overall and emergency food aid by over 55 percent compared to the FY 2011 request and FY 2010 enacted base level of $1.7 billion. Based on average beneficiary costs, the cut would likely leave more than 15 million people in drought and other humanitarian crises without access to food. While the program implements both emergency and non-emergency food aid, the entire cut would fall on the emergency side due to a statutory floor on the program's non-emergency aid.

The House bill would also cut Treasury's funding for international programs to 61 percent below the FY 2011 President's Request and nearly 45 percent below FY 2010 enacted. This would prevent the U.S. from fulfilling numerous commitments to international institutions and programs. Failure to keep these commitments will tarnish the Nation's image abroad, affect U.S. positions of leadership at these institutions, and harm our ability to conduct diplomacy that helps protect America from foreign threats.

Sen. Graham

There is no question belt-tightening is in order, and the FY 2012 budget request includes $1.6 billion for assessed costs for U.S. membership in the United Nations and over 40 other international organizations. What steps is the Administration taking to review U.S. participation in these international organizations, and decrease our involvement accordingly? While NATO assessed costs are justifiable, do we really need to participate in the International Coffee Organization or the International Rubber Study Group?

The Department of State evaluates U.S. participation in international organizations to determine their value to advance U.S. foreign policy objectives and to produce benefits for U.S. citizens and businesses. These objectives include reducing trade barriers, improving border and port security, obtaining international patent and trademark protection, maintaining the world's telecommunications networks, setting standards for aviation and maritime security, promoting international law in the areas of child custody and support, and disseminating information about the supply and demand of vital commodities. Pursuing foreign policy objectives through international organizations also enables the U.S. to leverage the financial contributions and expertise of other nations.

Specifically regarding the International Coffee Organization (ICO) and the International Rubber Study Group (IRSG), the FY 2012 Budget supports continued participation in the ICO but includes no funding for the IRSG. The ICO collects and publishes statistics on coffee production, prices and trade, and facilitates cooperation between governments and the private sector. The U.S. benefits from ICO's efforts to promote transparent and sustainable coffee markets. On the other hand, the limited benefits to the U.S. government membership in IRSG outweighed the financial, legal and staff resources required for continued participation and the U.S. has taken steps to withdraw from this organization. Withdrawing from organizations must be carefully considered to ensure that U.S. interests in continued participation are fully understood. However, we will continuously review our participation in international organizations and propose changes if justified.

Sen. Nelson

In the President's budget proposal, the takeover of Fannie Mae and Freddie Mac is estimated to cost a total of \$73 billion. However, the proposal only accounts for Federal aid through 2013, while relying on dividend payments from the two entities through 2021.

Could you explain how the administration determined that Fannie and Freddie would not need additional support past 2013? Do you have an estimate on Fannie and Freddie's expected losses this year and next year? If not, how can you predict with any accuracy how much liquidity they will require in the future? Do you expect the mortgage market to significantly pick up by 2013? And does the administration expect Fannie and Freddie to retain enough of the mortgage market to make the projected dividend payments through 2021, including payments as high as \$23 billion in 2013?

The Budget assumes that Treasury will make cumulative investments in Fannie Mae and Freddie Mac of \$224 billion from FY2009 through FY2012 and receive dividends of \$55 billion over the same period. Starting in 2013, the Budget forecasts that Fannie Mae and Freddie Mac will have sufficient earnings to pay part but not all of the scheduled dividend payments. These estimates are consistent with the "current baseline" case in the range of potential draws in stress test performed and analyzed by the GSE's regulator, the Federal Housing Finance Agency (FHFA), announced in October 2010. The Administration does assume that house prices will be growing in 2013, an assumption that is supported by the FHFA's analysis using Moody's projections, and repeatedly affirmed through industry surveys such as the monthly MacroMarkets Home Price Expectations Survey. The Budget projections of Treasury's investments are also consistent with the Department of Treasury's 2010 financial statement and take into account that the GSEs will be winding down their investment portfolios at an annual pace of no less than 10 percent as specified in their agreements with Treasury, but do not assume any changes to operating assumptions on their single family guarantee business (such as future pricing increases or legislative changes).

Sen. Nelson

In contrast to your cost estimate for Fannie Mae and Freddie Mac, the Congressional Budget Office believes the takeover of Fannie and Freddie will cost taxpayers $389 billion.

Could you explain why your estimate varies so widely from CBO's estimate? Are you treating mortgage backed-securities held by Fannie and Freddie the same as CBO? If not, why?

The Budget maintains the existing non-budgetary presentation for Fannie Mae and Freddie Mac, as it does for the other GSEs. This is consistent with financial accounting standards that do not require consolidation of an entity if ownership control is temporary. However, 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. CBO's estimates of the deficit impact of the GSEs are considerably higher than the Administration's because CBO defines the budget impact as capturing what a private entity would require as compensation for assuming Fannie Mae and Freddie Mac's commitments. The compensation is represented in CBO's description as the difference in market value between Fannie and Freddie's assets and their liabilities on a "risk adjusted" basis. This "risk premium" assigned by CBO does not constitute a federal outlay, and is not comparable to the budgetary estimates of GSE costs included in the President's Budget. The Administration presents the budget impact as the estimated transactions between Treasury and Fannie Mae and Freddie Mac under the PSPAs.

Sen. Nelson

In the President's budget proposal, $556 billion is directed toward surface transportation over the next six years, including the creation of a National Infrastructure Bank, requiring an investment of $30 billion over the same time period.

After the initial investment, would the Bank be able to be self-sustaining? Would it leverage private capital for financing? If so, how? Furthermore, do you expect the Bank to ever fully supplant the need for annual appropriations or future authorizations for surface transportation projects?

The proposal for a National Infrastructure Bank (I-Bank) provides $30 billion in budget authority over six years to fund grants and the subsidy costs of Federal loans and loan guarantees to projects of regional and national or regional significance, and to fund administration of the program. The proposed program will be compliant with the Federal Credit Reform Act. Because of the grants provided and the subsidized nature of the loan and loan guarantee financing, the program will not be self-sustaining. Rather, like other surface transportation programs funded under the reauthorization proposal, Congress would need to provide additional budgetary resources to support I-Bank activities beyond the levels provided. We do not envision the Bank fully supplanting the need for future authorizations and/or annual appropriations. Rather, we envision the Bank serving a specific niche: projects that will generate very significant benefits to our economy -- and in most cases will be associated with some revenue source to pay back the Bank's investment -- but may be difficult to finance with existing, stove-piped financing sources.

We do envision the I-Bank leveraging significant non-Federal co-investment, including private capital. In addition to cost-share requirements, project sponsors that demonstrate substantial commitments of non-Federal resources to projects of national or regional economic significance will be most competitive in the pursuit of I-Bank support. Private investors will be engaged on a project-by-project basis. Their participation in/evaluation of individual deals (i.e., their willingness to risk their own funds) is a key way that Bank managers will be able to gauge the financial returns associated with projects. A key advance that we would expect from a successful I-Bank is to advance the state of the art in evaluating projects based on overall benefits, both financial and otherwise, and prioritizing investments accordingly.

Sen. Cornyn

How much in discretionary spending does the President's FY2012 budget provide for the implementation of the Patent Protection and Affordable Care Act (P.L. 111-148) and the Health Care and Education Reconciliation Act of 2010 (P. L. 111-152)?

Implementing the Affordable Care Act is one of the Administration's highest priorities, and we are committed to its successful implementation and the efficient use of taxpayer resources. Funding for the continued implementation of ACA is built into the President's FY 2012 Budget for such agencies as the Centers for Medicare and Medicaid Services, the Administration on Aging, the Internal Revenue Service, the Department of Labor, the Office of Personnel and Management, and the Social Security Administration. ACA implementation activities in these agencies are interwoven with the execution of other statutes and authorities making estimates of resources that will specifically support ACA implementation difficult to disaggregate.

Sen. Murray

Director Lew, because my time ran out during the hearing, I would like to make sure that I am able to communicate the full scope of my question, and I look forward to your written response.

As I said, I'm pleased that the DOE Environmental Management budget has a slight increase, which I view as a sign that the Administration recognizes its legal obligations.

I appreciate the time and effort that you have put into making the EM budget compliant for fiscal year 2012. But I'm very concerned that at these funding levels, you're pushing off work that needs to be done in FY 12 to ensure DOE meets its legal obligations moving forward.

I also appreciate that the Administration is committed to modernizing our nuclear weapons facilities in the coming years, and I noticed that that OMB has said it will ensure that future allocations to that effort will occur in the required amounts. As you know, Mr. Lew, it's unusual for OMB to commit itself to future funds like that.

As I have been saying for years, this is exactly where we need to go with EM budgets. For fundamental legal reasons, and because there is also massive amounts of human and monetary capital wasted when EM doesn't have stable budgets, we need to make sure that the Administration budgets effectively over the long term to meet required compliance deadlines.

How can Congress and this Administration work together to develop a clear and consistent approach to EM budgets over the long term, like OMB is doing with NNSA?

The Administration has a clear and consistent approach to funding for the Department of Energy's (DOE) Environmental Management program as reflected in the 2012 Budget. The Budget proposes $6.13 billion for the cleanup program, +$83 million more than the 2011 budget request and +$122 million more than the 2010 enacted level. This includes sufficient funds to provide DOE the opportunity to meet all FY 2012 enforceable milestones in its various cleanup agreements, including the Hanford Tri-Party Agreement to protect the Columbia River. The Administration also is concentrating on improvements in management and oversight of the program and activities in EM, with the aim of maximizing performance from the funds we allocate to the program. The Administration recognizes the Department's cleanup obligations and will work with Congress to meet these environmental requirements over the long term in a fiscally responsible manner.

Sen. Cornyn

How much in discretionary funds does the President's budget provide for the administration and enforcement of the employer mandate and the individual mandate?

The individual and employer shared responsibility provisions of the Affordable Care Act become effective in 2014, so no enforcement is possible or necessary in 2012. However, the IRS Commissioner has informed Congress that $62.5 million in discretionary resources are necessary for IT operations support at IRS to set up systems that are related to enforcement activities.

Sen. Cornyn

How much in discretionary spending does the President's FY2012 budget provide for the implementation of the Dodd-Franks Wall Street Act (P.L. 111-203).

Because funding for Dodd-Frank is not segregated from other activities for the lead agencies responsible for implementing the Act, the Budget does not contain an explicit estimate of funding for Dodd-Frank. Some of the funding for Dodd-Frank implementation would be fee funded, and some would come from the General Fund, depending on the agency. Discretionary Dodd-Frank funding is allocated among the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), and the Department of Treasury. This funding will permit these agencies to bring greater transparency and accountability to the derivatives market, increase supervision of hedge funds and private equity funds, increase oversight of credit rating agencies, stand-up the new Federal Insurance Office and the Office of Minority and Women Inclusion, and draft the numerous regulations and reports required by the Act.

Sen. Cornyn

How many federal employees will be hired to implement the legislation under the President's budget?

Hiring agencies include the Department of the Treasury, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Consumer Financial Protection Bureau. Given the many agencies involved and the fact that Dodd-Frank implementation will be interwoven with existing responsibilities, the Budget does not include estimate of the number of full-time equivalents (FTEs) who will be hired.

Sen. Cornyn

The President's budget includes $36 billion of additional loan guarantee authority for nuclear power facilities. My state of Texas is no stranger to nuclear power. As you may know, there is a nuclear facility is located near Bay City, Texas called the South Texas Project. It is one of the newest and most productive nuclear power plants nationwide. This twin-reactor facility currently produces 2,700 megawatts of electricity, enough to serve more than two million homes in Texas.

There is an effort underway to expand the South Texas Project, and construct two additional units, which would add approximately 2,700 megawatts of power generation- enough to power approximately two million households in San Antonio, Austin, Houston and surrounding areas. Director Lew, I understand there is an application for a nuclear loan guarantee for the South Texas Project, and the application has made it through the Department of Energy's credit committee, and is now subject to OMB review. I know that the loan guarantee process for this project began in April of 2008, so I would appreciate anything you can do to expedite the review of their loan guarantee application. This project is very important to my state. Not only will Texas benefit from the energy production; the construction of this nuclear project will create approximately 6,000 jobs and $9 billion of economic activity for Texas.

1. **Can I count on your assurance that OMB will do a timely review?**

2. **What is the anticipated timeline for this review?**

The Administration is committed to the objectives of the Title XVII program, and we are committed to reviewing all applications, including the South Texas Project, as quickly as possible consistent with fulfilling our statutory responsibilities to protect taxpayer funds. In Texas, and across the country, there are clean energy projects with major potential economic and energy impacts, and with that in mind, we are working together across the Administration to implement the program expeditiously and prudently.

The OMB role in reviewing DOE loan guarantee transactions derives from its statutory oversight responsibility under the Federal Credit Reform Act of 1990 (FCRA). Section 503 of FCRA gives the Director of OMB the responsibility for the credit subsidy cost estimates for all Federal credit programs. Under this authority, OMB reviews and must approve subsidy cost estimates for all loan and loan guarantee programs, including the credit subsidy cost estimates generated by DOE for the Title XVII program, to ensure that costs are accounted for appropriately, as required by FCRA. OMB ensures that the costs of direct loans and loan guarantees are presented and reflect estimated risks consistently across Federal agencies so that taxpayer funds are invested in a prudent and effective fashion.

Sen. Wyden

Can you please provide further details on the funding levels that the President's Budget proposes for the Secure Rural Schools program for each of the 5 years of the reauthorization and the split of those funds that are intended to be allocated to the Forest Service payments and those that are designated for the BLM's Oregon and California grant lands? Can you provide details on how the funding is intended to be split and calculated among the states?

Following is information on each of the five years of the reauthorization, broken out by Forest Service and the Bureau of Land Management and by each title. More detailed information on funding by state will be made available by USDA once the proposed legislation is finalized. State level funding will be calculated in the same manner as currently done (estimated funding will be calculated by multiplying the adjusted share by the full funding amounts prescribed in the proposal).

Attachment: QFR attachment secure rural schools funding.pdf

	2010 Actual	2011 Estimate	2012 Proposed	2013 Proposed	2014 Proposed	2015 Proposed	2016 Proposed
Payments for Schools and Roads (Title I)	426	310	255	230	131	81	49
Forest Service (schools and roads)	*[353]*	*[276]*	*[227]*	*[205]*	*[117]*	*[72]*	*[44]*
Bureau of Land Management (county general fund)	*[73]*	*[34]*	*[28]*	*[25]*	*[14]*	*[9]*	*[5]*
Economic Investment & Forest Restoration/Protection (Title II)	49	35	64	64	64	64	64
Forest Service	*[42]*	*[32]*	*[57]*	*[57]*	*[57]*	*[57]*	*[57]*
Bureau of Land Management	*[7]*	*[3]*	*[7]*	*[7]*	*[7]*	*[7]*	*[7]*
Fire Assistance (Title III)	26	19	9	0	0	0	0
Forest Service	*[20]*	*[16]*	*[8]*	*[0]*	*[0]*	*[0]*	*[0]*
Bureau of Land Management	*[6]*	*[3]*	*[1]*	*[0]*	*[0]*	*[0]*	*[0]*
Total	501	364	328	294	195	145	113

These numbers are estimates and subject to change.

Sen. Wyden

Recent events across the Middle East and Northern Africa have demonstrated that this is a time of great instability in that region. This volatility emphasizes the importance of solid relationships among the U.S. and strategic partners, including Israel and Egypt. FY 2012 is the fourth year of a 10-year memorandum of understanding (MOU) between the U.S. and Israel on military assistance.

Does the Obama Administration remain committed to fully funding the aid promised under this MOU?

Is the Obama Administration committed to continuing to provide funding for the "Iron Dome" ballistic missile defense program, which is vital to Israel's strategic defense?

The FY 2012 Budget includes full funding to meet the fourth year of the 10-year memorandum of understanding (MOU) between the U.S. and Israel on military assistance.

The Administration maintains an unshakeable commitment to Israel's security, including efforts to expand coordination between the U.S. and Israel militaries and to preserve and strengthen Israel's qualitative military edge. The U.S. also supports efforts to fortify Israel's ballistic missile defenses, including a one-time request last year to provide U.S. financial support for Iron Dome, which protects against short-range rockets and mortars.

The Administration will continue to work with the Congress to enact the President's requests going forward, including full support for requested assistance programs for Israel.

Sen. Crapo

The 2012 Budget proposes to eliminate extra revenue sharing payments to certain counties from Federal geothermal leases, which are in addition to payments. Specifically, this proposal would repeal these geothermal payments to counties and return to the traditional 50/50 Federal-State revenue sharing arrangement.

Question #1: Please provide more information regarding the justification for reverting these distribution levels from the pre-EPACT arrangement. What is the Administration doing to offset this important revenue source for counties? Are you concerned that the new levels will seriously reduce essential public services?

The geothermal payments to counties established by the 2005 Energy Policy Act are inconsistent with longstanding revenue sharing arrangements. Revenues from similar mineral development on Federal lands have historically been split equally between the Federal Government and the State in which the lands were located. The additional 25 percent share provided to counties means that Federal taxpayers receive an inadequate return from the use of these Federal resources. States have the flexibility to allocate their share of revenue from Federal leases to counties if they consider that to be appropriate. It is also worth noting that Federal geothermal energy development creates jobs and many other economic benefits for nearby communities.

Sen. Crapo

Under the 2012 Budget, funding for the State Criminal Alien Assistance Program (SCAAP) would be reduced by $194 million. However, a recent Government Accountability Office study determined that states spend more than $1.7 billion each year to incarcerate criminal aliens and that Congress has reimbursed only 20 percent of these local expenditures.

Question #1: The reduction of SCAAP funding will undoubtedly increase the burden on state taxpayers. At a time when many states are experiencing unprecedented budget challenges, what plans does the Administration have for additional Federal reimbursement if SCAAP funding is decreased?

The Budget proposes to increase funds for a number of programs to help states and localities directly address crime and violence including increased immigration enforcement efforts by the Department of Homeland Security (DHS). In doing so, the Budget makes some trade-offs, including reduced funding for SCAAP. Under the Administration's 2012 Budget proposal, SCAAP will better target payments to states and localities by limiting reimbursements to those expenditures related to inmates who have verified status as illegal aliens. Payments for "unknowns" (58 percent of the persons for which reimbursements were provided in 2010) will be discontinued.

The Budget provides more than $2 billion in DOJ resources to help curtail illegal immigration and combat the violence associated with trans-border gangs and illicit gun and drug trafficking. In addition, the DHS's Immigration and Customs Enforcement (ICE) will continue efforts to remove criminal aliens through the Secure Communities and Criminal Alien Programs. In fact, the 2012 Budget seeks an additional $64 million for a total Secure Communities program level of $184 million. This funding includes personnel, IT, and other resources that are estimated to allow ICE to identify 199,000 more criminal aliens in FY 2012 than in FY 2010 through Secure Communities. Through Secure Communities, ICE uses technology to share information between law enforcement agencies and applies risk-based methodologies to focus resources on the removal of those criminal aliens representing the greatest threat to community safety.

Sen. Murray

Director Lew, because my time ran out during the hearing, I would like to make sure that I am able to communicate the full scope of my question, and I look forward to your written response.

As I said, I'm pleased that the DOE Environmental Management budget has a slight increase, which I view as a sign that the Administration recognizes its legal obligations.

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Sen. Murray

In the face of one of the worst economic crises our nation has faced, including an increase in home foreclosures, homelessness is affecting unprecedented numbers of children and youth. At the end of the 2008-2009 school year, public schools enrolled nearly one million homeless children and youth - a 41 percent increase since the 2006-2007 school year.

Homelessness is associated with a higher likelihood of multiple school transfers, truancy, dropout, and lower standardized test scores. Thus, homeless students often require additional supports to succeed in school. The Education for Homeless Children and Youth program removes barriers to elementary and secondary education. It is unique in its focus on finding, enrolling, and supporting our poorest children and Youth. Simply put, there is no other federal education program that does what it does to create access to and stability in public education. Yet for the second year in a row, the President's budget provides level funding for the Education for Homeless Children and Youth program.

Did OMB take the increases in enrolled homeless students reported by the Department of Education into account when it proposed level funding for this program? If not, on what other basis did OMB choose to level fund the Education for Homeless Children and Youth program? In May, the Administration released the first Federal Strategic Plan to End Homelessness, with the stated goal of ending family and youth homelessness in 10 years. How does the flat funding request for the Education for Homeless Children and Youth program factor into achieving this goal? Does the Administration believe that this goal can be achieved without increased access to education for homeless children and youth, and without additional resources for schools to meet their needs?

Homeless children are one of our nation's most vulnerable populations, and they suffer from significant barriers that impede their educational access and success. There is a critical need to provide adequate educational services and additional supports to these children in order to eliminate these barriers.

Even within this fiscally constrained environment, the Administration maintains a separate funding stream for homeless youth in 2012 and in its ESEA reauthorization proposal, focuses on strengthening the program to better serve homeless youth. Among some of these changes, program funds would be allocated to States based on the most recent State-reported data on the number of homeless children and youth available to the Department rather than on State shares of Title I funds to help ensure that state funding is based on need. An additional change would eliminate the exemption to the prohibition against operating separate schools for homeless youth, given that homeless students are unlikely to receive a high-quality education in a segregated environment.

Furthermore, the Administration requests funds for several other programs in 2012 that directly address problems most prevalent for homeless students. For example, the College Pathways and Accelerated Learning program would support efforts to increase high school graduation rates in middle and high schools with concentrations of students from low-income families and in high schools with low graduation rates. Title I in ESEA provides $14.8 billion to help disadvantaged students in high poverty communities meet high standards and graduate high school ready for college and careers.

Sen. Murray

Director Lew, as you know all too well, we are living in a challenging time for many Americans. The unemployment rate is 9 percent and families are struggling to make ends meet. The LIHEAP program provides vital assistance to seniors and low-income families in Washington state and across the nation to cover the cost of heating and cooling their homes. I hear over and over from folks in my state how important this funding is.

According to the most recent data, energy costs are increasingly taking up a larger share of U.S. consumers' budgets, accounting for more than 6 percent as of December. And research has shown that when energy costs approach 5 percent of consumers' budgets, economic growth is hindered - consumers are forced to reduce spending on other necessities such as food, health care, and housing. These are the hard economic realities facing millions of Americans as gasoline, heating oil, and electricity prices increase across the country.

And so it disappoints me to see that the Administration has chosen to slash funding for the LIHEAP programs to nearly half of the fiscal year 2010 enacted level.

Energy costs are already a huge burden for American families. What happens if heating and cooling costs increase this year, given the fact that your budget does not propose an emergency contingency fund for LIHEAP? Will you commit to revisiting funding for LIHEAP if there are energy cost increases that leave our seniors and low-income families struggling to make ends meet?

During this period of tough budget choices, the President's FY 2012 Budget provides $2.57 billion for the Low Income Home Energy Assistance Program (LIHEAP) to help low-income families offset a portion of their home heating and cooling expenses. This total includes $1.98 billion in block grants to States and $590 million in contingency funds to allow the Administration to respond to energy-related emergencies. The FY 2012 Budget does not re-propose the mandatory funding trigger that was included in prior Budgets. Reflecting forecasts for more moderate energy prices in winter 2011-2012, this returns LIHEAP funding to historic levels received for 2008, prior to the energy price spikes. The Administration will continue to monitor energy prices going forward and will be willing to revisit program needs if there are significant price increases.

THE PRESIDENT'S FISCAL YEAR 2012 BUDGET AND REVENUE PROPOSALS

THURSDAY, FEBRUARY 17, 2011

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, Sanders, Whitehouse, Begich, Coons, Sessions, Ensign, Cornyn, Thune, Portman, Toomey, and Johnson.

Staff present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

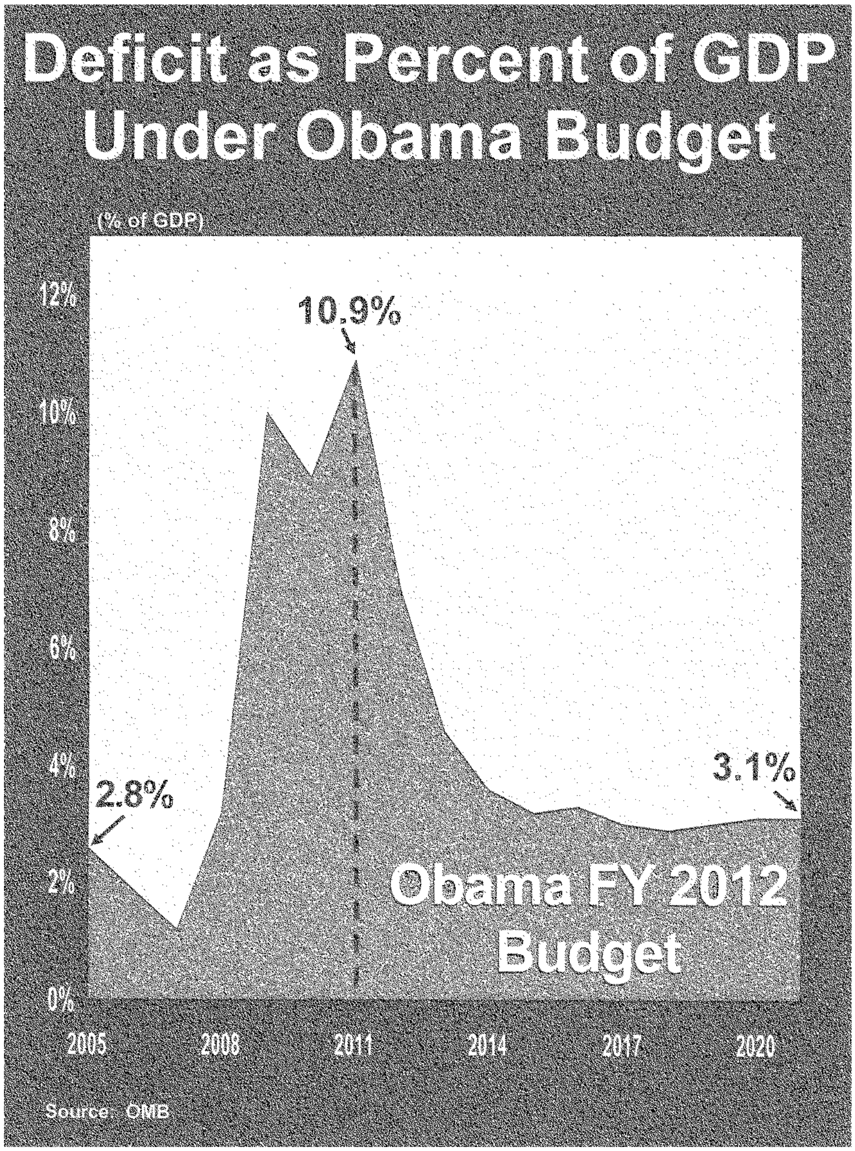
I want to welcome everyone to the Senate Budget Committee today. Today we will focus on the President's budget and revenue proposals. Our witness today is Treasury Secretary Tim Geithner.

Mr. Secretary, welcome back to the Committee. We look forward to your testimony. We also value your wise counsel as we have come through some of the most difficult times in our economic history. I believe history will record the steps that were taken at the end of the Bush administration and the initial days of the Obama administration were absolutely critical to averting a financial collapse. I believe that history will make that clear. And I believe you played a hugely constructive role, as did Secretary Paulson at the end of the Bush administration.

I believe the President's budget gets it about right. In the first year or 18 months, even as it moves to cut spending, it continues critical investments in the areas of education, energy, and infrastructure. These near-term investments will help strengthen economic recovery and lay the foundation for long-term economic growth.

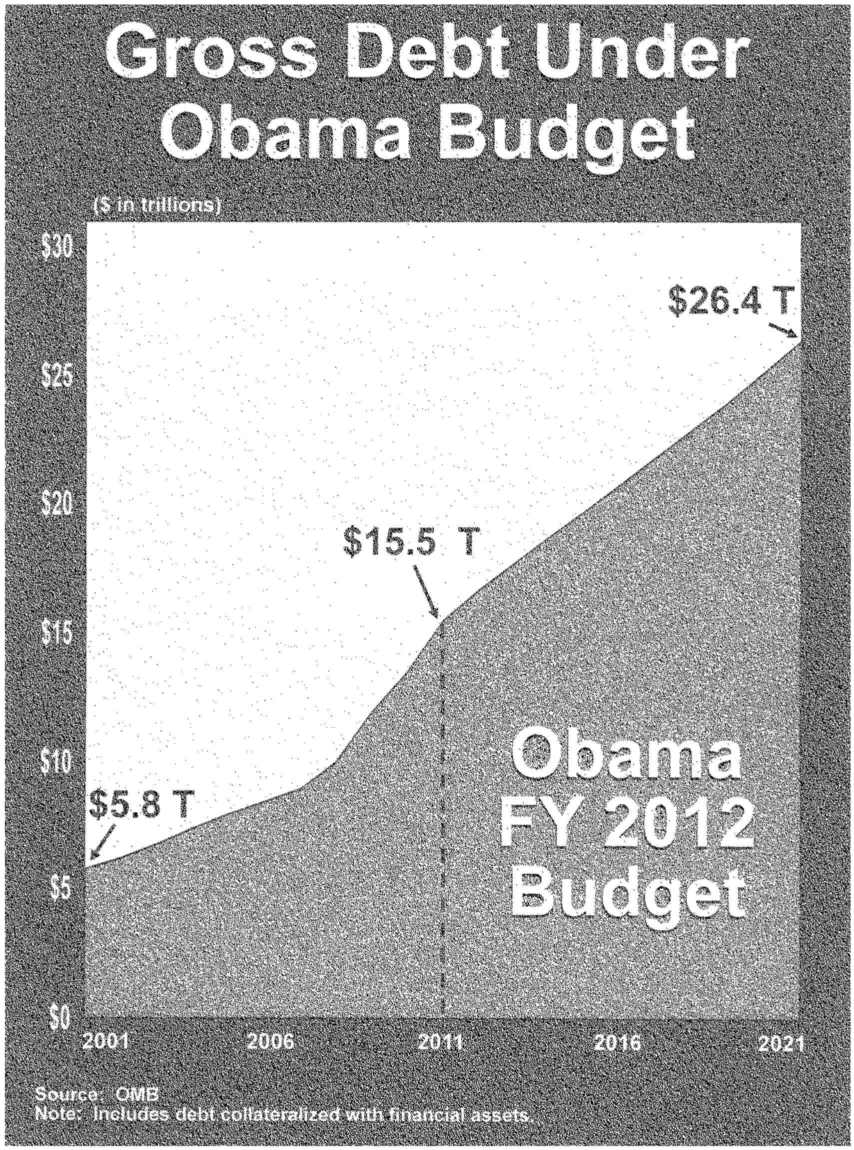
I was raised by my grandparents, and my grandmother was a school teacher. We called her "Little Chief." She was 5 feet tall, but she commanded respect. And in our family, she told us over and over, "There are three priorities in this household: No. 1 is education, No. 2 is education, No. 3 is education." And she meant it and we got the message. So I know that she would feel very strongly that education has to be the cornerstone for future economic growth.

But I do take issue with the President's budget in the medium and long term where I believe we simply have to do more to address our deficits and debt. According to the administration's estimates, the budget brings the deficit down from 10.9 percent of GDP to 3.1 percent by the end of the 10-year budget window. So that is the good news of this budget, as I see it.

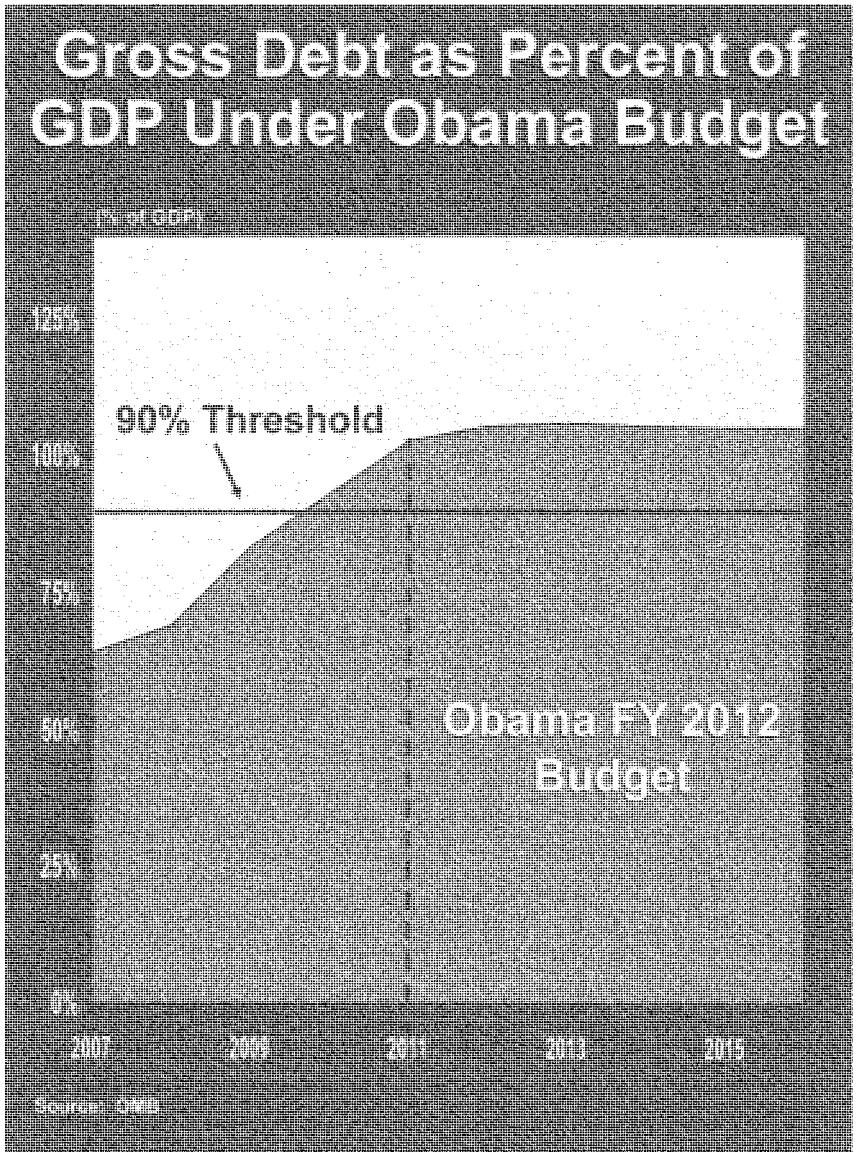


The President's budget does make substantial progress in bringing down the deficit as a share of the gross domestic product, which most economists say is the most valid measure. So a very substantial improvement in our deficit path by that measure.

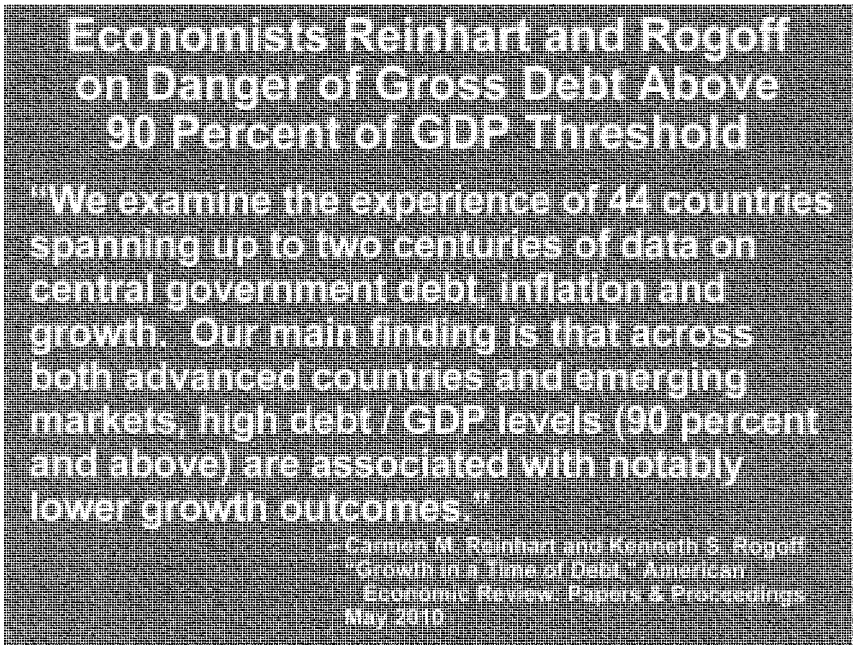
Let us go to the next, if we can.



If we are looking at dollar terms, the changes to the gross Federal debt under the President's budget goes from $15.5 trillion to more than $26 trillion at the end of the 10 years. So over 10 years, we are averaging an increase in the gross debt of $1 trillion a year. That to me cannot be the path.

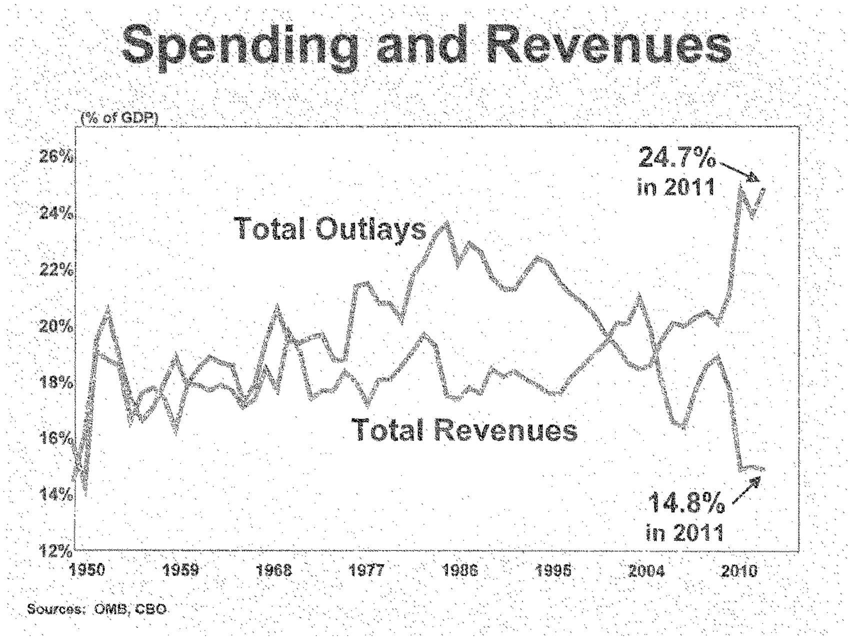


If we look at gross debt as a share of the economy under the budget, we can see it reaches 100 percent and continues rising slightly throughout the remaining budget window. Why is this important, that the debt is now—the gross debt, I want to emphasize, the gross debt, not the publicly held debt that you often see in the newspaper. The gross debt, taking all of the debt of the United States, is over 100 percent of GDP. Why does that matter?



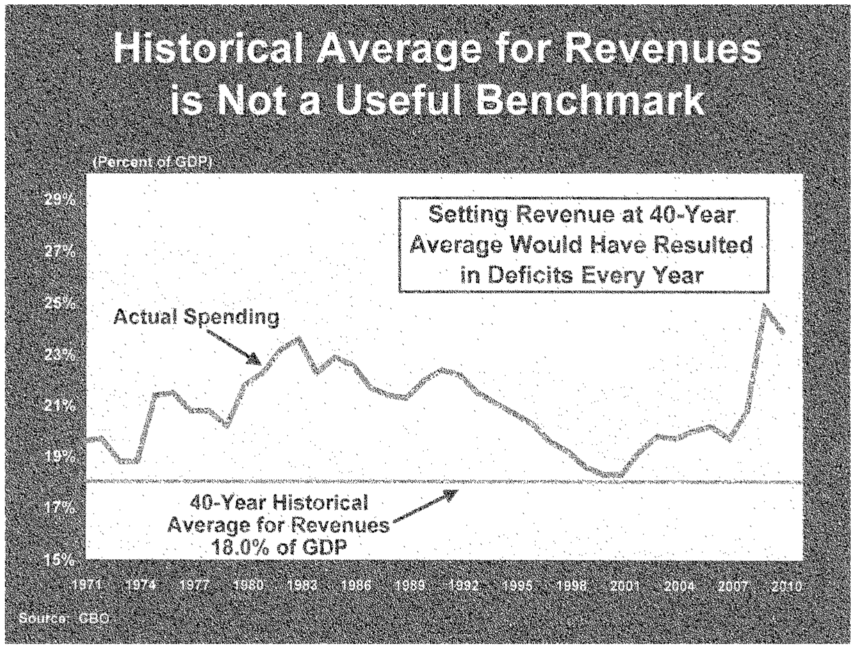
Well, it matters because the best analysis that has been done of financial history, work done by the economists Carmen Reinhart and Kenneth Rogoff, found this: We examine the experience of 44 countries spanning up to two centuries of data on central government debt, inflation, and growth. Our main finding is that across both advanced countries and emerging markets, high debt-to-GDP levels—gross debt above 90 percent—are associated with notably lower growth outcomes for the future. That is why this matters. A debt that is too high acts like an anchor on the economy, reduces future economic growth, reduces opportunity for the American people, reduces job prospects for those seeking employment.

So these debt figures are more than numbers on a page. This matters to real people and their lives. It matters to the thing I think everyone around this table cares the most about, which is future economic opportunity for the people of our Nation.

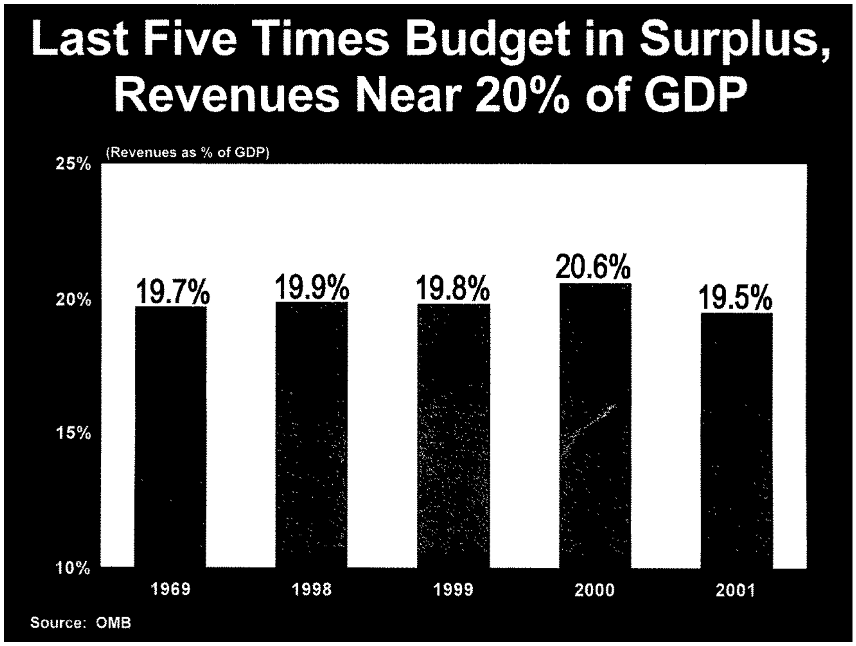


Make no mistake. We are at a critical juncture. We are borrowing 40 cents of every dollar that we spend. Let me repeat that. We are—you know, this is reality. We are borrowing 40 cents of every dollar that we spend. Spending is at its highest level in 60 years as a share of the economy. Revenue is at its lowest level as a share of the economy in 60 years. Revenue the lowest it has been in 60 years, spending the highest it has been in 60 years. No wonder we have record deficits.

This has to be addressed, I believe, on both side of the equation. Yes, we have to cut spending. Yes, we have to reform entitlements. But, yes, we also need tax reform to help reduce the deficit and make America more competitive. We need to be realistic about what is necessary to meet the needs of the Nation and return the budget to a sustainable long-term fiscal trajectory.



Looking at revenues in isolation has led some to argue that revenue should be held to the historical level of 18 percent of GDP. That has been the level over the last 40 years. Let me point out revenue at that level would not have produced a single balanced budget in a single year in all of those 40 years. In fact, on the five occasions when the budget has been balanced or in surplus since 1969, revenues have ranged between 19. 5 percent of GDP and 20.6 percent of GDP. So I would just say to those who say, you know, revenue, no more than 18 percent of GDP, we would not have balanced the budget ever in the last 40 years—not one time.



The five times we have balanced, revenue has been from 19.5 percent to 20.6 percent of GDP. I would argue it is going to have to be at the high end of that range given the retirement of the baby-boom generation.

The Need for Tax Reform

- Tax system out of date and hurting U.S. competitiveness
- Hemorrhaging revenue – tax gap, tax havens, abusive shelters
- Expiring provisions create uncertainty
- Simplification and reform keep rates low
- Long-term imbalance must be addressed

Fundamental tax reform must be a part of the approach to addressing our fiscal problems. The current state of the Tax Code is simply indefensible. As a former State tax commissioner and chairman of the multi-state tax commission, I am acutely aware of what has happened to the Tax Code, and it is a Chinese riddle. You know, you have to be a contortionist to deal with this Tax Code. It is out date, this Tax Code. It is hurting U.S. competitiveness. It is hemorrhaging revenue. The tax gap, offshore tax havens, abusive shelters undermine the effectiveness of the Tax Code and cost confidence in the fairness of it.

Tax Reform in Fiscal Commission Plan

- **Eliminates or scales back tax expenditures, and *lowers* rates**
- **Promotes economic growth and improves America's global competitiveness**
- **Makes tax code more progressive**
- **"Illustrative" tax reform plan:**
  - **Three rates for individuals - 12%, 22%, 28%; corporate rate of 28%**
  - **Capital gains / dividends taxed as ordinary income**
  - **Reforms mortgage interest and charitable deductions**
  - **Preserves Child Tax Credit and EITC**
  - **Repeals AMT**
- **Revenues grow to 21% of GDP by 2022**

This Tax Code is riddled with expiring provisions. This creates enormous uncertainty for citizens and businesses, making it difficult for them to plan ahead. If we took steps to simplify and reform the Tax Code, we could reduce tax rates below where they are today and produce more revenue. Tax expenditures are running at over $1.1 trillion a year. That is as much as all of domestic discretionary spending.

Although the President's budget called on Congress to work with the administration to begin the process of tax reform, it did not include any significant tax reform recommendations. I believe the only way we are going to solve the Nation's long-term fiscal imbalance is by enacting a comprehensive debt reduction plan. We need a plan in size and scope of what was proposed by the President's Fiscal Commission.

Here are the key elements of tax reform that were included in the Commission's plan. It eliminated or scaled back tax expenditures and lowered tax rates to promote economic growth and dramatically improve America's global competitiveness, which needs to be a goal. We are in a different world. When this Tax Code was written, we did not have to worry about the competitive position of the United States. We were dominant. Now we are in a tough, competitive global environment, and we have to be competitive.

The Commission proposal makes the Tax Code more progressive. I was proud that we made the Tax Code more progressive. The Commission's report included an illustrative tax reform plan that demonstrates how eliminating or scaling back tax expenditures can lower rates. Instead of six brackets for individuals, the plan includes just three: 12 percent, 22 percent, and 28 percent. The corporate rate would be reduced from 35 to 28. Capital gains and dividends would be taxed as ordinary income. The mortgage interest and charitable deductions would be reformed, better targeting those benefits to people that actually need them. The child tax credit and earned income tax credit would be preserved to help working families, and the alternative minimum tax would be repealed. The Commission's plan also increased revenue to 21 percent of GDP by 2022. That is the kind of tax reform I believe that we need to adopt.

Let me just conclude on that point. I have gone longer than I would normally, but I do think that it was important to lay out some of the elements of what the Commission said and what I strongly believe. I will be quick to say there are many things that I disliked intensely about the Commission's report. I remember one of my colleagues called me the night before we were to vote and said to me, "What are you going to do?" I said, "I tell you, the only thing worse than being for this is being against it." And, you know, at the end of the day here, we are going to have to put together a package nobody is going to like. It is going to be controversial. Nobody is going to be happy. But it has to be done. It has to be done.

Senator SESSIONS.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Mr. Chairman, thank you once again for your wise comments, your warnings to us. I think they absolutely should be heard, and the most important thing I think cannot be overemphasized is that we are not here fighting over spending and other issues and sacrifices that would have to be made for academic or political reasons, but because of the reasons you stated, our economy is in danger as a result of the path we are on.

Thank you, Secretary Geithner, for appearing before us in the Committee today and discussing the budget. I know you did face a serious challenge after our financial crisis, but it would have been better if Mr. Paulson and Mr. Bernanke and the Chairman of the New York Fed had seen it coming before the financial crisis hit, and maybe we could have avoided it. And so now we have some suggestions that we could be heading to another one, and we need to take steps now to avoid it.

It is clear that the plan submitted by the President does not seriously address the Nation's growing fiscal crisis. Here, Mr. Geithner, is how you described our fiscal situation earlier this week, correctly: "Our deficits are too high. They are unsustainable and, left unaddressed, these deficits will hurt economic growth and make us weaker as a Nation." Admiral Mullen said it is the greatest threat to our national security.

But the President's budget does not confront this danger. In fact, the President's budget continues the unsustainable course. The plan creates 10 straight years of deficits that never once fall below $600 billion and adds $13 trillion, at least from 2010, overall to our gross debt. Under the President's plan, interest alone on the debt will rise to $844 billion in 1 year, more than we pay for Medicare or Medicaid. It is almost unthinkable that the President would put this budget before Congress and the American people as a long-term plan for our Nation. But to hear his supporters and certain administration officials describe the budget, you would think they had achieved balance and brought the debt crisis, the deficit crisis to an end.

Here is what the President's Director of Budget Jack Lew said over the weekend: "Our budget will get us over the next several years to the point where we can look the American people in the eye and say we are not adding to the debt anymore. We are spending money that we have each year, and that we can work on bringing down the national debt."

And here is what President Obama said just 2 days ago: "What my budget does is to put forward some tough choices, some significant spending cuts, so that by the middle of this decade our annual spending will match our annual revenues. We will not be adding more to the national debt."

Clearly, these statements, as heard by the American people, are incorrect, false. Yet, remarkably, the President's new press secretary, Jay Carney, was asked about the President's claim yesterday whether it would withstand scrutiny, and he said, "Absolutely."

In what fantasy world do we double our gross debt to $26 trillion and then say we are not adding to the debt? This is a serious matter, and to tackle our fiscal challenges, we need to work together and the President needs to lead the Nation in an honest conversation.

But we have not seen from our President the willingness to look the American people in the eye and have a candid conversation about the challenges and what we will have to do to solve them. The message seems to be there is no problem; we have it taken care of; we are going to be living within our means under this budget.

So I do think the President is taking a risk here with his credibility. During the same press conference, he complained about the—he expressed a desire to work with Republicans toward meaningful reforms. I do hope that can be accomplished. But I have to note it was kind of a mixed message when a couple of hours later he threatened to veto if Republicans took steps to reduce current spending by $59 billion, which is $100 billion less than his proposal for spending in that year.

So let us remember, those arguing that we cannot reduce spending are the same ones who argued 2 years ago that the massive stimulus plan would speed our economic recovery. I believe they were wrong. Our recovery has lagged behind past recessions. Unemployment has remained painfully high. The failed effort to revive the economy through a surge in Government spending has instead imperiled our economy with a crushing debt that stifles job growth today, as economists have shown, and threatens our prosperity tomorrow.

So, Mr. Geithner, you will forgive me if I am unconvinced that arguments that are being made that we must preserve every cent of this year's $1.65 trillion deficit is critical and we cannot change the course we are on. So we need to stop growing the Government and start growing the economy. That means reducing spending now. The situation is too urgent and the need for a new direction too great for us to delay action any longer. Significant reductions in spending may not be easy, but the reason they are not easy is because we have been heading in the wrong direction for so long. So, yes, we will have to make some tough choices, but they will put us on the right road, the road that leads to a better future.

And, Mr. Chairman, we absolutely need to reform taxes. Thank you for raising that point. But I do want to emphasize that historically periods of frugality have helped us achieve a balanced budget also.

Chairman CONRAD. I thank the Senator.

Now we will turn to our witness. Secretary Geithner, thank you for your patience in listening to us. Thank you for your service. I have had a chance to work with you, and I have high confidence in you. And I know we are at really a defining moment in many ways for the fiscal future of the country. So please proceed with your testimony.

STATEMENT OF THE HONORABLE TIMOTHY F. GEITHNER, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary GEITHNER. Thank you, Mr. Chairman, Ranking Member Sessions, and members of the Committee. Thanks for giving me a chance to come talk to you about these important questions, and I want to compliment both of you for running a very high quality debate, conversation, discussion of options on this critical issue.

The President's budget presents a comprehensive strategy to strengthen economic growth and to expand exports, with investments in education and innovation and infrastructure. And alongside these investments, the budget presents a comprehensive, detailed multi-year plan to cut spending and reduce deficits.

As you quoted me saying, Senator Sessions, our deficits are too high. They are unsustainable; left unaddressed, they will hurt economic growth and weaken us as a Nation. We share a critical obligation to restore fiscal sustainability, fiscal responsibility, and go back to living within our means as a country.

Now, the President's budget cuts the deficit he inherited in half as a share of GDP by the end of his first term. These cuts are phased in over time in order to protect the recovery, the expansion. And in order to make it possible for us to invest in future growth and to reduce future deficits, the President proposes to reduce non-security discretionary spending to its lowest level as a share of the economy since Dwight Eisenhower was President.

To achieve this, as you know, the budget proposes a 5-year freeze of non-security discretionary spending at its 2010 nominal level, which will reduce the deficit by more than $400 billion over the next 10 years. But the President also proposes to cut defense spending, to freeze civil service salaries, and to improve efficiency in Government by eliminating and reducing a very substantial number of Government programs.

These savings create the necessary room for us to make targeted investments in support of reforms that will help strengthen future growth. The most important things we can do for future growth are to improve the quality of our education system, to invest in innovation, and to rebuild America's infrastructure. Without these investments, America will be weaker and less competitive.

Now, as part of this strategy for growth, the President proposes reforms to our tax system that are designed to encourage investment. We proposed to put in place a permanent and expanded tax credit for research and development; to eliminate capital gains taxes on small businesses; to encourage advanced manufacturing in clean energy technologies; to keep taxes on investment income, dividends, and capital gains low; to reform and extend the Build America Bonds program; to make college more affordable for middle-class Americans.

Now, these tax incentives are accompanied by reforms that would reduce incentives to shift income and investment outside of the United States and to close loopholes and tax preferences that we cannot afford.

Now, in addition, we propose to pursue comprehensive corporate tax reform that would lower the corporate tax rate. Our present system, as you all know, combined a very high statutory rate with a very broad range of expensive tax preferences for specific industries and activities. We need a more competitive tax system for businesses that allows the market, not tax lobbyists and tax planners, to allocate investment, a system which businesses across industries pay a roughly similar share of earnings in taxes, a system that provides more stability and certainty and is more simple to comply with. And we need to do this without adding to our future deficits.

Now, we have begun the process of trying to build support for a comprehensive corporate tax reform plan, and I hope we have the chance, the opportunity to move forward on that soon.

The President's budget also outlines some responsible reforms on the individual side. We propose, as we have in the past, to allow the 2001 and 2003 tax cuts for the wealthiest 2 percent of Americans to expire on schedule; to limit certain deductions for those same high-income Americans; to restore the estate tax levels and exemptions to 2009 levels; and to close the carried interest loophole. These proposals—and I want to emphasize this. These proposals are designed to help ensure that the savings we achieve together in reducing spending are devoted to deficit reduction, not to sustaining lower tax rates for the most fortunate 2 percent of Americans.

Now, this budget would achieve the dramatic reductions in our deficits over the next decade that are necessary, that are essential to stop the national debt from growing as a share of the economy and to stabilize the debt burden as a share of the economy at a level that will not threaten future economic growth.

Could I just pause there for a minute to make the following point clear? When CBO scores these proposals in the next few weeks, they will show higher deficits than we project. And, therefore, they will show deficits that are unsustainable over time. They will show debt rising as a share of the economy even in these next 10 years.

Now, we recognize, as you do, that these reforms, even if enacted, would represent only a first step, only a downpayment on the longer-term reforms that are necessary to address our long-term deficits. To address the deficits we face beyond the next decade, over the next century, we have to build on the progress we achieve in the Affordable Care Act to substantially reduce the rate of growth in the costs of entitlement programs, health care costs. And although Social Security is not a contributor to our short- or medium-run deficits, we have to work together across the aisle to try to strengthen Social Security for future generations.

Now, it is very important to understand that we cannot grow our way out of these deficits. They will not go away on their own. They will not be solved by cutting deeply into programs that are critical to future growth and competitiveness. And we have to find consensus on a multi- year plan that cuts where we can so that we invest where we need to and that reduces deficits over time. Making a multi-year commitment will allow us to make sure that these changes are phased in as the expansion continues, as the economy recovers from the crisis, and making a multi-year commitment will give businesses and individuals the chance to plan to adjust, to prepare for the impact of those changes on the economy over time.

Now, these proposals, as I said, represent a starting point for the discussion. We recognize that there are different ideas, different proposals from both sides of the aisle for how to achieve the necessary reduction in our deficits. And we know, as you know, that we need both parties and both Houses of Congress to come together to enact solutions.

Now, in December of last year, we were able to find bipartisan consensus on a very strong—not perfect in everybody's views, but very strong package of tax incentives to help sustain the recovery and restore confidence. We have to bring that same spirit of compromise, of bipartisanship to the challenge of fiscal responsibility.

Thank you.

[The prepared statement of Secretary Geithner follows:]

Embargoed Until 10:00 a.m. EST, February 17, 2011

Statement of Treasury Secretary Timothy F. Geithner
Committee on the Budget
U.S. Senate
February 17, 2011

Chairman Conrad, Ranking Member Sessions and members of the Committee, thank you for the opportunity to appear before you today to discuss the President's Fiscal Year 2012 Budget.

I. Introduction

When the President took office two years ago, the U.S. economy was in the middle of its deepest recession in more than 50 years. The economy was contracting at a rate of 5 percent per year, and private businesses were cutting more than 700,000 jobs per month.

In the face of this crisis, this Administration and Congress put in place policies that helped pull the economy back from the brink and established the basis for the ongoing recovery. Today the economy has grown for six straight quarters. Businesses have started to hire again and have added more than 1.3 million jobs since the labor market began to recover. Economic activity has accelerated over the last few months, supported by strong private demand.

This past December, the Administration and Congress agreed to a bipartisan tax package that will help ensure that the recovery continues. This agreement prevented a tax increase on middle class Americans, and also included crucial Administration initiatives – such as a temporary payroll tax cut, an extension of unemployment insurance benefits, and immediate expensing for certain business investments – that will provide a substantial boost to economic activity.

Consumers and businesses are now expressing more optimism about the future, suggesting momentum that will sustain growth in the coming months. At the same time, private sector analysts have issued more optimistic near-term forecasts and are projecting stronger growth in 2011 and 2012.

However, we still face very substantial economic challenges. Millions of Americans remain out of work, and families across the country are still struggling to make up for losses in their savings and in the value of their homes.

The President has outlined a broad strategy to help strengthen economic growth with investments in education, innovation, and the nation's infrastructure. Alongside those investments, we must reform the nation's finances to restore fiscal responsibility. Our deficits are too high and they are unsustainable. Left unaddressed, these deficits will hurt economic growth and make us weaker as a nation. We must go back to living within our means.

The Budget presents a detailed plan to cut spending and reduce deficits. The President's Budget cuts the inherited deficit in half as a share of the economy over his first term; includes proposals that will reduce deficits by more than $1 trillion over the next 10 years; and cuts non-security discretionary spending to its lowest level as a share of the economy since Dwight Eisenhower was President. These cuts are phased in over time to protect the recovery.

In addition, the Budget sets priorities by balancing spending cuts with the need to protect investments in education, innovation and infrastructure. Under-investing in these areas would compromise our competitiveness. Finally, the Budget reaffirms our commitment to reduce tax expenditures and reform entitlement programs.

II. A Credible Commitment to Fiscal Responsibility

The President's Budget meets the following five imperatives, all of which are necessary components of a credible commitment to fiscal responsibility:

- First, we must lower deficits over a multi-year period to stabilize or reduce the national debt as a share of the economy. Deficit reduction needs to be gradual to avoid endangering the recovery.

- Second, we need to reduce overall spending as a share of the economy, with spending cuts targeted at programs we cannot afford.

- Third, we need to protect and expand investments in targeted areas crucial for future economic growth.

- Fourth, we must develop tax policies that promote growth and investment while maintaining fairness and fiscal responsibility.

- Fifth, we must restore fiscal responsibility over the long term by reducing the rate of growth in health care expenditures and by strengthening and extending the solvency of Social Security.

The following sections outline in detail how the President's Budget meets each of these imperatives.

A multi-year commitment to stabilize the national debt

While our deficits will decline in coming years as the economy continues to recover, economic growth alone will not be enough to stabilize our finances. In the absence of further action, the deficit is projected to remain near 4.5 percent of GDP for the rest of the decade, even after the economy is fully recovered. Under this scenario, the national debt held by the public will grow from 62 percent of GDP in 2010 to nearly 85 percent of GDP by 2021, the highest share since 1948. Without reform, debt will continue to grow after 2021, as mandatory spending and interest payments on the debt grow faster than revenues.

Roughly speaking, stabilizing the debt as a share of the economy requires that outlays, excluding interest payments on the national debt, must equal revenues. This requires us to cut the deficit to approximately 3 percent of GDP and maintain deficits at about this level into the future.

The President's Budget accomplishes this over the medium term. Our proposals cut the deficit in half by 2013, reduce it to 3.2 percent of GDP by 2015, and maintain deficits around 3 percent of GDP for the second half of this decade. Under our proposal, the national debt held by the public as a share of the economy stabilizes around 76 percent starting in 2013, although it rises slightly at the end of the 10-year budget window. Excluding the financial assets held by the government, such as student loans and other investments, our proposals stabilize the national debt held by the public as a share of the economy at around 68 percent.

The pace of deficit reduction has to be calibrated to the path of recovery. Under the path envisioned in the Budget, significant deficit reduction starts in 2012 and accelerates in 2013 and 2014, due mainly to economic recovery and the expiration of support measures, and also due to Budget proposals that reduce the deficit. Starting in 2015, when the economy is projected to be closer to operating at full capacity, the Budget proposals will reduce the deficit by more than $150 billion each year on average through 2021.

The tension between the need for fiscal responsibility in the medium term and supporting the recovery in the short term creates a difficult challenge for policy makers. Because changes made one year can easily be altered the next, the best way to resolve this tension is for Congress and the Administration to commit to a multi-year plan of fiscal responsibility, phased in over an appropriate time horizon.

Committing to a multi-year deficit reduction plan would give businesses and individuals more certainty about the impact of future government policy. This can improve confidence today and help keep borrowing rates low. Moreover, committing to a multi-year plan would give businesses and individuals adequate time to adjust and prepare for future changes.

Cut spending and eliminate programs we cannot afford

Meaningful deficit reduction requires serious cuts to government spending. The Budget proposes a five-year freeze of non-security discretionary spending at its 2010 nominal level, reducing the deficit by more than $400 billion over the next decade, and bringing the level of non-security discretionary spending to its lowest share of our economy since the Eisenhower Administration.

This will not be easy. The President has asked each agency to make tough choices, and the Budget includes more than 200 terminations, reductions and savings proposals. The President has also asked civilian government employees to share responsibility for reducing deficits and has proposed freezing their salaries for two years, which will save more than $60 billion over the next 10 years. Finally, we are continuing to make government more efficient by reducing administrative overhead costs, reforming the government purchasing process, and embracing competitive grant programs.

In addition to cutting current non-security discretionary spending, the President is asking departments and programs outside of the spending freeze to reduce their future spending. Specifically, the Department of Defense is pursuing a variety of strategies to reduce defense spending; as a result, the Budget reduces defense spending by $78 billion over the next five years, relative to last year's Budget proposal. Secretary Gates believes these savings can be realized through reducing overhead costs, improving business practices, and cutting excess or troubled programs, and will not weaken our national security.

In addition to cutting spending, the Budget includes two proposals that will reduce our future obligations. The Budget proposes giving the Board of the Pension Benefit Guaranty Corporation (PBGC) the authority to adjust gradually the premiums it charges pension plan sponsors. This will encourage companies to fund their pension benefits fully while improving the PBGC's long-term financial position. Premium increases would be phased in, starting in 2014. The Budget also includes a proposal that would provide short-term relief to states and employers, while encouraging states to put their unemployment insurance programs on firmer financial footing. Together these two proposals would reduce the federal deficit by $60 billion over 10 years.

Increase investment in areas important to economic growth

It is not enough to spend less; government must also spend more wisely. The President's Budget sharply restrains overall spending, but it also invests in important areas where the government has a clear role to provide public goods that promote future economic growth and competitiveness: education, innovation and infrastructure.

- Education: An educated and skilled workforce is critical for the United States to compete in the global economy. Workers with a college education not only earn higher wages for themselves, but increase the productivity of those who work with them and of the economy overall. The need for additional investment in education is striking: America has fallen to ninth among advanced countries in the proportion of young people with a college degree. The Budget proposes targeted investments in education to help us regain our competitive edge.

  We propose to strengthen investments in programs across every stage of a child's education. The Budget includes $350 million for the Early Learning Challenge Fund, a program that would apply the lessons learned from the successful Race to the Top program to early education, and dedicates $100 million to help prepare 100,000 new teachers in science, technology, engineering and math over the next 10 years. The Budget also recommits to maintaining the maximum Pell grant award and to making permanent the American Opportunity Tax Credit, which provides up to $10,000 for a student for four years of college. These two programs help make college affordable for millions of students and their families.

- Innovation: Investments in research and development (R&D) produce the technological advancements that contribute to productivity growth and improvements in U.S. living standards. However, businesses may under-invest in R&D because they do not capture the full social returns on their investments. The President believes that government has an important role to play in promoting technological progress, and the Budget includes $148 billion in R&D investments for this year to support basic research and clean energy.

  These include maintaining the Administration's commitment to doubling the investment in basic research conducted at the National Science Foundation, the Department of Energy's Office of Science, and the National Institute of Standards and Technology labs. The Budget's proposal to increase the federal investment in the National Institutes of Health to a total of $32 billion will support innovations in biomedical research, improving future health care outcomes and economic growth.

  The Budget also provides $8.7 billion for clean energy technology, including more than doubling investments in energy efficiency research, development, and deployment; increasing renewable energy investments by over 70 percent; and expanding investments in the Advanced Research Projects Agency – Energy (ARPA-E).

- Infrastructure: Infrastructure is critical to economic growth and competitiveness, and yet our current investments in infrastructure are insufficient and often inefficiently allocated. In addition to a $50 billion up-front investment in transportation infrastructure to create jobs in occupations that have been hit hard by the recession, the Budget lays out a long-term plan for sustained, targeted investments in the most effective infrastructure programs and projects.

  The Budget proposes a six-year surface transportation reauthorization that increases average annual investment by $35 billion per year, in real terms, over the previous six-year authorization plus passenger rail funding appropriated in those years. This proposal includes $30 billion to create a National Infrastructure Bank, which will attract private capital to infrastructure projects while improving the process of allocating infrastructure funds. The proposal also includes $32 billion in competitive funding to encourage states and cities to reform their transportation programs to focus on more efficient and effective investments. We are committed to working with Congress on a bipartisan basis to ensure that there is sufficient revenue to keep the underlying Transportation Trust Fund solvent, because these investments must be fully paid-for.

Taken together, the Budget balances two priorities that guide our approach to government spending. First, spending cuts are necessary to lower the deficit. At the same time, we must protect targeted, responsible investments that allocate limited government resources towards programs that will boost economic growth and promote job creation over the long run.

A tax system that supports growth, fairness and fiscal responsibility

Strengthening our competitiveness and restoring fiscal responsibility will require reforms to our tax system.

Starting with revenue provisions that promote investment in innovation and clean energy, the President's Budget includes a series of specific tax policy changes that help us move towards a more efficient, fair and competitive tax system that will support economic growth.

Specifically, the Budget proposes making an expanded research and experimentation tax credit permanent, thereby increasing certainty for businesses making crucial long-term investments that will lead to more innovation. In addition, in order to support investment in clean energy technology, the Budget proposes tax credits for advanced manufacturing facilities, energy-efficient commercial buildings and an improved credit for plug-in vehicles.

The Budget proposals also reduce the incentives for multinational firms to shift income and assets to their foreign subsidiaries. Finally, the Budget proposes a fee on financial firms to recoup the costs of the extraordinary financial assistance the government put in place to resolve the crisis.

In addition to these proposals, we must pursue comprehensive corporate tax reform to create a competitive tax system that raises sufficient revenue in the most efficient, simple and fair way. The current system for taxing corporations and business hurts economic growth by placing burdens on U.S. businesses that negatively affect their investment and employment choices. Because of various loopholes and carve-outs, some industries pay an average rate that is four or five times higher than others, and although our statutory corporate tax rate is one of the highest in the world, we raise about the same amount of corporate tax revenue as our major trading partners.

Moreover, because of the high rate and because of the various loopholes and carve-outs, too many businesses end up making investments based on what their tax planners recommend, instead of what sound business judgment would suggest. This puts our entire economy at a disadvantage. As the President has announced, in consultation with the business community and other stakeholders, the Administration is examining ways to lower the corporate tax rate and to eliminate provisions that negatively affect investment. By pursuing these two objectives together, we can enact reform that does not add to current or future deficits. I look forward to working with you on this important endeavor.

Balancing the budget requires sacrifice from all Americans, but should also promote fairness for the middle class.

The Budget proposes reducing the value of certain tax expenditures on the wealthiest Americans by limiting the value of itemized deductions to 28 percent for high income households. This is a down payment on reform of the individual income tax system.

This provision alone will generate enough revenue to fully protect the middle class from a dramatic expansion of the Alternative Minimum Tax (AMT) for three years. The Budget calls on Congress to find additional ways to pay for permanent AMT relief, because if left unaddressed, the AMT will inappropriately sweep up tens of millions of families into this parallel tax system. Working with Congress to fully pay for AMT relief after 2014 would lead to an additional one percent of GDP in deficit reduction by the end of the decade.

In addition, the Budget proposes to reform the taxation of carried interests in financial partnerships, to close the loophole that allows some to pay tax at lower capital gains rates on what is effectively compensation.

We must also allow the 2001 and 2003 tax cuts for married couples with household incomes above $250,000 (and $200,000 for single filers) to expire and return the tax on large estates to 2009 levels. The President has been clear that we cannot afford these tax cuts for the wealthiest Americans, which do very little to support economic growth. Allowing these temporary tax cuts to continue indefinitely would increase the deficit by nearly $1 trillion over the next 10 years.

Fiscal sustainability over the long run

While stabilizing the debt-to-GDP ratio over the medium term is an important down payment on long-term fiscal stability, we must also reform entitlement programs, as entitlement spending is projected to increase more quickly than revenues due to an aging population and growing health care costs.

We made important progress on entitlement reform last year by passing the Affordable Care Act (ACA). Independent analysts have estimated that the ACA will significantly slow the growth of medical costs, relieving both government and businesses of some of the pressure of rising medical expenditures. According to the most recent analysis from the Congressional Budget Office, the ACA is estimated to reduce the deficit by more than $200 billion from 2012 to 2021, and by more than $1 trillion in the following decade. The most important step we can take right now for long-term deficit reduction is to implement the ACA fully and effectively.

Still, we know that more is needed, which is why the Budget includes additional provisions that address our rising medical expenditures. The Budget proposes $62 billion in specific savings in health programs that will fully pay for two years of relief from physician payment rate cuts called for by the Sustainable Growth Rate formula. The Budget calls for a long-term, fiscally responsible reform of physician payments that provides incentives to improve quality and efficiency while ensuring that payments will be predictable. A long-term solution will build on the fully paid-for, one-year relief for physicians enacted this past December. In addition, the Budget includes $250 million in grants to encourage progress on medical malpractice reform, which can reduce over-utilization of some expensive procedures without compromising patient outcomes.

Finally, the President is committed to strengthening Social Security. Together with Congress, we will consider ideas that put Social Security on more sound financial footing over the long term. However, we will reject plans that slash benefits; that fail to protect current retirees, people with disabilities and the most vulnerable; or that subject Americans' retirement savings to the whims of the stock market.

III. Conclusion

America is at a fiscal crossroads. We cannot pretend that our budget problems are merely the result of the financial crisis, nor can we pretend that we can restore fiscal responsibility without real sacrifice that affects all Americans.

Unless we act today, the national debt will continue to grow as a share of the economy over the medium run, even after the economy is fully recovered. Without reform, an aging population and rising health care costs will cause entitlement spending to grow more quickly than revenues in the long run, putting increasing strain on the budget and causing deficits to remain elevated far into the future.

If the debt were to continue to grow as a share of the economy, an ever-increasing share of revenues would have to be devoted just to paying the interest on the national debt, so that in 2020 interest payments would be nearly as large as all defense spending. Such escalating interest payments would create an unsustainable cycle that would eventually force dramatic adjustments. Without appropriate reforms, this path would have consequential effects on the U.S. economy.

While it is apparent that adjustments are necessary, we need to choose our path wisely. Cutting services and programs too much, too soon would jeopardize the recovery and destroy tens of thousands of jobs. Cutting the deficit today without making a long-term commitment to fiscal responsibility could enable a return to profligacy in the future. Cutting spending indiscriminately would force us to cut investments in vital public goods, and focusing reform solely on spending would impose an undue burden on those most in need while ignoring the opportunity to make our tax system more simple, fair, and efficient.

The President's plan navigates these challenges. The Budget lays the foundation for long-term growth while cutting spending in order to reduce the deficit. Making a multi-year commitment to the principles embodied in the President's Budget will reduce the risk of future crises, reassure investors and provide certainty about the future path of spending and taxes. In addition, a multi-year commitment will help ensure that borrowing costs remain low, making home ownership and higher education more accessible for Americans and making long-term investments more attractive for American businesses. Together the increased certainty and improved confidence will contribute immediately to economic growth and job creation.

History provides many examples of how past Congresses have made similar multi-year commitments. In some cases, Congress made permanent changes to policy that lowered the deficit over many years. For example, the 1983 amendments to Social Security extended the solvency of the Social Security Trust Fund for several generations. In other cases, Congress adopted budget rules that locked in a path of deficit reduction, limiting future deficit spending. For example, discretionary spending caps and PAYGO rules for mandatory spending and revenue legislation adopted in 1990 and 1993 contributed to reductions in the budget deficit, and eventually to budget surpluses.

Restoring fiscal sustainability will require courage from both the Administration and Congress, as we cannot move forward without compromise. We know compromise is possible. The December tax agreement proves that we are capable of forging agreements that move our economy forward.

There is no doubt that Members of this Congress – in both parties and both houses – have many good ideas of their own for promoting fiscal sustainability. While we believe the President's Budget is appropriately balanced in its priorities, we look forward to working with you to make a commitment that reflects our common ground – creating American jobs and promoting long-term economic growth.

Thank you, and I look forward to taking your questions.

Chairman CONRAD. Thank you very much for your testimony.

Let me go to the—not that one, but that. This to me is kind of the nub of the issue. It is true that the President's budget is stabilizing the debt, that is, that you are bringing down the deficits in a way that the debt as a share of the gross domestic product does not continue to increase.

The problem that I see is that it is stabilized at a level that is too high, that it is stabilized at a level of gross debt of over 100 percent of GDP.

I go back to the Reinhart-Rogoff study. Two hundred years of financial history, 44 countries, their conclusion: When you have a gross debt of over 90 percent of GDP, future economic growth is diminished, and pretty significantly.

Have you assessed the Reinhart-Rogoff study? Do you agree with it? Do you think that they are correct in terms of high levels of debt affecting economic growth adversely?

Secretary GEITHNER. Absolutely. It is an excellent study, and you could say in some ways from what you summarize understates the risks, because it is not just that governments or countries that live with very high debt-to-GDP ratios are consigned to weaker growth; they are consigned to the damage that comes from periodic financial crises as well.

Now, could you put that chart back up there for a second?

Chairman CONRAD. Yes.

Secretary GEITHNER. Let me just say two things about this. In some ways, that overstates the near-term problem because, as you know, we hold substantial financial assets, and you really want to look at debt net of financial assets, and you want to look at debt held by the public. But in many ways, that still understates the problem because that does not capture the future liabilities that are embedded in Medicare, Medicaid, and Social Security, which, of course, grow at a very rapid pace in the decades beyond that.

So if you are going to look at a true measure today of our full obligations to our citizens, the commitments we have made, of course, as you know better than anybody, it would be much higher than that.

Chairman CONRAD. You know, having served on the Commission, having served here on the Budget Committee for 24 years, if there is one thing I am absolutely persuaded of, the risk to this country is untenable. Absolutely untenable. So that takes me to the next one.

If we have agreed that this is too high a level of debt, that this does compromise future economic growth, then the question is: How do we go beyond what the President has proposed? I give him credit for stabilizing the debt, but it is stabilized at a level that is too high. And I am not one that expected the President to lay out a detailed plan in his budget because I know how this town works. Had he done that, the other side then spends all their time lacerating the plan.

The question is: How do we get to the table to have a serious negotiation between the House of Representatives, the U.S. Senate, the White House? What is your vision of how in the coming days and weeks we find a way to get to the table for a serious negotiation?

Secretary GEITHNER. Excellent question. I know you have thought a lot about that and offered a lot of ideas on that. I guess I would say that what we are going to see in the next few weeks is the following: In the House, the Republican leadership will have to propose and pass a budget resolution that lays out, like the President's budget does, a comprehensive plan, revenues and outlays to bring deficits down over the next 10 years. And they in that context will have to make the kind of choices we make in this budget, which is to answer the question: How far do you have to reduce the deficits? How far do you have to go? How deep do you have to go? How quickly or how gradually should you get there? What should be the composition of tax changes and reductions in spending to achieve that objective? What are you doing about things that matter to how we grow as a country in the future? So they will lay out those basic fundamental choices.

Now, there is a process in the Senate that is engaged in looking at a way to adapt the kind of comprehensive framework you saw on the Commission and see if you can translate that into consensus here. That, when it comes, will provide another contrasting vision about strategy. And then you will have a chance at that point for people to confront the tough choices you have to make in choosing among those basic paths.

Again, I think it is important to recognize that the President's budget does not solve all the problems facing the country. It is not a budget for the next century. What it does do is tell you how to get to a level over the next 10 years that leaves us with a level of debt as a share of the economy that is probably stable and would not weaken future growth. But, of course, it does not solve the questions beyond that.

If the Congress finds the will to go deeper, lower deficits over that 10-year period of time, which, as you said, would be desirable because it would start to bring the debt-to-GDP on a downward path, then—like the Commission did, the Commission achieved that—then people will say—will be able to look at it and they will say, Are we prepared to make the choices necessary to go beyond that?

And I think, again, the fundamental reality that I think we all have to confront—and it is both the Executive and the Congress—is that the current process we use for making these choices does not work. It has not worked. It is completely dysfunctional, in part because it leaves us with year-by-year incremental uncertainty creating changes to taxes with no clarity on spending. And the reason Rogoff-Reinhart produced the study that shows this effect on growth, opportunity incomes from high deficits, is because you leave the American people and American businesses to deal with a deeply uncertain future about what is going to happen to things that deeply affect their income and their business prospects.

So the costs of leaving that uncertainty out there are very, very high, and to resolve that you need something beyond a year-by-year political fight on incremental change. You need something that locks in comprehensive, multi-year reductions. That way people can look at it, and they can plan. They say, OK, I know what is going to happen now, I now know Congress is going to solve the problem, and I can plan and adjust and prepare for those changes.

Chairman CONRAD. Well, let me take you right—my time has almost expired. Let me just take you right to the Commission, because we did get 11 of 18 to agree—five Democrats, five Republicans, one Independent. And we reduced the debt $4 trillion over the next 10 years—$4 trillion. The President said about $1 trillion. Not only did we stabilize the debt, we started bringing it down as a share of GDP and over time brought it down markedly to a place where you would not only be—you would be guarding against—you would be hedging against future economic risk.

Is the size of what the Commission recommended a package that you believe would make sense, that is, $4 trillion of debt reduction, if we could get it on a bipartisan basis?

Secretary GEITHNER. I think you have slightly overachieved in terms of what is necessary, but, again, our risk, of course, as a country is that we do too little, not too much at the moment. So I admire you for laying out that path. But what——

Chairman CONRAD. So if $4 trillion is overshooting, what do you think? Three trillion?

Secretary GEITHNER. Again, I think the minimum test is to get the deficits comfortably below 3 percent of GDP for a sustained period of time.

Now, again, as you know, the basic——

Chairman CONRAD. But that does not reduce the debt. I mean, that will just——

Secretary GEITHNER. Right. But if you——

Chairman CONRAD. That will keep it from growing.

Secretary GEITHNER. You have to get them there soon enough that you stop the debt from growing as a share of the economy at an acceptable level. Again, I admire you for going further, and if we can do that, that would be excellent. But what is driving, you know, the 10-year deficits is not Medicare, Medicaid, and Social Security. What is driving the 10-year deficits is just a gap between resources and commitments outside those basic programs. It is beyond the 10-year window where you start to see those commitments, you know, eat an excessively large share of GDP. And so what really matters, if you want to go deeper than 3 percent of GDP, is what do you lock in for those entitlement programs outside that 10-year budget window.

Could I say one more thing, Mr. Chairman? There is a chart that I would like you to put back up which shows outlays and revenues to GDP, because I think that is the right way to think about it. If they are gone, then I will not do it. But what the President's budget does is to propose some changes in revenues that would leave revenues as a share of GDP slightly above the historic average. I think in the President's budget they rise to a little bit below 20 percent of GDP—a little bit less than what the Commission proposed. And outlays in the President's budget minus interest fall to around 20. Interest is about 3 percent of GDP at the end of that period if you do that.

So the reason I say that is because when you think about the choices we face, they are about like, What do you want Government to do? How large a share of income do you want the Government to take and spend? And what the President's budget does is get you to the point where revenues are not high at a level that would threaten future growth and outlays minus interest, which is just the cost of the cumulative mistakes of the past, are at a level that is really quite low in the historical period. You know, I said 20 percent of GDP minus interest, and, of course, the discretionary non-defense share is much, much lower as a share of GDP at the end of that 10-year window.

Chairman CONRAD. You know, I would like to continue the discussion. My time has expired, so we will go to Senator Sessions. But I would like, if we have a chance to get to a second round, to come back to this point.

Senator SESSIONS.

Senator SESSIONS. Well, that is a big national discussion. I do not think the American people want to see the percentage of the take of the Government increase substantially. That charts shows that it is now 25 percent, well above where we have ever been in this kind of environment. And it is very dangerous, and people are not happy about it. They think this is a limited Government of limited responsibility.

Senator Conrad, your chart, the one you have emphasized the most, having wrestled with these numbers, I think that is pretty close to the core chart. I have to give you credit. You have wrestled with it really hard, and when we are over 100 percent of GDP, we are in a danger area.

Mr. Geithner, you indicated not only could it reduce our growth, but you have indicated it makes us more susceptible to crises, debt crises, perhaps like the one we had in 2007, like Greece and other countries have had. Is that correct?

Secretary GEITHNER. I am very confident you are going to help us prevent that, but I am saying the reason why debt-to-GDP matters is not just because growth is weaker, but because—and if you look at all those countries in the past, they suffer—they are much more prone to crises in that context. But, of course, we are going to avoid that as a country.

Senator SESSIONS. Well, we need to take some steps to do so. In my opinion, we are too close, and as responsible Government officials we have a duty to help our country avoid risk that is unnecessary.

Let me just briefly run through this plan, because we are, I think, talking past us on the numbers. You do not contend that the 10-year budget calls for a single year, do you, in which we will not be adding more to the national debt?

Secretary GEITHNER. No. You are exactly right. The debt in aggregate terms does keep growing over this period of time, even if you achieve this deficit reduction, but the measure that economists use, just like families use, they look at the amount of debt they have relative to income.

Senator SESSIONS. Well, one of the reasons we got into trouble is that kind of logic. I admit it started with President Bush. But when you start politically allowing and accepting substantial deficits, it is hard for those of us who try to contain spending to have any moral basis on which to make that assertion. It is always that you are hurting somebody when you try to contain spending. I think it is a dangerous theory. It is part of the reason we are here, this GDP argument. The debt goes up.

Now, the administration does insist that the plan will reduce the total debt by $1 trillion over 10 years, but isn't it a fact that the debt is increasing substantially during that period and it is just $1 trillion less than it would otherwise have been? And I guess it otherwise would have been $14 trillion, and you are suggesting that it increases about $13 trillion.

Secretary GEITHNER. Well, I do not think those numbers are quite the way to think about it, and I want to——

Senator SESSIONS. Well, I am just asking you. The $1.1 trillion simply reduces the total debt by $1 trillion projected to accrue over the 10 years and that that is a $13 trillion range.

Secretary GEITHNER. What I am saying is that that slightly understates the amount of deficit reduction. Let me just make one clarifying point. That does not count the revenue gains of allowing what we call the Bush tax cuts for the top 2 percent to expire. If you allow those to expire and you preserve the rates and exemptions for the estate tax at 2009 levels, then you achieve another roughly $1 trillion in deficit reduction.

So, Mr. Chairman, if you look at the deficit reduction in our proposal relative to the Commission's, we are closer to $2 trillion relative to the Commission's $4 trillion. It is not really like $1 trillion versus $4 trillion.

The reason why, Senator Sessions, that is so important, of course, is that if you are not going to let those tax cuts for the high end expire, if you are going to extend them, and you want to achieve the same deficit reduction, you are going to have to find another $1 trillion in spending cuts to achieve that.

Senator SESSIONS. Well, my time is running, but I would just say to you that I am using your numbers, as I believe, and it is about $13 trillion, and it is not a very large reduction of the surge in debt, and we are still on the road to doubling it. And the plan, let me ask you, does not call for any change in Medicare, Medicaid, and Social Security as you mentioned?

Secretary GEITHNER. You are right that this budget does not propose changes to Social Security, and it does not propose detailed changes beyond the cost savings in the Affordable Care Act. But I would just restate, of course, that CBO does estimate very, very substantial savings from the Affordable Care Act over the next two decades, about $200 billion the next decade and $1 trillion in the second decade. And those represent the largest cost-saving entitlement reforms than we have considered or adopted as a country——

Senator SESSIONS. Mr. Geithner, we will continue to debate that issue. I believe that CBO's final letter right before the vote that it double counts the money is correct, and it is a miscalculation. And I do believe that it is driving up the cost of health care as CBO has said, not reduced it.

Let me ask you this: It has been repeatedly suggested that discretionary spending has been cut and tough choices have been made. But isn't it a fact that total discretionary spending increases every single year except maybe with the reduction in the military effort next year? But 2012 through 2021 discretionary spending increases every year is not reduced.

Secretary GEITHNER. I do not think that is quite right. I am sure what I am about to say is correct, which is that if you freeze non-security discretionary spending at the 2010 nominal levels and you do that for 5 years, and then after that you let it grow with inflation, then you do reduce the deficits by $400 billion over that 10-year period of time.

Senator SESSIONS. Well, let me just note that Table S. 10 shows that 2013 through 2021 there is an increase in discretionary spending every year. I think that is indisputable.

Secretary GEITHNER. I do not think that is quite fair, but, Senator Sessions, one of the great things about our system here is that CBO will resolve these debates for us, and we will have a chance to——

Senator SESSIONS. They will, and they are not dispute the numbers I read, I do not think.

Now, the budget plan calls for average annual deficits over this 10 years of $720 billion, that the lowest deficit in the 10-year period is $607 billion, and that in the last 4 years of your 10-year budget, the deficit is increased from 619 to 681 to 735 to 774, substantially increasing deficits. Would you disagree with that?

Secretary GEITHNER. Those numbers are exactly right. But, again, I think you have to look at them as a share of the economy as a whole, as a family would do. They look at debt to income.

Senator SESSIONS. We are not inclined to use a share of the economy anymore. That is why we are broke.

Now, let us talk briefly, as my time is winding down, about our interest situation. Under your budget the interest increases each year. It was $187 billion in 2009. Under your proposal it increases to $844 billion. I do not know if we have a chart here. Would you not agree that that is a stunning figure, perhaps the fastest-growing item in it, and all of that is a direct result of the debt we are running up and only a modest expectation of interest rate increases?

Secretary GEITHNER. Senator, absolutely. It is an excessively interest burden. It is unsustainable.

Senator SESSIONS. Well, it is your plan for the 10 years. I mean, that is the one the President has submitted. That is what he has asked us to vote on. It will result—and those are your numbers off your budget.

Secretary GEITHNER. Senator, you are absolutely right that with the President plan, even if Congress were to enact it and even if Congress were to hold to it and reduce those deficits to 3 percent of GDP over the next 5 years, we would still be left with a very large interest burden and unsustainable obligations over time. That is why we are having the debate. I completely agree with you. But the question, though, is, just to be direct about it: What is the alternative plan? And, again, the way our system works- -this is a good thing—you will be able to see from the House, we will be able to see from this body, whether people can find the political will here to go deeper. And if you can find——

Senator SESSIONS. But what your plan is, that plan is the one you are required by law to submit, and that is what you call for, and it is not acceptable. I am sorry. It is a plan not for winning the future but losing the future.

Secretary GEITHNER. No, I——

Senator SESSIONS. I am disappointed, really.

Secretary GEITHNER. No, Senator, I would just disagree again. But, again, the test of this is let us see the alternative. You know, we have laid out something that goes very deep, much deeper than we have gone as a country ever before.

Now, in terms of the scale of deficit reduction in a short period of time, if Congress can find a way to do that without gutting basic programs, killing investments, hurting growth, then we would welcome the chance to join you in embracing those reforms. But, again, the way our system works, we are proposing, and you will have the chance to see if you can do better.

Senator SESSIONS. Well, obviously you——

Chairman CONRAD. Senator——

Senator SESSIONS. That is your plan.

Chairman CONRAD. Senator, we have gone way over now.

Senator CARDIN.

Senator CARDIN. Thank you, Mr. Chairman.

Secretary Geithner, once again it is good to be with you. I think we all agree the deficit—we need to have a credible game plan to bring the deficit under control. That requires the administration and Congress to work together. It requires Democrats and Republicans to figure out a way to come together on a budget plan that will be in the best interest of our country. I think we all agree on that.

Now, there may be one area where we have some agreement, but from different sides, in that we all disagree with the Congressional Budget Office. My friends are telling me that they just want to ignore it in the House even though it is our impartial referee as to the scoring of costs.

I am disappointed that the Congressional Budget Office has not scored a lot of the savings that will come from the health reform that you pointed out. I think it is intuitive to the people of this Nation that if we can really get access to care, if we can have people out of the emergency rooms and into primary care, if we can deal with readmissions to hospitals and better management of people with serious illnesses, that America does not have to stand out alone with the highest cost burden to any economy on health care, that we can bring it more into line and we can reduce our health care spending to help bring not only our budget into balance but our economy into better performance.

So, yes, we do need action on spending, and I agree with Senator Conrad. I think the President's proposal for a freeze on domestic discretionary spending and the way he is handling the military is a way that is a very credible plan on the spending side and that we need to lead on the spending side. But even if we get those savings and even if we get the savings from the health care bill that I expect that we will get, you cannot do it on that alone. If we extend all of the tax policies that are currently in place in this outdated income tax structure we have, we will not only negate all the savings—all the savings we are talking about—but we will also be further in debt.

So you have to have a comprehensive plan that deals with all these, and quite frankly, I do not think the action in the House of Representatives this week is particularly helpful. I do not think it is helpful because I think it will negate the potential savings in the health care bill the way that they are restricting us to put in place good common-sense ways to try to keep people healthy in America. But also I think it is unrealistic, it is budget cuts, and will not produce the type of deficit reduction that is needed for this Nation.

So I just really want you to know, I think that the President in his budget has put forward a good-faith approach to dealing with the discretionary spending areas. And, yes, we need to work together and supplement that, as the Debt Commission did, in looking beyond just the discretionary spending in this country. We need to look at the entitlements. We need to look at the revenue side. And we need to come together for this country and not just make partisan speeches.

Now, I want to touch on one particular area that we had some questions on yesterday before the Finance Committee, but I want to move forward on it as it relates to small business. In your budget, you are moving forward with the initiatives on small business, particularly as it relates to the availability of credit. That is an area that, when we first attacked the problem on our economy, in my view the small business community was not given the type of attention it needed in order to have credit. We all know that job growth is going to come primarily from the small business sector. Innovation is higher in the small business sector.

Can you just give us the status of both the program at the national level that will extend credit to small businesses as well as the moneys that are made available to leverage State programs to help credit for small businesses?

Secretary GEITHNER. Again, I am happy to do that, but let me just start with the tax changes. At the end of the year in the tax package, there is a very powerful, sweeping set of incentives for small businesses that provide a lot of help and assistance at a time when they want to be able to have a chance to take advantage of growing demand for their products. They are very powerful, and they are very good economic sense, very practical, very creative. But the two programs you referred to we think will help, again, make sure that small businesses are going to be able to get access to credit and, therefore, bring more people back to work, bring more production online as demand improves. And those two programs are, first, a program to give small banks the chance to come and get capital from the Government for a very economically attractive price. We have about 250 applications in. We are going to be approving those for eligible banks as quickly as we can, and they will help leverage a substantial amount of borrowing capacity available to small businesses.

We also have approved three States now for some additional financial support to help reinforce their own small business credit programs. A lot of creativity around the country at the State level in those programs, and what Congress authorized last year was to provide a little additional financial resources for those programs, too. We think those will help, of course.

But, you know, a lot of small banks across the country still have themselves way overexposed to commercial real estate and have a lot of digging out to do still, and that is going to be a problem for those small businesses that were, frankly, unlucky in their choice of bank. But what these programs will do is help provide alternative sources of credit, make sure there is enough capital in the system to, again, help reinforce this recovery that is happening.

You are seeing loan demand start to increase again for the first time, and you want to make sure that banks are able to meet that demand.

Senator CARDIN. There is clearly a need out there, and there are clearly banks that are still sitting on the sidelines as it relates to making loans available to small businesses. If there is an existing relationship, it is a little bit easier for a bank and a small company. If you do not have that existing relationship, particularly if you are new company, it becomes very, very difficult.

We had that debate last year as to whether we should be using leveraging the private sector lending or whether we should try to do direct, and we went with leveraging the private sector. I would really appreciate you keeping us informed as to how well that is working so that we clearly need to pay attention to this issue, and we want to make sure that the money really is being leveraged to more activity.

I could speak for the program in Maryland. Governor O'Malley is one of those Governors that has a program and is requesting Federal participation. They leverage the public dollars at a very high ratio level. So for a relatively small investment of Federal funds, we leverage a lot of loans to small companies. That is critically important to companies that are having a hard time getting loans today.

Secretary GEITHNER. And I think the loss rates on those programs are really very low.

Senator CARDIN. Extremely low.

Secretary GEITHNER. I think on net they make money for the State, not lose money. So if you design them well, then you can make a big difference.

Senator CARDIN. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Ensign.

Senator ENSIGN. Thank you, Mr. Chairman.

I want to go back to what you were talking about, the exchange that you had with the Chairman about the gross debt, the 90 percent gross debt, because you said something that I thought was fairly interesting when you talked about the unfunded liabilities that are not on our balance sheets, because you said the situation was actually much more dire than what your budget or anybody else is really talking about. And even when we go back to the study, the Reinhart study, the 200 years that they talked about the 90 percent of gross debt, almost none of those countries had those unfunded liabilities.

So if you actually put those on the books, that 90 percent is much higher, and where you get to 110 percent is much higher with this country when you put the unfunded liabilities. And the reason I make the point is because this situation is much more dire. The criticality of us working together with President Obama on entitlement reform is so critical, and that is why I think that some of us on this side of the aisle are so disappointed with this budget, that the President did not show bold leadership.

It is politically risky. I will acknowledge that. And, Mr. Chairman, the one point that I disagree with you on is you said we would attack the President if he would have put that in his budget. I disagree, because you are showing—Paul Ryan, the Chairman of the Budget Committee in the House of Representatives, put out a proposal last year on entitlement reform, and he is putting it in his budget this year.

I am encouraging you, I am encouraging Senator Sessions, to put entitlement reform in this year's budget, so even though the President has not shown the leadership, the Congress needs now to show the leadership, and then to ask the President to join us, because we all know that these are politically, you know, third rails of American politics, but it is critical, because the numbers—and you agree, everybody agrees, everybody knows this is unsustainable. And if we do not show political courage right now, we are doomed as a country. We really are.

Secretary GEITHNER. Well, Senator, I agree with you, but I would just try to make sure I emphasize one key thing, which is that you are absolutely right about entitlements, and if you look beyond the next decade, they again gradually, progressively, but at an alarming rate start to eat too large a share of national income. But do not forget the next 10 years, because if we do not get these deficits down over the next 3 to 5 years to a level that is sustainable, then we will face the risk of a significantly weaker expansion.

I know everybody is showing a lot of ambition on entitlements now, which is good because it helps underscore the importance of making sure the Affordable Care Act reforms are allowed to get some traction, because they do reduce cost growth. But remember, the next 10 years are really important, too.

Senator ENSIGN. Absolutely, and let me just interrupt you for a second. I actually disagreed with one of your statements, too, where you said Medicare and Medicaid are not contributing to the deficit. They have been growing at such a rapid rate, they are absolutely contributing to the deficit right now. And so we need to get control of these entitlements, not just for the next decades to come. We need to get control of these entitlements for today. We need to design better systems.

I believe that, for instance, Medicaid, what we did on welfare reform in a bipartisan fashion during the 1990s, we block-granted it to the States because they were these institutions that had shown the ability to reform them and do it in a way with flexibility. And if we get the Federal Government out, we can cap the amount that we are sending. We know how much that could potentially save into the future. It could be huge amounts of money. And designing a better Medicare system that focused more on, you know, healthier behaviors for seniors and getting things under control, you know, chronic types of conditions. But we need to do that for this decade as well.

I do not have a heck of a lot of time, so I do want to go to one other thing, because we know we need to do this. I am just encouraging you to get the President to join us and actually show some Presidential leadership.

The comment, small business is the engine that drives the economy, do you think that that is a fairly true statement?

Secretary GEITHNER. Well, sometimes we get a little carried away, because big businesses matter, too.

Senator ENSIGN. It does, but——

Secretary GEITHNER. But in general, you are right, that there is a lot of innovation and job creation that comes from small business.

Senator ENSIGN. OK. The reason I bring this up is because in your budget, most small businesses—I was a small business owner. Most small businesses owners pay ordinary income because they are Subchapter S corporations, sole proprietors, LLCs, in various forms like that. And while I applaud you, I totally agree that we need to reform our corporate Tax Code. We need to bring it down. We need more of a territorial system. And I appreciated your comments yesterday about repatriating money back to the United States in a much easier way. All of that is good stuff.

But if you allow the tax rates to go up, now corporations can be paying a 24-percent tax rate where, you know, most small businesses in the country could be paying almost a 40-percent tax rate. And if it is really the engine that grows the economy, I think that you are going to stifle a lot of growth in small businesses with these high tax rates. And so, you know, I would like to hear your comments on that.

Secretary GEITHNER. I believe that if you are going to do a serious job of looking at corporate tax reform, comprehensive tax reforms, you have to look at business income more broadly defined, and you are going to have to look at how we treat income of businesses that are not corporations under the Tax Code. So I agree with that point.

But could I make one qualifying point?

Senator ENSIGN. By the way, I hope we can work together. I am actually working on something that treats them the same. It is a little expensive, and we are going to have to work on it, but I appreciate that comment.

Secretary GEITHNER. I would welcome a chance to do that. I do want to make sure, though, we put in context what the implications are for small businesses of letting the top 2 percent tax cuts expire, and this is very important because that would only affect less than 3 percent of small businesses. The average earnings of the less than 3 percent of small businesses affected are about a million. The median is about $700,000. And most of the small businesses that fall into that category—again, it is less than 3 percent—are really what we would typically look at as law firms or partnerships or investment companies in that context. So we are not talking really about a significant number of the hardware stores on Main Street or the small manufacturing companies. We are talking about partnerships, law firms. But——

Senator ENSIGN. You need to get out there in the real world and talk to folks. The reason I am saying this, because I have been out there in the real world. It is the veterinary clinics, it is the dental offices, it is the—and they want to expand their businesses. They want to create jobs. And if taxes are part of the thing that they are looking in the future, if their taxes are going up, business owners—and, by the way, those 3 percent produce about a quarter of the jobs, the new jobs. And so that is a significant thing, and if they want to grow their business and we all want more jobs in

America, we have to understand that small businesses do create jobs, and we are going to hurt job creation, which hurts the growth curve of revenues coming into the United States.

My time has expired. I apologize.

Secretary GEITHNER. Mr. Chairman, could I just say—of course, I understand this concern, but, again, just two other context notes about—you know, we are proposing to restore the rates that prevailed in the 1990s. That was the best record of small business job growth, small business creation that we had seen in a long time and have seen since. It is something that is manageable, that we can afford as a country. We do not have unlimited choices, and we are proposing in the budget alongside those changes some very well designed, very powerful incentives directly related to small businesses, like, for example, zero capital gains on investments in small businesses. And we are proposing to keep taxes on overall investment quite low as a whole.

But, anyway, happy to work with you on reform. You are right to say you have to look beyond corporates, although it is kind of difficult to do politically.

Chairman CONRAD. I thank the Senator.

Let me just say we are on 7-minute rounds to Senators. You know, typically with this number of Senators we do 5 minutes, but we went to 7 minutes today given having the opportunity to have the Secretary. So I am going to try to drop the gavel right at 7 minutes in fairness to the other colleagues who are here and waiting.

Senator SANDERS.

Senator SANDERS. Thank you very much, Mr. Chairman. And welcome, Secretary Geithner.

I find this to be an extraordinarily strange conversation. We hear a lot of discussion about great concerns about the deficit and the national debt. But the people who talk most loudly and vigorously about this issue are those people who helped create this national debt. So let us be clear about how we got here in the first place. We might want to talk about that.

This Senator voted against the war in Iraq, for a number of reasons, not the least of which it was unpaid for. Three trillion bucks. That is a lot of money. I did not hear too much discussion a few years ago about that war.

This Senator voted against huge tax breaks for the wealthiest people in the country. And you know what? Budgets are two things. I know this is a radical concept. It is not just spending, but it is also money coming in. And if you give hundreds and hundreds of billions of dollars in tax breaks to the very wealthiest people, lo and behold, deficits go up. I voted against that. Most of my friends on the other side of the aisle voted for it.

I voted against the Medicare Part D prescription drug program written by the drug companies and the insurance companies, not because we do not need a good program for seniors; that was a very wasteful, ineffective way to go. Most of my Republican colleagues who are now jumping up and down about the deficit, they voted for it.

I voted against the Wall Street bailout, and I do understand much of that money has been paid back. But, nonetheless, I did not hear at that point when we bailed out the largest financial institutions of the world whose illegal behavior, whose reckless behavior drove us to a recession, I did not my Republican friends say, "Oh, we cannot give them $800 billion. That will drive the deficit up." Maybe I missed that discussion. But I did not hear it too much.

So that is one of the reasons we got to where we are right now. Under Bush, as we all know, the national debt almost doubled.

The second part of the discussion I am not hearing about is we talk about America like we are all in this together. Well, let me give you some startling news. We ain't all in this together. The people on top, the top 1 percent, the top 2 percent, are doing phenomenally well at the same time as the middle class in this country is collapsing.

Mr. Geithner, when you respond, you tell me what I am missing here. All right?

The United States today has the most unequal distribution of income and wealth of any major country on Earth. The top 2 percent earns more income than the bottom 50 percent. And I hear the words about political courage. Oh, we need to be really tough. We can throw old ladies in the State of Vermont off the heating assistance program when it gets 20 below zero. Man, that is real political courage. Well, how about some political courage about taking on the big money interests who fund our campaigns, who provide millions of dollars and want tax breaks for the very wealthiest. Let us see some political courage there rather than throwing senior citizens off the LIHEAP program or low-income people off of life and death programs for them.

Now, Mr. Secretary, in 2007 the top 1 percent earned 23.5 percent of all income in this country. The top one-tenth of 1 percent took in 11 percent of all income. The percentage of income going to the top 1 percent has nearly tripled since the 1970s. Is that right, Mr. Secretary?

Secretary GEITHNER. I think that is largely right.

Senator SANDERS. From 8 percent to 23 percent. Between 1980 and 2005, 80 percent of all new income created in this country went to the top 1 percent.

Now, when we talk about how we move toward a balanced budget, I would appreciate my friends listening to this. In 2007, the wealthiest 400 Americans made an average of $345 million a year. Under the Bush administration, these 400 top earners saw their incomes double while their effective Federal tax rate was cut almost in half over the past 15 years.

So here is the dynamic that you have which must be thrown into this discussion. The middle class in many ways is collapsing. Real unemployment in America today—I have not heard a word about unemployment yet, by the way—is 16 percent if you talk about people who have given up looking for work and people who are working 20 hours when they want to work 40 hours. Meanwhile, we have cut substantially taxes for the very, very wealthiest people in this country, and in this agreement, this very poor agreement that the Obama administration agreed to with the Republicans, those are extended again for another couple of years.

So I would suggest that when we talk about sacrifice, maybe some of the campaign contributors and the wealthiest people in this country might want to make some of that sacrifice rather than just the middle class.

Let me ask Secretary Geithner a couple of questions. I was glad to hear you—and just let us go through this again. You would agree with me that Social Security has not contributed one nickel to the deficit and that Social Security has a $2.6 trillion surplus right now?

Secretary GEITHNER. I think that is largely right, yes.

Senator SANDERS. OK. And would you agree with me that, according to all the studies done, Social Security can pay out every benefit owed to every eligible American for roughly the next 25 to 30 years?

Secretary GEITHNER. I would have to check that, but I assume if you are quoting it, it is right.

Senator SANDERS. Yes, it is. And after that, it can pay out about 75 to 80 percent of all benefits.

Secretary GEITHNER. That is true, but I would not be so comfortable about that because, as you know, the minimum benefit is not a very rich benefit for many Americans.

Senator SANDERS. I know it. During the campaign, when President Obama was elected, he suggested that the solution to the long-term solvency of Social Security was to lift the cap on upper-income folks above $250,000, which I thought was exactly the right thing to do. Is that still the administration's or the President's position?

Secretary GEITHNER. Well, I want to be careful in how I say this because, again, we want to preserve some capacity for people to come together on something that is going to work, but I will be direct about it. You cannot do this in a way that is fair and responsible by simply cutting benefits, even if you do it in a progressive way. You have to go beyond benefits if you are going to do it in a way that is fair and has any realistic prospect of people coming together around the plan.

Senator SANDERS. I agree with you, and let me just say this. This is a quote from Candidate Obama during the campaign. He said, "John McCain's campaign has suggested that the best answer for the growing pressures on Social Security might be to cut cost-of-living adjustments or raise the retirement age. Let me be clear. I will not do either."

Do you think that that is still the President's position?

Secretary GEITHNER. Well, I think the President's position, again, is he just wanted to be very careful, as you heard him say in the State of the Union, to not be solving Social Security in a way that cuts deeply into benefits for people who need it or puts an undue burden——

Senator SANDERS. You make me nervous when you say "deeply." That is not what the President campaigned on.

Secretary GEITHNER. Well, I did not mean to change his words, but the President has spoken on this several times in the last few days, few weeks. His words govern. I cannot quote them for you directly. But, of course, those are his choices and his words.

Senator SANDERS. OK. Thank you very much.

Chairman CONRAD. Thank you, Senator. Thank you for respecting the time.

Senator THUNE. Thank you, Mr. Chairman. Mr. Secretary, welcome again. We had Secretary Geithner in front of the Finance Committee yesterday, and I appreciate your willingness to endure our questions.

I asked you yesterday about the individual mandate and whether you thought it was a penalty or a tax. You said that was up to the lawyers to decide. And I assume you have an opinion about that, but I will not go into that. I do have a question, though. Do you know how much that raises in your budget in terms of revenues?

Secretary GEITHNER. I have to respond to you in writing. I do not know the number. I do not have it at my fingertips now.

Senator THUNE. OK.

Senator THUNE. Well, my own view on where we are today, I mean, obviously we have a big problem which has been contributed to over the years by a lot of different factors. I think in a fantasy world where we were not fighting a war on terror, we might not have had to spend money fighting a war on terror, which would be great. But the fact of the matter is we have had to do that. We have had the debt grow just in the last 2 years alone by $3 trillion.

Now, my own view is that that is understated significantly because I believe that the health care bill, notwithstanding your assertions that it is actually going to reduce the debt and the deficit over time, is actually going to add significantly to it for a couple of reasons. One is I do not believe that this Congress is really going to cut $1 trillion out of Medicare. Now, maybe I am wrong, but when I first got here in 2005, we had a vote to try and achieve savings of somewhere on the order of $40 billion, and I think Vice President Cheney had to come back from Pakistan in order to try and break a tie on that. And at the end of the day, I do not think it ever happened. So I am very skeptical about whether or not we are actually going to reduce Medicare spending.

Second, there are a number of things, as was alluded to earlier by the Senator from Alabama, about the way that was scored, which I think—and we have heard testimony from the CBO about that, that it double counts revenue. Medicare, Social Security Trust Fund revenue being credited to the trust funds as well as being used to pay for the new entitlement program on the order of hundreds of billions of dollars.

The CLASS Act, which was scored in the near term as a revenue raiser, is, I think, going to be a huge deficit increaser in the outyears. That, too, is something that in my view is going to dramatically understate the fiscal picture, particularly when you look at the long run. And the SGR, which was not included in that, there are 2 years of offsets, I think, in this budget for the SGR, but the SGR is going to have to be dealt with as well.

So you have all this spending associated with the Affordable Care Act, and everybody says, well, it is going to be budget neutral or, better than that, it is actually going to generate surpluses over the years. I just do not subscribe to that. So I think this situation is much worse than actually most of us believe.

The other thing I would argue is that the growth rates that are assumed in the budget, which are significantly higher than the CBO's growth rates—4.4 percent I think in 2012 is what OMB assumes, and CBO says 3.1 percent. That makes a huge difference in the deficits that we are going to be looking at and the debt that we are going to be looking at.

So having said all that, I think this picture is much more grim than many of us realize, and it does come back, in my view, to a spending issue. You can look at—and the Chairman put up the chart. Over the period of time that he looked at, the five times the budget was balanced, the revenue was actually exceeding the historical average. But the other thing you have to look at, there was only one of those years that I saw where spending was not below the historical average. If we balance the budget, the assumption was that spending had to have been below the 20.6 percent average that we have seen over the past 40 years, too.

And what are we spending today as a percentage of our GDP? 25.3 percent. That is this year's number. The historical average over the last 40 years is 20.6 percent. This is a spending issue fundamentally. And we have to deal with it. And as painful and hard as some of those choices are—and I think the only way you do that is with the long-term structural changes in these entitlement programs that are going to explode in the out-years. And this budget just does not address that.

Again, I mean, I cannot tell you how disappointed we all are in that, and I know that they are saying, well, you guys come up with your plan. Well, there will be, I think, some suggestions made when the House Budget Committee does their budget resolution. But you still have 535 Members of Congress and only one President. The President is the CEO. The President has to lead. The President has to say, "This is what I would do to fix this problem." And kicking the can down the road for another 2 years until we get past the next election just does not cut it. So I think many of us up here are prepared to work with him to address the long-term problem we face.

Just a couple of quick questions for you. And, again, as we look at what we are going to be facing in the years ahead, the Treasury Department, of course, is tasked with running the auctions of U.S. securities, and I am wondering if you have any concern that any of the auctions are going to fail anytime within the 10-year budget window if we follow this budget.

Secretary GEITHNER. No, there is no risk of that. In fact, if Congress were to enact these proposals, meaning bring about this level of deficit reduction as a share of the economy in this period of time, you would see a dramatic improvement in investor confidence about the political will in Washington to deal with these problems, recognizing that it does not go far enough. But if Congress would enact it, go this far, it would be historic deficit reduction on a scale we have never as a country even been able to consider. And I say that acknowledging that it does not solve all our problems.

Senator THUNE. Maybe I am going to take issue with that, but it just strikes me that when you are—that the gross debt is going to grow to $26.3 trillion at the end of the decade. It is $14.3 trillion today. It is hard to see how you can get to where you are 100 percent debt-to-GDP, and in the second decade it goes above that, that the bond markets are going to recognize that and say this is something that we believe is actually going to get the fiscal situation of the Federal Government back in line. I have a hard time understanding how that would be interpreted by the bond markets to be a positive thing.

Secretary GEITHNER. Well, again, you know, Senator, this is all—you know, these things about confidence are all a judgment about the strength of political will in a country. And people do look at this country over history, and they say ultimately in the end Washington figured out how to fix it and get ahead of it. Right now, if we do not actually do that, we will suffer the risk of gradual erosion in confidence, and that will hurt us as an economy.

But I want to state, I know that people would like us to go further, and, again, if Congress can find a way to go deeper and further in a way that does not gut basic programs critical to our capacity to grow without creating growth, then we will join you in that cause. But what troubled me about where you began is the following: You said that you are concerned Congress will not have the will to enact the cost savings in Medicare and Medicaid that are in the Affordable Care Act. So I guess I would ask in response to that, if you are troubled about those cost savings, then what does that mean about what plan you are going to provide us for how we get this deficits down? Because then if you are going to say we cannot actually do that, then you are going to have to look at other things, and that is going to put us in the position where, I think—I do not know where else you are going to go, because you have to go to defense, or you are going to have to go dramatically deeper than the House on discretionary, non-defense discretionary, or you are going to have to go to revenues, like the Commission did on a substantial scale. But, you know, it is just a question about where you make those choices.

Senator THUNE. And if I could, Mr. Chairman, just in response to that, look, I do not disagree. I do not think Congress has the appetite to deal with some of these issues. But it was a fundamental mistake, in my view, to go after Medicare to fund yet a new entitlement program rather than using those savings to reform Medicare. I think you would have plenty of support up here for doing that.

Secretary GEITHNER. But, Senator, again, I think I agree. That is an interesting strategic question. But you could also take the other view, which is that apart from the basic rationale of extending coverage to all Americans, and apart from the other changes that are designed to improve how we use health care, you could ask yourself, Would Congress have legislated those reforms without that? It seems to me highly unlikely.

Again, if you jeopardize that law, then you will take off the table what is more than $1 trillion of cost savings for the taxpayer over the next two decades. And if you take that off the table, you have to say where are we going to find that revenue, where are we going to find those savings. And you will have to go places I think you are going to find it much, much harder to go.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman. Welcome, Secretary.

Secretary GEITHNER. Mr. Chairman, could I ask one question? Well, I do not want to take your time up. Go ahead. Sorry, Senator. Go ahead.

Senator WHITEHOUSE. I am happy to defer my 7 minutes for a moment if the witness has a question he wants to ask the Chairman. We can restart the clock—

Secretary GEITHNER. It is up to the Chairman. I can do it at the end, if you want.

Chairman CONRAD. Yes, I think we should keep going because we have a lot of members left here.

Senator WHITEHOUSE. Mr. Secretary, you have described in the past the importance of the housing market to the economic recovery, that you opposed the foreclosure moratorium basically on those grounds, and so I would like to ask a few questions about the housing market and specifically the mortgage situation, the foreclosure situation that is out there. And it strikes me that a lot of different arrows are pointing to a catastrophic bureaucratic failure on the part of the banks and the servicers in dealings with distressed homeowners.

The HAMP program is operating at one-fifth of its self-defined level of success, which was about less than half of the actual foreclosure liability that we face as a country. So that cannot be seen as anything resembling a success.

When I talk to my realtors in Rhode Island, to a person, literally at meetings with a dozen or more realtors, they have had short sales on the books with a bank, and that same bank has foreclosed on the property during the short sale, with the result that a property that was going to be sold for 90 percent of value is now trashed and is in the foreclosure pool at 40 to 50 percent of value.

When you deal with, as we all do, our constituents who are trying to work their way through mortgage modifications, it is a nightmare. I have had people who have been dealing for 19 months. They never found a person who would give them their last name. They never had anybody involved who could make a decision. And recently in Rhode Island, to sort of put a fourth arrow on this, the local bankruptcy court has made findings that in virtually every case there is literally no response on the part of the banks when these problems come in, and so they have had to develop a special program to try to do something incredibly simple: get a human from the bank who will make a decision in the room with the homeowner before you throw him out of his house. That is so offensive to Deutsche Bank that they have actually challenged the regulation in court, and we are trying to resolve that legislatively.

But when all those arrows point in the same direction—the HAMP failure, the foreclosure nightmare that people experience, the court decisions, the realtors' short sale experience—they all point to a huge bank bureaucracy that is incompetent, that is tormenting people, that is doing great damage to the investors—I mean, who got hurt when the short sale got wiped out because the bank foreclosed on its own short sale? The investors did.

We have been corresponding about this, and you have been sending me all these cheerful letters about how, you know——

Secretary GEITHNER. Not cheerful.

Senator WHITEHOUSE [continuing]. Do not worry, good news is around the corner.

Secretary GEITHNER. Not cheerful. Never cheerful.

Senator WHITEHOUSE. And I do not see good news around the corner. We have been doing this for more than a year. Have you analyzed the extent to which the HAMP incentives are overwhelmed by the existing financial incentives that the servicers have for dealing with foreclosure, dealing with programs? My take is that they are insignificant and, therefore, have not—that is one of the reasons the HAMP program has failed.

And the second thing is you have kept issuing these sort of memoranda and suggestions as to the timeframe within which banks should be acting. They are not. They just are not. I do not care what timeframe you have said. They are not doing it.

Where are you in terms of enforcement? Have you punished anybody for not doing it? And have you looked specifically at whether they are phonying up the file by continuing to demand—one of the things we hear all the time is that people have the same records asked of them six, seven, eight times. It strikes me that there is at least a reasonable case to be made that because your suggestions for the timing on this start with the close of the file, they have figured out that if you keep asking people for the same information over and over again and chucking it in the file or whatever they are doing, they can wait and never have the file closed and never start your clock.

So either your suggestions to them for timing are just failing, or they are not being enforced, or they are being gamed. Please tell me where that is, because I do think that is important to the underlying economic recovery.

Secretary GEITHNER. Senator, you are absolutely right that this is a tragic, terrible mess across the country still, and we are not coming to the end of that amount of pain and risk and trauma to homeowners caught up in this crisis. And many of them are completely innocent victims of the failures of the system before this.

Now, you are also right that servicers and banks on the whole I would say are still doing a terribly inadequate job of meeting the needs of their customers, helping customers navigate through this basic process. And we are going to have to do a better job of trying to reach as many people as we can reasonably reach with these programs.

Now, one thing about what we have accomplished, because it is important to recognize this, it is—about 4 million people have benefited from mortgage modifications since these programs were launched. Now, a relatively small number of those are permanent modifications in HAMP, but do not understate, please, the impact that it has had on millions of homeowners in reducing their monthly payments.

There are people we are not going to reach with these programs because a lot of the people facing foreclosure are individuals for whom it is their second home, it is——

Senator WHITEHOUSE. I get it. Let me interrupt, because I understand your point. All foreclosures cannot be prevented. That is not the point. And that was not the point when I urged you to do a foreclosure moratorium. The point of the foreclosure moratorium was not to stop all foreclosures. The point of the foreclosure moratorium was to smack the banking industry and the servicers up the side of the head and let them know there are not going to be foreclosures until they sort out this mess that has been for 2 years a bureaucratic nightmare that is ensnaring millions of Americans. And it is that bureaucratic nightmare that is the focus of my question, not the fact that for some people foreclosures are inevitable.

Secretary GEITHNER. I was going to agree with you, not disagree with you, in your characterization of the problem. You asked why isn't it stronger, why isn't it better, and you are right that this is always a mix of compulsion and incentive, and the incentives——

Senator WHITEHOUSE. Who have you whacked for failing?

Secretary GEITHNER. Under the law, we do not have the power under the law to compel. We have the capacity financially to provide incentives. Now, I think those incentives have not been powerful enough in all cases to overwhelm the rest of the muck these servicers have created. I agree with you about that. But we do not have the power to compel, Congress did not give us that power, and that limits our leverage over the outcome.

However, we are doing as much as we can given the tools Congress has given us to try to reach more people, and we are going to be able to reach substantially more people, although we will not come close to those initial estimates we laid out at the beginning of the program.

Senator WHITEHOUSE. My time has expired. Thank you, Chairman.

Chairman CONRAD. I thank the Senator for respecting the time.

Let me just indicate to members, they have told us now- -we expect a vote at 11:50. We have five members left. We are doing 7-minute rounds. The math does not quite work. So I am just going to ask everybody please come right in at the 7 because I will stay here until we have 5 minutes left on the vote so everybody gets a chance.

Senator JOHNSON.

Senator JOHNSON. Thank you, Mr. Chairman. I can talk fast.

Mr. Secretary, nice to meet you. There were a couple of interesting statements you made. The first one is basically it would be excellent if we could go further in deficit reduction. If you believe that, I guess my question is: Does the President believe that? And if he does, why doesn't he lead?

Secretary GEITHNER. Again, the question is how you do it. The challenge is not principally or only about how fast or how far you bring down the deficits, though that is really important. The question is how you do it. And the how matters because, again, you have to care a lot about the basic strength, competitiveness growth of the country, what you do to invest in incentives, education, things like that, but also you have to ask yourself what can you legislate. Because, again, if we sit here and we just talk about it forever and we do not legislate——

Senator JOHNSON. It would be far easier to legislate if there was leadership from the President.

Another comment you made was—this is maybe an unfair paraphrase, but you said, "What is your plan?" I mean, is this just political—are we playing a game of chicken here?

Secretary GEITHNER. No. Again, the way our system works—and, again, our system has a lot of strengths, but a lot of weaknesses, and I would say, as I said at the beginning, our current budget process does not work, has not delivered sustainable outcomes in this context. The way our system works is the President has to propose. We have to take the burden, as we have done, to lay out a plan for how we choose, how we propose to address these challenges.

Now, that is just the start of the process, and the way the process works is everybody else has the obligation and the opportunity to say we think here is a better way to do it. And then the process begins. So it is just the first stage of the process, and, again, we are not asking you to like the plan. You do not have to embrace it. But what we do want to see is if you want to go deeper or get there on a different path, tell us how you think we can do it.

Senator JOHNSON. We only have one President, and I am just going to tell you, I think the American people is hungering for leadership. The reason I ran for the Senate is because I believe we are bankrupting this Nation. You mentioned the unfunded liability. The figure I look at is the U.S. debt clock, that website. They list the top three entitlement programs. The total unfunded liability of those programs are $112 trillion. Total U.S. assets—household, small business, corporate assets—is $73 trillion. That is a $39 trillion shortfall. That is a huge problem.

And, again, what numbers do you use in terms of the unfunded liability?

Secretary GEITHNER. Well, Senator, again, I assure you, you cannot make me more concerned than I am as Secretary of the Treasury about the unsustainability of these commitments. And, again, I welcome, as everyone should, the fact that after years where people said deficits do not matter, these things pay for themselves, we do not have to care about the cost of this kind of stuff, people are coming around today and saying we are for trying to deal with this basic challenge. So that is a good thing to happen. We are seeing it at the State level. That is a very good thing to happen. So we have a chance now to try to translate that hunger for change on this kind of stuff into stuff that will actually matter over time.

But, again, we are not trying to put the burden on you. The Constitution puts the burden on you. What we did is lay out this is our path. Happy to work with you. And, again, we recognize there are different ways to do this, but you have to make choices about what you are going to do to programs and about growth and about fairness.

Senator JOHNSON. OK. Let me ask a couple nuts-and-bolts questions. I asked Director Lew the same question. I look at your—on your Table S. 1, your total cumulative deficit over that 10- or 11-year period was $8.9 trillion. Gross Federal debt increases $12.8 trillion. That is a $4 trillion difference.

Now, I know about $1 trillion, as I am looking at the figures, looks like it is an increase in financial assets. Where is that other $2.8 trillion increase in debt? Do you follow my question?

Secretary GEITHNER. I do not. I am sorry.

Senator JOHNSON. Total cumulative deficit increases $8.9 trillion, but our debt over that same period is growing by $4 trillion—I mean, by $12.8 trillion, an additional $4 trillion in debt over the deficit. I do not have a good explanation. Director Lew said that it was an increase in Social Security surplus. That makes no sense.

Secretary GEITHNER. Can I think about that and then respond accurately in writing? I just need to think about it a little more carefully. I do not know how to explain it——

Senator JOHNSON. We will submit that in writing.

Senator JOHNSON. I am concerned about three areas of risk in your budget. First of all, economic growth. Would you agree with the basic statement the more you tax something, the less you get of it?

Secretary GEITHNER. No, I would not agree with that. I think that—well, let me put it differently. If you want to think about revenues and the effect on growth, you have to think about it in the context and the size of our deficits. You need to look at not just the overall level of revenues relative to GDP. You have to look at what is the resulting deficits you are still left with. And so, again, what we propose is something that brings revenues back to a level slightly above their historic average. Only slightly above. Only slightly above, and we think that is sustainable over time.

Senator JOHNSON. The historic average is about 18.8 percent, correct? Regardless of marginal tax rates, isn't that kind of Hauser's Law? And what you are looking at is the last half of the 1990s when we had an incredibly strong economy and we did increase tax rates, and people could not basically shield their income. But then it did end up resulting in a recession.

Aren't you relying on unhistoric rates of percent of GDP in terms of revenue?

Secretary GEITHNER. No, again, the numbers are what they are. Again, you can disagree about what the impact is, but we are talking about rates overall that prevailed at a time when the economy was doing incredibly well relative to what we saw in the succeeding decade. So, again, I think our economy would do fine under those rates——

Senator JOHNSON. Now we have an extremely weak economy. How would increasing taxes produce that type of revenue? I think that is a really bad assumption?

Secretary GEITHNER. No, I am not—again, I do not—I am not going to try to change your view about the economics. I am saying what we are proposing is a reasonably balanced set of revenue changes and spending proposals to achieve very substantial deficit reduction. And if you want to go deeper, then you have to figure out whether you do more revenues or you do more spending cuts, and those have consequences for growth. Again, you know, this is not—no one will say any plan is a perfect plan.

Senator JOHNSON. I understand.

Secretary GEITHNER. But it is a proposal.

Senator JOHNSON. Let us talk about the risk in your health care projections. Basically the CBO, the way you gave them the figures, they are scoring it as a $1.5 trillion deficit reduction over two decades.

Secretary GEITHNER. Well, again——

Senator JOHNSON. Are you familiar with the ex-CBO's Douglas Holtz-Eakin's study where he is talking, instead of 3 million people moving into those exchanges——

Secretary GEITHNER. Senator, again, a great strength of our system is you and I do not get to decide these numbers. We have an independent, nonpartisan office that makes these judgments for us. So you do not need to take my word before anybody else's. Only one word governs, which is a good thing for the country, and it will be CBO's judgments. All I was doing is repeating them. They are not mine. They are theirs.

Senator JOHNSON. Do you agree only 3 million versus—OK.

Chairman CONRAD. Senator Coons.

Senator COONS. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for being with us today for this engaging conversation.

This morning, families in Delaware woke up to more tough news. About 100 folks are getting notice from Perdue they are getting laid off in our poultry industry. About 80 people due to A&P's ongoing bankruptcy are going to lose their jobs in my home county in the grocery store. As I think Senator Sanders strongly pointed out earlier in this hearing, this continues to be a very tough time for working folks in this country.

What in this budget gives them and should give me some optimism about the investments you are making to try and strengthen this recovery?

Secretary GEITHNER. Well, I think you would have to look at the proposals for a very, very substantial improvement in public infrastructure, which is very good for you to think about these challenges, because a lot of the unemployment caused by the crisis was concentrated in construction. So that is one plan.

A second piece of this I would look at is the tax incentives that are there for investment. It is very important we do everything we can to make sure the Tax Code is making it more likely that the great American companies, small and large—and foreign companies, too—are building their next facilities here so that we are creating and building more jobs in the United States.

We are proposing a substantial set of changes to help improve export growth. There has been very good export growth in the early part of the recovery, and it is very broad-based. Manufacturing, industrial production, agriculture, high technology—there is a lot of job growth with that.

There is a whole range of other proposals in there to help encourage innovation, education. That is what I would focus on.

Senator COONS. Some have criticized your growth estimates as being overly ambitious. I am optimistic, given some of the proposals in here, that they are potentially achievable. Things like the zero capital gains and small business investment I think are particularly a good idea. Making permanent the R&D tax credit I think is an excellent idea. You testified yesterday in the Senate Finance Committee and touched on repatriation of foreign-earned profits and the possibility of tax reform, which I think has to be a piece of the solution here moving forward.

Help me understand how you think it might be possible to change our current corporate rate, encourage repatriation in a way that would reinvest in hiring and in capital and in R&D rather than simply in bonuses or dividends, and how you might structure that. You also—I was interested—suggested that we could make fundamental change in the corporate rates and the corporate structure without doing it on the individual side. As Senator Ensign mentioned before, there are some complexities to doing that. I would be interested in hearing your views.

Secretary GEITHNER. Well, I guess I would just stay with these simple, basic principles, elements about design. Again, you want to bring the statutory rate, which is now the highest in the world, down very substantially. You want to bring it closer to the range that prevails across our major competitors. To do that, you have to substantially reduce, scale back a set of very broad-based tax preferences that go to businesses. You need to do that in a way that makes clear that we are reducing, not improving, opportunities to shift income and investment outside the United States. You want to change those incentives in the other direction to the extent you can. And you cannot do that responsibly if you are going to be adding to future deficits. You have to do it in a way that is revenue neutral.

Senator COONS. Right.

Secretary GEITHNER. You cannot, I think, offer the hope of raising more revenue from business as a whole over time because we live in a much more competitive world. But you cannot take the other risk, which is that we lose revenue.

Senator COONS. And for those very folks I mentioned who today are getting bad news, how do I reassure them that by making that dramatic reduction in at least the statutory corporate rate I am not simply—were I to be supporting that, I am not simply encouraging more offshoring, more loss of American manufacturing jobs? You do have some specific incentives targeted at manufacturing, I think are a strong part of this plan. But I am very concerned about how we make sure that we do not further lose manufacturing in this country.

Secretary GEITHNER. Well, again, the critical test we apply to any reform program that we are presented with or that we propose would be we improve, not reduce, the incentives to invest here; we reduce, not increase, the opportunities to shift income outside of the United States. That is a critical test. And it is very important, as you are implying, that when you look at these proposals for changing how we tax worldwide income, territorial options, you do not—not just risk losing revenue, but you do not want to create the incentives to have more of that stuff happen outside the United States.

Senator COONS. There are a number of things about how budget scoring works here at the Federal level that are new to me. I got familiar with how to balance budgets at the county level. The Federal budget is fundamentally different. There are a number of things folks have brought to me that I am trying to get my head around. One of them is the idea that the student loans, when they have been moved to direct lending, are scored as being without risk, essentially presumed to be fully repaid, and that that creates the impression, the false impression of savings, when, in fact, any realistic assessment would include some risk. Can you comment on that?

Secretary GEITHNER. You know, I need to think about that a little more carefully, but I would be happy to respond to you in writing about that.

Again, I think the general principles we try to abide by and we should abide by are that you need to show on the budget the full costs, the potential risks of loss associated with any type of loan or guarantee program, whatever its basic form. And obviously it is important we try to achieve—hold to that. But I would be happy to think about that more carefully and get back to you.

Senator COONS. Please.

Senator COONS. Then, last, there are some, I think, strong moves in this budget in terms of the sustainable growth rate, the doc-fix, so-called, and the changes to the Pension Benefit Guaranty Corporation. Could you just give me a little more detail on the PBGC changes and how that will ensure stability or solvency farther into the future and, thus, reduce some of the future liabilities that I think all of us on both sides here are quite concerned about?

Secretary GEITHNER. Well, the way the current PBGC, the benefit scheme works is, just to be direct about it, we do not give the PBGC the capacity, the authority to charge a guarantee fee that covers their liability. And what that means is all sorts of other people pay the costs of those unfunded pension funds when companies fall into bankruptcy. So, again, a basic test of responsibility is you want to make sure, if you are providing guarantees, you need to charge for them. They need to be risk based, and they need to be fair in design. We do not allow them to do that now. We think that is important for Congress to do.

Again, if you think about the consequence of getting that wrong, think about Fannie and Freddie.

Senator COONS. I think the point and that model also should be applied to the student lending work that the Federal Government is now more directly involved in.

I will close, if I might, Mr. Chairman, by saying, you know, while Senator Sanders I think laid out a very compelling case about how we got here, I was encouraged by Senator Ensign's tone, which really focused on how do we solve the problems that all of us have. And I do think that we need to look to leadership across both sides of the aisle, by this Committee and by the other chamber of Congress, and invite the President to join us.

Thank you very much, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator TOOMEY.

Senator TOOMEY. Thank you very much, Mr. Chairman, and thank you, Mr. Secretary, for joining us today.

I would like to address the debt limit debate that is upon us, but I want to start with a little bit of context, and we have touched on some of these things. But it is very important, I think, to inform our judgment as we debate the debt limit. And I want to emphasize a point that Senator Thune made earlier. While we rightly focus on the level of our deficits and our debt, it is spending that hasten us here. Since 2000, just since 2000, total Federal spending has doubled. And so we have debts now—deficits now far greater than deficits we were running recently. In 2007, for instance, as you know, Mr. Secretary, our deficit was only 1.2 percent of GDP. This year it is over 10 percent. It is over $1.5 trillion.

This is a recent phenomenon. The public debt that we had in 1988 was about 41 percent of GDP. In 2008, public debt was about

40 percent of GDP. Today it is 64 percent, and by October it is going to be 72 percent of GDP. The debt has doubled in 4 years. It is scheduled to triple in 11 years. And as we discussed briefly earlier, but I really want to stress, this is a fraction of the problem that we have. The unfunded liabilities that we have, the contingent liabilities through the guarantees of Fannie and Freddie, the big entitlement programs, you know, we could argue about how to do the math and how to discount this unfunded liability, but anyway you do it, within reason, it is a number that is at least well into the tens of trillions, and it might be, as Mr. Johnson says, over $100 trillion. So any way you look at it, those obligations dwarf the numbers that we have seen on the board, the actual publicly traded debt.

So I think we have an enormous problem, and it is already upon us. And what concerns me is what this administration has done in this environment. What have we seen? The administration created a new trillion dollar entitlement program, launched an $800 billion stimulus spending, pushed huge increases in discretionary spending in recent years. The President is now calling for another—basically a stimulus bill, $50 billion to build high-speed rail, which I think would be a shocking waste of money. The President is threatening to veto a CR because the Republicans want to cut back the spending that was added in the last couple of years. And the President proposes a budget that increases our debt every year, and I think you acknowledge that CBO will observe that it increases it even as a percentage of GDP. And the President, as we have observed repeatedly this morning, does absolutely nothing about the entitlements that are ultimately driving this whole train wreck.

In fact, I think part of the problem is the administration is populated with people who think at some level that the more Government spends, the richer we all become. And I just have to say this just is not working, and I think this is dangerous. And I think the administration thinks it is working, but I do not.

So when the President says that now that the country has, metaphorically speaking, reached the limit on its credit cards and we should just give it a new one and not make any changes to the process, talk about that later, I just do not think that is a good decision.

Now, let me emphasize—and I have said this before, and I have said this to you, Mr. Secretary—I am willing to vote to raise the debt limit. But I am only willing to do that if we are going to make the cuts in spending and the changes in process that got us here. You have acknowledged that the process is broken. I just do not think we can kick this can down the road anymore.

Now, we apparently disagree about whether we should make increasing the debt limit contingent on getting the kind of process reforms that fix this problem. But there is one thing that I know we do agree on—and this is something I have also written about—and that is, under no circumstances should the United States ever even get close to defaulting on the debt that we have issued. And I know you agree with that. It would be a complete disaster. It is unnecessary. We have a moral obligation to repay people who have lent us money.

And so, as you know, I have introduced a bill that would simply guarantee that as we try to resolve our differences over what to do about the debt limit, if we have not got it resolved at the time at which we reach it, we would at least not default on our debts. And my bill would do that by simply requiring that the Treasury make as a priority payments on interest and principal, with the ample resources the Treasury would continue to have.

Now, you have argued that my bill does not work, and while at least implicitly you have acknowledged that, yes, you could continue servicing the debt, even delays in payments to vendors would be perceived by the markets as much of a default as a missed payment on a Treasury bond. So basically you are telling us that if we have to delay a payment to the guys who mow the lawn around The Mall, that would have the same kind of impact and cause the same kind of financial crisis that would result if we failed to make an interest payment on a Treasury security.

I have to tell you, Mr. Secretary, that is just not true. I spent years as a professional in the bond market. I was trading fixed-income securities, including U.S. Treasuries. But whether you are a bond trader or whether you are a pension fund manager in Pittsburgh or a senior citizen in Allentown investing your IRA savings, the market knows the difference between delaying a payment to a vendor and defaulting on our Treasuries.

Chairman Bernanke was asked last week at the Budget Committee in the House if he thought it would be a good idea for the Federal Government to adopt this kind of bill. His answer was, and I will quote: "Well, it would reduce the risk of the debt limit, that's for sure."

So I have to say I think it has been inappropriate for the administration to raise the specter of a default on our debt in the context of this debt limit, because you and I both know there is no circumstances in which we are going to default on our debt. We should not even really have to have this discussion because we know this. But since the administration has raised this specter, I felt it was necessary to try to clear this.

I believe that we are already in the early stages of a fiscal train wreck. I think the problem is very, very serious. It is a spending problem that both parties are responsible for to varying degrees. The debt level, if you ask me, is already at dangerous levels. I just do not think we can kick this can down the road any further, and I think what the administration is implicitly asking us to do is to just go ahead and give them another credit card without making the fundamental process reforms that we need to get onto a sustainable path.

Secretary GEITHNER. May I respond, Mr. Chairman?

Chairman CONRAD. Certainly.

Secretary GEITHNER. Senator, you and I probably disagree on less than you think, and I appreciate very much your review of history about what produced this big acceleration or debt burdens, because that is a very helpful context for everybody, and I very much appreciate your commitment to making sure that people understand we will meet our obligations to the country. You are right to emphasize the cost of not doing so, and we should not let the markets start to build any risk that Congress will not ultimately pass that increase we need.

But I just want to make sure that I clarify one thing that is very important which is that we agree that we have to work together on a plan that Congress can enact that will start to deal with these very daunting, very formidable deficit challenges. A hundred percent agree with you. That is critically important. We cannot put that off. And again, we look forward to working with the processes that are set up to try and make sure we achieve that.

But I would caution everybody against taking any risk that Congress does not act to increase the limit within the timeframe we need, because for the reasons you said, we cannot afford to let the market lose any confidence that ultimately Congress will act well in advance of any time we are going to hit the limit, because that would be catastrophic, would cause grave damage to the recession, to the expansion underway, to our capacity to dig out of this recession, and we cannot afford to take that risk.

Chairman CONRAD. Senator Portman.

Senator PORTMAN. Thank you, Mr. Chairman. And, Mr. Secretary, thank you for your testimony today. I want to associate myself with the comments of Senator Sanders, actually, which might seem unusual to you. But he said he thought this was an extraordinarily strange conversation, and I agree with him for different reasons, as you might imagine.

I just think we are at the point in our country's history where we can't afford to play politics, and I think this budget presentation, which has been talked about a lot, and Senator Toomey just talked about some of the numbers, it is a political statement and it does not rise to the challenge. In fact, it does not rise to the very challenge the President has laid out, including the challenge you have laid out and Director Lew has laid out and others.

So that is what I find strange about this conversation. You said to us today that by doubling the gross debt between last year and 10 years from now, which is in the budget, by ending up with interest payments on the debt alone that are in excess of all of the discretionary spending, by the fact that we have this fiscal time bomb on our doorstep and we are not dealing with this in this budget, you called it unsustainable today.

You have acknowledged that there will be weaker growth in our economy because of the debt that is building up under this budget.

Secretary GEITHNER. If we do not act.

Senator PORTMAN. Well, under your budget, you are saying, you have acted——

Secretary GEITHNER. No, no, absolutely not.

Senator PORTMAN. You have put forward your——

Secretary GEITHNER. No, no, no.

Senator PORTMAN. You said that there will be weaker growth because of the debt which will be—the gross debt will be over 100 percent of our GDP——

Secretary GEITHNER. No, if Congress does not——

Senator PORTMAN [continuing]. Under this budget.

Secretary GEITHNER. If Congress does not act, then we face that risk, but——

Senator PORTMAN. No. I am talking about the numbers in your budget. This is unsustainable. I assume you still agree with that. If you do not, this is an extraordinarily strange conversation, if the Secretary of Treasury does not believe that 100 percent of GDP is going to limit growth in our economy.

And then you ask us, well, we are waiting to see what you provide us. Look, this has to be an effort, again, that gets away from the politics. We cannot afford it and we have to start solving the problem. I would say that, unfortunately, as you have noted yourself today, and I appreciate your candor on this, your budget is worse than it looks. CBO will end up saying that these deficits are higher than you have projected. In fact, I suspect they are going to end up saying that it grows our deficit not just in nominal terms, but as a percent of GDP.

Let me give you one concern that I have here. Your growth assumptions are too high, and we have talked about this. But if you use the CBO growth assumptions and the Blue Chip, the private forecasters' growth assumptions, compared to yours, and I am extrapolating here from CBO's rule of thumb which is a lower growth rate of .1 percent, it would result in a 10-year deficit of about $310 billion. If you assume .5 percent lower growth, which is what the difference is between the Blue Chip, CBO, and yours, we are talking about a higher deficit of over $1.5 trillion over the next 10 years.

Now, that wipes out all of the claimed savings in your budget, that alone. So this situation is even worse than, again, being stated in your budget and I think we will see this through the CBO analysis.

My other concern, obviously, is that the growth side of the equation is not addressed. You and I have talked about this. And I commend you yesterday for talking about the necessary expansion of exports we need to get this economy growing again, and, in fact, you had specifically talked about your support for the three trade open agreements that have already been negotiated and giving the President the ability to negotiate further trade openings.

I would ask you today to talk a little about the pro- growth side of things. We are looking at 9.6 percent unemployment in Ohio today. We have lost over 170,000 jobs in Ohio since the stimulus was signed into law 2 years ago today. Today is the anniversary.

We still do not have the kind of growth we need, coupled with the spending restraint, to get this deficit and debt under control. I would just ask you about what you would support. I know you claim there are some things in the proposal on growth and on taxes that will help the economy. I see just the opposite. I see the tax increases. I see the lack of any tax reform, a huge opportunity missed.

In fact, I look at your budget and you actually continue this assault on deferral, which is where you have a U.S. company that does business overseas being taxed more under your budget. There is a recent report out on this by Robert Shapiro, who was a Clinton administration official, and AEI that says the elimination of deferral would cost U.S. companies 159,000 jobs.

In Ohio, by the way, there is a separate study that has been done by an economist at Kenyon College that says it is 17,000 jobs lost in Ohio. And yet, your budget continues a number of changes to an international tax system that limits this practice.

So if you could address, what do you think we ought to be doing in terms of taxes? Can we lower the rate and broaden the base and make our tax system more efficient and therefore add more to economic growth, which in turn will add more revenues? And why is that not in the budget? And what else would you propose to get this economy moving?

Secretary GEITHNER. Senator, let me just start by again acknowledging that you have a long distinguished career in the Executive branch. It is nice to see you back here helping solve these problems.

When I left the Treasury at the end of 2000, the CBO was projecting us to have surpluses in the range of, I would say, north of $5 trillion over the next 10 years, and when I came back in on January 1, 2009, CBO was projecting, I think, a $13 trillion swing in the projected deficits facing the country as a whole. And I think it is very good to hear, across the political spectrum now, a recognition that we have a deep imperative to recognize deficits matter and we have to fix them over time. Again, we are looking forward to working with you on how best to achieve that.

I want to say a couple things in response to your points you made in your questions. A few things on the growth assumptions. CBO's are lower in part because they have to assume that the Bush taxes, all of them, expire in 2013. That is a big hit to GDP. We are not proposing that. It forces CBO to show lower growth estimates because of that.

Now, when they score our proposed policies, they will show a higher GDP growth than they did initially because of that basic change. Again, you have had the privilege of doing these assumptions before. Nothing perfect in them.

Senator PORTMAN. How about Blue Chip?

Secretary GEITHNER. And you are right. Our growth scenario is just a little above Blue Chip, but I actually look back and compare them to yours when you were OMB Director, and my suspicion is, you will find when you look at them——

Senator PORTMAN. When the deficit was one-tenth of what it is today.

Secretary GEITHNER. No, but—well, again, not dramatically higher than when I left the Treasury.

Now, if you look at our growth assumptions over the next 10 years, we are assuming, as we should, that growth on average is significantly lower than it is in past recoveries, as we should expect given the nature of this basic crisis.

But again, the good thing about our system is, CBO will govern. It is their assumptions that govern. You and I do not need to debate the future. They will decide for the Congress.

Now, on deferral, just one quick thing on deferral. I know this is unpopular proposals for a lot of people in the business community, but let me explain what they are designed to do. They are designed to, again, reduce the incentive to shift investment outside the United States.

So as you know better than anybody, if there are two companies in your state today and one builds their next plant outside the

United States, one builds their next plant in your state, that first company gets a lower effective tax rate. That means they have incentives to make that next marginal investment outside the country.

We do not think that makes sense at a time when we want to encourage more job creation investment here, so we want to redress that, at least get it back to neutral. But again, I think our view is the best way to get there, is through a comprehensive reform that lowers the statutory rate very substantially, but does it in a way that is deficit neutral.

Senator PORTMAN. That would have been great to have seen in the budget and we can talk about this, but what it does is it hurts jobs in this country because we are not able to sell as many products overseas. That is the point of growth.

Chairman CONRAD. Senator Cornyn.

Senator CORNYN. Thank you, Mr. Secretary, good to see you. Is it correct to say that this proposed budget relies, in part, on a $1.6 trillion tax increase over the next 10 years?

Secretary GEITHNER. Well, the way I encourage you to look at this, you should look comprehensively at the tax proposal in the budget, and I will just do the numbers for you.

Senator CORNYN. With all due respect, would you answer my question?

Secretary GEITHNER. Three trillion in net tax reductions for individuals.

Senator CORNYN. I am not talking about—I am asking, does it increase taxes for some taxpayers on $1.6 trillion?

Secretary GEITHNER. Oh, absolutely. As I said, we are proposing to allow the tax cuts for the top 2 percent to expire. We are proposing to reduce tax expenditures for the top 2 percent. And there is a series of other changes, more modest changes, that do raise revenues, but you have to look at the overall——

Senator CORNYN. Let me ask you specifically, Mr. Secretary, because time is limited. $90 billion of tax increases in the President's budget are going to be imposed on the domestic energy industry under this budget. This is a sector that is one of the largest employers in the country supporting more than 9.2 million jobs, contributing 7.5 to GDP, and which is already contributing $100 million a day to the Federal treasury.

How does that tax increase on the domestic energy industry reduce our reliance on imported oil?

Secretary GEITHNER. Well, Senator, you know the arguments in this context. What we are proposing to do is to scale back what are very expensive tax expenditures that go to a limited number of industries and distort overall investment and require all other businesses to pay more tax as a result. And that is one proposal in that direction.

Senator CORNYN. Well, if you increase taxes on domestic energy supply, that will translate into increased costs of gasoline for consumers and diesel, will it not?

Secretary GEITHNER. No, it will not have that effect because the price of oil and gas as a result is set in the world markets and modest changes in the subsidies we give the domestic oil company will not affect the price.

Senator CORNYN. So you can increase taxes on an industry and it will have no impact on price to consumers, is what you are saying?

Secretary GEITHNER. In a market like this, I believe almost any economist would tell you that there will be no impact on the broad price of oil to the U.S. consumer.

Senator CORNYN. Will you agree with me, if you increase taxes on domestic production of energy, it will necessarily increase our dependence on imported energy because they will not bear that same tax burden and it will be cheaper?

Secretary GEITHNER. No, probably not materially at all. But you are right, we are proposing to reduce the subsidy we give through the Tax Code to that industry. Now, they still will benefit a whole range of other subsidies, but we are proposing to reduce those again because we do not have unlimited resources. And again, if we do not do that, we are going to have to raise taxes on somebody else.

Senator CORNYN. Let me go on to another question, which I continue to be amazed that there is any really disagreement, that increasing taxes on an industry will not have an impact on consumers. But I hear your answer.

Senator Sanders asked a number of questions about tax, who pays taxes, and isn't it true that about 97 percent of the income taxes that are paid in America today are paid by the top 50 percent of income earners?

Secretary GEITHNER. Well, again, you know these numbers. I think what the Senator was pointing out, which is true, which is if you think about——

Senator CORNYN. Well, I am asking what I am—my question, not his.

Secretary GEITHNER. Again, what I would look at is, what is the effective tax rates for people who make, for example, in the top 1 percent of income. What is their effective tax rate versus the effective tax rate of middle class America. And that is the question he was speaking to and I think he is right in that.

Senator CORNYN. Well, but my question is, isn't it true that 97 percent of income taxes are paid by the top 50 percent of income earners in America?

Secretary GEITHNER. Well, I am not sure exactly what those numbers are, but I would be happy to provide them in writing.

Senator CORNYN. Well, if you are not sure about the exact number, isn't that approximately correct?

Secretary GEITHNER. I am not sure. Again, you are right to say that a large fraction—because income inequality is so high in the United States, a large fraction of tax revenues come from the relatively well-off, but their effective tax rate is, in many ways, sort of strangely much lower than the average, you know, a less fortunate American.

Senator CORNYN. Mr. Secretary, I do not expect you to know the exact numbers, but I am, frankly, astonished that the Secretary of the Treasury would not know generally where the tax burden lies.

But let me just ask another way. Would you agree with me that the top 20 percent of income earners in the country pay approximately two-thirds of Federal taxes?

Secretary GEITHNER. Again, that sounds broadly right, but I think what you are debating a little bit is what is the distribution of the effective tax burden, and one way to measure that is what is the rate they pay relative to income.

Senator CORNYN. Well, I am not debating it right now. I am just asking for information from you to answer those questions.

One of the hardest things I have found in Washington, D.C. is to get the facts because it seems like everybody spins. Once you get the facts, then it is a whole lot easier to figure out how to solve the problem.

Secretary GEITHNER. I would never dispute the facts. Facts are easy to agree on.

Senator CORNYN. So may I make just a respectful suggestion? Under the Budget Act, it is the President's statutory obligation to produce a proposed budget.

Secretary GEITHNER. Yes.

Senator CORNYN. And we have talked about that and, frankly, I am among those who are disappointed that the President did not go further and deal with more than 12 percent of all Federal spending that included a $1.6 trillion in new taxes, and it appears to not engage is own fiscal commission's recommendations, which I found to be dramatic and sobering and bold.

And so, I hope that we will engage on these issues. The only way we are going to get a resolution of the crisis facing our country is if the President is engaged. And if the President is disengaged, it will not happen. It will not happen. We will sort of fall back into the traditional demagoguery—

[sic] that occurs whenever we talk about dealing with important and large fiscal matters.

So if I could just make a respectful suggestion, we saw in the expiring tax provisions in the end of December that the President and the Vice President got very directly engaged with the Republican leader and with the assistant Republican leader, Senator McConnell and Senator Kyle. My suggestion to you is, that if the President would invite those two individuals, along with House leadership, over to the White House and say, How can we work together to fix this problem, it would be a dramatically constructive move and help move this in the right direction, rather than to resort into the same old he said/she said and blame game.

Thank you, Mr. Chairman.

Chairman CONRAD. Let me just say that this is something I have repeatedly asked for. I do not see any way around, and the question is timing. I understand that. We, in Congress, have an obligation to lay out our plans and we will do that. But some time very soon I believe it is critical that there be a summit, a negotiation, whatever one calls it, that involves the leadership of the House and the Senate, Republican and Democrat, and the President.

That was really at the heart of the proposal Senator Gregg and I made for a commission that involved the Secretary of the Treasury and the head of OMB. That was our proposal. We got 53 votes for that proposition. We did not get 60.

Senator CORNYN. I was one of them, Mr. Chairman, and I admire your leadership, along with Senator Gregg's leadership, on this issue. But the fact of the matter is, unless the President is willing to engage on this—and I am not suggesting they do it in public. I am suggesting they have a meeting and get to the solution, because as you have noted many times, we cannot kick the can down the road. Unfortunately, I see this history repeating itself.

Chairman CONRAD. Let me just say that I do not think anybody who has listened to me does not know that I deeply believe this can can be kicked down the road. I appreciated the Senator's support.

I want to go to one point before we leave. I have heard over and over that what we have is a spending problem. Deficits are the result of spending and revenue, the difference between the two. We do not just have a spending problem, although we do have a spending problem, we also have a revenue problem.

I am so, frankly, tired of hearing that there is just one side to the calculation of the deficit. There is not just one side. There are two sides. There is revenue and there is spending, and the reality is, the truth is, we have a problem on both sides of the equation. The spending is the highest it has been in 60 years, as a share of the GDP. The revenue is the lowest it has been in 60 years, as a share of the GDP.

So let's get real. Let's get real. Yes, we have to do spending and yes, we have to do revenue. If people are not going to be serious about what has to be done here, we are not going to solve the problem. With that, I thank the Secretary.

Senator SESSIONS. Mr. Chairman, I would agree with that. Both are factors, but we see as the economy comes back, revenue will come back to its historic levels. But if we get entrenched in spending at 25 percent of GDP, we are going to have a very difficult time getting back there.

Chairman CONRAD. Look, nothing could be more clear. Anybody who has listened to me for 5 minutes knows I am serious about cutting spending and I voted to do it on the Commission. I wish others had. Five of the six Senators did. Five of the six representatives of the President did. Five of the six Representatives of the House took a walk.

Senator SESSIONS. Thank you, Mr. Chairman.

[Whereupon, at 12:11 p.m., the Committee was adjourned.]

Questions for the Record
Treasury Secretary Timothy F. Geithner
Senate Budget Committee hearing on the President's FY12 Budget and Revenue Proposals
February 17, 2011

Questions from Senator Sessions

1. **The President's budget assumes a rosy growth scenario for the economy relative to forecasts made by the non-partisan Congressional Budget Office and by private forecasters. Yet, despite assuming stronger GDP growth, the administration shares the view with others that unemployment will remain unacceptably high. Why does the administration believe that GDP growth will be stronger than others believe, yet does not believe that labor markets will correspondingly be stronger?**

   The Administration's economic projections are prudent and conservative. In the short term, the Administration's economic assumptions are close to those of the non-partisan Congressional Budget Office and the consensus of private forecasters. For 2011, both the Administration and the Congressional Budget Office (CBO) forecasts for annual GDP growth are identical at 2.7 percent. Likewise, the Administration's economic assumptions are conservative in the medium term. The Administration is forecasting average annual growth of 3.6 percent from 2012Q4 to 2017Q4. This is substantially below the observed rate of growth in economic recoveries following the past eight recessions; after the past eight recessions, growth has averaged 4.1 percent in the 5 years following the trough.

   Similarly, the Administration's unemployment projections are in line with the CBO's forecasts for 2011. CBO projects 9.4 percent unemployment while the Administration projects 9.3 percent.

   We share your concern for unacceptably high levels of unemployment, and the Budget includes proposals to address this critical issue.

2. **Why does the administration believe that its proposed new government spending on what it calls "investments" will *not* help bring the unemployment rate down more rapidly than its economic assumptions reveal, given that the administration touts government spending as a job creator?**

   The proposed targeted investments in education, infrastructure, and research and development are designed to promote stronger economic growth and increase our competitiveness in the global economy. These investments will not only promote growth in the near term but will pay dividends over the longer term, including increased productivity, higher living standards and, ultimately, more jobs for American workers.

   Targeted investments in education will help us regain our competitive edge. As the President noted in his State of the Union address, America has fallen to ninth in the proportion of young people with a college degree. Having an educated and skilled workforce is critical to competing in the global economy—workers with a college education not only earn higher wages for themselves, but increase the productivity of those who work with them and of the economy overall.

Investments in research and development (R&D) will generate the technological advancements that contribute to productivity growth and improvements in U.S. living standards.

Finally, ensuring that we have modern infrastructure is critical to economic growth and job creation. The President's budget proposes $50 billion in up-front investment to repair, rebuild, and modernize the nation's transportation infrastructure. As the Treasury Department and the Council of Economic Advisers found in a recent report, the average unemployment rate among those who gain employment as a result of additional investment in infrastructure is over 15 percent. Further, the vast majority of jobs created from additional infrastructure investment would be middle class jobs.

3. **The administration treats the mortgage giants Fannie and Freddie as separate from the Federal government. Indeed, the Appendix to the FY 2012 Budget states that: "The Budget continues to reflect the GSEs as non-budgetary entities..." In contrast, according to the Congressional Budget Office (CBO): "...it is appropriate and useful to policymakers to include their financial transactions alongside all other federal activities in the budget." CBO points out that "...the federal government controls both entities and operates them to fulfill the public purpose of supporting the housing and mortgage markets. Moreover, both entities rely on federal backing to maintain their low-cost access to financial markets. Why does the administration not account for impacts on the budget of the government-run housing GSEs, Fannie and Freddie, in the way that the Congressional Budget Office argues is appropriate?**

The Administration has carefully considered whether Fannie Mae and Freddie Mac should be classified as budgetary and consolidated in the Government's financial statements. The budgetary classification of an entity depends on whether the Government owns and controls the entity in question. 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.

The Budget treats Fannie Mae and Freddie Mac as non-budgetary, but all of the Federal programs that support Fannie Mae and Freddie Mac, including the Senior Preferred Stock Purchase Agreements (PSPAs), are treated as budgetary. The conservatorships of the GSEs are being operated by 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.

4. **The Appendix to the budget states, on the one hand, that the GSEs "...are not included in the Federal Budget because they are private companies, and their securities are not backed by the full faith and credit of the Federal Government." On the other hand, the budget says that the administration "...will continue to ensure that the GSEs have sufficient capital to honor any guarantees issued now or in the future and the ability to meet any of their debt obligations..." It is, thus, ambiguous whether GSE obligations are backed by the full faith and credit of the U.S. government. Are debt obligations and other securities issued by Fannie and Freddie backed by the full faith and credit of the federal government or not?**

   The debt obligations and other securities issued by Fannie Mae and Freddie Mac are not backed by the full faith and credit of the federal government. Fannie Mae and Freddie Mac are independent entities under conservatorship of the Federal Housing Finance Agency (FHFA). The Treasury provides support to the entities through the Preferred Stock Purchase Agreements (PSPAs), which help the entities maintain positive net worth and thus help them to fulfill their obligations, but they are not guarantees of the obligations or the entities.

5. **According to the administration's 2012 budget, Fannie Mae and Freddie Mac will cost taxpayers $73 billion through 2021, nearly half of what they have received from the Treasury Department so far. The Federal Housing Finance Agency estimated in October 2010 that Fannie and Freddie could cost between $221 billion in a best-case scenario and $363 billion if the economy recedes again through 2013. Banking analysts at Credit Suisse estimated a $321 billion price tag for the bailout of Fannie and Freddie. Secretary Geithner, can you explain why the administration has such a rosy assessment of losses that the mortgage giants will generate for American taxpayers?**

   The budgetary treatment of Fannie Mae and Freddie Mac is consistent with the Federal Housing Finance Agency (FHFA) stress test "baseline" estimates released in October 2010. The FHFA stress tests only projected draws through the PSPAs through the end of 2013. The budgetary treatment includes these draws as well as dividends received through 2021. Therefore, the $73 billion cumulative projected cost to taxpayers takes into account the dividends paid by the GSEs to Treasury over a longer time period than the FHFA stress tests.

6. **Page 29 of the Analytical Perspectives on the budget states that: "Earnings resulting from the expansion of the Federal Reserve's balance sheet through the purchase of GSE debt, GSE MBS, and long-term Treasury securities have increased the profits the Federal Reserve remits to the Treasury, *reducing the budget deficit*." (Italics added). Secretary Geithner, could you explain the sense in which payments of interest on**

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Treasury securities to the Federal Reserve, once returned to the Treasury from the Fed through a remittance, reduces the budget deficit in any real sense? If remittances do reduce the budget, could the Federal Reserve purchase ever increasing amounts of Treasury obligations, by creating reserves, and thereby drive the deficit toward zero?

The Federal Reserve earns interest on the Treasury debt it holds, just as other holders of Government securities earn interest. The Fed also earns interest on other assets in its portfolio. The Fed remits all of its interest earnings back to the Treasury, less the cost of operating the Fed including the expense of printing and issuing currency. This remittance of earnings reduces the Federal budget deficit, but the Fed will not follow a course of action that increases remittances unless it is consistent with its dual mandate maintaining price stability and promoting growth and employment. That would prevent it from attempting to drive the deficit toward zero.

7. **Secretary Geithner, you recently testified that: "The President has outlined a broad strategy to *help strengthen economic growth* with investments in education, innovation, and the nation's infrastructure." (Emphasis added). The American people were recently sold a so-called "stimulus" package consisting of almost $1 *trillion* which included what were then called "shovel-ready" infrastructure projects. You now say that what you are labeling as "investment" will help strengthen economic growth. Before, we were told that the infrastructure spending was short-term stimulus to boost jobs and output, though it is not clear that there were any boosts. Can you identify your most prominent tbree examples of those shovel-ready, debt-financed stimulus spending actions and can you identify how they increased economic growth or productivity?**

As the Treasury Department did not directly award or allocate infrastructure investment as part of the Recovery Act, we are not the appropriate agency to provide specific examples or to compare specific projects.

However, the Treasury Department, along with the Council of Economic Advisers, conducted an analysis of the economics of infrastructure investment. The report found evidence of large private sector productivity gains from public infrastructure investments. Research has also shown that well-designed infrastructure investments can not only raise economic growth, productivity, and land values, but also provide significant positive spillovers to areas such as economic development, energy efficiency, public health and manufacturing.

In addition, the report found that construction costs and other costs associated with building projects are especially low in the current environment. The Department of Transportation's (DOT) experience with the Recovery Act funding has shown that more than 2,000 additional airport, highway, bridge and transit projects were funded because of low bids, or projects were completed under budget. Finally, analysis suggests that nearly 90 percent of the jobs in the three sectors most affected by infrastructure spending would be middle class jobs. Moreover, the jobs that would be created by additional investments in infrastructure are concentrated in occupations and industries that have been disproportionately affected by the economic downturn. Overall, the average unemployment rate among those who would be put to work by additional investment in infrastructure is over 15 percent. Well-designed infrastructure investment can create middle class jobs in the short term while boosting economic growth and competitiveness in the long term.

8. **The President's budget calls for the creation of a National Infrastructure Bank to channel $30 billion of taxpayer resources into government spending on things that are loosely called "infrastructure." What constitutes infrastructure is ambiguous. How an Infrastructure Bank's funding allocations are made could easily be subject to political favoritism. Mixing private profit motives with government-backed financing, as envisioned by Infrastructure Bank proponents, is a recipe for disaster, as Fannie and Freddie showed. An Infrastructure Bank runs the risk of the government again mixing social goals and private profit-motivated activities. Infrastructure Bank guarantees of debt-financed infrastructure projects puts American taxpayers at risk of loss. Secretary Geithner, why should taxpayers again be put at risk of loss by backing funding for public-private partnerships envisioned in the Infrastructure Bank?**

I share your concerns about putting taxpayers at risk through a private entity that enjoys implicit government support. The President has proposed a transparent, accountable and fully on-budget National Infrastructure Bank that would not be subject to the potential pitfalls that you raise.

We need to increase our overall level of infrastructure investment. We must also reform the ways in which we invest. Not all infrastructure investments are good investments, and too often we have seen transportation projects exemplify the worst of Washington – the 'bridges to nowhere' that rightly make American taxpayers cringe. That's why the President's plan will reform our current system to promote merit-based investment by creating a National Infrastructure Bank. A cornerstone of the Infrastructure Bank's approach will be a rigorous project comparison method that transparently measures which projects offer the greatest value to taxpayers and our economy. The National Infrastructure Bank will also draw private capital to invest in American infrastructure so that we can better leverage scarce taxpayer dollars. We will support projects that produce significant returns on our investment, allow Americans more choices in their modes of transportation, and improve the interconnectedness of our existing transportation networks to maximize the value of our current infrastructure.

9. **The President's budget calls for $392 million of funding in 2012 for the new Consumer Financial Protection Bureau (CFPB). Secretary Geithner, what oversight will Congress**

and the American people have over how the close-to-$400 million of funds proposed in the administration's budget for the new CFPB might be spent and how does the proposed CFPB funding compare to past expenditures by other financial regulatory agencies on financial regulatory oversight?

The Dodd-Frank Act provides budget accountability in several ways:

- Reports to Congress and OMB: The CFPB must submit annual financial reports to Congress and submit reports and testimony on a semi-annual basis to report its activities and justify its budget from the previous year. The CFPB must also submit financial operating plans and forecasts, and quarterly financial reports, to OMB.
- GAO audit: The GAO will conduct an audit each year of the agency's financial statements and assertion of internal controls and submit a report to Congress.
- IG oversight: The Federal Reserve Inspectors General (and, until the transfer date, July 21, 2011, the Treasury IG) will provide another means of safeguarding against waste, fraud, and abuse.
- Funding cap: The agency's funding transfers from the Federal Reserve System will be capped at a percentage of the operating expenses of the Federal Reserve System, and the cap will adjust over time.

The proposed FY 2012 CFPB budget of $329M represents the estimated resources needed to implement and carry out the requirements of the Dodd-Frank Act, including supervision of the largest and most complex banks and thousands of non-depository institutions. However, this funding is considerably less than comparable financial regulatory agencies. In FY 2010, the Office of the Comptroller of the Currency (OCC) obligated $740 million, and the Federal Deposit Insurance Corporation (FDIC) obligated $1.3 billion, for operating expenses. The CFPB is expected to supervise more than all other federal bank supervisors combined, including the largest, most complex banks.

10. Secretary Geithner, relative to the recommendations of his own blue-ribbon deficit commission, does President Obama, in his budget, face the difficult decisions that we must face in order to rein in deficits and debt in the long-run?

Yes. The President's Budget presents a detailed and comprehensive plan to cut spending and reduce deficits and debt in the medium- and long-run. The Budget proposes a multi-year plan to reduce the deficit and stabilize the debt. If the President's proposals are enacted, the deficit will be cut in half by 2013 and fall to 3.2 percent of GDP by 2015. It is expected to remain around 3 percent of GDP for the second half of this decade, which would roughly stabilize the debt as a share of the economy.

The proposals in the President's Budget are a much-needed down payment on long-term fiscal stability. Looking ahead, we will also need to take on entitlement reform. Mandatory entitlement spending is projected to increase more quickly than revenues due to an aging population and growing health care costs. We have made important progress in this area with the Affordable Care Act (ACA). The CBO estimates that ACA will reduce the deficit by more than $200 billion from 2012 to 2021 and by more than $1 trillion over the following decade.

11. **The Analytical Perspectives section of the budget touts the President's Executive Order 13563, titled "Improving Regulation and Regulatory Review." That Order calls on federal agencies to consider use of so-called benefit-cost analysis. The idea put forward by the administration is that such analyses will provide steps to take in order to, as the budget perspectives section states "...eliminate unnecessary burdens, which may have adverse effects on job creation and growth." According to the recently issued Executive Order, "where appropriate"—and there are no rules to determine appropriateness—government agencies are to consider, among other things "...values that are difficult or impossible to quantify, including equity, human dignity, fairness, and distributive impacts." When unelected regulators are the arbiters of fairness, dignity, and equity, what limits can we expect on regulation? What will place a check on an agency, using vague justifications of fairness and dignity, to prevent it from pursuing partisan political activism at the expense of jobs for the American people?**

    Public participation in the rulemaking process is vitally important in crafting regulations that are fair and equitable. Members of the public participate in the rulemaking process at many levels including the pre-rule development stage, by petitioning for rulemaking, by submitting thoughtful, written comments during the comment period, and at public hearings and stakeholder meetings. All of these communications are maintained in a single administrative record to ensure transparency. The Department of the Treasury carefully considers all comments received during the rulemaking process and relies on thoughtful comments in creating efficient, workable rules that are focused on promoting societal benefits while limiting costs.

    In addition, in weighing costs and benefits, especially those benefits that are difficult to quantify, the Department uses the best available technical and economic data and information.

12. **Secretary Geithner, one consequence of the unsustainable fiscal course that we find ourselves on is that the Federal government is approaching its statutory debt limit. In a letter that you recently wrote to the Senate majority leader, you wrote the following:**

    "Reaching the debt limit would mean the Treasury would be prevented by law from borrowing in order to pay obligations the Nation is legally required to pay, an event that has no precedent in American history. Such a default should be understood as distinct from a temporary government shutdown resulting from failure to enact

appropriations bills, which occurred in late 1995 and early 1996. Those government shutdowns, which were unwise and highly disruptive, did not have the same long-term negative impact on U.S. creditworthiness as a default would, because there was headroom available under the debt limit at that time.

I am certain you will agree that it is strongly in our national interest for Congress to act well before the debt limit is reached. However, if Congress were to fail to act, the specific consequences would be as follows:

- **The Treasury would be forced to default on legal obligations of the United States, causing catastrophic damage to the economy, potentially much more harmful than the effects of the financial crisis of 2008 and 2009."**

Since you perceive that reaching the debt limit would cause "catastrophic damage to the economy," and since you felt a need to covey that perception formally to the majority leader, you must perceive that there is a nontrivial risk to the economic and financial systems. According to the so-called "Dodd-Frank" financial regulatory legislation, the Financial Stability Oversight Council (FSOC), which you chair, is set up to discuss, evaluate, and provide warnings about systemic threats. Secretary Geithner, have or will you bring up with the FSOC that you perceive that the Nation's approaching a Federal debt limit represents a systemic threat?

As I stated in my January 6th letter, a failure by Congress to raise the debt limit in a timely manner would cause catastrophic damage to the economy. Congress, however, has the ability to prevent that damage by raising the debt limit before it is reached. Never in our history has Congress failed to increase the debt limit when necessary, and we do not expect it to fail to do so now. Provided Congress acts responsibly and in the best interests of the American people on this issue, the catastrophic consequences discussed in my letter will not materialize.

As you noted the FSOC was created in large part to identify and monitor emerging risks to U.S. financial stability. In this role, the FSOC will monitor the debt limit issue as appropriate, just as it will review other issues with the potential to affect the stability of the financial system going forward.

Questions for the Record
Treasury Secretary Timothy F. Geithner
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Questions from Senator Whitehouse

1. **In responding to my question about servicer penalties, you said that Treasury does not have the ability to "compel" servicers to comply with rules of the HAMP program. Treasury's own HAMP Servicers Handbook[1] warns servicers that "[if] information is not received or is inaccurate as determined by audits and other compliance activities, it may result in financial remedies, including the withholding or recapture of incentives." It appears that Treasury has threatened servicers with financial sanctions for failure to comply with information reporting requirements. If Treasury has threatened sanctions for non-compliance with information reporting requirements, can it not threaten sanctions for other violations of HAMP rules such as the requirement that a servicer must approve or disapprove a short sale request within ten days of receipt?**

   The Congressional Oversight Panel has recommended that Treasury "be more willing to use its power to withhold or clawback incentive payments. It should then publicly detail its sanctions for non-compliance by both its financial agents and HAMP servicers."[2] Under the HAMP servicer participation agreements, what rights does Treasury and/or Fannie Mae or Freddie Mac (as agents for Treasury) have to withhold or claw back incentive payments? Has Treasury in fact withheld or clawed back any incentive payments to date? If so, for each penalty assessed, please specify: (1) name of servicer; (2) date of penalty; and (3) type and amount of penalty.

   The U.S. Government Accountability Office (GAO) has said, "Treasury has . . . yet to establish specific consequences or penalties for noncompliance with HAMP guidelines . . . . The HAMP servicer participation agreement describes actions that Fannie Mae, as program administrator (at Treasury's direction), may take if a servicer fails to perform or comply with any of its material obligations under the program, but does not lay out the specific conditions under which these actions should be taken."[3] To what actions under the HAMP servicer participation agreements does GAO refer?

   Finally, are there not other means by which the Department of the Treasury can influence banks and servicers to improve their operations in this area, such as investigations, notices of proposed rulemaking, or sharper oversight?

   Treasury has a contractual relationship with the servicers that have elected to participate in the Making Home Affordable Program ("MHA"), of which HAMP is a part. Specifically,

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[1] Making Home Affordable Program: Handbook for Servicers of Non-GSE Mortgages, Version 3.0, as of December 2, 2010.
[2] December Oversight Report: A Review of Treasury's Foreclosure Prevention Programs, Congressional Oversight Panel, December, 14, 2010.
[3] Troubled Asset Relief Program: Further Actions Needed to Fully and Equitably Implement Foreclosure Mitigation Programs, GAO, June 2010.

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Treasury's financial agent, Fannie Mae, enters into a contract – a Servicing Participation Agreement ("SPA") – with participating servicers. The SPA contracts govern the rights and remedies of the parties. Your questions focus on the contractual terms and remedies in those SPAs, and I am happy to address both the specific governing provisions of the contracts and Treasury's remedies in cases of non-compliance.

Treasury has both non-financial and financial remedies available to it under the SPAs, and it has imposed both remedies. For example, Treasury can require a servicer to re-evaluate a specific homeowner for HAMP, require a servicer to make process and systems changes to accommodate MHA guidelines, and require a servicer to make corrections to that servicer's net present value calculations. All of these non-financial remedies are governed by the SPA contract.

A servicer that fails to perform or comply with any of its material obligations under the SPA is in default under the contract. Section 6 of the SPA sets forth the remedies for a servicer's default, including, without limitation, the ability to (i) withhold certain payments due to the servicer under the SPA, (ii) obtain repayment of prior payments made to the servicer under the SPA, and (iii) subject the servicer to additional oversight and quality controls.

Treasury can also implement financial remedies pursuant to the SPA contract. As you note in your question, these include withholding or clawing back incentive payments made to servicers under the SPAs. If it deems a violation sufficient to warrant the imposition of a financial remedy, Treasury may direct Fannie Mae to withhold or claw back the incentive payment in question. Any financial remedies may be imposed on a servicer in an amount up to the amount of total incentives scheduled to be paid and/or previously paid to that servicer in respect of permanent modifications made (or in the case of the short sale and deed-in-lieu of foreclosure program, in respect of such short sales or deeds-in-lieu) by that servicer. Treasury is not a regulator, and cannot enforce fines or penalties in the manner that a regulator would for violation of a law or regulation.

Treasury has, to date, implemented some financial remedies. Beginning in August 2010, Treasury suspended incentive payments to certain servicers until data consistency errors in their reporting to the HAMP system of record were corrected.

The Office of Financial Stability (OFS), which manages MHA, monitors and enforces compliance with the SPAs. Treasury has also retained a division of Freddie Mac (Making Home Affordable – Compliance or "MHA-C") to act as compliance agent. MHA-C regularly conducts extensive reviews of each servicer's compliance with the SPA and MHA programs generally. All potential instances of non-compliance identified by MHA-C are evaluated by a Committee within Treasury.

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To address your final question about the ability of Treasury to influence servicers generally, it is important to remember that HAMP consists of a series of contractual relationships. As such, there are contractual limitations to what Treasury can do and what remedies we can impose. That said, Treasury constantly works with servicers to improve performance and increase the number of homeowners helped by MHA. For example, there are regularly scheduled calls on various MHA matters that are organized by the program administrator, and as necessary, Treasury holds individual meetings with senior executives from participating servicers to address HAMP performance. In addition to a robust compliance effort, these and other meetings help Treasury balance the dual priorities of ensuring servicer adherence to MHA requirements while also maximizing the number of taxpayers assisted through MHA programs including HAMP.

It is also important to note that Treasury's compliance goal first and foremost is to ensure that homeowners are appropriately treated in accordance with MHA guidelines and have the opportunity to avoid foreclosure. Thus, servicers are subject to various compliance activities, including periodic, on-site compliance reviews as well as on-site and off-site loan file reviews. Compliance activities are performed by more than 200 staff at MHA-C using a risk-based approach. MHA-C's compliance reviews range from generally monthly for the largest servicers, to at least twice annually for the smaller-sized servicers.

MHA-C has performed more than 250 compliance reviews on participating servicers, many of which shaped servicer behavior in order to address the most vital issue: the ultimate impact on the homeowner. Examples of actions MHA-C has taken include requiring servicers to re-evaluate homeowners for HAMP, requiring servicers to make process and systems changes to comply with MHA guidelines, and corrections to the servicer's net present value calculations.

Finally, Treasury will shortly start to release a scorecard for each of the ten largest HAMP servicers. The scorecard will highlight servicer compliance on a number of key performance metrics and will rate them against their peers. We will continue to require servicers to perform the remedial actions described above, as well as begin withholding financial incentives for those servicers receiving an unsatisfactory grade on their scorecards.

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Questions from Senator Cornyn

The President's FY12 budget outlines reasons for changes to fossil fuel preferences stating several times in the "green book" that "This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution."

1. **How is producing energy Americans need here at home, instead of importing it – detrimental to our long-term energy security?**

2. **Does this Administration believe our energy and economic security lies in importing the fuel needed by American's who use gasoline to get to work, or who get their electricity from natural gas or coal?**

   (Responds to questions 1 and 2)

   Concerns about our nation's energy security should focus on our dependence on oil, whether domestic or imported. Any sudden and lasting disruption in oil supplies would lead to a substantial increase in the price of oil. Such an increase in prices could have ripple effects throughout our economy by leading to a decline in output in energy intensive industries, potentially reducing the real resources consumers have to spend on goods and services, and by making energy intensive capital stock obsolete.

   The domestic price of oil is determined on the world market, and our domestic production has little influence on the world price of oil. As such, current tax subsidies that encourage domestic production are very unlikely to affect the domestic price of oil and do not significantly promote our energy security. Instead, these subsidies distort markets by encouraging more investment in the oil and gas industry than would occur under a neutral system and, to the extent they encourage our continued dependence on oil, are detrimental to our long-term energy security. Policies that reduce our dependence on oil, such as investing in clean energy technologies, are a more effective way to reduce our vulnerability to an oil price shock and promote energy security.

   A large majority of the natural gas consumed in the U.S. is domestically produced and the U.S. is a net exporter of coal. The elimination of tax subsidies for natural gas and coal is unlikely to have any significant effect on domestic production of those commodities. Moreover, the Administration has proposed policies that will increase investment in clean coal and efficient natural gas technologies, highlighting the important role these fuels will continue to play in our nation's energy future.

3. **How does this budget reduce reliance on oil?**

First, the budget proposes to eliminate the tax subsidies for oil. As noted in the response to questions 1 and 2, these subsidies distort markets by encouraging more investment in the oil and gas industry than would occur under a neutral system and, to the extent they encourage our continued dependence on oil, are detrimental to our long-term energy security.

In place of the subsidies for oil, the Administration proposes investments in clean energy technologies that reduce our dependence on oil. Current budget proposals that reduce America's dependence on oil include investments in the transportation sector, our country's largest user of oil. The budget includes a $5 billion expansion of the Section 48C Advanced Energy Manufacturing Tax Credit, created by the Recovery Act to spur private investment in facilities that manufacture advanced energy technologies, including energy storage systems and other electric vehicle components as well as renewable fuel technologies.

The budget also appropriates nearly $2.4 billion for energy efficiency and renewable energy programs, including $220 million for biofuels and biomass Research and Development and $325 million for advanced vehicle technologies. Investments in new battery technology and production capacity, along with other initiatives such as improvements to the electric vehicles tax incentive, will help achieve the President's goal of putting one million advanced technology vehicles on the road by 2015. Together these investments will help reduce dependence on oil and create long-term, sustainable economic growth and employment in the low-carbon industries of the future.

Beyond supporting investments in new vehicle technologies, the Administration is reducing our dependence on oil through new fuel efficiency standards and spurring private sector innovation in alternative fuels. In April 2010, EPA and NHTSA announced a joint Final Rule to establish greenhouse gas (GHG) emissions standards and CAFE standards, respectively, for model year 2012-2016 light-duty vehicles. In September 2010, EPA and NHTSA issued a Notice of Intent to begin developing new standards for greenhouse gases and fuel economy for light-duty vehicles for the 2017-2025 model years. The two agencies are also focused on medium- and heavy-duty vehicles, and in October 2010, announced a proposed rule to, for the first time ever, establish GHG emissions standards and CAFE standards for such vehicles for model years 2014-2018. In parallel to these rule-makings, the Recovery Act provided the Department of Energy with the opportunity to invest nearly$718 million in the future of biofuels and biopower.

4. **The oil and gas industry supports more than 9.2 million jobs. Has the Administration calculated what impact raising taxes on domestic energy producers will have on these jobs?**

Because the elimination of these subsidies will have only a very small effect on the domestic production of oil and natural gas, employment in the oil and natural gas production and supply industry would not change by a significant amount. Moreover, eliminating the distortionary influence of the tax preferences for oil and natural gas will result over time in new jobs being created in other sectors.

According to 2009 Treasury estimates, removing the subsidies for the oil industry will decrease domestic production by less than one half of one percent, even in the long run. A rough assumption would be that employment in oil production could fall in the same small proportion as the decline in output (less than one half of one percent).

Unlike oil, a large majority of the natural gas consumed in the U.S. is domestically produced, and global trade in natural gas has little impact on domestic prices. As a result, changes in domestic natural gas production costs have the potential to influence U.S. prices. According to the 2009 Treasury estimates, any price increase would likely be less than one percent in equilibrium. A one percent increase in natural gas prices might result in a reduction in natural gas consumption and production of less than half a percentage point over the long term. Over the long term, employment in the natural gas production and supply industry could change by an amount similar to the change in production.

In terms of the overall economy, it is also important to note that the oil and gas industry is about ten times more capital intensive than the U.S. economy as a whole. Consequently, subsidizing oil industry production is not an effective policy for raising labor demand. As noted above, over the long term, reducing tax preferences will result in a more efficient allocation of capital and labor, which will tend to increase national output.

5. **Good paying jobs and needed government revenue have been put at risk by the Administration's moratorium imposed last year and resulting permitting delays for deepwater and shallow water exploration. In December, the Administration also reversed scheduled plans for new lease sales off the Outer Continental Shelf. Analysis by IHS Global Insight last July of the economic contribution offshore oil and gas development in the Gulf of Mexico shows that the industry generated nearly 400,000 jobs, $70 billion in economic values and $20 billion in federal, state and local revenue in 2009.**

   If domestic oil and gas production is to be discouraged, through the tax code and the ongoing de facto moratorium in the offshore, what impact does this have on federal revenues going forward?

   The Administration's proposals to eliminate oil and gas subsidies in the tax law would raise an estimated $44 billion dollars in tax revenue over 10 years.

   The oil and gas subsidies in the tax law distort markets by encouraging more investment in the oil and gas industry than would occur under a neutral tax system. Moreover, the tax subsidies for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive areas of the economy. The resulting distortions in resource allocation result in inefficiency and generally reduce economic growth. Removing these distortions can increase overall economic growth, potentially resulting in an increase in tax revenues.

6. **What is the expected loss in cumulative government revenue from lost production in the form of royalties, severance taxes, property taxes, income taxes, and lease bonuses?**

   As noted in the answer to question 3, the Administration's proposals to eliminate oil and gas subsidies in the tax law would raise an estimated $44 billion dollars in tax revenue over 10 years and can potentially result in efficiency gains giving rise to additional tax revenues beyond those reflected in the budget estimates.

   Because the elimination of these subsidies will have only a very small effect on the domestic production of oil and natural gas, any reduction in government revenues attributable to that production such as royalties, severance taxes, and lease bonuses will also be very small.

   We have estimated that removing the subsidies for the oil industry will decrease domestic production by less than one half of one percent, even in the long run.4 Unlike oil, a large majority of the natural gas consumed in the U.S. is domestically produced, and global trade in natural gas has a small impact on domestic prices. As a result, changes in domestic natural gas production costs have the potential to influence U.S. prices. According to the Treasury estimates in 2009, any price increase would likely be less than one percent in equilibrium. A one percent increase in natural gas prices might result in a reduction in natural gas consumption and production of less than half a percentage point over the long term.

[4] Statement of Alan B. Krueger, Assistant Secretary for Economic Policy and Chief Economist, U.S. Department of the Treasury, Senate Committee on Finance Subcommittee on Energy, Natural Resources, and Infrastructure, September 10, 2009.

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Questions from Senator Begich

1. **We've heard that China is going to let its currency float for a long time. We've also heard that it's in their best interest and it's inevitable. Given the pressure that the U.S. put on China over a year ago about its currency exchange rate relative to the dollar and the promises that China appeared to make, did you expect the currency to be more fairly valued by this point? When is there going to be real movement so that we can better export goods there?**

   The Chinese market offers tremendous opportunities to U.S. firms and workers. The Administration is committed to making the most out of those opportunities, and to making the U.S.-China economic relationship more beneficial to the American people.

   China has begun to adjust its nominal exchange rate in recent months, and we welcome this progress. Since June 2010, China's authorities have allowed their currency to appreciate against the dollar at a pace of about 6 percent a year in nominal terms, and over 10 percent a year in real terms, given higher inflation in China than in the United States. But, despite this, progress thus far is insufficient. China's currency remains substantially undervalued and more rapid progress is needed. China's leaders seem to recognize increasingly that exchange rate flexibility needs to be part of China's efforts to change its pattern of growth.

   It is important to note China's exchange rate remains an important issue for all of China's trading partners, not just the United States. In this regard, the G-20 committed to a new framework to reduce excessive external imbalances; and the members agreed that all economies have a shared responsibility to support global macroeconomic rebalancing. A critical part of this process is enhancing exchange rate flexibility.

2. **I am deeply committed to tax reform and to deficit reduction both. We have to get our fiscal house in order and address significant flaws in our tax code to position this country to grow and be competitive in the world. We've heard much about tax reform already this year, and it's my sense that just as we think everything should be on the table for deficit reduction, I think we need to take a hard look at all aspects of our tax code, including tax expenditures. Do you see a link between taking a careful look at our tax expenditures in tax reform and deficit reduction?**

   Tax reform should include a careful review of the Internal Revenue Code, including tax expenditures. As the National Commission on Fiscal Responsibility and Reform demonstrated, revenue from the elimination of tax expenditures could be used to lower tax rates and reduce the deficit.

3. **President Obama proposed eliminating certain tax incentives for American oil and gas companies. In order to lessen our energy dependence, I believe oil and gas need to play**

an important role. Eliminating these incentives would make it even more difficult for American oil and gas companies to compete globally and would be very significant for Alaska. Keep in mind, we already import roughly 2/3 of the oil and gas we consume in this country. I would like you to address two tax credits particularly important for American oil and gas – the Intangible Drilling and Development Costs (IDC) tax treatment, and the Percentage Depletion tax deduction. These tax credits have been around for a long time – IDC since 1913 and Percentage Depletion since 1926 – and are crucial for American independent producers, which are responsible for roughly 1/3 of domestic production. Elimiuating these tax credits would significantly reduce American production. Can you address the administration's proposal to eliminate these tax credits, and how this diverges from our goal of lessening our energy dependence?

The Administration's goal is to lessen our dependence on oil, whether domestic or imported. The domestic price of oil will be determined by the world price of oil, and the size of our domestic production has little or no influence on the world price of oil.

Tax subsidies that encourage domestic production (such as the expensing of intangible drilling costs and percentage depletion) distort markets by encouraging more investment in the oil and gas industry than would occur under a neutral system and, to the extent they encourage our continued dependence on oil, are detrimental to our long-term energy security. Policies that reduce our dependence on oil, such as investing in clean energy technologies, are a more effective way to reduce our vulnerability to an oil price shock and promote energy security.

4. **I know that the IRS has been working on new regulations to require a registration and certification process for those who prepare tax returns. I am aware that there are a lot of tax professionals who are not CPAs or Attorneys that work honestly and fairly. But I am wondering about those who are dishonest and cheating the system and how we can regulate these individuals. I am told that there are 700,000 out of 1 million tax professionals out there who are not CPAs or attorneys. Can you talk a little bit about what this new registration/certification process would potentially entail, and also about the instances of fraud and abuse that have occurred at the hands of those who are not CPAs or attorneys? I am also wondering how involved or if the CFPB should be in this process? Finally, would it be better for the federal government to take the lead or to work in close concert with state regulators?**

The IRS is increasing its oversight of paid tax return preparers by requiring tax return preparers to get a preparer tax identification number (PTIN), creating testing and continuing education requirements, and revising Circular 230 (which regulates those who practice before the IRS) to subject tax return preparers to the same ethical standards that apply to attorneys and CPAs. The new requirements were put in place after over a year of public meetings, consultation, and public comment during which numerous changes and accommodations were made based on input from stakeholders.

In September 2010 the IRS launched the new online PTIN (Preparer Tax Identification Number) application system. It is up and running with hundreds of thousands of preparers already registered in the system. The PTIN registration process gives the IRS an important and better line of sight into the return preparer community. It will leverage that information to better communicate, analyze trends, spot anomalies and potentially detect fraud.

With respect to state regulators, we do not view this as an either/or proposition. The IRS must administer appropriate nationwide standards, but where there are state laws (e.g., those that govern CPAs or attorneys), the IRS routinely works with state regulators on matters of common interest. Because this initiative extends an existing set of IRS oversight responsibilities, relationships, expertise, and infrastructure, there are no current plans for the CFPB to have a substantive role.

5. **On Tuesday, you said that that the United States needs to cut the corporate tax rate substantially with a goal in the high 20 percent range, down from the current 35 percent. I know that you have said that Congress and the Administration need to work together to overhaul the tax code and must start with corporate taxes. I am wondering what you think is the best way to accomplish this? Also, I know that the President has called for Congress to make this happen without adding to the deficit, which is something I support. I know that this process will undoubtedly help some businesses and harm the productivity of others. I am wondering if this will slow down the process and what you suggest we do to ensure we stay on the path to lowering the corporate tax rate?**

   Corporate tax reform should be part of a plan to make America more competitive and to create more U.S. jobs while not adding to the deficit. The best way to accomplish those goals is to limit or remove special tax incentives for certain activities that may distort investment and hurt growth. Such reform could improve the allocation of capital in the economy, increase growth and give us a fairer tax system that allows the market, rather than tax considerations, to drive investment.

   Revenue-neutral corporate tax reform will not be easy and will require difficult decisions in order to lower the statutory rate. The Administration will continue to work with various stakeholders, including Congress, to ensure that the process moves forward.

6. **Many people have argued that repatriating money that companies have kept overseas would create jobs because of the infusion of money into our economy. But I would like to know if you have any thoughts about increased tax revenue that might come from this repatriated money. I know that's counterintuitive because most of the time when**

we talk about repatriating we are talking about giving up revenue. Do you have any estimates on increased tax revenue we may see from repatriated money once it's back in the economy?

The overwhelming economic evidence is that the last repatriation holiday did not promote either investment or job creation in the United States and resulted mainly in companies increasing stock buy-backs and dividend payments.
Moreover, in the past the Congressional Joint Committee on Taxation has scored such proposals as losing revenue.

Corporate tax reform should focus on permanent changes to our tax system, and not involve one-time policy shifts. Another repatriation holiday could further exacerbate problems with our current corporate tax and would not provide a stable tax system that properly encourages investment in the United States. The Administration remains committed to reducing inappropriate tax incentives favoring offshore investments over investments here in the United States.

7. **Can you tell me the revenue that will be raised by limiting the Mortgage Interest Deduction to the 28 percent bracket? The housing market is still very fragile. Is it possible that the negative impact to the housing market will outweigh the potential revenue raised?**

The Administration's Budget proposal would restrict to 28 percent the value of all itemized deductions taken by high-income taxpayers -- not just the value of the deduction for home mortgage interest. Overall, this proposal is estimated to raise about $320 billion over the ten-year budget window. For taxpayers affected by this proposal, less than 25 percent of the dollar value of itemized deductions is from home mortgage interest. Accordingly, we would expect a similar fraction of the revenue raised from this proposal to be attributed to home mortgage interest. We do not expect that this proposal would have a substantial impact on the housing market. Under our proposal, all taxpayers would continue to be able to deduct home mortgage interest. For the small fraction of taxpayers who are at the very top of the income distribution, our proposal limits, but does not eliminate, the value of the deduction for home mortgage interest. Our proposal does not apply to the vast majority of taxpayers, and demand for homes among these taxpayers would be unaffected.

Specifically, our proposal applies only to the roughly 2 to 3 percent of taxpayers who itemize and have incomes above $200,000, in the case of single filers, or $250,000, in the case of married taxpayers filing jointly, and pay home mortgage interest. For these taxpayers, our proposal caps the value of all itemized deductions, including the home mortgage interest deduction, at 28 percent, rather than allowing the deduction to be taken at the taxpayer's marginal income tax rate. But it is important to note that these taxpayers would still retain the majority of the value of the deductions. Moreover, even for high-income taxpayers, our proposal would have no direct effect on the tax cost of owning a house to the extent that the house is financed with equity rather than with a mortgage.

8. **Section 104 of the Comprehensive Iran Sanctions Accountability and Divestment Act (CISADA) requires the Secretary of the Treasury to prohibit or impose strict conditions on the opening or maintaining of accounts for foreign financial institutions that he finds knowingly engage in certain activities related to Iran.**

   Why has the Treasury Department failed to sanction foreign, non-Iranian, banks that continue to work with sanctioned Iranian entities in violation of U.S. law?

   Since publishing regulations implementing section 104(c) of CISADA in August, 2010, the Department of the Treasury's Office of Terrorism and Financial Intelligence has been engaged in an extensive and coordinated outreach effort to both foreign governments and specific foreign financial institutions to ascertain whether they are providing financial services to Iran, as outlined in section 104(c) of CISADA. Ensuring that foreign financial institutions do not provide such financial services has been the goal of the Department, and the risk of sanctions under section 104(c) has proved to be a powerful incentive for foreign financial institutions to alter their behavior. The response of the vast majority of overseas institutions and their regulators has been very positive and has resulted in further isolating Iran. Where we have had additional questions, we are aggressively pursuing answers. We will implement this law fully and if we determine that an institution is engaging in sanctionable activity under section 104(c) of CISADA, we will take appropriate measures.

9. **Under CISADA, the Secretary of the Treasury is required to prescribe regulations for U.S. banks, which maintain foreign correspondent accounts, to have an audit or certification requirement that neither they, nor their correspondents abroad, are servicing designated Iranian banks. These regulations have not been issued.**

   Why have these regulations not been issued? When can we expect the regulations to be issued?

   Treasury moved quickly to implement CISADA's financial provisions. On August 16, 2010, 45 days after CISADA enactment, we published the Iranian Financial Sanctions Regulations to fully implement all provisions of section 104 of CISADA that are subject to the law's statutory 90-day deadline. Since then our focus has been on finalizing regulation implementing section 104(e) and we are working hard to do so based on the options provided under CISADA. We appreciate that the Congress recognized the complexities associated with section 104(e) implementation by not setting a specific deadline for this regulation. We are currently finalizing a Notice of Proposed Rulemaking and we anticipate that it will be published in the Federal Register shortly.

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10. The Treasury Department has repeatedly warned about the role of the Central Bank of Iran (CBI) in facilitating Iran's illicit financial activities and has warned international banks to exercise extreme caution in dealing with it. As the U.S., and increasingly our allies, has sanctioned Iranian banks, Iran's Central Bank has stepped in to take over the illicit activities of the sanctioned entities. Congress has urged tough action against the Central Bank of Iran.

Why has the U.S. not sanctioned the Central Bank of Iran pursuant to Executive Orders 13224 or 13382?

As a result of existing U.S. sanctions on Iran, U.S. financial institutions are generally prohibited from doing business directly or indirectly with all Iranian banks, including the Central Bank of Iran. The United States will continue to take all necessary action to ensure that the international financial system is protected from all abuse, including from the Central Bank of Iran.

11. Do you believe the Central Bank of Iran is supporting Iran's proliferation activities or facilitating the activity of entities under U.S. or U.N. sanctions?

The United States harbors no illusions about Iran's efforts to do whatever it can to evade international sanctions. Treasury has noted previously that the Central Bank of Iran and Iranian commercial banks have requested that their names be removed from global transactions to make it more difficult for intermediary financial institutions to determine the true parties in the transaction, and we remain concerned that the Central Bank of Iran may be facilitating transactions for sanctioned Iranian banks. We assume that Iran will attempt to circumvent the measures put in place in response to its behavior, and we have sought to create a sanctions program that is specifically adaptive and responsive to Iranian attempts at evasion. As called for in UNSCR 1929, we will remain vigilant over the activities of the Central Bank of Iran and other Iranian financial institutions, and the United States will continue to highlight its concerns with foreign governments and the private sector. We have been diligent in exposing and publicizing Iran's deceptive practices, as a result of which many in the private sector – unable to distinguish between Iran's legitimate and illicit transactions – have become increasingly wary of engaging in any business with Iran.

12. Are you aware of any commitment made by the U.S. to a foreign government that the U.S would not sanction the Central Bank of Iran?

No.

13. It is widely known that Hezbollah, a U.S. designated terrorist group, utilizes Lebanese banks to finance its activities. These same Lebanese banks are accessing the U.S. financial system and providing Hezbollah access to U.S. dollars. Until last week's

action against the Lebanese Canadian Bank, the Treasury Department had failed to take action against any Lebanese bank for their involvement with a terrorist entity that has killed hundreds of Americans.

Is the Treasury Department investigating Lebanese banks for providing financial services to Hezbollah?

The Treasury Department does not comment on pending or possible investigations.

14. **Will the Treasury Department ban Lebanese banks from the U.S. financial system if they are found to be conducting transactions on behalf of Hezbollah?**

As we said publicly following initial discussions with Lebanese authorities regarding the Lebanese Canadian Bank, we will continue to target institutions that threaten the integrity of the U.S. financial system anywhere in the world, including Lebanon.

THE PRESIDENT'S FISCAL YEAR 2012 EDUCATION BUDGET

TUESDAY, MARCH 1, 2011

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

The Committee met, pursuant to notice, at 10:01 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Sanders, Whitehouse, Merkley, Begich, Coons, Sessions, Cornyn, Thune, and Johnson.

Staff present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, 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 today. Today we will continue our series of hearings on the President's budget. Before the recess we heard from OMB Director Jack Lew and Treasury Secretary Tim Geithner. Today our witness is Secretary of Education Arne Duncan. Tomorrow we will hear from Energy Secretary Chu, and on Thursday our witness will be Transportation Secretary Ray LaHood.

Next week we will also be holding a hearing on Defense and State Department budgets. I want to alert members that both of those Departments have asked to testify together.

I am very pleased to welcome Secretary Duncan to the Budget Committee today. This is the Secretary's first appearance before the Committee, and we look forward to his testimony.

I personally believe that education is the key to our country's economic future. The importance of education is something that was ingrained in me at a very young age. I was raised by my grandparents. My grandmother was a school teacher, Mr. Secretary. She was 5 feet tall, and we called her "Little Chief" because she commanded respect. And in our household, I will never forget, she said, "In this housing there are three priorities: No. 1 is education, No. 2 is education, No. 3 is education." And we got the message, and she was right.

So even as we look to cut spending to bring down the deficit, which we must do, we also need to ensure that we get our priorities right, and education needs to be a priority as we proceed with reducing Government expenditure.

We need to be careful not to cut education in a way that would come back to hurt the Nation's long-term economic growth and security. We simply must maintain a strong education system if we want to keep pace with our global competitors.

Let me just go through quickly a couple of charts that I think raise concern.

U.S. Ranks 25th Out of 34 OECD Countries in Math

Korea	546
Finland	541
Switzerland	534
Japan	529
Canada	527
Netherlands	526
New Zealand	519
Belgium	515
Australia	514
Germany	513
Estonia	512
Iceland	507
Denmark	503
Slovenia	501
Norway	498
France	497
Slovak Republic	497
OECD Average	496
Austria	496
Poland	495
Sweden	494
Czech Republic	493
United Kingdom	492
Hungary	490
Luxembourg	489
United States	**487**
Ireland	487
Portugal	487
Italy	483
Spain	483
Greece	466
Israel	447
Turkey	445
Chile	421
Mexico	419

Source: OECD, Program for International Student Assessment (PISA) 2009 Database
Note: Scores on PISA scale of subject competency.

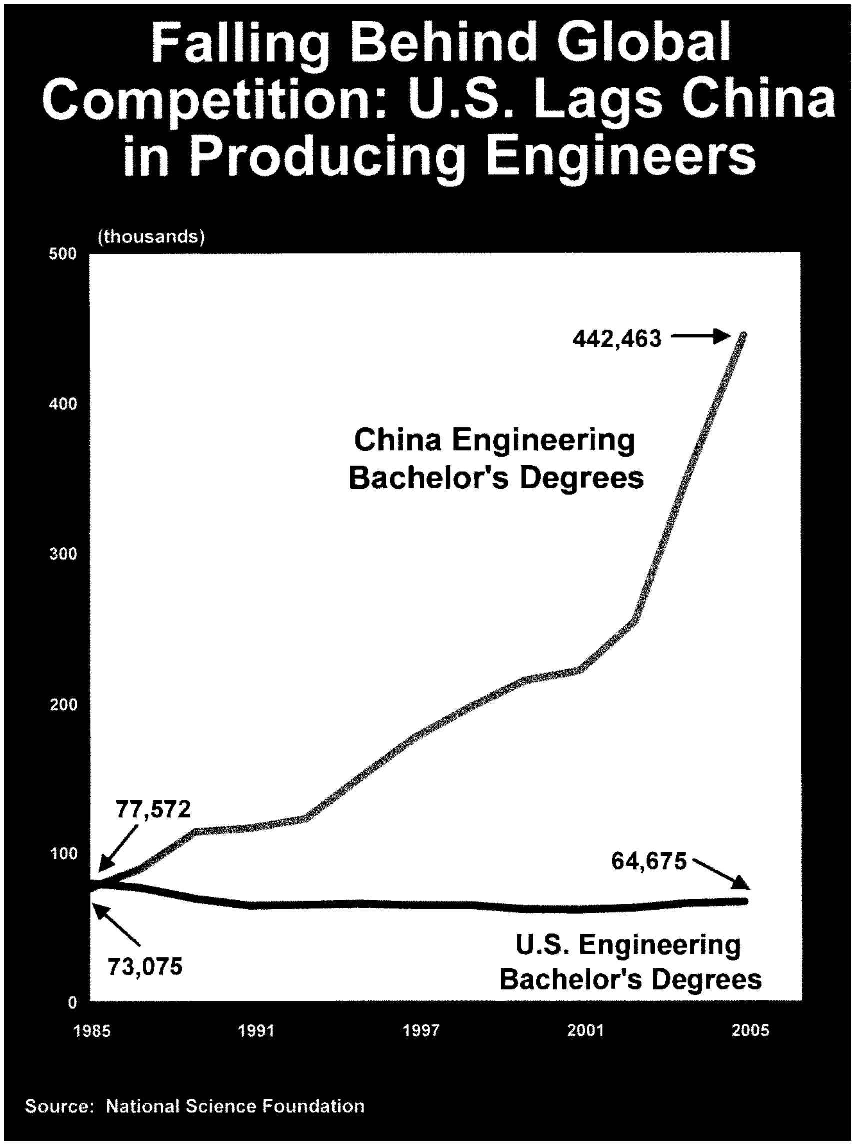
First of all, we are now falling behind competitors in key areas. American students no longer are at the top of their class. We rank 25th out of 34 Organization for Economic Cooperation and Development countries in math, well below the OECD average. We rank 17th out of 34 OECD countries in science. Our global competitors are making education a priority.

U.S. Ranks 17th Out of 34 OECD Countries in Science

Finland	554
Japan	539
Korea	538
New Zealand	532
Canada	529
Estonia	528
Australia	527
Netherlands	522
Germany	520
Switzerland	517
United Kingdom	514
Slovenia	512
Ireland	508
Poland	508
Belgium	507
Hungary	503
United States	**502**
OECD Average	501
Norway	500
Czech Republic	500
Denmark	499
France	498
Iceland	496
Sweden	495
Austria	494
Portugal	493
Slovak Republic	490
Italy	489
Spain	488
Luxembourg	484
Greece	470
Israel	455
Turkey	454
Chile	447
Mexico	416

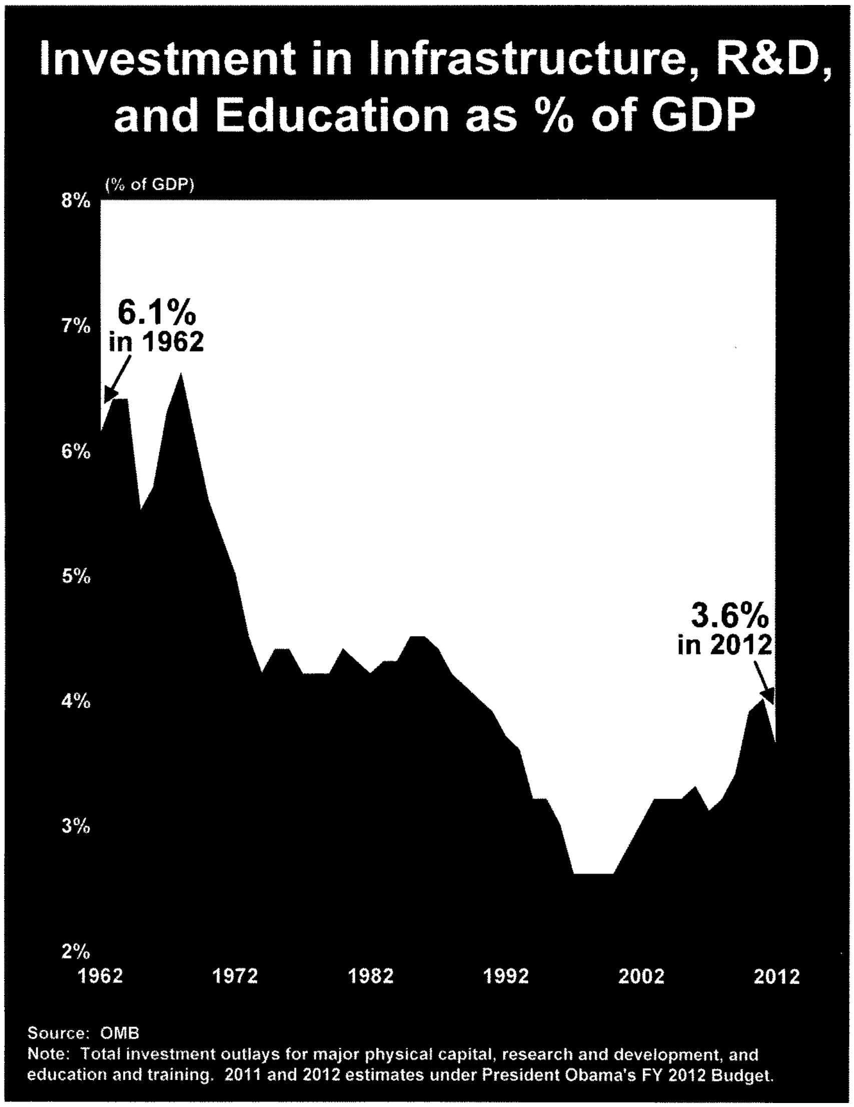
Source: OECD, Program for International Student Assessment (PISA) 2009 Database
Note: Scores on PISA scale of subject competency.

The contrast with China is striking. In the mid-1980s, we produced nearly as many engineers in graduate schools as China, but now China is producing far more engineers than we do, as this chart depicts.



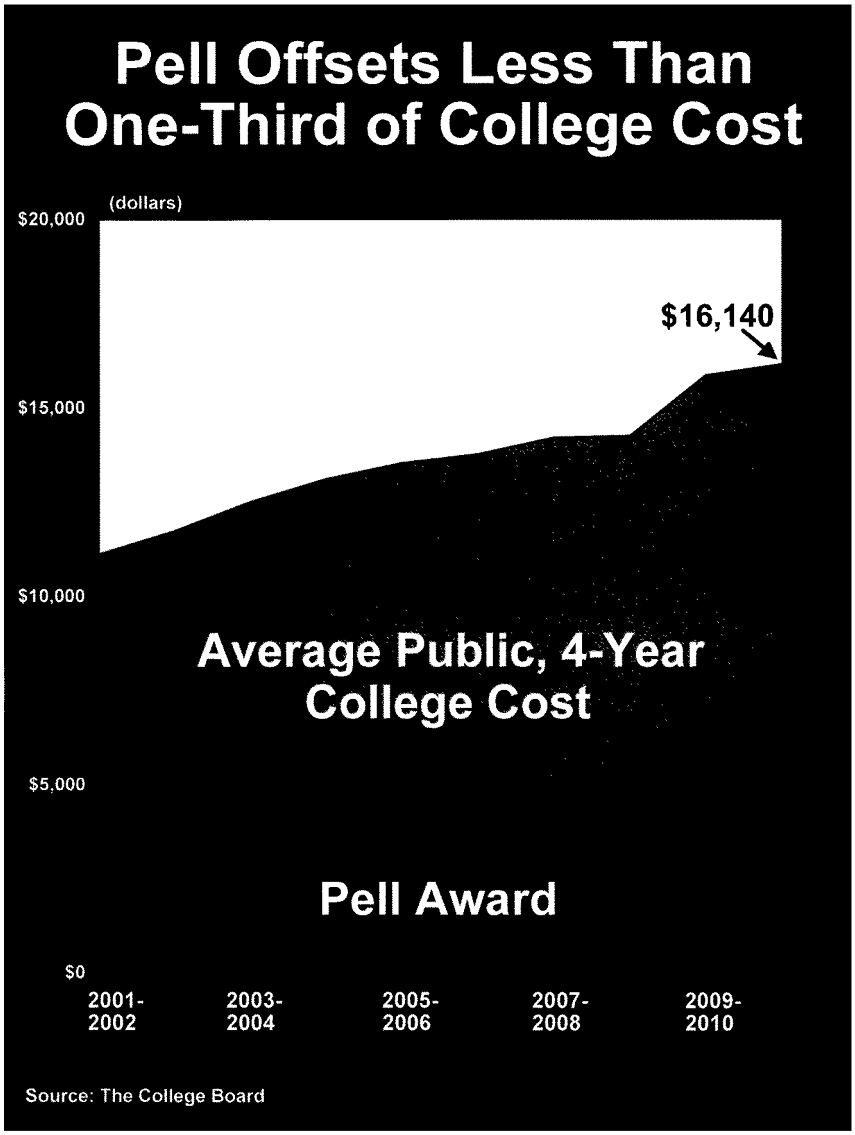
The education achievement gap that has opened between the United States and its global competition is already hurting our economic strength. Here are the findings of the study done by the consulting firm McKinsey & Company in which they quantified the economic impact of the education gap. They wrote, in part, "The persistence of educational achievement gaps imposes on the United States the economic equivalent of a permanent national recession. The recurring annual economic cost of the international achievement gap is substantially larger than the deep recession the United States is currently experiencing."

Let me go to the next chart.

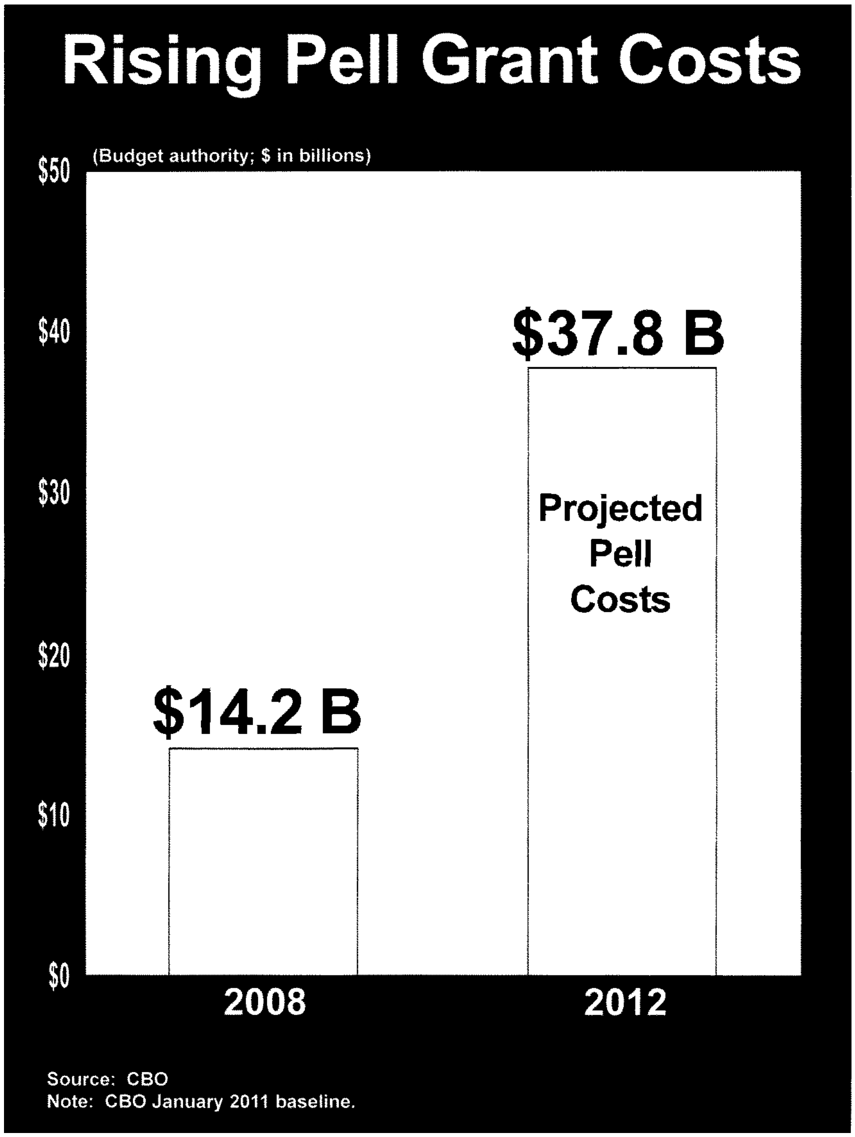


The reality is that we have not been focusing our Nation's resources as productively as possible. This chart, which was made with data from the President's budget, shows that our combined investment in infrastructure, research and development, and education has fallen as a share of GDP from 6.1 percent in 1962 to 3.6 percent in 2012. That is, even while deficits and the share of debt to GDP has grown, our commitment to these areas—infrastructure, education, research and development—has shrunk.

How can that be? Well, it can be because what is happening is the entitlements, the mandatory side of the budget has grown and displaced much of what has been traditionally domestic discretionary spending. So as a share of the economy, we are spending a smaller amount of education than these other critical areas than we did in the 1960s.

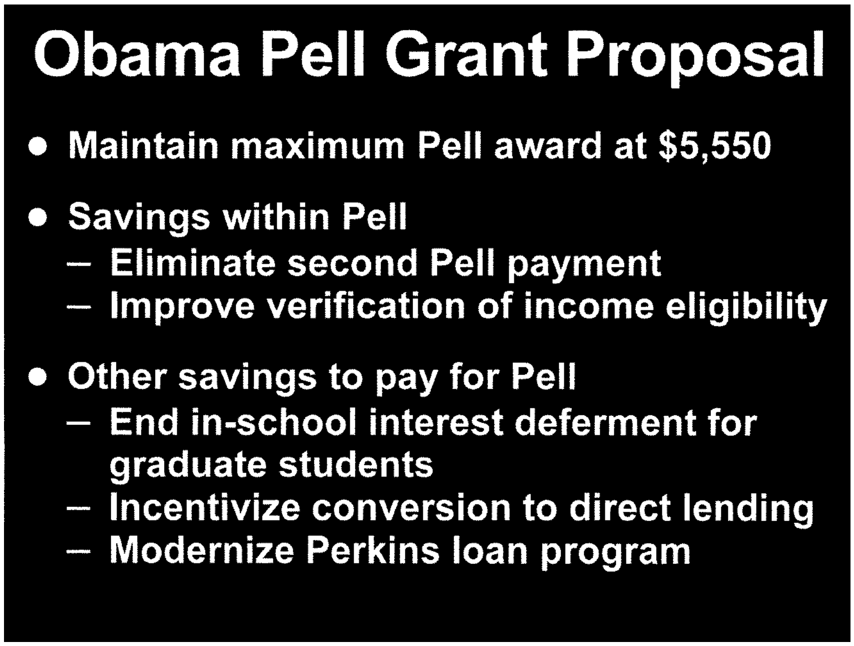


One of the key challenges we face in education funding is the Pell Program. It is important to remember that even the maximum Pell award of $5,550 offsets only a small portion of the cost of college, less than one-third of the annual cost of a public 4-year college. That portion hasten smaller as the rising cost of college has outpaced the increases in the Pell award.

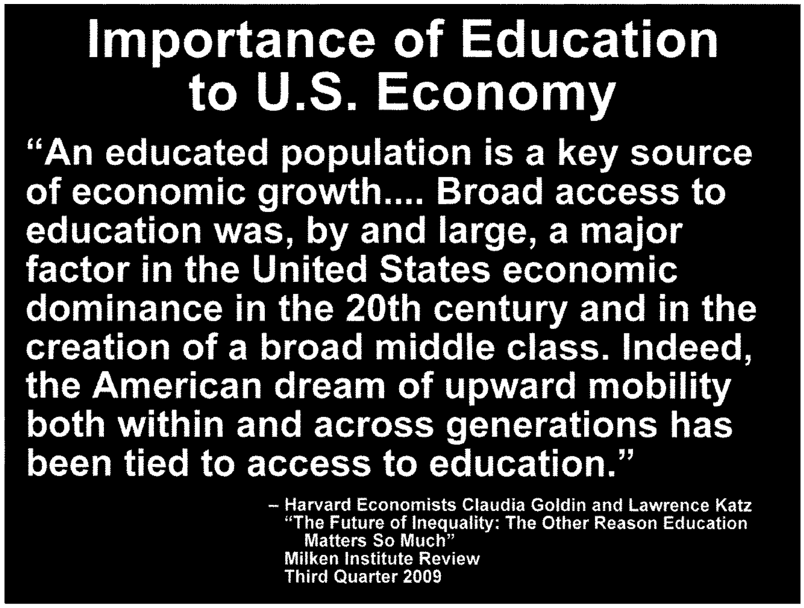


At the same time, due to the recession and increased demand for Pell grants as well as changes that we made as to who qualifies, the cost of the program has increased. So we are paying a smaller share of the cost, but the overall cost of the Pell Program has increased.

In 2008, the Pell Program cost $14.2 billion. CBO now projects that, without changes to the program, Pell costs in 2012 will be $37.8 billion.



Here is what the Obama administration has proposed in its budget for the Pell Program. It proposes to maintain the maximum Pell award at $5,550. It proposes savings within Pell by eliminating the second Pell payment, which was established to help students pay for summer school. It also proposes other savings in education accounts to help pay for Pell, including ending in-school interest deferment for graduate students, incentivizing conversion to direct lending, and modernizing the Perkins Loan Program. I look forward to hearing more from Secretary Duncan on these proposals.



I want to end by emphasizing again the importance of education to our Nation's economic strength. Here is a statement from Harvard economist Claudia Goldin and Lawrence Katz from a paper they wrote entitled, "The Future of Inequality: The Other Reason Education Matters So Much." They wrote: "An educated population is a key source of economic growth, both directly through improved labor productivity and indirectly by spurring innovation and speeding the diffusion of advanced technologies. Broad access to education was, by and large, a major factor in the United States' economic dominance in the 20th century and in the creation of a broad middle class. Indeed, the American dream of upward mobility both within and across generations has been tied to access to education."

I think they have it right. Education is a key to our past success and our future strength.

With that, we will turn to Secretary Duncan. Before we do that, I will turn to my colleague Senator Sessions for his opening comments, and then we will go to Secretary Duncan for his initial testimony. Then we will go to questions. We are going to have a large turnout today, so we are going to go to 5-minutes rounds.

Senator Sessions, welcome.

OPENING STATEMENT OF SENATOR SESSIONS

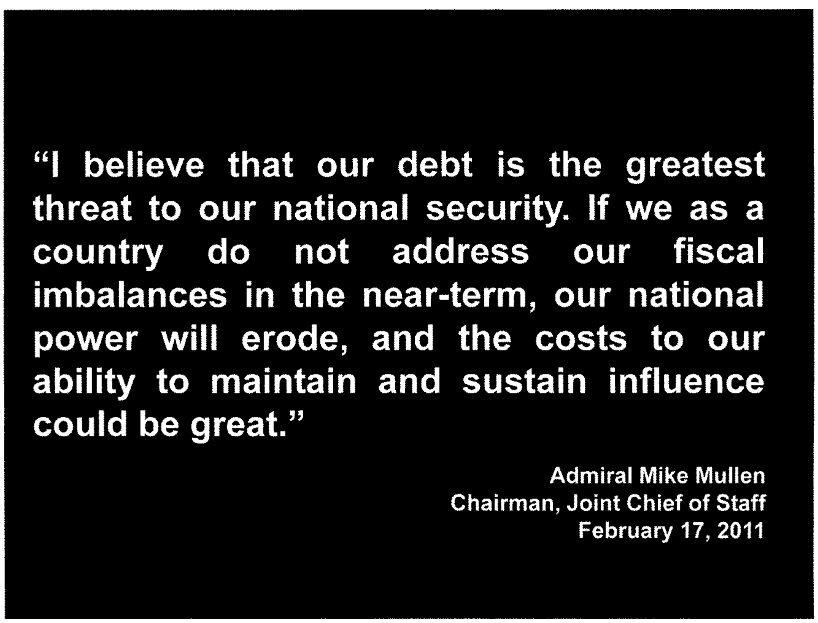
Senator SESSIONS. Well, 5 minutes will be short, but maybe that will be satisfactory, Mr. Chairman. We have so much to do.

Thank you, Secretary Duncan. Thank you for your service and for raising some tough questions about maybe some of the sacred cows in the education establishment. I appreciated your recent comments to the Governors' conference, for example, noting that somewhat large classrooms with better teachers outperform smaller classrooms, and that is good, honest talk and can result in saving and improving education at the same time.

And I was also pleased you met with Dr. Katherine Mitchell of Alabama. She designed the Alabama Reading Initiative. That program, with very little cost except training and startup, has transformed teaching and learning and reading proficiency in Alabama. In just a few years, Alabama's K–4 schools led the Nation in reading improvement. Massachusetts and Florida used the same type program. They were No. 2 and three in reading increase in 1 year. That kind of technique that costs less money is what we need—does not cost more money is what we need more of. It was technique and not funds, I think, that made that difference.

So I strongly believe our education focus should be on advancing learning, increasing those magic moments in the classroom when a child gets it and learning occurs. For too long, we have judged our education system on whether the building is new, what kind of equipment they have, classroom size, and how much we spend. But just throwing money at the problem is clearly not the answer. The test for education can only be whether learning is occurring adequately.

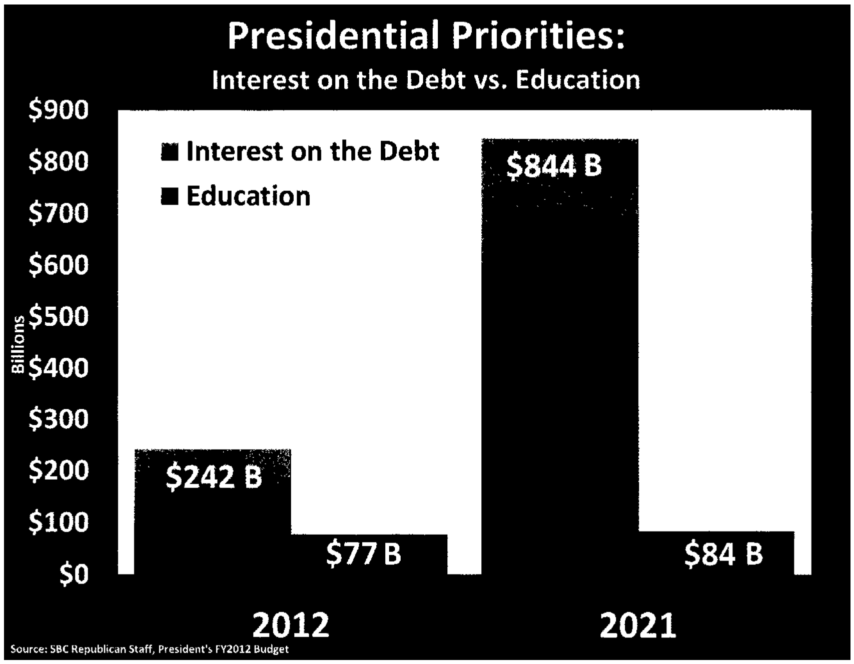
I think you believe this, and I see you nod at that. We are spending more, Mr. Chairman, than those countries that are beating us in education achievement, spending a good deal more than most of them. So I think it is time now for honest, fact-based budgeting. Everyone knows we are in a financial crisis.



Admiral Mullen, Chairman of the Joint Chiefs, said our debt is the greatest threat to our national security. This year's deficit alone is projected to be $1.65 trillion. That amounts to $7,500 for each American adult over the age of 25.

While the President tells the American people that the budget asks Washington to live within its means, the facts show the opposite. The President's budget adds $13 trillion to our gross national debt, doubling it by the end of the decade. Over the next 10 years, the smallest annual deficit the budget calls for is over $600 billion, and the number rises to $800 billion in the tenth year. We borrow that money, of course.

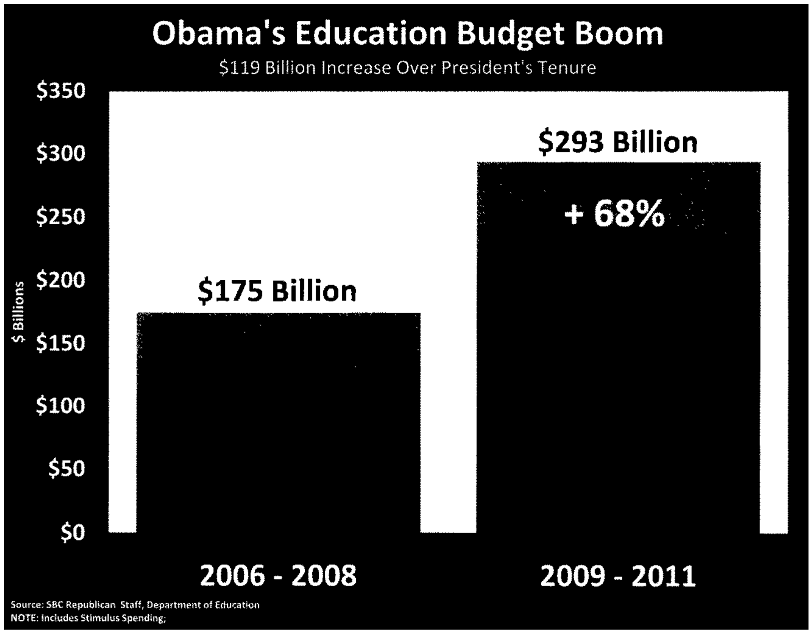
Interest on our debt was $196 billion last year, three times as large as the education budget this year.



Interest was three times the education budget this year. But in 10 years, under the President's plan, because of the increased debt, the annual interest payment will be $844 billion, 10 times the size that the budget calls for education spending in that year.

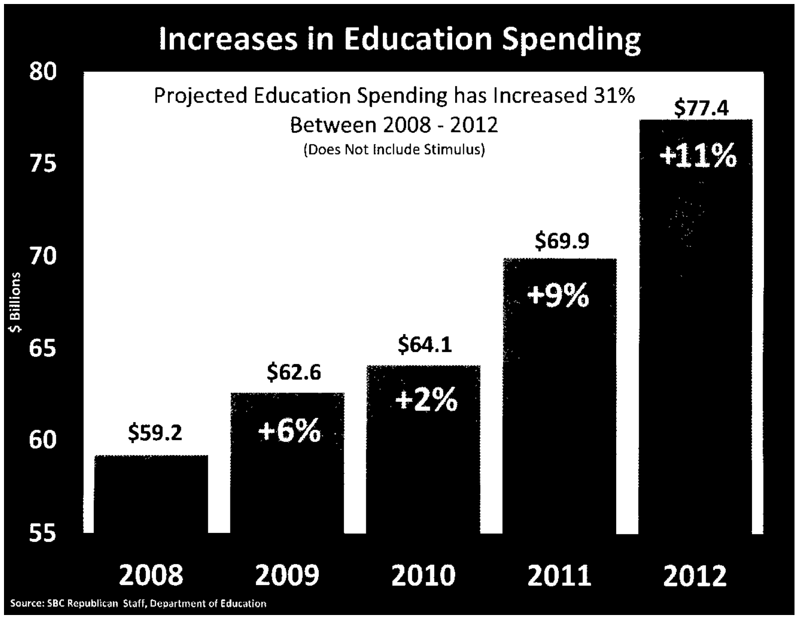
Interest, the fastest-growing item in the budget, will crowd out our future hopes for education and for all other programs. It is an unsustainable path. That is why I am flabbergasted by the education budget. I think it only could have been written in Washington in a bubble detached from the reality I have just described.

Over the last 3 years, we spent 68 percent more on education than the 3 years before that from the Federal Government.



The budget now calls for an 11-percent increase in Federal spending on education. Sir, we do not have the money. Everyone knows that. American families are tightening their belts every day, doing more with less, as are cities, counties and States. It is time for the Federal Government to do the same. We have to.

All of us favor education, but we cannot continue these large increases in spending, every dollar of which is borrowed.



This request for an 11-percent increase, more than 30 percent more than we were spending in 2008, is an affront to common sense, an affront to the will of the voters. These charts show that education has been the beneficiary of unprecedented increases in recent years without, let me add, any significant increase in student performance. And with the stimulus money, education has risen by stunning unprecedented amounts. Your prepared statement acknowledges a 4-percent increase in education spending, discretionary spending, but you note that that does not include increases in discretionary Pell grants. Well, that is not fact budgeting. That is beltway budgeting. When you consider Pell grants—and we should—it is an 11-percent increase.

What we need is leadership that focuses on why our education system is not meeting our expectations. This funding crisis I think is an opportunity to challenge our educational establishment, to thoroughly and honestly review the plain facts, what works, what does not work. We owe that to our children today for their education. And we owe our children a country that is not burdened by crippling debt. The President says his budget is a plan for winning the future, but you cannot win the future for our children with borrowed money.

As Secretary Geithner acknowledged last week, our surging debt threatens our economic growth, jobs for young graduates, and even economic turmoil. It would be wrong to leave our country weaker and diminished because we lack the courage to confront the fiscal crisis we are in.

So we need a dramatic course correction. We need to get the message. We need to get in sync with reality of what is happening in the world today. We need to trim bloated Government. We need to start now, and it goes without saying that the Education Department is not exempt. We will vote this week on a continuing resolution to fund the Government for some period of time. No continuing resolution to fund the Government that fails to reduce spending will pass. It will not pass the House or the Senate. We are going to fight for spending cuts this week, next week, next month, next year. We are going to fight for spending cuts in this Budget Committee and the Appropriations Committee and on the Senate floor. We are going to keep fighting for a leaner, more productive Government until we have restored confidence in our economy and put our country back on the right path—the path to prosperity.

So this battle over the budget is just beginning. I respect your leadership. I think you have some great ideas. But we cannot approve, and I do not think will approve, an 11-percent increase in education funding.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you. It sounds to me like you have a bit of a cold there.

Senator SESSIONS. I do.

Chairman CONRAD. So we hope you will recover.

Senator SESSIONS. Thank you.

Chairman CONRAD. We want to welcome the Secretary. Please proceed with your testimony, and then we will go to the rounds. Let me just say that I initially said 5-minutes rounds. If the turnout is the same as the turnout that we see here, we will go to 7-minute rounds. We have indicated from Senators ten more Senators would be here. If that were the case, we would need 5-minute rounds, but we will just wait and see.

Secretary Duncan, welcome.

STATEMENT OF THE HONORABLE ARNE DUNCAN, SECRETARY, U.S. DEPARTMENT OF EDUCATION; ACCOMPANIED BY THOMAS SKELLY, ACTING CHIEF FINANCIAL OFFICER, U.S. DEPARTMENT OF EDUCATION

Secretary DUNCAN. Thank you, Chairman Conrad, Ranking Member Sessions, and members of the Committee. Thank you so much for this opportunity to come before the Committee and to talk to you about President Obama's fiscal year 2012 education budget.

This proposed budget reflects our administration's dual commitments to reduce spending and to be more efficient while investing to secure our future, and at the very top of that list of investments we must make is education. Education is the foundation for a free and a democratic society. It is the blanket of security for the middle class and the only path out of poverty for millions of Americans who have been left behind by a changing economy.

Education gives immigrants and their children the chance to be productive citizens and contribute to our collective wealth. Education enables us as a country to compete in a global economy with other countries that are heavily investing to prepare the next generation of innovators and leaders in business.

Education is not just an economic security issue. It is a national security issue, which is why retired General Colin Powell devotes so much of his energy today to education. Last year, military leaders stood with me and called for more education funding because only one in four, only 25 percent of young high school graduates today, is educationally or physically equipped to serve in the military.

Today all across America people are meeting the challenge of improving education in many different ways, from creating high-quality early learning programs to raising standards, strengthening the field of teaching, and aggressively attacking and closing achievement gaps.

While the Federal Government contributes less than 10 percent of K–12 funding nationally, our dollars play a critical role in promoting equity, protecting children at risk, and more recently supporting reform activities at the State and at the local level.

In terms of reform, the last administration focused on charter schools and performance pay, two programs that benefited our students when I was a CEO of the Chicago public schools. Our administration has used competitive dollars to get State and local educators to think and to act differently. Our administration's Race to the Top program has prompted Governors and educators to jointly embrace bold and courageous reform programs. With our support, 41 States adopted higher college and career-ready standards, and several States passed new laws and policies around teacher evaluation. Several States altered charter laws and policies to foster creation of new learning models.

Race to the Top also prompted us to rethink the Federal role. As I said, the Department was established to promote equity in education and to protect students most at risk. To that end, we have steadily boosted our commitment to formula programs like Title I and IDEA.

The Federal Government also has a long history of supporting higher education from the land grant colleges in the 19th century to the GI bill and the Pell Grant Program in the 20th. This budget further increases our investments in higher education through both student lending programs and grants.

But today our most critical role is in supporting reform at the State and local level by providing increased flexibility and incentives, while holding States and district accountable in a fair, honest, and transparent way. In fulfilling this role, we must strike the right balance, providing as much freedom and flexibility as possible to schools and districts, while ensuring that children are learning what they need.

I have spent 2 years traveling the country, visiting many of your States and districts and talking with your teachers and your parents. I have visited schools in rural, urban, and suburban communities, and there is a lot of dissatisfaction I hear across the country with the current Federal law around public education.

Many people feel the Federal Government went too far with sanctions, mislabeling schools as failures, and issuing one-size-fits-all mandates. That's why we're asking Congress to rewrite and to fix No Child Left Behind, and I look forward to working with you on that in the next couple months as we move forward.

But there is also a deep appreciation for the Federal commitment to children and to learning. They are grateful for our support of the STEM subjects. Americans know that even in challenging times, particularly in challenge fiscal times like these, we must prepare our young people to compete in tomorrow's economy. They know that even as States face greater financial pressure than at any time in recent history, we cannot put our children and our country's future at risk. So our budget proposal reflects these aspirations and commitments.

Overall, we are seeking a $2 billion increase in non- Pell spending. That includes a modest increase in formula programs like Title I and IDEA, while maintaining programs for English language learners and other at-risk populations, such as rural, migrant, and homeless students.

We are calling for a new round of Race to the Top funds, though we would change the program in two significant ways: targeting school districts rather than States, and including a carveout for rural communities.

We will continue to invest in innovation and research. We want to support a well-rounded education that includes the arts and foreign languages, literacy, STEM, and physical education. We want to strengthen the teaching profession in a number of ways and work harder to attract the top students to pursue teaching degrees.

We proposed a new competition to strengthen early learning program, and we are challenging every single State to boost college completion rates. Today more than half of our young people who go to college fail to earn a degree. As a Nation, we cannot sustain that any longer.

There is a lot more in our budget outlined in the written testimony, but before I take questions, I just want to highlight how we have been and continue to be more efficient. In the 2010 budget enacted by Congress, we eliminated four programs, saving $360 million. In our proposed 2012 budget, we propose eliminating 13 additional programs, saving another $147 million. Together these savings total more than $500 million annually, which is helping fund our other priorities. Mindful of the significant paperwork burdens we placed on local school districts, we are proposing to consolidate 38 separate elementary and secondary education programs into 11 simpler funding streams. These common-sense reforms will make it easier for school districts to focus on educating their community's children rather than dealing with bureaucrats here in st.

We are also proposing to reduce our investment in career and technical education, not because we do not believe in CTE but because we feel the current program is not getting the results we need. Even with the reduction, we are still seeking $1 billion for CTE, and we are committed to working with States to reform these programs for the new economy.

This year, we have also identified efficiencies in the student aid program that, coupled with a change in Pell grant policy, will help close a $20 billion shortfall in the Pell grant program and save $100 billion over the next decade. Those savings mean we can protect the $5,550 maximum Pell grant award and help millions of young people meet rising tuition costs.

Those savings also mean that we can meet the skyrocketing demand for Pell grants, which has risen from less than 4 million grants in 2000 to a projected 9.6 million grants next year. In the last 2 years alone, an additional 3 million students received Pell grants. In my view, this is a good problem—this is actually a great problem for our country to have. We desperately need more young people going to college, and in this economy they desperately need our help. But we must do more to make sure they finish college and earn their degrees.

Let me close by saying that we share with you the responsibility for being efficient and smart in how we invest. But we also share an even greater responsibility, which is to prepare the next generation to lead. We share the responsibility for the 20 million disadvantaged students served by Title I, the nearly 7 million students served by IDEA, the 5 million English language learners, and the 16 million college students who benefit from student aid programs.

In his recent speech to Congress, the President talked about winning the future. To emphasize the point, he announced his budget at a STEM-focused elementary school in Baltimore. He believes, as I do, that winning the future starts in the classroom. He also believes the Government spends too much, and he has outlined more than $1 trillion in deficit reduction over the next decade.

This is an important national conversation that will take a great deal of time, energy, thought, and courage. It will take real courage on the part of Congress and the administration. We have to be truthful with each other and truthful with the American people about what is and is not working. We have to take the heat together for the cuts that we are making. To win the future while cutting spending, we must be absolutely vigilant about how we invest and how we support reform at the State and local level. We must be responsible in what we say and do, and we must show results.

Responsibility, reform, and results are the hallmarks of our budget and our administration and our guiding principles as we move forward. And this applies at the State level as well. I spoke with Governors this weekend, and we are now sharing ideas with them for more flexibility and productivity in spending.

I just want to close by thanking Congress for supporting education over the last 2 years. Because of you, we helped protect millions of children in classrooms all across America, from the greatest economic crisis since the Depression.

Because of your leadership, we helped States and districts all across America advance their reform agendas, raise standards, and challenge the status quo in significant ways.

Because of you, almost 1,000 underperforming schools have launched radical restructuring plans to improve the lives of children and many more in the process.

Because of you, there is a greater determination than ever before to ensuring that our children can compete and win in our globally competitive economy.

And because of you, we face a brighter future and a greater prospect that the world we leave behind will be better than the one we inherited.

Soon behalf of 80 million students of all ages, their parents, our hard-working teachers, principals, and administrators, and all the people of America who value education and recognize its importance, I thank you for your leadership.

I will stop now, and I am happy to take any questions you might have.

[The prepared statement of Secretary Duncan follows:]

U.S. Secretary of Education
Arne Duncan
March 1, 2011
Senate Committee on the Budget
"Department of Education Fiscal Year 2012 Budget"
Testimony

Chairman Conrad, Ranking Member Sessions, and Members of the Committee:

Thank you for this opportunity to come before this Committee and talk about President Obama's fiscal year 2012 budget to help America out-educate the rest of the world. There is broad agreement that the Federal government has to start living within its means, and the President's 2012 budget represents a good first step toward our shared long-term goal of reducing the Federal deficit. However, we believe it is absolutely essential to keep investing in education so that, as the President put it, "every American is equipped to compete with any worker, anywhere in the world."

PRESIDENT OBAMA'S 2012 BUDGET REQUEST

President Obama's 2012 request is a responsible budget that invests in education reforms that will deliver results. The overall discretionary request for the Department of Education, excluding Pell Grants, is $48.8 billion, a $2 billion or 4 percent increase over the 2011 continuing resolution (CR) level, which at the time our budget was released was roughly the same as the Department's 2010 discretionary appropriation.

As you know, financing the Pell Grant program, which is funded through a combination of discretionary and mandatory appropriations and has faced growing demand in recent years as more and more students and working adults seek to improve their knowledge and skills, has been a real challenge for the Department and for the Congress. The historic demand for Pell Grants has created a shortfall that we project could reach $20 billion in 2012. The President's Budget responds to this challenge by proposing a combination of tough choices to generate savings from Pell Grants and student loan programs and increased discretionary funding— $5.4 billion above the 2011 CR level for a total of $28.6 billion in 2012. The overall goal of our Pell Grant proposals is to protect the $5,550 maximum Pell Grant award, put the program on more sustainable financial footing in 2012 and beyond, and ensure that more than 9 million low-income students can continue to rely on Pell Grants to enter and complete a college education.

To rein in Pell costs and place the program on more solid financial footing, the Pell Grant Protection Act would eliminate the extra Pell Grant; end the interest subsidy for graduate student loans; and allow the conversion of guaranteed student loans to the Department. The Department will also work with the Internal Revenue Service, taking administrative action to implement enhanced income verification procedures for Pell Grant applicants as part of improvements in the processing of the Free Application for Federal Student Aid (FAFSA) to better manage the transmission of accurate information. Combined, these actions would reduce the discretionary need for the Pell grant program by $100 billion over the next ten years.

MAKING TOUGH CHOICES

Before I describe some of the key investments we are proposing for 2012, I want to emphasize that our overall strategy for supporting effective education reform is fully consistent with the current fiscal environment. From the beginning, this Administration has envisioned a smaller Federal role focused on key priorities and structured to ensure the most productive use of the resources entrusted to us by taxpayers and the Congress. This is why, for example, our reauthorization proposal for the Elementary and Secondary Education Act (ESEA) would consolidate 38 existing programs into 11 more flexible authorities that would give communities more choices to implement their own research-based reform strategies. We also have worked hard to identify and eliminate duplicative, unnecessary, or ineffective programs. In 2010, we worked with the Congress to terminate four programs for a savings of $360 million, and our 2012 request proposes the elimination of 13 additional programs for a total savings of $147 million. In addition, we took a close look at our Career and Technical Education (CTE) programs, which too often have not lived up to their promise of preparing students for careers and college, and are proposing a $264 million cut in CTE State grants. All levels of government will be facing budget shortfalls and challenged to do more with less in these times of financial constraint. The budget places a priority on spending smarter through cost-effective reforms that improve student outcomes.

We look forward to working with Congress to strengthen the Perkins Act, which shapes the CTE program, and improve its alignment with the education reform efforts at the core of our ESEA reauthorization proposal, so that the Perkins Act is a stronger vehicle for supporting the President's 2020 college completion goal and the Department's efforts to improve secondary schools.

While Pell costs remain substantial, we made tough choices in our 2012 budget; the changes we are proposing in the Pell Grant and student loan programs will save more than $100 billion over the next decade. Cuts like these are never easy, but in the current fiscal climate they are the responsible thing to do, and the only way to ensure that we can make the investments we need to secure our future.

Make no mistake; the budget request for education is more about investment than cuts. President Obama has said that to win the future, we have to win the education race, and his 2012 budget would provide the resources we need to educate our way to a better economy. More specifically, the 2012 request for education is designed to promote reform, reward success, and support innovation at the State and local levels while maintaining strong support for students most at risk of educational failure. To meet these goals, our 2012 investments in education are divided into five significant priorities.

EARLY LEARNING

First, we are seeking $350 million for the Early Learning Challenge Fund (ELCF), which we see as a key investment in our children's success. Research tells us that high-quality early learning is one of the best investments we can make. It prepares children for success in school and puts them on track to graduate high school and go on to college. This new competitive grant program would challenge States to establish model systems of high-quality early learning supports and services for children from birth to kindergarten entry. Such systems would support early learning standards, promote better coordination of resources, and measure program results to help ensure that more children enter school ready to succeed.

The Department of Education would administer the ELCF jointly with the Department of Health and Human Services (HHS), providing significant opportunities for streamlining and leveraging other Federal and State early learning investments to improve results for young children and their families. The President has also proposed targeted, complementary 2012 increases at HHS of $866 million for Head Start and $1.3 billion for quality child care.

SUSTAINING REFORM MOMENTUM

Second, the President is proposing to sustain and expand important reforms by providing $900 million for Race to the Top, which already has demonstrated how competitive rewards create powerful incentives for State and local leaders to make groundbreaking education reforms. In the first two RTT competitions, forty-six States created bold comprehensive reform plans that have buy-in from governors, legislators, local educators, union leaders, business leaders and parents. The 2012 request would focus on supporting district-level reform plans while also emphasizing cost-effective strategies that improve student achievement in a time of tight budgets. The Department would also carve out a portion of funds for rural school districts to ensure that communities of all sizes and from all geographic areas are able to compete for a fair share of Race to the Top funds.

The 2012 request also would encourage reform and innovation through a $300 million request for the Investing in Innovation (i3) program to develop, evaluate, and scale up promising and effective models and interventions with the potential to improve educational outcomes for hundreds of thousands of students. The request includes priorities for science, technology, engineering, and mathematics (STEM) education and early learning, as well as an overall focus on increasing productivity to achieve better student outcomes. The Department would include a refined rural priority in the i3 competition to ensure geographic diversity in the communities served by recipients, and would fund applications from providers and other entities proposing evidence-based approaches to address the unique needs and priorities of rural districts and schools. We also would take a page from the Department of Defense by creating a new Advanced Research Projects Agency: Education (ARPA-ED) that would use $90 million in discretionary and mandatory funds to pursue breakthrough developments in educational technology and learning systems, support systems for educators, and tools that improve outcomes from early learning through postsecondary education. We see this as a natural complement to the innovations found in the field through the i3 program.

In addition, we would significantly boost funding for the Promise Neighborhoods program to $150 million to support comprehensive, innovative and cost effective approaches to meeting the full range of student needs, drawing on the contributions of schools, community-based organizations, local agencies, foundations, and private businesses. Also, the Department would maintain its $365 million investment in safe school programming designed to reduce substance use, violence, and bullying while providing states with greater ability to adapt interventions to school needs and drive resources to the most unsafe schools.

GREAT TEACHERS AND LEADERS

Our third priority is teachers and school leaders. I think we can all agree that nothing is more important, or more likely to improve student achievement and other key educational outcomes, than putting a great teacher in every classroom and a great principal in every school. Our 2012 request, together with a proposed restructuring of teacher and leader recruitment and preparation programs as part of our ESEA reauthorization plan, is designed to support State and local reforms of systems for recruiting, preparing, supporting, rewarding, and retaining effective teachers and school leaders. For example, the budget includes \$500 million for the Teacher and Leader Innovation Fund to support ambitious reforms, including innovative teacher evaluation and compensation systems, to encourage effective teachers, principals, and school leadership teams to work in high-need schools. We also are seeking \$250 million for Teacher and Leader Pathways to expand high-quality traditional and alternative pathways into teaching, with an emphasis on recruiting, preparing, and placing promising teacher candidates for high-need (including rural) schools, subject areas, and fields. Included in this request is an \$80 million set-aside to help prepare 10,000 new STEM teachers over the next two years, as part of the President's plan to prepare 100,000 new STEM teachers over the next decade. In addition, a new Presidential Teaching Fellows program (formerly the TEACH program), paid for with mandatory funds, would award \$10,000 scholarships for the best students attending our most effective teacher preparation programs who agree to work in high-need schools.

COLLEGE COMPLETION

Our fourth priority is college completion. I've already talked about the Pell Grant program, which is the foundation of Federal efforts to support both increased college access and completion for low-income students. Unfortunately, we know that far too many students who enroll in college drop out and never earn a degree. Currently, one-third of postsecondary students leave school without earning a degree and only half finish after six years. Clearly, access isn't enough, and we need a much stronger emphasis on attainment in postsecondary education. Through the \$123 million "First in the World" competition, we'll provide venture capital to develop innovative approaches to increase college completion rates and improve educational outcomes while lowering costs and time to degree for students in higher education. And through our proposed College Completion Incentive Grants program, we would provide \$1.25 billion of mandatory funding over the next five years in grants to States to reward institutions with exemplary college completion outcomes.

The President's budget also would continue support for key existing programs supporting college access and completion, particularly for minority and disadvantaged students. The request includes a \$67 million increase for the Federal TRIO programs, for a 2012 total of \$920 million, and \$323 million for the GEAR UP program, which helps an estimated 756,000 middle and high school students prepare for and enroll in college. The 2012 budget also provides \$651 million in combined discretionary and mandatory funding for the Aid for Institutional Development programs, which support institutions that enroll a large proportion of minority and disadvantaged students, and \$239 million in combined discretionary and mandatory funding for the Aid for Hispanic-Serving Institutions programs, which help ensure that Hispanic students have access to high-quality postsecondary education opportunities.

SUPPORT FOR AT-RISK STUDENTS AND ADULTS

Finally, the President's 2012 budget for education would maintain, and in some cases expand, the Federal government's commitment to formula programs for students most at risk of educational failure. For example, a $14.8 billion request for the reauthorized Title I College- and Career-Ready Students program (currently Title I Grants to Local Educational Agencies) includes a $300 million increase to recognize and reward high-poverty districts and schools where disadvantaged students are making the most progress. The $600 million request for a reauthorized School Turnaround Grants program would expand support for school districts undertaking fundamental reforms in their persistently lowest-achieving schools, while the budget provides $750 million to help English Learners meet the same college- and career-ready standards as other students.

In Special Education, a $200 million increase for Individuals with Disabilities Education Act Grants to States would help States and school districts pay the additional costs of educating students with disabilities, while a $50 million increase in early intervention Grants for Infants and Families program, for a 2012 total of $489 million, would complement the proposed Early Learning Challenge Fund.

The 2012 request also provides significant resources to help adults pursue educational and employment opportunities, including $635 million for Adult Basic and Literacy Education State Grants to help adults without a high school diploma or equivalent to become literate and obtain the knowledge and skills necessary for postsecondary education, employment, and self-sufficiency, and a total of $3.1 billion in mandatory and discretionary funds for Vocational Rehabilitation (VR) State Grants to help States and tribal governments to increase the participation of individuals with disabilities in the workforce.

We are looking forward to the reauthorization of the Workforce Investment Act (WIA) so that low- skilled adults and individuals with disabilities have access to the education and training they need to be successful in the 21st century economy. A reauthorized WIA would provide opportunities to upgrade the skills of our nation's workers so that they are able to compete in this new economy. One of those opportunities includes a new Workforce Investment Fund, which we are proposing in partnership with the Department of Labor, to help provide flexibility for the connections necessary to get people into good jobs or the education needed for a better job. The Fund will also provide resources to evaluate and replicate best practices so that we better serve those who have the hardest time finding work -those with limited basic skills and individuals with disabilities.

CONCLUSION

In conclusion, President Obama's 2012 budget for education is part of a comprehensive and responsible plan that will put us on the path toward fiscal sustainability in the next few years. Like every other agency across the government, we are working hard to more efficiently steward the Department's resources. At the same time, education remains a priority for the Administration due to the critical importance of our education system for our continued economic prosperity. The Department's budget includes a responsible mix of savings and investments that will promote reform and innovation, support a comprehensive ESEA reauthorization, and encourage improved postsecondary outcomes. I look forward to working with the Committee to build support for the President's 2012 budget for education and to secure the best possible future for America by providing the best possible education for all of our children.

Thank you. I would be happy to answer any questions you may have.

Chairman CONRAD. Thank you, Mr. Secretary.

You know, this really is a difficult time. Looking back, I believe that history will record that we averted a fiscal collapse. I think we can very, very close to a global financial collapse. I will never forget being called to a meeting in the Majority Leader's office with the then Secretary of the Treasury, Hank Paulson, and the Chairman of the Federal Reserve, who told us they were taking over AIG the next morning, and they told us that if they did not do it, they believed there would be a financial collapse within days. Those were the exact words they used, and they gave us plenty of evidence to support that conclusion.

So I believe that the steps that were taken, as unpopular as they have proven to be—TARP, stimulus—taken together averted a financial collapse. I believe the work of Mr. Zandi and Alan Blinder that concludes that if we had not done those things, unemployment today would be at 15 percent, there would be 8 million fewer jobs.

But with all that said, we are now left with the residue, and the residue is not just the recovery effort. It is also what came before in the previous administration, a doubling of the debt, a tripling of foreign holding of U.S. debt. And now we face a circumstance in which we are borrowing 40 cents of every dollar that we spend.

Let me repeat that. We are borrowing 40 cents of every dollar that we spend. Spending as a share of our national income is the highest it has been in 60 years. Revenue as a share of our national income is the lowest it has been in 60 years. Those are facts, and that means we have to take action.

There have been three bipartisan commissions who have come back with recommendations on what we do going forward. All three of them said make modest changes now, this year, as things are still weak, but make big changes over the next 10 years—big changes in spending, big changes on our revenue side of the equation, big changes to entitlement programs, reform them.

I supported the President's Fiscal Commission recommendations, the Commission on which I served, and I believe—though there are a lot of things I do not like about that set of recommendations, I think in terms of size they got it about right. They have talked about $4 trillion of debt reduction debt reduction over the next decade.

So I say this as an opening frame, Mr. Secretary. When we are borrowing 40 cents of every dollar we spend, all of us—all of us—have to be in on the solution, and that includes education. Even though I personally would put education at the top of the list for prioritization, our problem is so big, every part of the budget has to be in on the solution.

Here is the thing that is so striking to me. As I have gone to my State dozens of times and asked students, How many of you do 2 hours of homework a night?, almost no hands go up. When I go to Asia, Russia, Europe, I ask that question. Almost all the hands go up.

When I asked back home, I asked the principal and the teachers, Why are almost no hands going up when I ask who is doing 2 hours of homework a night?, they say, well, it is not assigned. Why isn't it assigned? It is not assigned because if they assign homework, the parents complain. What's the nature of their complaint?

They say, well, the kids do not have time to do homework. I said, Why not? Because they got a job. And, of course, why do they have a job? Because they have to pay for the car.

I mean, frankly, we have something that goes beyond money here going on, and it is a very, very serious problem, I believe, to America's future competitive position. As I say, I have been in Asia number of times. I have asked the question there in every school I went to, How many of you do 2 hours of homework? The hands shoot up, virtually every hand. In Europe, the hands shoot up. In Russia, the hands shoot up.

So, you know, if our kids are not doing homework—guess what?—and these other kids are, it is no wonder than when we stack it up, our kids are falling behind in math, they are falling behind in science in terms of global competition. What do we do about it?

Secretary DUNCAN. Let me give you a couple other facts that add to your compelling sense of urgency, almost crisis. Our dropout rate in this country is 25 percent. That is about a million young people leaving our schools for the streets each year, and in many of our minority communities—African American, Latino—it is often closer to 40 to 50 percent. As everyone in this room knows, there are no good jobs out there today—none—for high school dropouts. There are basically no good jobs with a high school diploma. Some form of higher education—4-year universities, 2-year community colleges, trade, technical, vocational training—has to be the goal for every single child.

You talked about the PISA results internationally. The fact of the matter is our 15-year-olds on average are a year behind our counterparts in Canada. Other folks are out-working us, they are out-educating, they are out-investing. One generation ago, we led the world in college graduates. It is interesting. It is not that we have dropped. We have stagnated. We have flatlined. And nine other countries have passed us by. We are now tied with four other countries for ninth. And then we wonder why we have a tough economy.

The final thing I will say is at a time of desperately high unemployment, we have about 4 million good jobs in this country that are unfilled because we are not producing the talent to fill those jobs. When the President and I met with a number of CEOs from around the country last week, it was staggering how many said: We would love to hire tomorrow; we have jobs we simply cannot fill because the talent is not there.

So we have to address those brutal facts openly and honestly. The President has talked about this being our Sputnik moment. We are simply being out-educated, and we are going to be out-competed if we do not change pretty significantly.

On the cultural side of this equation, the President often tells the story of when he visited the President of South Korea. He always asks about education. He says: What is your biggest educational challenge? And immediately the South Korean President said: My biggest challenge is my parents are too demanding. Even my poorest parents demand a world-class education. He said: I am spending millions and millions of dollars to import teachers to teach English to our students because our parents refuse to wait until second grade for their children to learn English. They have to start learning in first grade.

So this is about investing very differently, but it is also a cultural component that we have to address very openly and honestly that other folks revere education. In South Korea, teachers are known as nation builders. I think our teachers are and should be known as nation builders.

Our teacher work force has been beaten down. We have to work harder. Your success in what you do, so many of you are successful at what you do because you work hard. And if someone else is working two or 3 hours harder than you every single day, week after week, month after month, year after year, guess what? They are going to be in a very different place than we are. And so we have to invest differently. We have to invest wisely. We have to address the lack of competitiveness of where we are relative to our international peers. Jobs are not confined to a district or to a State or to the country. Jobs are going to follow where the good workers are, where the knowledge workers are. And we have to think very differently about how we invest, and w have to challenge parents and challenge the community to put a much larger priority on education.

The final thing I would say is I wish we had more parents beating down our doors demanding better education. I would love that problem. What I often get is we are moving too fast, we are being too radical. And when we have a 25-percent dropout rate that is unsustainable, I think we have to be radical. We have gone from first in the world to ninth in college graduates. We have to be radical. But we need to encourage parents and the community to challenge us to do more and to improve faster than we ever have in the history of this country.

Chairman CONRAD. Let me just say that my time has expired, but, you know, it does not cost money to do homework. That is a matter of the homework being assigned and the kids doing the homework and that the parents insist that the schools are demanding something from their kids.

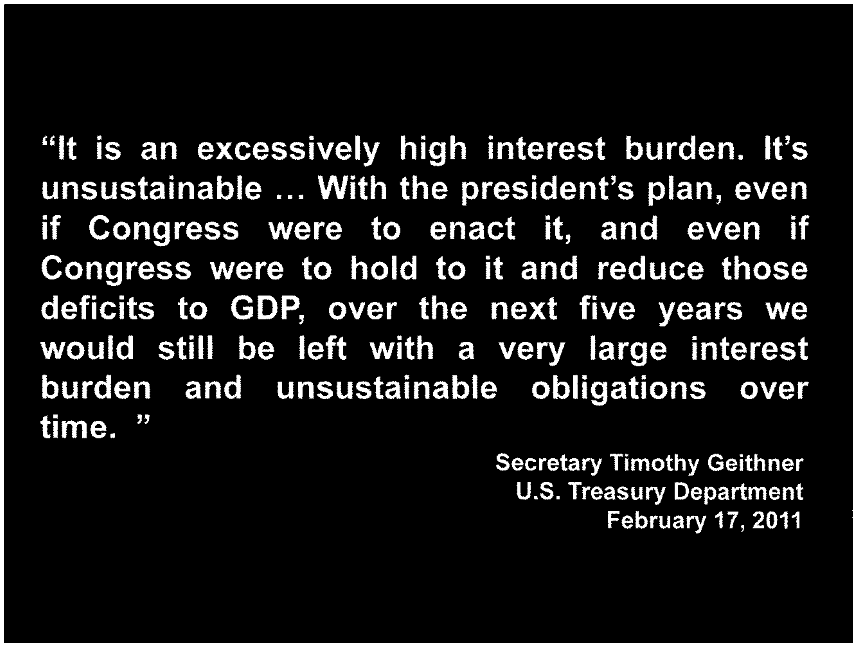
Secretary DUNCAN. Let me add——

Chairman CONRAD. I cannot go further on this because it is unfair to my colleagues. We will go to 7-minute rounds. Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman. That was a very important question. We blame teachers, I think, too much for problems in education, and like you said, Mr. Secretary, in the cultural situations in which students refuse to do homework or parents will not insist that they do and efforts by teachers to insist on excellence are not affirmed, it is a deep thing.

I would note that your praise for Canada is good, but Canada spent $8,500 per student last year on education, and we spent $11,500 on students. So we are spending much more and need to get more for what we spend as we are. The President says—you said he believes that the Government spends too much, and you are taking heat for cuts. But we are not cutting. You are increasing spending across the entire board, and that is the problem.

I know Admiral Mullen of the Joint Chiefs said our debt is the greatest threat to national security. Secretary of State Hillary Clinton said the same thing. Do you agree with that?



Secretary Geithner said that the debt we are leaving could leave us with a very large interest burden and unsustainable obligations. Do you share those concerns?

Secretary DUNCAN. I think those are valid, absolutely valid concerns. As I said in my statement, the President is committed to $1 trillion in deficit reduction over the next decade. As the Chairman said, as we move forward, I think there are lots of sacred cows that collectively the administration and Congress have to look at very seriously.

Senator SESSIONS. Well, over the next decade, the deficit will double from $13 trillion to $26 trillion, and you can say that cuts and saves $1 trillion, but it does not seem like it to me. That is plain fact, and that is the budget fact.

For example, under the programs here of interest, Pell grants, under the President's budget total Pell grant aid available for 2012 would be $36 billion, double the amount available in just 2008. Is that correct?

Secretary DUNCAN. We can go through the numbers. We are going to save—we have a way of closing the Pell shortfall $20 billion. But let me be very, very clear. What our country desperately needs is many more young people going to college and graduating. Again, we have 4 million unfilled jobs today in a tough economy. They are unfilled because we are not producing the skilled workers that our country needs at a time when going to college has never been more important, has never been more expensive, and our Nation's families have not been under this kind of financial duress in a long, long time. So the fact that we have a 50-percent increase over the past couple years of students accessing Pell grants I think is hugely important.

Senator SESSIONS. Well, I think we can all agree that funding and money does not necessarily improve education. We have seen that dramatically. We are going to be—in 2008, we provided Pell grants for 6 million. Now we are providing Pell grants under your proposal for 9.6 million, increasing that, doubling the entire budget, and we do not have the money.

Now, with regard to student loans, we have now taken over the student loans; 100 percent of it is Federal. But according to our calculations, the total student loan, total in billions of dollars will go from $98 billion in 2008 to $167 billion in 2012, a 68-percent increase. Is that correct?

Secretary DUNCAN. I do not know that exact number. What I will say is when we took over the direct lending, we did that for one very simple reason——

Senator SESSIONS. Well, I know we took it over. We had a fight over that.

Secretary DUNCAN. Well, let me just——

Senator SESSIONS. But I am talking about the total direct—comparing guaranteed and direct loans have increased from $98 billion in 2008 to $167 billion.

Secretary DUNCAN. We have many more people accessing higher education, which as a country we desperately need. The only way we strengthen our economy long term is to produce the innovators, the entrepreneurs, the knowledge workers, the——

Senator SESSIONS. Well, why don't we just spend three times as much?

Secretary DUNCAN. On Pell grant?

Senator SESSIONS. On Pell grant. Won't that just help us fix it all?

Secretary DUNCAN. Well, actually we made some very tough cuts in Pell grants, and so we asked for a $5 billion increase but we are reducing costs by $15 million.

Senator SESSIONS. Well, this is Washington math. You have not cut Pell grants. Pell grants are increasing dramatically, Mr. Secretary. The numbers are plain.

Secretary DUNCAN. That is correct, and they would have increased even more substantially, more significantly, had we not made the tough and painful decision to eliminate——

Senator SESSIONS. You are proposing to increase that much. They are not going to be increased that much because we do not have the money.

Secretary DUNCAN. So what we have proposed is to eliminate two Pell grants each year. That is a tough cut. That is a painful cut. That is not one that I wanted to do, but we think it is a responsible way to close the Pell shortfall.

Senator SESSIONS. You talked about program consolidation, consolidate 38 K–12 programs into 11 programs as part of the ESEA reauthorization. I think consolidation and program efficiency is a worthy goal. I believe you are a strong administrator. I think you have the ability to do that. You note that some of this program structure is fragmented and ineffective and there is little evidence of success. But the total budget that you submit for the consolidated activities is $900 million more. Instead of saving money, you are spending more money. That is not what we have to have today. Since we are so short of funds, we need to see some real efficiencies that actually enhance education without driving up costs. Don't you agree?

Secretary DUNCAN. Well, I hear your concerns, and we have tried to do a couple things. Our goal in consolidation—these are tough cuts and tough consolidations, and not everyone supports them, but we think it is the right thing to do. We think, again, particularly in small communities, rural communities, when it is very difficult to deal with the Federal bureaucracy, the easier we can make that relationship, that makes a lot of sense. It will enable folks to spend their time working with students rather than dealing with us. So we consolidated a number of programs. We eliminate a number of programs that we do not think are as effective as they can be. But at the end of the day, I believe we have to invest in education, that when as a country we have gone from first to ninth in college graduates with a 25-percent dropout rate, our students and our country deserve better than what they are getting today.

Senator SESSIONS. Well, we need to figure out what is happening out there. A recent report indicated that colleges are demanding less and students are learning less. We are sending more students, we are spending more money, and we are getting less for it. And I really am worried, as the Chairman expressed, that our global competitiveness is at stake. Education is important. Thank you for promoting some of the reforms you have been working on.

Secretary DUNCAN. One final comment, if I could say that I think what is so important to both your questions is one of the big things we have tried to do is encourage States to raise standards. Part of the reason there is not homework, part of the reason students are less prepared for college is because standards have been dummied down in far too many places. We have 41 States that have raised standards, colleges have raised standards, and my goal is to get universities out of the remediation business. Those who do graduate from high school, often 30, 40, 50 percent have to take remedial classes in college. They are not ready. With States raising standards, I think that is a game changer. That is a huge step in the right direction.

Chairman CONRAD. Senator Coons.

Senator COONS. Thank you, Mr. Chairman.

Thank you, Secretary Duncan, for your presentation today. I am extremely pleased to see that this budget continues on the President's public commitment to invest in world-class education for all our students, and I look forward to working with you on the Elementary and Secondary Education Act reauthorization.

I think there are some very tough choices in this budget, and I was pleased to see some reductions, some trimming, some realignment. In your opening statement, you reasserted that your goal, given that Federal spending is just 10 percent of all education spending, is to promote reform, reward success, and support innovation at the State and local levels.

In my view, Race to the Top has succeeded significantly in doing that. There are 11 States and the District of Columbia that are directly benefiting from Race to the Top, but as you mentioned, dozens of other States that may not have been selected made significant changes.

If Race to the Top has, in my view catalyzed education reforms in both those States that won and lost the competition, what do you think would be the impact if funds were not appropriated to continue Race to the Top in this year's budget?

Secretary DUNCAN. Well, what you have seen around the country over the past 2 years I think is reform at a level of unprecedented speed. As you said, you have 41 States that adopted college and career standards, raised the bar for children, and for the first time in this country, a child in Massachusetts and a child in Mississippi will be held to the same standard.

You have 44 States today working together on the next generation of assessments to be much more thoughtful in how we do that. We had almost three dozen States eliminate barriers to innovative schools and create more room for flexibility. You have seen every single State that had laws on the books that prohibited the linking of student performance, student achievement, and teacher evaluation, all those laws have been eliminated. And you now have almost 1,000 schools around the country, dropout factories were historically 50, 60, 70 percent of students were dropping out, finally were challenging the status quo.

So there has been a huge amount of movement at the State level. That has to continue. That has to be sustained. In our budget request for a third round of Race to the Top, $900 million, we want to see that same pace of change at the district level, and we also want to have particular focus with a set-side in rural communities.

And so we have to play at the State level, at the district level, at the community level, Promise Neighborhoods, and, again, we have to get better faster than we ever have in this country. Race to the Top has been a huge catalyst for raising the bar.

Senator COONS. How do you see the competition being different this year with a district-level focus? And how through the Effective Teachers and Leaders State Grants Program, as you begin to implement local teacher and principal evaluations systems, how do you see us working together to ensure that teacher collaboration is sustained in the development of these valuable systems?

Secretary DUNCAN. I think it is so important in this work that all of us move outside our comfort zones. We had a wonderful conference 2 weeks ago in Denver where we had 150 districts, and 100 districts who wanted to come but could not get in, where the superintendent, the board chair, and the union leader came together to figure out how we work differently and how we use collective bargaining to drive student achievement. We had a number of districts presenting how they have done this in extraordinarily creative ways. So our themes at the district level would echo those at the State level, but with a real focus for closing the achievement gaps, raising the bar, and all of us moving outside our comfort zones. And what we want to do is simply reward courage. There are so many folks around the country who are doing this hard work, who, you know, want to be creative, that have never been rewarded for success.

One of my biggest problems with the current law, No Child Left Behind, is that there are about 50 ways to fail, and your only reward for success is you are not labeled a failure. And so we want to shine a huge spotlight through reauthorization, through Race to the Top, through the Investment Innovation Fund, through Promise Neighborhoods, on folks that are willing to challenge the status quo, raise the bar for all students, and close those insidious achievement gaps.

Senator COONS. I do think you are making significant progress through all those different vectors in strengthening the focus, strengthening the reform.

One area of the budget that did concern me was the change to a direct loan program, so the incentive to convert so-called split loans to direct lending. Are you concerned about the additional debt that the Department will be taking on? And are you confident that the budget scoring of these savings is real? Or do you think it may possibly reflect a lack of an accurate assessment of the risk associated with direct lending?

Secretary DUNCAN. Well, the folk that do the budget scoring are a lot smarter than I am, so I can only assume and think they are doing good work. The goal here is to simply make things simpler for the borrowers and to have, you know, one servicer rather than multiple servicers. This is an optional program. It is not mandatory. But we think it is the right thing for the students who are dealing with multiple relationships, and that is difficult and complicated. At the end of the day, we think this could save us $2.1 billion.

Senator COONS. I have some concerns about that and will followup with outcome on that in more detail. But if I could as a last question, as you know, we have both worked over many years on improving postsecondary outcomes, particularly for minority or low-income students who are the first in their family to attend college. And I am very interested in the First in the World Initiative, which strikes me as sort of a venture capital fund approach to trying to really deal with these critical problems and the college completion incentive grants.

Please, if you would, as my last question, just talk for a minute about what is different about these. How are these going to make it different going forward? And how is this going to make it possible for us to close those critical gaps the Chairman spoke about at the outset in terms of college completion in the United States?

Secretary DUNCAN. So first let me just quickly say how lucky we are to have you in the Senate and to have you on this Committee, and almost no one brings your deep passion and knowledge of what it takes to help children who have not had these opportunities and families and communities that have not had these opportunities for decades, to give them the chance to break through. And so your leadership and insight and expertise I think is going to be extraordinarily valuable to this Committee and to me personally, and I look forward to our continued work together.

At the end of the day, it is interesting, universities are not too dissimilar to high schools, and you see some that have, you know, first-generation college goes and many EL students who do a wonderful job of building cultures around completion. You see others where completion rates are very, very low. And just at the high school level, you see some high schools that are 95 percent minority and 95 percent poverty, with 98 percent graduation rates and 95 percent going on to college. You see others with similar demographics with 60-percent dropout rates, wildly different outcomes.

What we want to do is almost a mini Race to the Top at the higher education level to put significant resources behind those States and those universities that want to build a culture not just around access—and access is huge—but it has to be around attainment, around completion. And some places do an amazing job with that. Some do not. When I was the CEO of the Chicago Public Schools, we tracked this data very carefully, and, quite frankly, I started to steer my students toward certain universities and away from others because students with identical GPAs, identical ACT scores were getting radically different outcomes at different universities. And the more we can build cultures around completion, that is what our children need, that is what their communities and families need, but ultimately that is what our economy needs. That 50-percent dropout rate from college has to go down.

Senator COONS. Thank you.

Chairman CONRAD. Senator Cornyn.

Senator CORNYN. Thank you, Mr. Secretary. It is good to have you here today, and I want to tell you at the outset that some of the things I have heard you say during your tenure as Secretary of Education give me some hope that we can work together on a bipartisan basis to improve public education in America, recognizing the Federal Government does have a relatively small role, 10 percent of spending, in K–12 education. So I look forward to working with you on the reauthorization of No Child Left Behind. And I hope that we can do some good there.

But part of the problem that States that do fund 90 percent of public education in the country are experiencing is that the Federal Government has basically commandeered State budgets in a number of ways. There is a recent report that just came out, today as a matter of fact, demonstrating the Medicaid expansion that was part of the health care bill has essentially crowded out the ability of States to spend money on K–12 and higher education. In my State alone, it is $27 billion of an unfunded mandate over the next 10 years, and we have to get that under control.

I appreciate what the Ranking Member Senator Sessions, his questions relating to money equaling quality education. We know that is not true, and there are a lot of good examples of charter schools, for example, the KIPP program, featured prominently among other charter school programs in the documentary "Waiting for 'Superman,'" where we know that there are a number of innovative and more cost-effective means of delivering education taking place across the country. And just pouring more money into the same broken system is not going to improve outcomes in my view.

But I want to ask you specifically about a Texas issue that you are well acquainted with. Congress, of course, appropriated $10 billion for the Education Jobs Fund, and my understanding is that roughly $975 million remain unobligated. Is that your understanding?

Secretary DUNCAN. Yes, sir.

Senator CORNYN. Of course, my State had submitted an application, and my understanding is that its share of funds would be roughly $830 million if indeed that application had been accepted and granted. But because of a provision that was put into the bill by Congressman Doggett in the House basically requiring the Governor to do something that he is barred from doing under the Texas Constitution—that is, guaranteeing certain levels of education expenditures in future legislative sessions—Texas was in a Catch–22 and could not qualify for that funding.

As you know, there are provisions in the law for alternative methods of allocating that money, and I would like to know what you intend to do to work with us to try to make sure that Texas is not discriminated against when it comes to the allocation of these education funds.

Secretary DUNCAN. Let me try and address the first part of your statement first, and then I will come to that specific question.

I share your concern about where the Federal Government has been inflexible or commandeered local budgets. I spoke before the NGA this weekend, talked a lot about us trying to provide much greater flexibility at the State level, trying to help them become more productive in very tough budgetary times, and, again, I put some pretty non-traditional ideas out there for what folks can do in tough times, and actually this week we will be sending documents to every Governor of our best ideas about how we can be more flexible, challenging States to take advantage of that flexibility, which they often do not do, and really trying to be a much better partner.

I just want to assure you that I have no interest in pouring more money into the status quo. We have a very different vision of where we are going. We are trying to push a very strong reform agenda, and I would agree with you: If we perpetuate the status quo with more money, that does not get our country where we need to go.

I do think we need to invest but in a very different vision of what education can be and should be and to continue to work in a bipartisan way through ESEA. A big goal there for me, frankly, is to provide much more flexibility than exists today under the current law. The current law——

Senator CORNYN. Well, I look forward to working with you on that, but obviously we only have 7-minutes rounds and——

Secretary DUNCAN. Sorry.

Senator CORNYN. What I am really interested in is how you intend to work with me and the Texas congressional delegation and Congress to make sure that the State of Texas is not penalized to the tune of $830 million for a requirement in the law that under the Texas Constitution the Governor does not have the power to do.

Secretary DUNCAN. I am intimately familiar with the details. We obviously have to follow the law and congressional intent. I was having, I thought, good, productive conversations both with the Governor and the State superintendent, and then, frankly, they decided to sue the Department of Education in this matter.

Senator CORNYN. So all discussions have ended?

Secretary DUNCAN. Well, it is in litigation now, so——

Senator CORNYN. So all discussions have ended?

Secretary DUNCAN. I do not know if all discussions have ended, but it makes it more difficult now that we are being sued to——

Senator CORNYN. Well, what is a State with 25 million people supposed to do when the Federal Government discriminates against it in the distribution of tax dollars to help public education? Your Department would not accept the application. What is the State official supposed to do other than to go to court to try to force you to do it because of the unconstitutional requirement? Now you are telling me because they have resorted to litigation that you are not going to continue negotiations with them to try to resolve this impasse.

Secretary DUNCAN. No, I did not say either one of those. And to be clear, we did not reject their application, and so there is ongoing——

Senator CORNYN. Well, you said it was not in acceptable form because it——

Secretary DUNCAN. No, I——

Senator CORNYN [continuing]. Because it did not meet the requirements of the Doggett amendment, which required an unconstitutional condition for State officials.

Secretary DUNCAN. So we are not going to solve it this morning. What I will say is the children of Texas desperately need these resources, and our intent from day one was to make sure children around the country had access to it. Texas schools in many places are having huge budget cuts. We have seen skyrocketing class sizes. The dropout rate in Texas is pretty staggering. And if you have thoughts or creative ways that this could be resolved, I am all ears. But at this point, because they chose to sue, it makes it a little bit tougher to——

Senator CORNYN. Well, Mr. Secretary, I am deadly serious about this issue, and it is not going to go away, and we are going to have to work it out. And I would invite you to engage with me and other Texas representatives to try to find a solution, because this is unacceptable—unacceptable—for a State, one of the largest States in the country with 25 million people, with the kinds of needs that you just described, that you and I both understand, for the Federal Government to basically thumb its nose at my State. It is just unacceptable, and we are going to have continuing problems unless you and I can work out some solution.

Secretary DUNCAN. We have until September to do that, and 48 States have received their money and put it to great use and saved a couple 100,000 educator jobs around the country and driven reform, and I would love to see the children of Texas get their fair share.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Mr. Chairman. Thank you, Secretary Duncan.

One of the areas that I have taken an interest in over the years, I come at this from a point of view of somebody who was a prosecutor. And when I moved from being the United States Attorney for Rhode Island to be Attorney General for Rhode Island, I began to oversee the prosecution of hundreds and hundreds and hundreds of children. And as I inquired as to what the best way to prevent this would be, over and over again I was steered toward middle school. Over and over again I was steered not only toward middle school but toward attendance and truancy and performance in middle school, particular emphasis on truancy.

Over and over again I was shown cases where kids had become truant, completely fallen off the radar screen, engaged in the kind of really unhealthy behaviors that historically people never associated with middle school—gang membership, pregnancy, drug addiction—and that we really needed to bear down on our middle schools, and that it was an area, kind of a fulcrum period between the younger years where, as long as people are getting, you know, sort of basic needs met and getting their literacy needs met, both reading and mathematics, they are in pretty good shape; and then in high school they get to be much tougher kids, and it gets to be much more challenging to pull them back into the mainstream if they have fallen out of it. And it is usually just a 3-year program.

The President supported it energetically, his success in the middle bill I was a cosponsor of when he was a Senator here. My senior Senator, Jack Reed, has picked that bill up, and yet I do not see much in the way of focus here on middle schools.

Based on that experience, I adopted a middle school and started to work with the middle school in Providence. And as I have talked to teachers, this has been a continuing issue, and nobody has ever pushed back, ever. Teachers, law enforcement, administrators, no matter where you go, everybody says, oh, yeah, we get it, middle school is really a fulcrum period and investment there can make a particularly big difference because if you turn a kid around to a high-performing student in middle school, you are in a far better position than having to chase them through high school trying to pick them up if they are failing that.

So I would love to hear from you where your focus is on middle school in this area, what specific programs you propose to help in that area, and then I would like to ask briefly about after-school as well.

Secretary DUNCAN. So a couple thoughts. I think your sense of the challenge, and you have lived it, is real and painful and is too often the norm rather than the exception. Both Senator Coons and I got our start in education, starting with middle school students and trying to work with them for 6 years through college, and so I have lived this.

Senator WHITEHOUSE. A special breed.

Secretary DUNCAN. So this one is very personal. A couple thoughts there.

One of the biggest things that matters for children who are struggling is getting an adult in their lives who can be with them through thick and thin, so through the middle school years, a teacher, a social worker, a counselor, through high school, some adult that when things go wrong at home or it is tough in the community helps them to persevere. So school districts, some are doing some really innovative things, but I honestly think school districts cannot do this alone. Nonprofits, social service agencies, the faith-based community are stepping up. We know what——

Senator WHITEHOUSE. I get the big picture. My narrow focus is what is the Department of Education doing in this area.

Secretary DUNCAN. So a couple different things. One is a huge focus on the STEM area, STEM fields to try and keep great math and science teachers in there when often those teachers do not have the content knowledge they need. It ties to your question for after-school. We are asking for additional after-school money. I think when students are engaged in extracurriculars—art, dance, drama, music, band—that helps them stay engaged in very different ways. We are supporting programs like——

Senator WHITEHOUSE. Those are all general programs, so they do not relate to middle schools specifically. They may apply to a middle school, but they are——

Secretary DUNCAN. They are part of an overall spectrum, but gear up——

Senator WHITEHOUSE. Let me roll, in the time that I have left, to the after-school question because one of the things that we hear from the education community enormously, regularly, is how important it is for a school to have community support; that the more the school is engaged in the larger community and the more the larger community is engaged in the school, the better off everybody is, the better off the kids perform and so forth.

So in Providence, Rhode Island, in particular, we have a really exceptional after-school program. That has involved the community for a long time. It has been in many ways sort of the incubator for a lot of the education reform activity that has taken place in Rhode Island. And I worry that your emphasis in after-school in giving priority to more expensive extended school day, extended learning time programs over these community-supported and community-developed after-school programs risks crowding them out. It risks crowding them out because of the priority. It risks crowding them out because it is more expensive to extend the learning day than to work through the community. And I think it fails to take into account the added value that comes when the community is that engaged.

So I hope that as you go forward with your program you will take into account concerns like mine that in some places—it is not the solution for everybody, but where it is a proven solution, you should be protecting and defending and growing and helping these very, very successful after-school programs rather than putting them at a competitive disadvantage with extended learning programs. I am not quite sure how this prioritization is going to work out in practice, but it really worries me that one of the best things going on in education in Rhode Island is going to be on the losing end of this priority shift of yours.

Secretary DUNCAN. I would love to continue the conversation. It is a very fair, you know, concern and critique. What I ultimately believe is we just have to do more in this after-school space. It is not an either/or. It is a both/and. We are asking for about $100 million——

Senator WHITEHOUSE. It is not both/and in the way you have designed it. There is a priority that—you put a thumb down on the side of the extended day and against the after-school program, so it is not quite both/and. It is both/and with a bias, and it is the bias that concerns me.

Secretary DUNCAN. And additional resources. But your point is well taken. I do think school days are too short, school weeks are too short, school years are too short. But the idea of schools being open 12, 13, 14 hours a day, wrap-around services—it is one of the things I was proudest of in Chicago. I had 150 schools that were open very extended hours. What happens in Providence I think is fantastic. We do not want to hurt that. We will actually look at that——

Senator WHITEHOUSE. My time just expired, so I will leave on that, because that is a great note to leave on, and we will continue the discussion.

Secretary DUNCAN. To be continued.

Chairman CONRAD. Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman, and, Mr. Secretary, I want to start off thanking you for your service. I try to make that same comment to school board members when I meet them. I realize this is not exactly a thank-filled position, so I want to thank you at least.

Seeing as this is the Budget Committee, I would like to kind of zero in a little bit on costs. I did here a recent interview with Joel Klein, the chancellor of New York City's—former chancellor of their Department of Education, where he commented that our spending in real terms has doubled since 1983, and we have not seen the results, but in particular I would like to hone in on college tuition.

I have seen a number of studies—and what I will quote is from the Heritage Foundation—that States' college tuition since 1982 has increased 439 percent. To put that relative to things like health care and general inflation, health care has risen 250 percent; just general inflation has gone up about 105 percent. So let us talk dollars.

Just general prices, something that cost $10,000, today would cost a little over $20,000. College tuition, though, has gone from about $10,000 to over $50,000.

I would kind of like to hear your comment on what has caused that.

Secretary DUNCAN. It is a huge concern of mine, and I do not have a good answer as to what has caused it. We see college costs, college tuition escalating far ahead of the rate of inflation in many places, and so it is a real challenge. As I have said repeatedly, you know, going to college now is desperately, desperately important for all of our young people, and when tuition makes it untenable or too difficult, that is not good for families or the country.

So I think colleges historically, frankly, have not always been as efficient as they need to be, have not made some of the tough cuts that families are having to make every single day, and tough priorities, and that we are trying to make in our budget, that you guys are trying to do in your work. So it is a real challenge.

We have had very tough, candid conversations internally. You know, is there a legislative play? Is there anything to do there? I will tell you what my current thinking is, but I am not satisfied with it. I think our system of higher education is the best in the world. I think we have a couple thousand great options around the country. Parents today, they are smart, they are savvy. Students, they have more choices, more options than ever before. They want a great education, but they want value for their money. And so when colleges are escalating, you know, expenses way ahead of where they need to be, I think folks are going to start voting with their feet and going other places.

Senator JOHNSON. Do you think Federal infusion of dollars has played anything—into that? Why else would we see such a dramatic difference in general prices versus the cost of college tuition?

Secretary DUNCAN. I mean, I guess that is a possibility. That is not my first thought because—well, what I was going to say is you see actually huge variation. You are actually seeing movement the other direction. You have a university 2 weeks ago that reduced tuition 10 percent. You have other universities going to 3-year programs. You have other universities going to no-frills campuses. And what you are seeing is the marketplace starting to play, and parents are starting to vote with their feet, and they are starting to go to places to get a good education for less money.

So I think, again, by transparency and good information, the bad actors will not get rewarded and the good actors will get a greater market share, and that is a good thing for the country.

Senator JOHNSON. I will agree. Information is powerful as the free market enterprise system is pretty powerful as well.

You may have noticed a few news reports within my State, the State of Wisconsin, that there are a few issues there.

Secretary DUNCAN. I have.

Senator JOHNSON. And I guess I would like to just ask you, What role—or how helpful have public sector unions been to education? And what would be the evidence of that?

Secretary DUNCAN. So just in the midst of the Wisconsin situation—I have a good relationship with the Governor, talked to him several times, worked well with him, have a good relationship with the union, talked well—you know, talked with them.

In the midst of the Wisconsin situation—this was coincidence, it was not planning—we had a conference in Denver with 150 districts from around the country and a waiting list of 100 on this very issue. And we talked about how historically in too many places collective bargaining had not worked for anybody, had not worked for the adults, had not worked for the children, had not driven student achievement, that we needed a third way, we needed to do things very, very differently. And, again, this is not just unions, to be clear. This is management. Often management has not been strong here. School boards have not been as effective as they need to be. So it is not about pointing fingers, about all of us doing things differently. But what we had is we had over a dozen districts present to the 150—we did not lead the conference. They did—present how they had used the vehicle of collective bargaining to drive student achievement and to close achievement gaps.

The goal there was to say if this works, why not make this the norm? And can we go from 15 creative, innovative districts, doing some radically different things through collective bargaining to drive much better student outcomes? Can we go from 15 to 150 to 1,500 to 15,000?

So in many places, collective bargaining has not led to better student achievement, has not led to more satisfied workers, has not helped move the country where we need to go. But we have a number of places that are starting to break through, and we need to replicate those successes.

Senator JOHNSON. Earlier in your testimony, you said that we need 4 million more college graduates. A lot of my volunteer work over the last 10 years has been in education in Oshkosh, primarily the K–12 level. What we were seeing as employers is just a mismatch, you know, whether it is colleges, whether it is our schools simply not providing the types of degrees, the types of educational opportunities to match the employment opportunities, as opposed to just cranking our more college graduates. Can you speak to that?

Secretary DUNCAN. You are seeing reality, and I hear that complaint from CEOs all around the country. And one of the things we are doing actually in partnership with the Department of Labor is trying to put resources out there to community colleges and communities in the private sector where they come together to provide real training that leads to real jobs. A and where you have these mismatches, you know, students come out with greater debt, they are not employable. The employer ultimately moves overseas if they can get more workers there. There is no upside there. So there is an absolute mismatch at lots of different levels, and we want to put resources behind places—there are also some fantastic public-private partnerships that are leading to real jobs every single day. I visited one yesterday in Philadelphia around the health care industry where workers—some were just coming to the country to learn English, and then ultimately, because of great partnerships, are getting real jobs in the health care field around there. We have to do a lot more of that. So that is a real concern.

Senator JOHNSON. One final question. I am a manufacturer, so I generally try and look at the root cause of a problem. To me a lot of what we talked about in terms of the problems of education really relates back to just the social pathologies, the fact that our out-of-wedlock birth rates have gone from 7.5 percent to 40 percent from the 1960s. Can you just comment on that a little bit?

Secretary DUNCAN. So I think our children are coming to school today with probably more challenges than ever before, and whether it is, you know, families that are not intact or whether it is the video games and all the distractions we talk about, the lack of time spent on homework. So those are absolutely real challenges. I think we are asking more of our teachers and administrators than we ever have.

Having said that, in these very tough times with high poverty and high crime and, you know, single-parent families, we have never had more high-performing schools who are beating the odds every single day. We are trying to turn around these chronically underperforming schools, and so those challenges are real. They take long hours. They take after school. They take mentoring. But we have never, I do not, ever had so many high-performing, high-poverty schools in some of our neighborhoods—some of our country's most distressed communities, and we have to learn from those successes and take them to scale.

Chairman CONRAD. Senator Begich.

Senator BEGICH. Thank you, Mr. Chairman. And thank you, Mr. Secretary, for being here, and thank you for your visit to Alaska, to Hooper Bay. And I know——

Secretary DUNCAN. I will never forget it.

Senator BEGICH. I know you will not. We had a great conversation on the way back on the plane as we sat there and talked about education. There is a clearly a much different view in rural Alaska than it is in Chicago. You have to, I guess, admit that.

Secretary DUNCAN. Absolutely.

Senator BEGICH. Let me also, again, just so you know, I come from a family of educators. My parents were educators. My two sisters are educators. My sister-in-law is an educator. I chaired the Student Loan Corporation for 7 years, the Postsecondary Education Commission for 7 years. But saying all that, when I campaigned for this office, I actually ran an ad because I think in Alaska, especially in Alaska, No Child Left Behind was a disaster. It had no understanding of really rural America, and when I say rural America, rural Alaska. And it had basically a system that penalized communities that were trying, as you saw firsthand out there, and it really worked in the wrong direction. So I want to followup to some degree on a couple comments I heard you say.

First, on Race to the Top, can you describe what you meant when—I heard you say rural set-asides, so it caught my attention, because every time I have heard rural set—— aside, usually it means it is a Washington, D.C., description of rural set-aside, which is nothing—nothing—like Alaska. So define what you see as rural set-aside, and it would be great if you started with Hooper Bay as an example.

[Laughter.]

Secretary DUNCAN. So if I start on Hooper Bay, this is a conversation obviously to continue with you and with the Chairman, but let me be very, very clear. We have seen significant change in Race to the Top, in the Investment Innovation Fund. We want to make sure we are having an impact everywhere around the country. We think we can do more and do a better job in rural communities. I would be happy to work through the technical definition with you guys and get your thoughts there.

But let me be very clear. In both a third round of Race to the Top and a second round of the Investment Innovation Fund—and you have been so supportive of that effort. I appreciate it. In both of those we want to make sure that we are playing in a significant way in the rural community. So we are learning there, and the technical definition you guys can probably shed some light on it for me.

Senator BEGICH. I have a feeling the Chairman and I will be happy to assist you in that effort, because I think in a lot of ways—and I mean it in respect to my colleagues here in the lower 48—that rural here is so much different. You can drive everywhere. You can drive down the street. Maybe the street is 50 miles away to the grocery store. In Alaska you cannot. If you are in Adak, it is 1,200 to the hub by air. There is no road. And so we have a different ability to deliver education, and our competition is not—I mean, if we are competing against the L.A.s and the Chicagos and the Seattles, we will not win that battle for dollars, because you will look at it from a cost per pupil, and you will see that you can hit Chicago with so many thousands of students that will hit. And yet in a village of maybe 50 kids, this is their lifeline to the future.

Secretary DUNCAN. Yes. So to me it is not—we were trying to make very significant strides and improvements in, you know, Race to the Top and Investment Innovation Fund, but you hit it earlier. I think so much of No Child Left Behind was broken for the country, but particularly broken in rural and remote communities, and I think we can fix the law this sessions. We want to fix it before we go back to school this fall. We could fix it in a bipartisan way, and a huge part of our goal is, frankly, to shrink the Federal footprint, to give much more flexibility, hold folks accountable for results, but to give them room to move.

One of the biggest complaints I've heard in rural America is that you have a teacher teaching multiple subjects.

Senator BEGICH. That is right.

Secretary DUNCAN. And they are basically labeled not highly qualified, and they are often extraordinary.

Senator BEGICH. Which is amazing, because in Alaska these teachers are doing amazing things in multiple disciplines, and yet because of the technical language, they are not highly qualified. And we would consider them the best of the highly qualified.

Secretary DUNCAN. It makes no sense, and we are desperately trying to keep great teachers in underserved communities, be they rural, remote, or inner city. And so we have to remove that, moving from a paper-based definition of qualifications to effectiveness as the way to go. And so there are a number of common-sense fixes that we can put in place that will remove the perverse incentives and put in place the right incentives.

Senator BEGICH. And, again, on Race to the Top as well as—and I heard you say, and I want to make sure we are clear—on I3 also, programming to figure out how we do a rural set-aside that clearly recognizes the value and how we educate within those communities.

Secretary DUNCAN. Absolutely.

Senator BEGICH. OK. The other piece in rural communities—and especially, again, I will use Alaska, obviously, as an example—some of the requirements require matches by local communities. In some of these communities, they have no property tax base. We are in some cases subsistence hunters, and their food and their belongings are caught off the land.

Will you be flexible to help us address those kind of communities that just do not have—it is hard to believe in this country that there are cashless in some cases or limited cash communities, and they are basically in Alaska.

Secretary DUNCAN. We will absolutely be flexible. So the short answer is yes. But I would also say one of the things we found as we got into this work—and you guys know this intimately—is we did not have enough foundations playing in the rural community. And so, frankly, one thing I am really proud of is we have encouraged a number of foundations to step up and be much more generous and targeted in rural areas. So we are helping to drive that market and increase investment in rural communities. We are going to continue to drive it. But will we be flexible and thoughtful on how we do this? Yes.

Senator BEGICH. OK.

Secretary DUNCAN. My fallback is just not to do nothing. My primary focus is to get many more of these foundations to play and create and reward great work in rural communities.

Senator BEGICH. Right, we would love it. We do not have a Microsoft in Hooper Bay, but we would love an opportunity——

Secretary DUNCAN. We can talk about it. We have a number of foundations that have increased their commitments, thanks, frankly, to us working with them.

Senator BEGICH. Let me go to one other quick one here, and that is the $350 million to the Early Learning Challenge Fund. You and I actually had a conversation on the plane—you may remember this—about Head Start and how that plays a significant role in rural Alaska. It is truly—an educator in rural Alaska can point out a kid who has had Head Start in the third grade and say they had it. They do not even have to have their paperwork to show it. They can tell.

So how will you ensure that the Head Start program that is in Health and Human Services and your Early Learning Challenge Fund will not create a conflict and run very seamlessly, especially, again, in rural communities that are critical for Head Start programs to be successful?

Secretary DUNCAN. So hold us absolutely accountable for that, but, frankly, I am absolutely confident we can do that. Kathleen Sebelius has been an amazing partner. We have done a lot of work together on a lot of issues. We want to do two things. HHS is, you know, the big player here. We think we need to be an investor. We think we do not need another study, that if we can get our babies off to a great start in live, lots of these problems we talk about disappear. And——

Senator BEGICH. Very good. My time is up. If I can just ask a yes or no question. When you say college, do you mean college/career education, voc. ed. technical schools?

Secretary DUNCAN. Yes.

Senator BEGICH. Yes. I just want to make sure.

Secretary DUNCAN. And community colleges.

Senator BEGICH. Community colleges. The broad array of higher education.

Secretary DUNCAN. I always say 4-year, 2-year, trade, technical, vocational.

Senator BEGICH. OK. Thank you.

Chairman CONRAD. Senator Thune.

Senator THUNE. Thank you, Mr. Chairman.

Mr. Secretary, thank you for being with us today, and I, too, appreciate your service. It is a tough job, and most of us, there are lots of things where I do not agree with the current administration and some of the things that you are doing, and education is actually one of the areas that I do support some of the things that are being done.

I do want to raise a concern that I have about some of the things that are happening with regard to the budget, and one has to do with this move toward competitive grant programs, which I know are probably good for urban areas, but formula funding is something that traditionally has benefited the more rural areas of the country. And it seems to me at least—and I am somebody who comes from an education family as well. My dad was the school teacher, he was the athletic director, he was the coach, and he was the bus driver. And so most cases I know that these are not people who have a lot of time to write grant proposals and grant requests. And that is a concern I hear repeatedly from school districts in rural places like South Dakota, that this process of distribution of funds, which traditionally was done through formulas, is now shifting more toward competitive grants. And these smallest school districts just cannot do that. They do not have the resources to write grant requests and proposals and that sort of thing.

So I am wondering how you suggest that we deal with the issue of making sure that rural school districts do not get left out of this.

Secretary DUNCAN. That is a great question. It is one we have spent a lot of time wrestling and debating, so let me just give you the facts: 84 percent of our proposed budget continues to be formula-based, so there is a perception out there that we are moving everything to competitive. It is actually 16 percent tops. So 84 percent, again, we are asking for increased formula funding, IDEA, Title I. We are maintaining the REAP funding, which is really important. So a couple other things. So that is just the facts. There is not some massive shift there. We do think it is important to reward excellence in the competitions that we talked about. We are going to do a rural set-aside to make sure those districts can play.

A couple other areas. We think by consolidating 38 programs into 11 we make it much easier for rural communities to focus on their children and not focus on us here in Washington and trying to make, you know, ourselves a much better partner, much more flexibility.

The Pell grant increases that we are asking for, about 38 percent of our young people go to community colleges from rural areas. North Dakota specifically, recipients are up 58 percent, so we are really trying to create access in communities that have not had that historically. We think it is very important.

Turning Around Schools, it is interesting, people think Turning Around Schools is an urban issue. About half are urban, about 20 percent are suburban, about 30 percent of these dropout factories are rural. So we are trying to invest in some very different ways in the rural community. We are trying to create more access through the competitions. Please be assured that the vast majority of our money always has been and always will continue to be formula-based. But where we have competitions, we are now putting a rural set-aside, a carveout. And so we think folks can play. And we are not looking for the fancy PowerPoint presentation. We are looking for folks for a vision of how we drive student achievement and get better, and that is what we want to reward.

Senator THUNE. The other question I have—and this pertains not just to rural school districts, but obviously federally impacted lands, which we have a lot of as well. Since 1950, the Federal Government has provided financial assistance to school districts that are impacted by Federal land or federally connected students within their district. And my State has 38 such districts that rely heavily upon impact aid payments.

In the past few years, there has been an increased number of impact aid school districts that have contacted me for assistance in reaching out to the Department of Education to ask for the Department to finalize payments for the previous fiscal years. For example, in May of 2010, a school district still had not received any payments from the Department of Education going back to June of 2008. So I am wondering what you can do to help ensure that the Department provides payments to school districts in a more timely way. There ought to be a better audit process.

Secretary DUNCAN. No question. And it is one that our staff, frankly, has worked very hard on. Just to give you—it goes back even further. Six months ago, there were 4,000 outstanding final payments for fiscal years 2006, 2007, and 2008—sorry. Six months there were 4,000 outstanding final payments; all of those have been made, every single one. And so we are working very hard to fix the backlog from the previous administration and expedite these things. But that is 4,000 off the books in the past 6 months.

Senator THUNE. All right. As you know, much of Indian country is faced with unacceptable levels of suicide and, unfortunately, tribal youth are especially affected, making up 64 percent of those suicides. So I guess my question has to do with the Native American students attend primarily BIE, and BIE and tribally run schools, and 93 percent of all Native American youth nationwide do attend public schools. So I am wondering what steps, if any, the Department is taking to work with the IHS and/or the BIE to help coordinate an effective response to what is really a terrible crisis, and particularly in Indian country.

Secretary DUNCAN. It is staggering. In a couple days, you know, you visit lots of places. The day in Hooper Bay is one I will never forget, and in Montana, Northern Cheyenne country. You know, I thought I knew poverty in the south and west sides of Chicago, and in that community there is a 70-percent unemployment rate. The high school I went to had had one child in 6 years go to college. So it was a level of challenges that I had never seen before in my life. And it was a pretty profound experience.

So we are working very, very closely with the BIE. There is a new leader there who we have a lot of confidence in. Our team has done—we have all been, you know, affected personally, quite frankly, by this. We have had many of our team members, including our general counsel, spend a lot of time on tribal consultations and trying to get out in the community and listen and hear and figure out how we can be a better partner.

One of our winners in the Promise Neighborhoods Initiative, which is rallying around entire communities, was a Native American community, and as you know much better than I, there are no easy answers here. But please know we are trying to be the best partner we can. We are trying to invest. We are trying to travel the country and get out there and do everything we can to get much better outcomes for children who desperately need those opportunities.

Senator THUNE. One final quick question. My time is running out here. The Department had a series of proposed changes with regard to the way that Christian colleges—you probably heard this, a concern about some regulations that were moving forward that might affect the accreditation process, and particularly impacting Christian religious universities. And I am wondering if that is something that you are continuing to move forward with or what accommodation you are making for some of those institutions.

Secretary DUNCAN. I do not know the details on that one, so I will have to get back to you on that.

Senator THUNE. Good. I would be interested in following up with you on that, because we had some correspondence with your Department on that.

Secretary DUNCAN. Yes, sir.

Senator THUNE. Thanks.

[The information referred to follows:]

Arne Duncan
U.S. Secretary of Education

Biography

Arne Duncan was nominated to be Secretary of Education by President-elect Barack Obama and was confirmed by the U.S. Senate on Inauguration Day, Jan. 20, 2009.

Prior to his appointment as secretary of education, Duncan served as the chief executive officer of the Chicago Public Schools, a position to which he was appointed by Mayor Richard M. Daley, from June 2001 through December 2008, becoming the longest-serving big-city education superintendent in the country.

Prior to joining the Chicago Public Schools, Duncan ran the non-profit education foundation Ariel Education Initiative (1992-1998), which helped fund a college education for a class of inner-city children under the I Have A Dream program. He was part of a team that later started a new public elementary school built around a financial literacy curriculum, the Ariel Community Academy, which today ranks among the top elementary schools in Chicago.

Duncan formerly served on the boards of the Ariel Education Initiative, Chicago Cares, the Children's Center, the Golden Apple Foundation, the Illinois Council Against Handgun Violence, Jobs for America's Graduates, Junior Achievement, the Dean's Advisory Board of the Kellogg School of Management, the National Association of Basketball Coaches' Foundation, Renaissance Schools Fund, Scholarship Chicago and the South Side YMCA. He also served on the Board of Overseers for Harvard College and the Visiting Committees for Harvard University's Graduate School of Education and the University of Chicago's School of Social Service Administration.

He has been honored by the Civic Federation of Chicago and the Anti-Defamation League. In 2007, he received the Niagara Foundation's Education Award, the National Foundation for Teaching Entrepreneurship Enterprising Educator Award and the University High School Distinguished Alumni Award. He also received honorary degrees from the Illinois Institute of Technology, Lake Forest College and National-Lewis University. In 2006, the City Club of Chicago named him Citizen of the Year. He was a member of the Aspen Institute's Henry Crown Fellowship Program, class of 2002, and a fellow in the Leadership Greater Chicago's class of 1995.

From 1987 to 1991, Duncan played professional basketball in Australia, where he also worked with children who were wards of the state.

Duncan graduated magna cum laude from Harvard University in 1987, majoring in sociology. He was co-captain of Harvard's basketball team and was named a first team Academic All-American. He credits basketball with his team-oriented and highly disciplined work ethic. Duncan is married to Karen Duncan and has two school-aged children, a daughter Clare and a son Ryan.

PROGRAM INTEGRITY REGULATIONS

The regulations referred to, published in the Federal Register on October 29, 2010 (75 FR 66832), relate to the State authorization provisions of the program integrity regulations for the Federal student aid and other programs. The regulations establish minimum requirements under which an institution offering a program of postsecondary education must demonstrate that it has State approval to do so. The regulations do not require a State to have a particular structure for conferring approval or maintaining oversight for postsecondary institutions, so long as the State has authorized the educational institution to operate within its borders and establishes a process for accepting complaints about those institutions.

Under these regulations, States are explicitly permitted to exempt religious schools from the authorization process. For these purposes, a religious school is defined as one that is owned, controlled, operated and maintained by a religious organization lawfully operating as a nonprofit religious corporation; and, awards only religious degrees or certificates, such as an associate of Biblical studies, or a doctor of divinity.

The Administration fundamentally believes that the States, along with the Federal Government and accrediting agencies, play a critical role in protecting students. In order to protect these students and our investment in them, these regulations are necessary help maintain the integrity of the student aid programs. The State authorization provisions, specifically, serve an important oversight role in providing consumer protections for students. Because of this, States are required to set up a process applying to all schools (including religious ones) to review complaints and protect students from abuse.

GROWTH IN COST OF COLLEGE EDUCATION

Presented below is information about two aspects of the cost of postsecondary education for students: the growth, over time, in the costs of this education; and the net cost to students, which is a reflection of the costs of an institution's tuition and fees less grant aid a student receives.

All of the data and information provided in this supplement can be found on the National Center for Education Statistics (NCES) website, and in most cases the link to the table or information's source is included.

The Growth in Postsecondary Costs Over Time

In the 2008-09 academic year, the annual price for undergraduate tuition, room and board was estimated to be $12,283 at public institutions and $31,233 at private institutions. After adjusting for inflation, this is a 32 percent increase between 1998-99 and 2008-09 at public institutions, and a 24 percent increase at private institutions over the same period of time.

The table below (which can also be found at http://nces.ed.gov/fastfacts/display.asp?id=76), displays these costs, beginning in academic year 1980-81. This data is a selection from a larger table that includes all years from 1976-77 through 2008-09 for each of the institution types; the complete table can be found in NCES' *Digest of Education Statistics, 2009*, Table 334 or via the following web address: http://nces.ed.gov/programs/digest/d09/tables/dt09_334.asp?referrer=report.

Total tuition, room and board rates charged for full-time students in degree-granting institutions, by type and control of institution: Selected years, 1980-81 to 2008-09						
	Constant 2007-08 dollars			Current dollars		
Year and control of institution	All institutions	4-year institutions	2-year institutions	All institutions	4-year institutions	2-year institutions
All Institutions						
1980-81	$7,579	$8,552	$5,450	$3,101	$3,499	$2,230
1990-91	10,373	12,017	6,213	6,562	7,602	3,930
2000-01	13,081	15,624	6,601	10,818	12,922	5,460
2001-02	13,520	16,204	6,793	11,380	13,639	5,718
2002-03	13,966	16,786	7,268	12,014	14,439	6,252
2003-04	14,736	17,639	7,628	12,953	15,505	6,705
2004-05	15,231	18,232	7,826	13,792	16,509	7,086
2005-06	15,563	18,561	7,693	14,629	17,447	7,231
2006-07	16,057	19,156	7,742	15,483	18,471	7,466
2007-08	16,159	19,323	7,637	16,159	19,323	7,637
2008-09	16,907	20,154	8,116	17,143	20,435	8,230
Public Institutions						
1980-81	$5,800	$6,233	$4,954	$2,373	$2,550	$2,027
1990-91	7,520	8,288	5,482	4,757	5,243	3,467
2000-01	9,172	10,463	5,851	7,586	8,653	4,839
2001-02	9,530	10,926	6,104	8,022	9,196	5,137
2002-03	9,883	11,378	6,512	8,502	9,787	5,601
2003-04	10,519	12,143	6,839	9,247	10,674	6,012
2004-05	10,894	12,618	7,041	9,864	11,426	6,375
2005-06	11,122	12,882	6,906	10,454	12,108	6,492
2006-07	11,458	13,272	7,067	11,049	12,797	6,815
2007-08	11,573	13,429	6,975	11,573	13,429	6,975
2008-09	12,113	14,060	7,463	12,283	14,256	7,567
Private Institutions						
1980-81	$13,368	$13,670	$10,516	$5,470	$5,594	$4,303
1990-91	20,408	20,926	14,705	12,910	13,237	9,302
2000-01	25,836	26,426	17,880	21,368	21,856	14,788
2001-02	26,628	27,202	18,801	22,413	22,896	15,825
2002-03	27,133	27,653	20,638	23,340	23,787	17,753
2003-04	28,012	28,520	22,250	24,624	25,069	19,558
2004-05	28,505	28,998	22,190	25,810	26,257	20,093
2005-06	28,607	29,061	22,522	26,889	27,317	21,170
2006-07	29,493	29,990	21,035	28,439	28,919	20,284
2007-08	30,258	30,778	21,685	30,258	30,778	21,685
2008-09	30,803	31,267	22,429	31,233	31,704	22,742

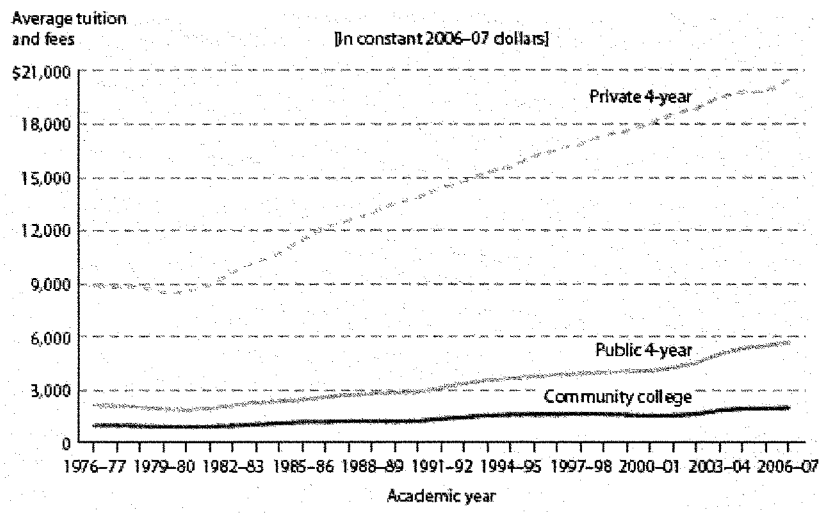
All 2008-09 data are preliminary data based on fall 2007 enrollment weights.

NOTE: Data are for the entire academic year and are average total charges for full-time attendance.

Source: U.S. Department of Education, National Center for Education Statistics. (2010). *Digest of Education Statistics, 2009* (NCES 2010-013), Table 334.

NCES also performed a comparison of community college costs to 4-year institutions in the public and private sectors. On average, community college tuition and fees for full-time students increased 25 percent between 1999-2000 and 2006-07 (a $405 increase), and, in constant dollars, by 105 percent between 1976-77 and 2006-07 (a $1,032 increase). In 2006-07, the average annual tuition and fees for a full-time, in-State student attending a community college were $2,017. A comparison of the growth of community college tuition and fees to both public 4-year and private 4-year institutions is included below. (This information and chart can be found at: http://nces.ed.gov/programs/coe/2008/analysis/sa02e.asp#info.)

Average Annual Undergraduate Tuition and Fees for Full-Time Students in Degree-Granting Institutions, by control and type of Institution: Academic Years 1976-77 through 2006-07



The average tuition and fees full-time undergraduates are charged may vary by State. The following table shows these costs, by State, for academic years 2007-08 and 2008-09:

Table 335. Average undergraduate tuition and fees and room and board rates charged for full-time students in degree-granting institutions, by type and control of institution and state or jurisdiction: 2007-08 and 2008-09

[In current dollars]

State or jurisdiction	Public 4-year						Private 4-year						Public 2-year, tuition and required fees (in-state)	
	2007-08		2008-09\1\				2007-08		2008-09\1\					
	Total	Tuition and required fees (in-state)	Total	Tuition and required fees (in-state)	Room	Board	Total	Tuition and required fees	Total	Tuition and required fees	Room	Board	2007-08	2008-09\1\
United States	**$13,429**	**$5,943**	**$14,256**	**$6,319**	**$4,322**	**$3,616**	**$30,778**	**$21,979**	**$31,704**	**$22,449**	**$5,042**	**$4,214**	**$2,061**	**$2,137**
Alabama	11,031	4,916	12,166	5,538	3,288	3,340	21,383	14,428	22,444	15,358	3,538	3,548	2,823	2,833
Alaska	11,725	4,747	12,970	5,008	4,367	3,595	26,380	18,401	28,839	19,317	4,284	5,036	2,920	3,119
Arizona	12,275	4,951	13,995	5,580	4,915	3,500	22,858	14,188	21,813	13,124	4,962	3,727	1,475	1,412
Arkansas	10,615	5,425	11,669	5,762	3,234	2,673	19,967	14,025	21,053	14,860	3,105	3,089	1,921	2,128
California	14,885	4,870	15,683	5,254	5,425	5,004	35,182	24,616	37,017	26,032	5,958	5,026	588	586
Colorado	13,342	5,262	14,240	5,683	4,352	4,205	30,126	19,587	29,331	19,293	5,698	4,340	2,077	2,197
Connecticut	16,253	7,459	17,364	7,691	5,275	4,399	40,209	29,321	42,268	30,911	6,295	5,063	2,829	2,982
Delaware	16,162	7,819	17,185	8,288	5,261	3,636	20,251	12,523	21,454	13,005	4,345	4,105	2,490	2,684
District of Columbia .	†	3,140	†	3,140	†	†	35,592	24,826	37,554	26,352	7,424	3,978	†	†
Florida	10,698	2,967	11,506	3,309	4,592	3,605	27,396	19,645	28,185	19,325	4,809	4,051	1,664	2,099
Georgia	10,952	3,988	11,540	4,270	4,360	2,911	28,988	20,074	30,594	21,283	5,323	3,988	1,873	1,890
Hawaii	12,178	4,630	13,439	5,391	3,936	4,107	21,465	11,344	22,957	12,297	4,588	6,073	1,567	1,757
Idaho	9,861	4,380	10,408	4,612	2,626	3,170	10,886	6,025	11,724	6,335	1,794	3,596	2,110	2,242
Illinois	16,782	8,968	18,213	9,847	4,366	4,001	30,853	21,304	32,359	22,599	5,370	4,390	2,375	2,519
Indiana	14,084	6,590	14,973	6,923	3,898	4,152	29,639	22,101	33,310	23,350	6,021	3,938	2,819	2,930
Iowa	13,380	6,219	13,831	6,435	3,593	3,804	24,122	17,680	25,280	18,643	3,079	3,558	3,264	3,415
Kansas	11,335	5,402	12,012	5,746	3,075	3,191	22,662	16,589	23,842	17,522	2,980	3,439	2,029	2,091
Kentucky	12,611	6,320	13,190	6,823	3,328	3,034	22,407	15,817	23,691	16,779	3,424	3,488	2,772	2,929
Louisiana	9,462	3,826	10,384	4,085	3,598	2,700	30,320	22,157	32,013	23,454	4,839	3,720	1,634	1,713
Maine	14,818	7,275	16,112	8,018	4,028	4,066	32,495	23,651	34,784	25,059	4,672	5,053	3,287	3,272
Maryland	15,661	7,155	16,111	7,249	4,963	3,899	36,213	26,883	38,453	28,483	5,396	4,083	3,014	3,071
Massachusetts	16,107	7,929	17,112	8,201	5,212	3,699	41,396	30,408	43,522	32,086	6,453	4,984	3,070	3,255
Michigan	16,014	8,479	17,039	9,078	4,236	3,725	21,890	14,829	22,862	15,552	3,684	3,426	2,166	2,255
Minnesota	14,173	7,696	15,105	8,292	3,474	3,338	30,076	22,595	31,776	23,860	4,101	3,745	4,532	4,614
Mississippi	10,794	4,764	11,047	4,942	3,419	2,686	18,372	12,659	19,358	13,276	2,942	3,140	1,725	1,770

State or jurisdiction	Public 4 year, 2007-08, Total	Public 4 year, 2007-08, Tuition and required fees (in state)	Public 4 year, 2008-09\1\, Total	Public 4 year, 2008-09\1\, Tuition and required fees (in-state)	Public 4 year, 2008-09\1\, Room	Public 4 year, 2008-09\1\, Board	Private 4 year, 2007-08, Total	Private 4 year, 2007-08, Tuition and required fees	Private 4 year, 2008-09\1\, Total	Private 4 year, 2008-09\1\, Tuition and required fees	Private 4 year, 2008-09\1\, Room	Private 4 year, 2008-09\1\, Board	Public 2-year, tuition and required fees (in-state), 2007-08	Public 2-year, tuition and required fees (in-state), 2008-09\1\
Missouri	13,383	6,541	14,009	6,924	4,258	2,847	25,092	17,629	26,509	18,576	4,022	3,911	2,384	2,456
Montana	13,606	5,418	13,970	5,462	2,986	3,522	21,359	14,982	22,804	16,054	3,107	3,723	2,995	3,042
Nebraska	11,857	5,446	12,641	5,878	3,320	3,443	22,642	16,189	23,722	17,079	3,416	3,229	2,129	2,220
Nevada	12,152	3,034	12,863	3,148	5,469	4,052	25,764	15,025	25,897	15,995	5,583	4,318	1,763	1,920
New Hampshire	18,766	9,601	19,247	10,193	5,405	3,644	34,959	21,483	36,786	26,817	5,714	4,255	5,975	6,001
New Jersey	19,479	9,636	20,735	10,375	6,597	3,763	35,073	24,804	37,156	26,305	5,849	5,002	3,057	3,193
New Mexico	10,619	4,147	11,266	4,413	3,666	3,186	24,441	16,057	25,458	16,720	4,371	4,367	1,267	1,272
New York	14,143	5,060	14,865	5,103	5,818	3,943	36,394	26,044	38,488	27,527	6,486	4,475	3,422	3,526
North Carolina	10,894	4,390	11,333	4,373	3,848	3,112	29,343	21,492	30,963	22,904	4,185	3,874	1,376	1,494
North Dakota	11,137	5,757	11,418	5,780	2,479	3,159	14,804	10,108	15,614	10,666	2,159	2,790	3,599	4,104
Ohio	16,353	8,093	16,582	8,067	4,697	3,817	30,113	22,360	31,611	23,542	4,085	3,985	3,200	3,150
Oklahoma	10,607	4,470	12,333	5,011	3,441	3,881	22,898	16,221	24,762	17,420	3,612	3,730	2,360	2,531
Oregon	13,852	5,926	15,179	6,386	4,611	4,282	31,765	23,906	33,763	25,254	4,435	4,074	2,893	2,937
Pennsylvania	17,218	9,608	18,124	10,132	4,557	3,435	35,939	26,559	37,964	28,057	5,395	4,512	3,185	3,308
Rhode Island	15,809	7,147	17,266	7,648	5,776	3,842	36,586	26,783	39,072	28,409	5,870	4,792	2,846	3,090
South Carolina	15,091	8,375	16,136	8,976	4,587	2,574	24,944	18,307	25,335	18,553	3,315	3,468	3,231	3,361
South Dakota	10,530	5,393	11,373	5,755	2,543	3,074	20,559	15,242	21,697	15,774	2,757	3,167	3,707	3,931
Tennessee	11,343	5,361	12,026	5,680	3,431	2,915	25,810	18,510	27,364	19,659	4,122	3,583	2,631	2,778
Texas	12,337	5,535	13,222	6,030	3,778	3,414	27,241	19,735	29,228	21,124	4,423	3,681	1,430	1,471
Utah	9,685	4,025	10,352	4,262	2,579	3,510	12,817	6,144	13,482	6,598	3,400	3,484	2,439	2,553
Vermont	18,295	10,443	19,601	11,316	5,302	3,943	33,883	25,149	36,101	26,789	5,121	4,192	4,420	4,684
Virginia	13,926	6,890	14,868	7,448	4,084	3,336	25,684	18,551	27,280	19,673	3,937	3,669	2,486	2,666
Washington	13,512	5,378	14,165	5,704	4,188	4,273	31,408	23,442	33,455	24,955	4,489	4,010	2,768	2,850
West Virginia	11,425	4,383	12,131	4,703	3,935	3,493	21,950	15,221	19,859	12,625	3,463	3,770	2,704	2,790
Wisconsin	11,750	6,162	12,406	6,554	3,531	2,322	28,410	21,329	30,003	22,520	3,939	3,642	3,375	3,536
Wyoming	10,068	2,990	10,556	3,057	3,346	4,153	10,890	10,890	†	11,325	†	†	1,920	2,007

†Not applicable.

\1\Preliminary data based on fall 2007 enrollment weights.

NOTE: Data are for the entire academic year and are average charges. Tuition and fees were weighted by the number of full-time-equivalent undergraduates, but were not adjusted to reflect student residency. Room and board are based on full-time students. (See Appendix A: Guide to Sources for details.) Degree-granting institutions grant associate's or higher degrees and participate in Title IV federal financial aid programs. Some data have been revised from previously published figures. Detail may not sum to totals because of rounding.

As illustrated in the two-part table shown below, full-time students may face a vast array of price points even when looking at higher education institutions of the same type. For example, a student attending a 4-year public institution in the 2008-09 academic year could see tuition, room and board costs as low as $10,616 (the 10th percentile), or as much as $19,291 (the 90th percentile).

The first table shows this cost variation for public institutions: the average for all public institutions, for public 4-year, and for public 2-year institutions.

The second table includes data for private institutions: the average for all private institutions, for 4-year, for 2-year, and, in academic year 2008-09, not-for-profit and for-profit institutions.

Table 336. Undergraduate tuition and fees and room and board rates for full-time students in degree-granting institutions, by percentile of charges and control and type of institution: 2000-01 through 2008-09

[In current dollars]

Control and type of institution, and year	Tuition, room, and board: 10th percentile	25th percentile	Median (50th percentile)	75th percentile	90th percentile
1	2	3	4	5	6
All public institutions\1					
2000-01	$5,701	$6,878	$8,279	$9,617	$11,384
2001-02	6,153	7,342	8,602	10,136	12,207
2002-03	6,385	7,801	9,138	10,885	13,094
2003-04	6,909	8,522	10,029	12,085	14,440
2004-05	7,265	9,081	10,797	12,842	15,401
2005-06	7,700	9,623	11,348	13,543	16,264
2006-07	8,337	10,125	12,042	14,505	16,965
2007-08	8,827	10,890	12,690	15,446	17,979
2008-09\2\	9,379	11,534	13,616	16,283	18,866
Public 4-year\1					
2000-01	6,503	7,347	8,468	9,816	11,611
2001-02	6,998	7,697	8,881	10,525	12,416
2002-03	7,325	8,121	9,446	11,250	13,408
2003-04	7,924	9,023	10,447	12,292	14,655
2004-05	8,380	9,574	11,022	13,031	15,622
2005-06	8,863	10,219	11,596	13,830	16,443
2006-07	9,461	10,797	12,272	14,748	17,160
2007-08	10,012	11,471	13,035	15,819	18,384
2008-09\2\	10,616	12,136	13,911	16,583	19,291
Public 2-year\1					
2000-01	3,321	3,804	4,627	5,750	6,871
2001-02	3,613	4,078	4,921	6,187	7,060
2002-03	3,730	4,475	5,347	6,510	7,829
2003-04	3,874	4,725	5,562	6,983	8,360
2004-05	4,097	4,889	6,021	7,420	9,015
2005-06	4,380	4,822	6,234	7,567	8,993
2006-07	4,487	5,199	6,376	8,035	9,719
2007-08	4,637	5,361	6,777	8,138	10,471
2008-09\2\	4,900	5,633	6,935	8,823	11,183

\1\Average undergraduate tuition and fees are based on in-state students only.

Control and type of institution, and year	Tuition, room, and board 10th percentile	25th percentile	Median (50th percentile)	75th percentile	90th percentile
All private institutions					
2000-01	13,514	17,530	22,398	27,280	32,659
2001-02	14,675	18,673	23,585	28,788	33,993
2002-03	15,400	19,657	24,885	30,453	35,753
2003-04	16,332	20,833	26,455	32,242	37,710
2004-05	17,144	21,746	27,872	34,342	39,565
2005-06	18,243	23,044	29,279	35,783	41,707
2006-07	19,102	24,350	31,009	38,448	43,770
2007-08	19,982	25,762	32,710	40,778	46,203
2008-09\2\	21,297	27,318	34,658	43,214	48,524
Not-for-profit\2\	21,668	27,438	34,849	43,246	48,524
For-profit\2\	17,150	17,150	25,834	29,959	32,742
Private 4-year					
2000-01	13,972	17,714	22,493	27,430	32,659
2001-02	14,740	18,790	23,645	28,907	34,064
2002-03	15,592	19,755	24,981	30,459	35,743
2003-04	16,364	20,833	26,536	32,242	37,710
2004-05	17,156	21,808	27,925	34,468	39,565
2005-06	18,350	23,238	29,294	35,912	41,707
2006-07	19,187	24,500	31,099	38,448	43,792
2007-08	20,005	25,876	32,768	40,778	46,203
2008-09\2\	21,454	27,368	34,658	43,232	48,524
Not-for-profit\2\	21,668	27,827	34,967	43,348	48,524
For-profit\2\	17,150	17,150	25,834	29,959	30,400
Private 2-year					
2000-01	6,650	6,850	13,220	16,400	21,845
2001-02	10,314	11,527	16,118	17,391	24,214
2002-03	11,293	12,189	16,919	21,374	29,777
2003-04	11,955	14,119	17,124	26,560	40,780
2004-05	13,807	15,486	19,844	27,276	34,385
2005-06	11,560	15,680	18,410	22,809	43,425
2006-07	8,685	16,568	19,115	26,677	40,130
2007-08	15,529	17,460	20,362	26,727	40,232
2008-09\2\	16,085	18,714	22,347	26,863	43,382
Not-for-profit\2\	16,085	17,568	19,860	24,878	39,463
For-profit\2\	21,442	23,327	26,863	43,382	43,382

\2\Preliminary data based on fall 2007 enrollment weights.

(This table was prepared August 2009.)

The Net Cost of College

As the last table particularly illustrates, a student might apply exclusively to postsecondary institutions of the same type, but encounter many different price tags, whether between States or between institutions in general. What might be most helpful for the student to know is not how much the institution is charging in tuition and fees, but the net cost of attending, which measures these costs less any grant aid.

NCES has produced two reports looking at this issue. The first is an excerpt from *The Condition of Education 2010* (NCES 2010-028) report, and summarizes data related to Indicator 47, Price of Attending an Undergraduate Institution. Among other things, this report looks at the net cost of college by family income and by type of institution, and compares these figures at several points in time.

The second report is a study of total, net, and out-of-pocket prices for college in academic year 2007-08. The study, published by NCES in December 2010, asked three questions:

- What are the average prices paid by full-time undergraduate students and how do these prices vary by the type of institution attended?
- How do the average total price of attendance and net prices vary by institution type?
- How do the net prices paid by undergraduates vary by family income?

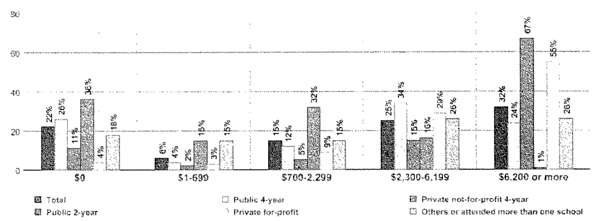
This study not only reviewed net price (as in, net price after grants), but also 'out-of-pocket net price' which calculates the price which must be paid to the institution after factoring in all other types of financial aid, including student loans. Among other findings, the study calculated the average out-of-pocket net price of all institution types, which represents the amount for which students or families would be directly responsible. These costs ranged from $9,100 at public 2-year institutions to $16,600 at private non-profit 4-year institutions.

These studies can be seen at the following NCES websites, and copies will be provided directly to the Senate committee.

http://nces.ed.gov/programs/coe/2010/pdf/47_2010.pdf (Indicator 47), and http://nces.ed.gov/pubs2011/2011175.pdf ("What is the Price of College?")

A final piece of information to study the net cost issue is a chart which displays net cost (tuition and fees minus all grants) for full-time students by the type of institution they attend:

Net Cost of College for Full-Time Students, by Type of Institution



Note: Compiled using data from U.S. Department of Education, National Center for Education Statistics, NPSAS: 2008 Undergraduate Students

As of October 29, 2011, all postsecondary institutions that receive Title IV aid must include a "Net Cost Calculator" on their website, so that prospective students and families can understand the potential cost of attendance. The Calculator, required by the *Higher Education Opportunity Act of 2008* (HEOA), must meet certain minimum standards. To assist institutions in developing a useful tool, the Department has published a sample net cost calculator, informational files, frequently asked questions, and other resources on the NCES website at http://nces.ed.gov/ipeds/resource/net_price_calculator.asp.

U.S. DEPARTMENT OF EDUCATION DECEMBER 2010 NCES 2011-175

What Is the Price of College?

Total, Net, and Out-of-Pocket Prices in 2007–08

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Students and parents see college attendance as a principal avenue to middle-class life, and, given the rising price of postsecondary education, they are apprehensive about their ability to afford it.[1] In a recent survey of college freshmen, about two-thirds (66 percent) reported having concerns about being able to finance their education.[2] Many U.S. policymakers and researchers share their concern, and are exploring ways to make college more affordable.[3] Legislators have required colleges and universities to provide more extensive information about tuition and prices, and in the Higher Education Opportunity Act of 2008 mandated a host of price-related measures, including institutional net price calculators on college websites, the reporting of net price data to the U.S. Department of Education, and the creation and posting of "College Affordability and Transparency Lists" by the Department. These lists highlight institutions with the highest and lowest tuition and fees, net prices, and percent changes in them, within their sectors.[4]

This Statistics in Brief illustrates the kinds of questions that national data can answer

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[1] A recent public opinion poll showed that increasing numbers of Americans view college as a necessity for success (Immerwahr et al. 2009). The College Board (2009) reports that the total price of attendance has increased more rapidly than the price of other goods and services over the past three decades. See also Lewin (2009), which reported on the College Board's findings.
[2] The Higher Education Research Institute at the University of California, Los Angeles, has conducted a survey of freshmen each year since 1973 (Pryor et al. 2009). See also recent media attention to the issue (Marchand 2010).
[3] Both governmental and nongovernmental study commissions have convened to address this. See, for example, The College Board (2008).
[4] Public Law 110-315, Sec. 111. August 14, 2008. *Higher Education Opportunity Act of 2008.*

This report was prepared for the National Center for Education Statistics under Contract No. ED-CO-0033 with MPR Associates, Inc. Mention of trade names, commercial products, or organizations does not imply endorsement by the U.S. Government.

STUDY QUESTIONS

What are the average prices paid by full-time undergraduate students and how do these prices vary by the type of institution attended?

How do the average total price of attendance and net prices vary by institution type?

How do the net prices paid by undergraduates vary by family income?

about the amounts U.S. undergraduates pay annually, on average, for postsecondary education, with and without financial aid. This brief draws upon the National Postsecondary Student Aid Study (NPSAS), a nationally representative survey of all postsecondary students enrolled in Title IV institutions.[5]

Included in this report are the average prices paid by undergraduates attending one of the four major types of institutions: public 2-year, public 4-year, private nonprofit 4-year, and for-profit institutions at all levels.[6] Most of the figures in this Brief display data only for full-time undergraduates[7] who attended one institution. These students constituted about one-third (35 percent) of all undergraduates in 2007–08.[8] Of all full-time undergraduates, 18 percent were enrolled in public 2-year institutions, 43 percent attended public 4-year institutions, 21 percent were at private nonprofit 4-year institutions, and 8 percent were enrolled in for-profit institutions, which is a different distribution than among all undergraduates (table 1).[9] Focusing on full-time students who attended only one institution[10] allows for comparisons in tuition, price of attendance, and financial aid across institution types, since students at different institutions enroll full time at different rates. Those attending full time generally have higher overall expenses than do all students, regardless of attendance status (table 1). They also qualify for federal aid and other assistance not available to many part-time students, and hence larger proportions of full-time students receive financial aid when compared with all undergraduates (table 2).

All comparisons of estimates in this Brief were tested for statistical significance using the Student's t-statistic, and all differences cited are statistically significant at the $p < .05$ level.[11]

[5] "Title IV institutions" refers to institutions eligible to participate in federal financial aid programs under Title IV of the Higher Education Act.

[6] For-profit institutions include less-than-2-year, 2-year, and 4-year institutions.

[7] "Full-time" status is defined as having been enrolled full time in one postsecondary institution for 9 months or more during the academic year.

[8] National Postsecondary Student Aid Study (NPSAS:08) Data Analysis System.

[9] The remaining students (11 percent) were enrolled in other types of institutions or in more than one institution during the academic year.

[10] Tuition, total price of attendance, and all net price estimates are available in NPSAS only for students attending one institution during the academic year.

[11] No adjustments for multiple comparisons were made. The standard errors for the estimates can be found at http://nces.ed.gov/das/library/reports.asp.

KEY FINDINGS

- There is a wide range of prices for postsecondary education. This Brief shows the *total price of attendance* (tuition and living expenses), the *net price after grants* (total price of attendance minus all grants), and the *out-of-pocket net price* (total price of attendance minus all financial aid)[12] for the four major types of postsecondary institutions.
- Full-time students enrolled at public 2-year institutions had the lowest average total price of attendance ($12,600). Those at public 4-year institutions had an average total price of $18,900, those at for-profit institutions had an average total price of $28,600, and those at private nonprofit 4-year institutions had the highest average total price ($35,500).
- After all financial aid is received (including grants, loans, and work-study), the average out-of-pocket net price ranged from $9,100 at public 2-year institutions to $10,300 at public 4-year institutions, $16,000 at for-profit institutions, and $16,600 at private nonprofit 4-year institutions.
- Along with income, a student's total price of attendance is also a factor in determining eligibility for financial aid. Students at a lower priced institution will have less eligibility for aid than if they had attended a higher priced institution. Those attending private institutions had the highest tuition but they also received the most financial aid. Undergraduates at private nonprofit 4-year institutions received the greatest amount of institutional grant aid while those at for-profit institutions had the largest proportion of borrowers.
- Low-income undergraduates enrolled full time at for-profit institutions had the highest average net price after grants as well as the highest average out-of-pocket net price when compared with low-income students enrolled at other institutions. The average net price after grants was $21,300 for low-income students at for-profit institutions but ranged from $7,800 to $17,900 at other institutions. Similarly, the average out-of-pocket net price was $11,700 among low-income students at for-profit institutions but the average for those enrolled elsewhere ranged from $6,000 to $9,800.

[12] The "net price after grants" subtracts any form of gift aid, or aid that does not need to be repaid, from the total price of attendance. This can be need or merit-based grant or scholarship aid. NPSAS does not have measures for net price that distinguish between need- and merit-based aid. The "out-of-pocket net price" subtracts all financial aid from the total price of attendance. All financial aid includes grants, student loans, Parent PLUS loans, work-study, employer aid, job training benefits, veterans benefits, and any other financial aid received.

TABLE 1.

UNDERGRADUATE ENROLLMENT, TUITION, AND TOTAL PRICE for all undergraduates and full-time undergraduates, by type of institution attended: 2007–08

	All undergraduates			Full-time		
	Percentage distribution	Average tuition[1]	Average total price[1]	Percentage distribution	Average tuition[1]	Average total price[1]
Total	100.0	$5,800	$14,000	100.0	$10,300	$22,400
Type of institution						
Public 2-year	40.0	1,200	7,000	17.8	2,400	12,600
Public 4-year	29.2	5,500	15,200	42.7	7,100	18,900
Private nonprofit 4-year	13.0	17,800	28,200	20.6	23,400	35,500
For-profit	9.0	10,200	20,600	8.5	11,900	28,600
Other, or more than one institution	8.8	4,800	12,300	10.5	7,000	18,000

[1] Average tuition and average total price estimates are shown for those attending one institution only.

NOTE: "All undergraduates" include both full- and part-time students. "Full-time" is defined as having been enrolled in a postsecondary institution for 9 months or more full time. "Tuition" includes all tuition and fees. The "total price" includes tuition and fees, books and supplies, housing, meals, transportation, and other miscellaneous, or personal, expenses. "For-profit" includes less-than-2-year, 2-year, and 4-year institutions. "Other, or more than one institution" includes those attending private nonprofit less-than-4-year, public less-than-2-year, and multiple institutions. Estimates include students enrolled in Title IV eligible postsecondary institutions in the 50 states, the District of Columbia, and Puerto Rico. Detail may not sum to totals because of rounding. Standard error tables are available at http://nces.ed.gov/das/library/reports.asp.

SOURCE: U.S. Department of Education, National Center for Education Statistics, 2007–08 National Postsecondary Student Aid Study (NPSAS:08).

TABLE 2.

FINANCIAL AID for all undergraduates and full-time undergraduates, by type of institution attended: 2007–08

	Any grants		Any loans		Any work-study		Any aid	
	Percent received	Average amount	Percent received	Average amount	Percent received	Average amount	Percent received	Average amount
All undergraduates	51.7	$4,900	38.5	$7,100	7.4	$2,400	65.6	$9,100
Type of institution								
Public 2-year	39.6	2,200	13.2	4,100	3.3	3,000	47.6	3,400
Public 4-year	52.9	5,200	46.2	6,600	7.7	2,500	71.3	9,400
Private nonprofit 4-year	73.6	10,200	58.9	9,100	23.2	2,100	84.7	17,400
For-profit	70.4	3,200	91.6	8,100	2.0	3,500	96.3	10,800
Full-time	65.3	7,200	53.1	8,000	13.7	2,300	80.1	12,900
Type of institution								
Public 2-year	55.7	3,700	22.5	4,900	6.9	2,600	65.7	5,400
Public 4-year	60.4	6,100	52.7	7,100	10.5	2,400	78.3	11,000
Private nonprofit 4-year	81.2	12,300	65.0	9,800	31.5	2,100	89.4	21,100
For-profit	71.9	4,000	91.6	9,600	2.0	3,600	96.7	13,100

NOTE: "Any grants" include scholarships and tuition waivers. "Any loans" include federal, state, institutional, or private student loans, excluding Parent PLUS loans. "Any aid" includes grants, loans, job training, veterans benefits, employer aid, and Parent PLUS loans. The total for "All undergraduates" includes students attending full time, part time, or more than one institution. "Full-time" is defined as having been enrolled in one postsecondary institution for 9 months or more full time. "For-profit" includes less-than-2-year, 2-year, and 4-year institutions. Average aid amounts are calculated only for students receiving a particular type of aid. Those not receiving a specific type of aid (i.e., zero values) are not included in the average for that aid. Estimates include students enrolled in Title IV eligible postsecondary institutions in the 50 states, the District of Columbia, and Puerto Rico. Standard error tables are available at http://nces.ed.gov/das/library/reports.asp.

SOURCE: U.S. Department of Education, National Center for Education Statistics, 2007–08 National Postsecondary Student Aid Study (NPSAS:08).

1 What are the average prices paid by full-time undergraduate students and how do these prices vary by the type of institution attended?

This Brief discusses three different measures of the price of an undergraduate education: the total price of attendance, the net price after grants, and the out-of-pocket net price.

Total Price of Attendance

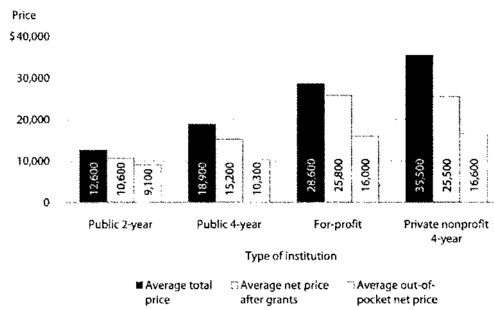
The total price of an undergraduate education includes tuition[13] and all other nontuition and living expenses such as books, supplies, and housing.[14] The total price varied widely by the type of institution attended in 2007–08, ranging from an average of $12,600 among undergraduates enrolled full time at public 2-year institutions, to $18,900 at public 4-year institutions, $28,600 at for-profit institutions, and $35,500 at private nonprofit 4-year institutions (figure 1).

[13] In this report, the term "tuition" includes both tuition and fees. Sometimes institutions treat tuition and fees as a single charge, and sometimes as separate charges. Tuition is defined as the price of instruction and fees as the price of other services provided by the school. The tuition amounts shown here include those charged to all undergraduates: both in-state and out-of-state students enrolled in public 4-year institutions, and both in-district and out-of-district students enrolled in public 2-year institutions.

[14] "Housing" can be on campus, off campus, or with parents or relatives. In the case of dependent students, this includes housing for themselves only; for independent students, it can include housing for themselves as well as their spouse and/or any dependents.

FIGURE 1.

THE PRICE OF AN UNDERGRADUATE EDUCATION for full-time undergraduates, by type of institution attended: 2007–08



NOTE: The "total price" includes tuition, books and supplies, housing, meals, transportation, and other miscellaneous, or personal, expenses. The "net price" is the price that must be paid after receiving grants. The "out-of-pocket net price" subtracts from the total price all forms of financial aid, including grants, student loans, Parent PLUS loans, work-study, employer aid, job training benefits, veterans benefits, and any other financial aid received. Both the net price after grants and the out-of-pocket net price are calculated for all full-time students, regardless of whether or not they received any financial aid. "Full-time" is defined as having been enrolled in one postsecondary institution for 9 months or more full time. "For-profit" includes less-than-2-year, 2-year, and 4-year institutions. Estimates include students enrolled in Title IV eligible postsecondary institutions in the 50 states, the District of Columbia, and Puerto Rico. Standard error tables are available at http://nces.ed.gov/das/library/reports.asp.

SOURCE: U.S. Department of Education, National Center for Education Statistics, 2007–08 National Postsecondary Student Aid Study (NPSAS:08).

Of the total price of attendance, the portion that can be attributed to tuition varies widely by institution type. For some institutions (private nonprofit 4-year institutions, in particular), the tuition is a large component of the total price. In 2007–08, average tuition was $2,400 at public 2-year institutions, $7,100 at public 4-year institutions, $11,900 at for-profit institutions, and $23,400 at private nonprofit 4-year institutions (figure 2).

Nontuition expenses, which include books and supplies, housing and meals, transportation, and personal (or miscellaneous) expenses, also can vary by institution type. College or university financial aid officers usually develop an estimate of the total price, known in financial aid parlance as the "student budget." Student budgets vary according to students' attendance and dependency status, family responsibilities, and residence (e.g., living at home with parents, in an on-campus dormitory, or in off-campus housing) (Wei 2010, table 2.1-A).

In 2007–08, students enrolled full time in for-profit institutions had the highest average nontuition expenses ($16,700), when compared with those at other types of institutions (where average nontuition expenses ranged from $10,200 to $12,100). Many students at for-profit institutions are financially independent and are supporting their own families (Wei 2010, table 5.1-A). This raises their nontuition expenses as compared with students who have no family responsibilities, because costs such as housing, food, and other necessities that are associated with supporting one or more dependents are included in a student's budget.

Students attending public 2-year institutions—mostly community colleges—had the lowest nontuition expenses. A larger proportion lived at home with their parents, which reduces costs for room and board, as compared with students at for-profit institutions (many of whom are supporting themselves or their own families) and those at 4-year institutions (where a larger proportion lived on campus or in off-campus housing) (Wei 2010, table 5.1-C).

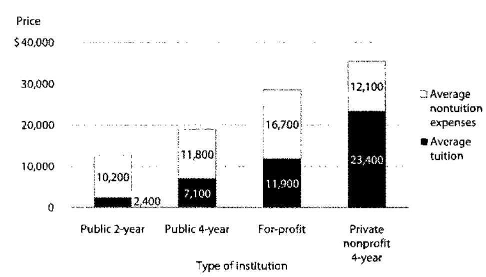
In-state vs. out-of-state tuition

At most public 4-year institutions, tuition charges are generally higher for out-of-state students than for in-state residents, reflecting the state subsidies public institutions receive. In 2007–08, the average in-state tuition was $6,200 and the average out-of-state tuition was $15,100 for full-time undergraduates enrolled in public 4-year institutions.*

* NPSAS:08 Data Analysis System (data not shown).

FIGURE 2.

TUITION AND NONTUITION EXPENSES for full-time undergraduates, by type of institution attended: 2007–08



NOTE: "Full-time" is defined as having been enrolled in one postsecondary institution for 9 months or more full time. "Tuition" includes all tuition and fees. "Nontuition expenses" include books, supplies, housing, meals, transportation, and miscellaneous or personal expenses. "For-profit" includes less-than-2-year, 2-year, and 4-year institutions. Estimates include students enrolled in Title IV eligible postsecondary institutions in the 50 states, the District of Columbia, and Puerto Rico. Standard error tables are available at http://nces.ed.gov/das/library/reports.asp.
SOURCE: U.S. Department of Education, National Center for Education Statistics, 2007–08 National Postsecondary Student Aid Study (NPSAS:08).

Net Price After Grants

Policymakers and researchers generally subtract grants from the total price when discussing the net price of attending a postsecondary institution. For example, Congress recently required institutions to make public both the total price and the average net price of attendance, calculated as the total price of attendance minus all grants received (see the 2008 Higher Education Opportunity Act). In this Brief, two measures of net price are discussed: the "net price after grants" and the "out-of-pocket net price," which is the price after all financial aid (including loans, which must be repaid) is taken into account.[15]

Grant aid helped to lower the average total price among full-time undergraduates at public 2-year institutions from $12,600 to an average net price after grants of $10,600 (figure 1). For those at public 4-year institutions, grant aid to full-time undergraduates lowered the average total price of $18,900 to an average net price after grants of $15,200.

For those at private institutions (both for-profit and nonprofit), the average net price after grants was about $25,700. For those attending for-profit institutions, the difference between the average total price and the net price after grants was about $2,800. At private nonprofit 4-year institutions, however, that difference was $10,000.

Out-of-Pocket Net Price

The "out-of-pocket net price," defined as the total price less all financial aid received, takes into account all forms of financial aid, including grants, loans, work-study, and other aid (as well as Parent PLUS loans).[16] The out-of-pocket net price represents the amount that must be paid immediately by the student or family to enroll in a postsecondary institution for that academic year. Because the out-of-pocket net price subtracts loans from the total price, it measures the net price only in the short term. Loans offset immediate costs to students and their families, but they must be repaid over time.

Full-time undergraduates enrolled at public 2-year institutions had the lowest average out-of-pocket net price ($9,100), reflecting the already lower total price at these institutions (figure 1). Those at public 4-year institutions had a slightly higher average out-of-pocket net price ($10,300). Students at private institutions had the highest average out-of-pocket net prices ($16,000 at for-profit institutions and $16,600 at private nonprofit 4-year institutions).

[15] Both net price and out-of-pocket net price averages are calculated for all students, regardless of whether they received any financial aid. This method of calculating net price averages for all students differs from that used to calculate average aid amounts in this report (see table 2). Average aid amounts are calculated only for students receiving a particular type of aid. Those not receiving a specific type of aid (i.e., zero values) are not included in the average for that aid. The average grant, therefore, will be greater than the difference between the total price and the net price after grants.

[16] Since 1998, the federal government has also provided postsecondary students and their families with various federal tax benefits. These are not included in the definition of financial aid and are not used in the calculation of net price in this study.

2 How do the average total price of attendance and net prices vary by institution type?

Prices vary by institution type for several reasons. Institutions charge different levels of tuition (based on whether they are public or private and the amount of state and local subsidies received); the demographic characteristics of students (and thus their nontuition expenses and eligibility for federal and state grant aid) vary by type of institution; and institutional policies for awarding institutional aid differ. This section discusses the major differences in prices by institution type.

As noted previously, the amount of tuition charged by institutions is a primary factor in the total price of attendance, but students also incur different nontuition expenses depending on their family responsibilities and living arrangements.

Average net prices are further affected by differences in the proportion of aid recipients at each type of institution. For example, the number of students eligible for federal Pell Grants or state-funded grant aid at a particular school will affect the average net price after grants, as will a school's policies for awarding grants from institutional funds. The out-of-pocket net price further depends on the level of borrowing among students and their parents and other types of aid received, such as work-study.

Public 2-Year Institutions

Full-time students attending public 2-year institutions had the lowest average total price ($12,600), net price after grants ($10,600), and out-of-pocket net price ($9,100) compared with full-time undergraduates attending other types of institutions (figure 1).

Because students at public 2-year institutions had a lower average total price initially, their average net prices also were lower—even though they had the smallest proportions of grant recipients (56 percent) and students who borrowed (23 percent took out a student loan) (table 2).

Public 4-Year Institutions

Tuition at public 4-year institutions was higher than at public 2-year institutions, but not as high as at the private institutions (figure 2). Students at these institutions also have slightly higher nontuition expenses than those at public 2-year institutions, with a larger proportion living on campus or away from home (see Wei 2010, table 5.1-C).

Among those enrolled full time at public 4-year institutions, 60 percent received grant aid, about one-half (53 percent) took out student loans, and 10 percent received work-study support (table 2). Grant aid helped to lower the net price after grants to an average of $15,200, and the addition of loans, work-study, and other aid resulted in an average out-of-pocket net price of $10,300 (figure 1). This compares to an average out-of-pocket net price of $9,100 at public 2-year institutions—a difference of $1,200 in the average out-of-pocket net price, even though the difference in the average total price was $6,300.

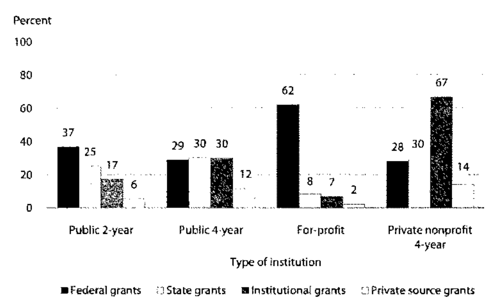
For-Profit Institutions

For-profit institutions are privately owned and operated and the profits they generate benefit individual owners and shareholders. The programs can range from less than 1 year to 4-year bachelor's and graduate degrees. Most undergraduates enrolled in less-than-4-year for-profit institutions are pursuing certificates or associate's degrees in occupational training programs (73 percent) (Staklis 2010, table 2.1). Compared with undergraduates enrolled at other types of institutions, those at for-profit institutions tend to be older, financially independent, and have family responsibilities. This increases their nontuition expenses and hence, their total price of attendance. More undergraduates at for-profit institutions received federal grants (62 percent) than did students in any other type of institution in our analysis (figure 3). However, a smaller percentage of for-profit students received state, institutional, or private grants than students in other sectors. On average, these students had a net price after grants of $25,800—not measurably different than that of private nonprofit 4-year institutions, and higher than that of public institutions (figure 1).

Student loans were critical to reducing the average out-of-pocket net price for all undergraduates, but particularly for those at for-profit institutions. For-profit institutions had the largest proportion of full-time undergraduates

FIGURE 3.

SOURCES OF GRANT AID for full-time undergraduates, by type of institution attended: 2007–08



NOTE: "Grants" include scholarships and tuition waivers. "Full-time" is defined as having been enrolled in one postsecondary institution for 9 months or more full time. "For-profit" includes less-than-2-year, 2-year, and 4-year institutions. Estimates include students enrolled in Title IV eligible postsecondary institutions in the 50 states, the District of Columbia, and Puerto Rico. Standard error tables are available at http://nces.ed.gov/das/library/reports.asp.
SOURCE: U.S. Department of Education, National Center for Education Statistics, 2007–08 National Postsecondary Student Aid Study (NPSAS:08).

with at least one loan in their financial aid package: 9 out of 10 (91 percent) received an aid package containing a loan (figure 4), compared with 65 percent of those at private nonprofit 4-year institutions, 53 percent at public 4-year institutions, and 23 percent at public 2-year institutions. The high level of student borrowing at for-profit institutions contributed to an average out-of-pocket net price of $16,000 (figure 1).

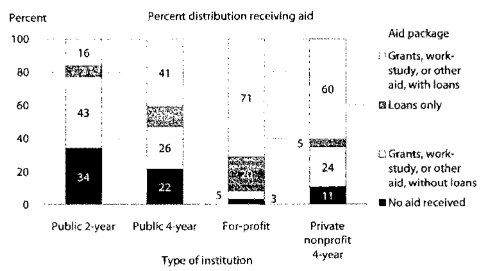
Private Nonprofit 4-Year Institutions

Even though they had the highest average total price ($35,500) of the four major sectors, financial aid recipients at private nonprofit 4-year institutions also received the largest average amount of total aid ($21,100), when compared with those at for-profit institutions ($13,100), public 4-year institutions ($11,000), and public 2-year institutions ($5,400) (table 2).

In fact, aid received by undergraduates at private nonprofit 4-year institutions resulted in an average net price of $25,500 and an average out-of-pocket net price of $16,600, both of which were not measurably different from undergraduates at schools with the next highest total price: for-profit institutions ($25,800 and $16,000, respectively) (figure 1).

FIGURE 4.

TYPE OF AID PACKAGE
for full-time undergraduates, by aid package received and type of institution attended: 2007–08



NOTE: "Grants" include scholarships and tuition waivers. "Loans" include federal, state, institutional, or private student loans, excluding Parent PLUS loans. "Other" aid includes job training, veterans benefits, employer aid, and Parent PLUS loans. "Full-time" is defined as having been enrolled in one postsecondary institution for 9 months or more full time. "For-profit" includes less-than-2-year, 2-year, and 4-year institutions. Estimates include students enrolled in Title IV eligible postsecondary institutions in the 50 states, the District of Columbia, and Puerto Rico. Detail may not sum to totals because of rounding. Standard error tables are available at http://nces.ed.gov/das/library/reports.asp.
SOURCE: U.S. Department of Education, National Center for Education Statistics, 2007–08 National Postsecondary Student Aid Study (NPSAS:08).

The receipt of institutional grants, in particular, was critical in lowering the price for those attending private nonprofit 4-year colleges and universities. About two-thirds (67 percent) of students in private nonprofit 4-year schools received institutional grants or tuition waivers, a larger proportion than at any other type of institution (30 percent at public 4-year institutions, 17 percent at public 2-year institutions, and 7 percent at for-profit institutions) (figure 3). The average institutional grant received by those attending private nonprofit 4-year institutions was $10,400,[17] which helped reduce the average total price to an average net price after grants of $25,500 (figure 1).

Work-study was also an important source of aid to those at private nonprofit 4-year institutions. Nearly one-third (31 percent) of all full-time undergraduates at private nonprofit 4-year institutions received work-study aid, the highest percentage among all full-time undergraduates (between 2 and 10 percent of undergraduates at other types of institutions received work-study aid) (table 2). With the aid of student loans, work-study, and other types of support, full-time undergraduates at private nonprofit 4-year institutions had an average out-of-pocket net price of $16,600—not measurably different from those attending for-profit institutions ($16,000) (figure 1).

[17] NPSAS:08 Data Analysis System (data not shown).

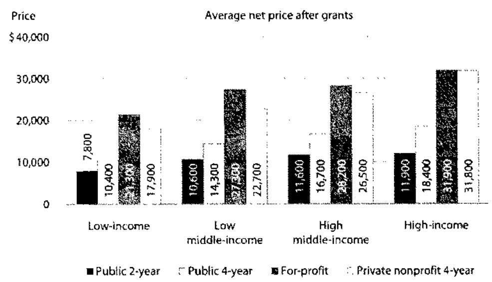
3 How do the net prices paid by undergraduates vary by family income?

This section discusses both the net price after grants and the out-of-pocket net price by family income level among full-time dependent students only.[18] Figure 5 shows the average net price after grants by both family income and type of institution attended. Among low-income and low middle-income dependent students, those with the highest average net price after grants were enrolled at for-profit institutions. In contrast, among high middle-income and high-income students, the average net price after grants for those at for-profit institutions was not measurably different from those at private nonprofit 4-year institutions.

[18] Full time dependent students constituted 76 percent of all full-time undergraduates attending one institution in 2007–08 (NPSAS:08 Data Analysis System). Independent students are not analyzed by income level in this Brief. Parental income for independent students is not available from NPSAS.

FIGURE 5.

NET PRICE AFTER GRANTS BY INCOME
for full-time dependent undergraduates, by family income category and type of institution attended: 2007–08

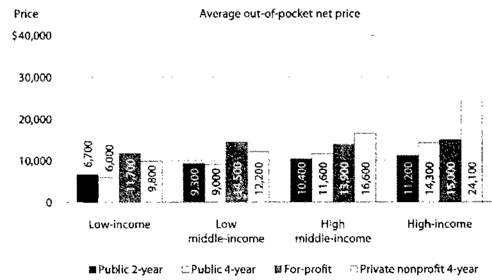


NOTE: The "net price after grants" is the price of attending a postsecondary institution after all grants have been received. This amount is calculated by subtracting total grant aid from the total price of attendance. The total price of attendance includes tuition, books and supplies, housing, meals, transportation, and other miscellaneous, or personal, expenses. Grant aid includes grants, scholarships, tuition waivers, and other gift aid that does not need to be repaid. The net price after grants is calculated for all students, regardless of whether or not they received any grant aid. Family income categories were based upon parents' annual income in 2006. Dollar cutoffs are based on the distribution among all dependent undergraduates: "Low-income" was the lowest 25th percentile (less than $36,100); "Low middle-income" was the 26th to 50th percentile ($36,100–$66,600); "High middle-income" was the 51st to 75th percentile ($66,600–$104,600); and "High-income" was the highest 25th percentile ($104,600 or more). "Full-time" is defined as having been enrolled in one postsecondary institution for 9 months or more full time. "For-profit" includes less-than-2-year, 2-year, and 4-year institutions. Estimates include students enrolled in Title IV eligible postsecondary institutions in the 50 states, the District of Columbia, and Puerto Rico. Standard error tables are available at http://nces.ed.gov/das/library/reports.asp.
SOURCE: U.S. Department of Education, National Center for Education Statistics, 2007–08 National Postsecondary Student Aid Study (NPSAS:08).

The average out-of-pocket net price, on the other hand, shows a slightly different pattern (figure 6). After borrowing, low-income and low middle-income undergraduates enrolled at for-profit institutions continued to have the highest average out-of-pocket net price, when compared with those at other institutions. However, among those with incomes above the median (i.e., high middle-income and high-income students), the average out-of-pocket net price was highest for those enrolled at private nonprofit 4-year institutions.

FIGURE 6.

OUT-OF-POCKET NET PRICE BY INCOME
for full-time dependent undergraduates, by family income category and type of institution attended: 2007–08



NOTE: The "out-of-pocket net price" is the price of attending a postsecondary institution after all aid has been received. This amount is calculated by subtracting total financial aid from the total price of attendance. The total price of attendance includes tuition, books and supplies, housing, meals, transportation, and other miscellaneous, or personal, expenses. Financial aid includes grants, student loans, Parent PLUS loans, work-study, employer aid, job training benefits, veterans benefits, and any other type of aid. The out-of-pocket net price is calculated for all students, regardless of whether they received any aid. Family income categories were based upon parents' annual income in 2006. Dollar cutoffs are based on the distribution among all dependent undergraduates: "Low-income" was the lowest 25th percentile (less than $36,100); "Low middle-income" was the 26th to 50th percentile ($36,100–$66,600); "High middle-income" was the 51st to 75th percentile ($66,600–$104,600); and "High-income" was the highest 25th percentile ($104,600 or more). "Full-time" is defined as having been enrolled in one postsecondary institution for 9 months or more full time. "For-profit" includes less-than-2-year, 2-year, and 4-year institutions. Estimates include students enrolled in Title IV eligible postsecondary institutions in the 50 states, the District of Columbia, and Puerto Rico. Standard error tables are available at http://nces.ed.gov/das/library/reports.asp.

SOURCE: U.S. Department of Education, National Center for Education Statistics, 2007–08 National Postsecondary Student Aid Study (NPSAS:08).

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http://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2011175

More detailed information on the price of undergraduate education and undergraduate financing can be found in Web Tables produced by the National Center for Education Statistics (NCES) using the 2007–08 National Postsecondary Student Aid Study (NPSAS:08) data. These Web Tables are a comprehensive source of information on financial aid awarded to undergraduate students during the 2007–08 academic year. Included are estimates of tuition, price of attendance, and financial aid. Additional information on the demographic characteristics of 2007–08 undergraduates can be found in a second set of Web Tables.

Web Tables—Student Financing of Undergraduate Education: 2007–08 (NCES 2010-162). http://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2010162

Web Tables—Profile of Undergraduate Students: 2007–08 (NCES 2010-205). http://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2010205

Readers may also be interested in the following NCES products related to the topic of this Statistics in Brief:

2007–08 National Postsecondary Student Aid Study (NPSAS:08): Student Financial Aid Estimates: First Look (NCES 2009-166).
http://nces.ed.gov/pubs2009/2009166.pdf

Undergraduate Financial Aid Estimates by Type of Institution in 2007–08 (NCES 2009-201).
http://nces.ed.gov/pubs2009/2009201.pdf

TECHNICAL NOTES

Survey Methodology

The estimates provided in this Statistics in Brief are based on data collected through the 2007–08 National Postsecondary Student Aid Study (NPSAS:08). NPSAS covers broad topics concerning student enrollment in postsecondary education and how students and their families finance their education. In 2008, students provided data through instruments administered over the Internet or by telephone. In addition to student responses, data were collected from the institutions that sampled students attended and other relevant databases, including U.S. Department of Education records on student loan and grant programs and student financial aid applications.

NPSAS:08 is the seventh administration of NPSAS, which has been conducted every 3 to 4 years since 1986–87. The NPSAS:08 target population includes students enrolled in Title IV postsecondary institutions in the United States and Puerto Rico at any time between July 1, 2007, and June 30, 2008.[19] This population included about 21 million undergraduates and 3 million graduate students enrolled in over 6,000 institutions.

The institution sampling frame for NPSAS:08 was constructed from the 2004–05 and 2005–06 Institutional Characteristics, Fall Enrollment, and Completions files of the Integrated Postsecondary Education Data System (IPEDS). The sampling design consisted of first selecting eligible institutions, then selecting students from these institutions. Institutions were selected with probabilities proportional to a composite measure of size based on expected 2007–08 enrollment. With approximately 1,700 institutions participating in the study, the weighted institution unit response rate was 90 percent. Eligible sampled students were defined as study respondents if at least 11 key data elements were available from any data source. Approximately 114,000 undergraduates and 14,000 graduate students were study respondents, and the weighted student unit response rate for both levels was 96 percent. Estimates were weighted to adjust for the unequal probability of selection into the sample and for nonresponse.

In this Statistics in Brief, the analytical groups consisted of undergraduate students enrolled full time in one of the four major types of institutions in 2007-08. Out of the total NPSAS:08 undergraduate sample, approximately 21,000 were enrolled in public 4-year institutions, about 13,000 were enrolled in private nonprofit 4-year institutions, about 7,000 were attending public 2-year institutions, and approximately 6,000 were enrolled in for-profit institutions.

VARIABLES USED

All estimates presented in this Statistics in Brief were produced using the Data Analysis System (DAS), a web-based software application that allows users to generate tables for many of the postsecondary surveys conducted by NCES. See "Run Your Own Analysis With DataLab" below for more information on PowerStats, the next generation of the DAS. The variables used in this Brief are listed below. Visit the NCES DataLab website (http://nces.ed.gov/datalab) to view detailed information on how these variables were constructed and their sources. Under *Detailed Information About PowerStats Variables, NPSAS Undergraduates: 2008*, click *by subject* or *by variable name*. The program files that generated the statistics presented in this Brief can be found at http://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2011175.

Label	Name
Attendance status	ATTNSTAT
Family income for dependent students	PCTDEP
Federal grants	TFEDGRT
Institutional grants	INGRTAMT
Net price after grants	NETCST3
Non-tuition expenses	BUDNONAJ
Out-of-pocket net price	NETCST1
Private grants	PRIVAID
State grants	STGTAMT
Total financial aid	TOTAID
Total grants	TOTGRT
Total price	BUDGETAJ
Total student loans	TOTLOAN
Tuition	TUITION2
Type of aid package	AIDTYPE
Type of institution	SECTOR4
Work-study	TOTWKST

[19] The target population of students was limited to those enrolled in an academic program, at least one course for credit that could be applied toward an academic degree, or an occupational or vocational program requiring at least 3 months or 300 clock hours of instruction to receive a degree, certificate, or other formal award. The target population excluded students who were also enrolled in high school or a high school completion (e.g., GED preparation) program.

Key variables used in this Brief include tuition (TUITION2), total price of attendance (BUDGETAJ), and various measures of net price (NETCST1, NETCST3). These composite variables are derived from multiple sources of data including IPEDS, the Free Application for Federal Student Aid (FAFSA), the National Student Loan Data System (NSLDS), institution records, and the student interview.

Two broad categories of error occur in estimates generated from surveys: sampling and nonsampling errors. Sampling errors occur when observations are based on samples rather than on entire populations. The standard error of a sample statistic is a measure of the variation due to sampling and indicates the precision of the statistic. The complex sampling design used in NPSAS:08 must be taken into account when calculating variance estimates such as standard errors. NCES's online Data Analysis System (DAS), which generated the estimates in this report, uses the balanced repeated replication (BRR) method to adjust variance estimation for the complex sample design.

Nonsampling errors can be attributed to several sources: incomplete information about all respondents (e.g., some students or institutions refused to participate, or students participated but answered only certain items); differences among respondents in question interpretation; inability or unwillingness to give correct information; mistakes in recording or coding data; and other errors of collecting, processing, sampling, and imputing missing data.

For more information on NPSAS:08 methodology, see appendix B of *2007–08 National Postsecondary Student Aid Study (NPSAS:08): Student Financial Aid Estimates for 2007–08: First Look* (http://nces.ed.gov/pubs2009/2009166.pdf).

Item Response Rates

NCES Statistical Standard 4-4-1 states that "[a]ny survey stage of data collection with a unit or item response rate less than 85 percent must be evaluated for the potential magnitude of nonresponse bias before the data or any analysis using the data may be released" (U.S. Department of Education 2002). In the case of NPSAS:08, this means that nonresponse bias analysis could be required at any of three levels: (1) institutions, (2) study respondents, or (3) items. Because the institutional and study respondent response rates were 90 percent and 96 percent, respectively, nonresponse bias analysis was not required at those levels.

The student interview response rate, however, was 71 percent, and therefore nonresponse bias analysis was required for those variables based in whole or in part on student interviews. In this report, seven variables required nonresponse bias analysis: AIDTYPE (60 percent), NETCST1 (58 percent), NETCST3 (59 percent), PCTDEP (55 percent), TOTAID (60 percent), TOTGRT (61 percent), and TOTLOAN (67 percent). For each of these variables, nonresponse bias analyses were conducted to determine whether respondents and nonrespondents differed on the following characteristics: institution sector, region, and total enrollment; student type, gender, and age group; whether the student had Free Application for Federal Student Aid (FAFSA) data, was a federal aid recipient, was a Pell Grant recipient, or took out a Stafford Loan; and the amount, if any, of a student's Pell Grant or Stafford Loan. Differences between respondents and nonrespondents on these variables were tested for statistical significance at the 5 percent level. All other variables used in this Brief had a pre-imputation response rate of 85 percent or higher.

Nonresponse bias analyses of the variables in this report with response rates less than 85 percent indicated that respondents differed from nonrespondents on 71 percent to 80 percent of the characteristics analyzed, indicating that there may be bias in these estimates. Any bias due to nonresponse, however, is based upon responses prior to stochastic imputation. The potential for bias in these estimates is tempered by two factors.

First, potential bias may have been reduced due to imputation. Because imputation procedures are designed specifically to identify donors with similar characteristics to those with missing data, the imputation is assumed to reduce bias. While item-level bias before imputation is measurable, such bias after imputation is not, so whether the imputation affected the bias cannot be directly evaluated. Therefore, the item estimates before and after imputation were compared to determine whether the imputation changed the biased estimate, thus suggesting a reduction in bias.

For continuous variables, the difference between the mean before imputation and the mean after imputation was estimated. For categorical variables, the estimated difference was computed for each of the categories as the percentage of students in that category before imputation minus the percentage of students in that category after imputation. These estimated differences were tested for statistical significance at the 5 percent level. A significant difference in the item means after imputation implies a reduction in bias due to imputation. A nonsignificant difference suggests that imputation may not have reduced bias, that the sample size was too small to detect a significant difference, or that there was little bias to be reduced. Statistical tests of the differences between the means before and after imputation for these seven variables were significant, indicating that the nonresponse bias was reduced through imputation.

Second, for some composite variables, the components of the variables from which the composites are constructed often constitute a very small proportion of the total variable, attenuating the potential bias introduced by nonresponse. For example, most of the components of TOTAID (total amount of all financial aid received) were obtained from federal databases and institutional records and have very high response rates. Some components of TOTAID, however, are types of financial aid that are often disbursed directly to students and not through institutions (e.g., employer aid and private loans). Because the primary source of information about such types of aid is the student interview, these variables were missing for interview nonrespondents.

In the case of missing information from the student interview, values were stochastically imputed and the imputed values were used to construct the composite variables. In the example cited above, both employer aid and private loans were received by relatively few students and were small components of the total. For example, 52 percent of all undergraduates received any grants (TOTGRT), a primary component of TOTAID, and the average among all undergraduates was $2,500. In comparison, 8 percent received any employer aid, with an average among all undergraduates of $200. Therefore, despite the low response rates of these components, any bias they contribute is likely to be minimal.

For more detailed information on nonresponse bias analysis and an overview of the survey methodology, see appendix B of the report *2007–08 National Postsecondary Student Aid Study (NPSAS:08): Student Financial Aid Estimates for 2007–08: First Look* (http://nces.ed.gov/pubs2009/2009166.pdf).

Statistical Procedures

Comparisons of means and proportions were tested using Student's *t* statistic. Differences between estimates were tested against the probability of a Type I error[20] or significance level. The statistical significance of each comparison was determined by calculating the Student's *t* value for the difference between each pair of means or proportions and comparing the *t* value with published tables of significance levels for two-tailed hypothesis testing. Student's *t* values were computed to test differences between independent estimates using the following formula:

$$t = \frac{E_1 - E_2}{\sqrt{se_1^2 + se_2^2}}$$

where E_1 and E_2 are the estimates to be compared and se_1 and se_2 are their corresponding standard errors.

There are hazards in reporting statistical tests for each comparison. First, comparisons based on large *t* statistics may appear to merit special attention. This can be misleading since the magnitude of the *t* statistic is related not only to the observed differences in means or percentages but also to the number of respondents in the specific categories used for comparison. Hence, a small difference compared across a large number of respondents would produce a large (and thus possibly statistically significant) *t* statistic.

A second hazard in reporting statistical tests is the possibility that one can report a "false positive" or Type I error. Statistical tests are designed to limit the risk of this type of error using a value denoted by alpha. The alpha level of .05 was selected for findings in this report and ensures that a difference of a certain magnitude or larger would be produced when there was no actual difference between the quantities in the underlying population no more than 1 time out of 20.[21] When analysts test hypotheses that show alpha values at the .05 level or smaller, they reject the null hypothesis that there is no difference between the two quantities. Failing to reject a null hypothesis, i.e., detect a difference, however, does not imply the values are the same or equivalent.

[20] A Type I error occurs when one concludes that a difference observed in a sample reflects a true difference in the population from which the sample was drawn, when no such difference is present.

[21] No adjustments were made for multiple comparisons.

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You can replicate or expand upon the figures and tables in this report, or even create your own. DataLab has several different tools that allow you to customize and generate output from a variety of different survey datasets. Visit DataLab at

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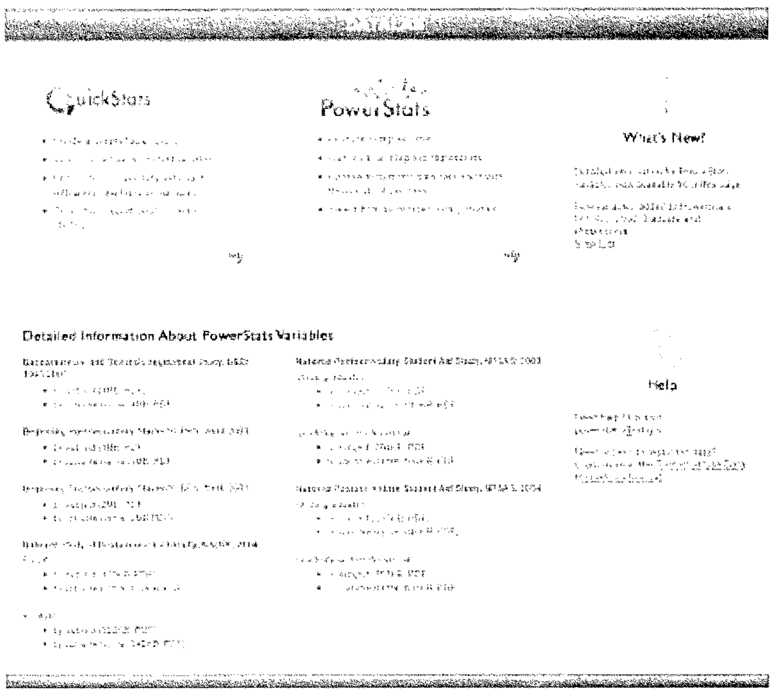

The Condition of Education 2010

Indicator 47

Price of Attending an Undergraduate Institution

The indicator and corresponding tables are taken directly from *The Condition of Education 2010*. Therefore, the page numbers may not be sequential.

Additional information about the survey data and supplementary notes can be found in the full report. For a copy of *The Condition of Education 2010*, visit the NCES website (http://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2010028) or contact ED Pubs at 1-877-4ED-PUBS.

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NCES 2010-028
U.S. DEPARTMENT OF EDUCATION

ies NATIONAL CENTER FOR EDUCATION STATISTICS
Institute of Education Sciences

Indicator 47
Price of Attending an Undergraduate Institution

For full-time, full-year, dependent undergraduates, the total price of education was higher in 2007–08 than in 1999–2000 at all institutions.

The total price of attending a postsecondary institution (also called "the student budget") includes tuition and fees, books and materials, and an allowance for living expenses. In 2007–08, the average total price, in constant 2008–09 dollars, of attendance for full-time, full-year, dependent students was $12,000 at public 2-year institutions, $19,100 at public 4-year institutions, $37,000 at private not-for-profit 4-year institutions, and $22,400 at private for-profit less-than-4-year institutions (see table A-47-1). The average total price of attendance for students at each of the four major types of institutions was higher in 2007–08 than in 1999–2000.

Many students and their families do not pay the full price of attendance; they receive financial aid to help cover their expenses. The primary types of aid are grants (which do not have to be repaid) and loans (which must be repaid). Grants (including scholarships) may be awarded on the basis of financial need, merit, or both, and may include tuition aid from employers. The loan amounts reported in this indicator include student borrowing through federal, state, institutional, and alternative (private) loan programs, as well as loans taken out by parents through the federal Parent Loans for Undergraduate Students (PLUS) program. When adjusted for inflation, the average amount borrowed by students at each of the four major types of institutions was higher in 2007–08 than in 1999–2000. The average grant amounts for students at public 2- and 4-year institutions and private not-for-profit 4-year institutions were higher in 2007–08 than in 1999–2000, when adjusted to 2008–09 dollars (see table A-47-1).

The net price is an estimate of the cash outlay, including loans, that students and their families need to pay in a given year to cover educational expenses. It is calculated here as the total price of attendance minus grants (which decrease the price). The net price for full-time, full-year, dependent undergraduates at all four major types of institutions was higher in 2007–08 than in 1999–2000. After adjusting for inflation, the net price of attendance was higher in 2007–08 than in 2003–04 for students at public 2- and 4-year institutions, as well as for students at private not-for-profit 4-year institutions.

The net price of sending a student to a postsecondary institution (of any type) was higher in 2007–08 than in 1999–2000 for families at all income levels, with the exception of low-income students at public 2-year institutions and middle- and high-income students at private for-profit less than 4-year institutions (see table A-47-2). For middle-income students at public 2- and 4-year institutions and private not-for-profit 4-year institutions, the net price was significantly higher in 2007–08 than in 2003–04; this was also true for high-income students at public 2- and 4-year institutions.

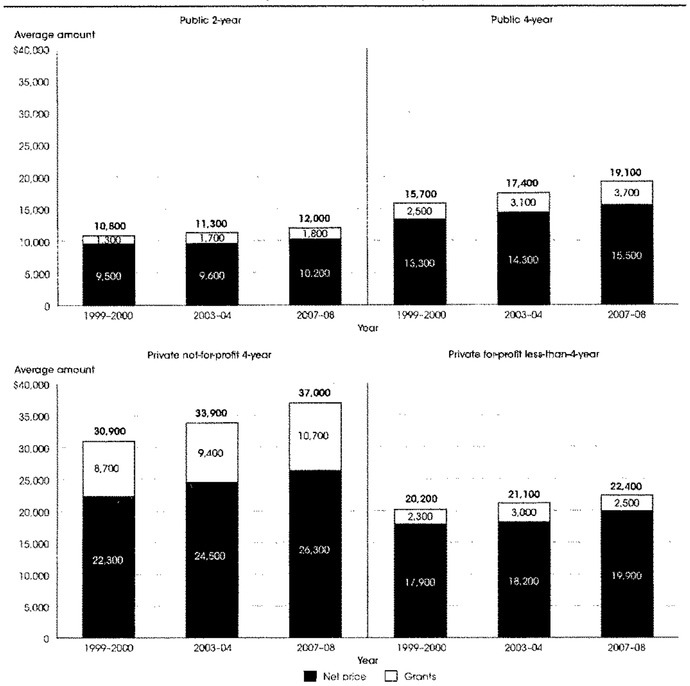
For more information: *Tables A-47-1 and A-47-2; Indicator 46*
Glossary: *Consumer Price Index (CPI), Four-year postsecondary institution, Private institution, Public institution, Two-year postsecondary institution*

Technical Notes

Full time refers to students who attended full time (as defined by the institution) for the full year (at least 9 months). Information on the use of tax credits by individual families is not available and therefore could not be taken into account in calculating net price. Averages were computed for all students, including those who did not receive financial aid. Detail may not sum to totals because of rounding. Data were adjusted by the Consumer Price Index for All Urban Consumers (CPI-U) to constant 2008–09 dollars. For more information on the CPI-U, see ***supplemental note 10.*** Estimates exclude students who were not U.S. citizens or permanent residents and who were therefore ineligible for federal student aid, students who attended more than one institution in a year due to the difficulty matching information on price and aid, and students who attended private for-profit 4-year institutions.

Figure 47-1. Average total price, grants, and net price for full-time, full-year dependent undergraduates, by type of institution: Academic years 1999–2000, 2003–04, and 2007–08

[In constant 2008–09 dollars]



NOTE: *Full time* refers to students who attended full time (as defined by the institution) for the full year (at least 9 months). *Net price* is an estimate of the cash outlay that students and their families need to make in a given year to cover educational expenses. It is calculated here as the total price of attendance, including loans, minus grants. Information on the use of tax credits by individual families is not available and therefore could not be taken into account in calculating net price. Averages were computed for all students, including those who did not receive financial aid. Data were adjusted by the Consumer Price Index for All Urban Consumers (CPI-U) to constant 2008–09 dollars. For more information on the CPI-U, see *supplemental note 10*. Estimates exclude students who were not U.S. citizens or permanent residents and who were therefore ineligible for federal student aid, students who attended more than one institution in a year due to the difficulty of matching information on price and aid, and students who attended private for-profit 4-year institutions.

SOURCE: U.S. Department of Education, National Center for Education Statistics, 1999–2000, 2003–04, and 2007–08 National Postsecondary Student Aid Studies (NPSAS:2000, NPSAS:04, and NPSAS:08).

Supplemental Tables to Indicator 47

Price of Attending a Postsecondary Institution

Table A-47-1. Average total price of attendance, loans, grants, and net price for full-time, full-year dependent undergraduates, by type of institution: Academic years 1999–2000, 2003–04, and 2007–08

[In constant 2008–09 dollars]

Type of institution	1999–2000	2003–04	2007–08
Public 2-year			
Total	**$10,800**	**$11,300**	**$12,000**
Grants	1,300	1,700	1,800
Net price	9,500	9,600	10,200
Loans	600	600	900
Public 4-year			
Total	**15,700**	**17,400**	**19,100**
Grants	2,500	3,100	3,700
Net price	13,300	14,300	15,500
Loans	3,100	3,700	4,500
Private not-for-profit 4-year			
Total	**30,900**	**33,900**	**37,000**
Grants	8,700	9,400	10,700
Net price	22,300	24,500	26,300
Loans	6,100	6,900	8,400
Private for-profit less-than-4-year			
Total	**20,200**	**21,100**	**22,400**
Grants	2,300	3,000	2,500
Net price	17,900	18,200	19,900
Loans	6,800	7,600	8,900

NOTE: *Full time* refers to students who attended full time (as defined by the institution) for the full year (at least 9 months). *Net price* is an estimate of the cash outlay that students and their families need to make in a given year to cover educational expenses. It is calculated here as the total price of attendance, including loans, minus grants. Information on the use of tax credits by individual families is not available and therefore could not be taken into account in calculating net price. Averages were computed for all students, including those who did not receive financial aid. Data were adjusted by the Consumer Price Index for All Urban Consumers (CPI-U) to constant 2008–09 dollars. For more information on the CPI-U, see *supplemental note 10*. Estimates exclude students who were not U.S. citizens or permanent residents and who were therefore ineligible for federal student aid, students who attended more than one institution in a year due to the difficulty of matching information on price and aid, and students who attended private for-profit 4-year institutions. Detail may not sum to totals because of rounding.
SOURCE: U.S. Department of Education, National Center for Education Statistics, 1999–2000, 2003–04, and 2007–08 National Postsecondary Student Aid Studies (NPSAS:2000, NPSAS:04, and NPSAS:08).

Table A-47-2. Average net price for full-time, full-year dependent students after grants and loans, by type of institution and family income: Academic years 1999–2000, 2003–2004, and 2007–2008

[In constant 2008–09 dollars]

Type of institution and family income	1999–2000	2003–04	2007–08
Public 2-year			
Total	**$9,500**	**$9,600**	**$10,200**
Low income	7,600	7,500	7,800
Lower middle income	10,000	9,900	10,600
Upper middle income	10,400	10,800	11,800
High income	10,600	11,000	12,000
Public 4-year			
Total	**13,300**	**14,300**	**15,500**
Low income	9,800	10,200	10,300
Lower middle income	12,800	13,900	14,400
Upper middle income	14,500	15,500	16,900
High income	15,400	17,000	18,600
Private not-for-profit 4-year			
Total	**22,300**	**24,500**	**26,300**
Low income	15,000	18,000	18,100
Lower middle income	20,200	21,500	22,900
Upper middle income	22,300	24,600	26,400
High income	28,200	30,800	32,200
Private for-profit less-than-4-year			
Total	**17,900**	**18,200**	**19,900**
Low income	14,900	15,600	17,700
Lower middle income	19,700	19,300	21,100
Upper middle income	21,200	20,500	23,700
High income	23,300	22,300	24,000

NOTE: *Full time* refers to students who attended full time (as defined by the institution) for the full year (at least 9 months). *Net price* is an estimate of the cash outlay that students and their families need to make in a given year to cover educational expenses. It is calculated here as the total price of attendance, including loans, minus grants. Information on the use of tax credits by individual families is not available and therefore could not be taken into account in calculating net price. Averages were computed for all students, including those who did not receive financial aid. Data were adjusted by the Consumer Price Index for All Urban Consumers (CPI-U) to constant 2008–09 dollars. For more information on the CPI-U, see *supplemental note 10*. Estimates exclude students who were not U.S. citizens or permanent residents and who were therefore ineligible for federal student aid, students who attended more than one institution in a year due to the difficulty of matching information on price and aid, and students who attended private for-profit 4-year institutions. Detail may not sum to totals because of rounding. The cutoff points for low, lower middle, upper middle, and high income were obtained by identifying the incomes at the 25th, 50th, and 75th percentiles.

SOURCE: U.S. Department of Education, National Center for Education Statistics, 1999–2000, 2003–04, and 2007–08 National Postsecondary Student Aid Studies (NPSAS:2000, NPSAS:04, and NPSAS:08).

Standard Error Tables to Indicator 47

Price of Attending a Postsecondary Institution

Table S-47-1. Standard errors for the average total price of attendance, loans, grants, and net price for full-time, full-year dependent undergraduates, by type of institution: Academic years 1999-2000, 2003-04, and 2007-08

[In constant 2008-09 dollars]

Type of institution	1999-2000	2003-04	2007-08
Public 2-year			
Total	**$140**	**$190**	**$110**
Grants	140	70	40
Net price	240	190	110
Loans	60	50	40
Public 4-year			
Total	**130**	**130**	**80**
Grants	40	50	70
Net price	120	130	90
Loans	50	70	90
Private not-for-profit 4-year			
Total	**460**	**430**	**280**
Grants	200	390	230
Net price	410	430	310
Loans	200	170	180
Private for-profit less-than-4-year			
Total	**500**	**700**	**770**
Grants	130	330	150
Net price	520	650	780
Loans	590	640	450

SOURCE: U.S. Department of Education, National Center for Education Statistics, 1999-2000, 2003-04, and 2007-08 National Postsecondary Student Aid Studies (NPSAS:2000, NPSAS:04, and NPSAS:08).

Table S-47-2. Standard errors for the average net price for full-time, full-year dependent students after grants and loans, by type of institution and family income: Academic years 1999–2000, 2003–2004, and 2007–2008

[In constant 2008–09 dollars]

Type of institution and family income	1999–2000	2003–04	2007–08
Public 2-year			
Total	**$240**	**$190**	**$110**
Low income	360	290	130
Lower middle income	210	200	190
Upper middle income	320	260	200
High income	260	190	250
Public 4-year			
Total	**120**	**130**	**90**
Low income	150	190	140
Lower middle income	160	190	140
Upper middle income	140	170	120
High income	170	160	130
Private not-for-profit 4-year			
Total	**410**	**430**	**310**
Low income	320	590	500
Lower middle income	450	490	450
Upper middle income	390	480	440
High income	540	610	510
Private for-profit less-than-4-year			
Total	**520**	**650**	**780**
Low income	690	720	900
Lower middle income	790	790	1,120
Upper middle income	600	750	1,480
High income	890	1,230	1,280

SOURCE: U.S. Department of Education, National Center for Education Statistics, 1999–2000, 2003–04, and 2007–08 National Postsecondary Student Aid Studies (NPSAS:2000, NPSAS:04, and NPSAS:08).

Chairman CONRAD. Senator Sanders.

Senator SANDERS. Thank you very much, Mr. Chairman, and thank you, Mr. Secretary, for being with us.

Let me begin, Mr. Secretary, picking up on a point that Senator Johnson raised, because I was not quite sure about your answer. As I understand it, the Governor of Wisconsin now is trying to end collective bargaining for State employees in that State, including teachers. Do you believe unequivocally that teachers have a right to engage in collective bargaining?

Secretary DUNCAN. Not only do I believe it, I believe that collective bargaining can be a tool for improving student achievement and is a tool for improving achievement in a number of districts.

Senator SANDERS. And I agree with you, but I want to just be very clear, because I was not sure about your answer to the Senator. You would disagree, then, with what the Governor of Wisconsin is trying to do?

Secretary DUNCAN. I have been very clear on that. I have had great conversations with him, and I have been very public on it, so yes.

Senator SANDERS. Could you be public with it right now? You disagree with what the Governor of Wisconsin is trying to do.

Secretary DUNCAN. Yes.

Senator SANDERS. Yes?

Secretary DUNCAN. Yes. Let me just take a moment, if you want to, on it.

Senator SANDERS. Are you going to be very clear by being unclear?

Secretary DUNCAN. No, sir. What he asked from the teachers union was to have them help on the pension costs and the health care costs.

Senator SANDERS. Yes. Collective bargaining is the issue I want to focus on.

Secretary DUNCAN. They agreed to that, and I thought he had his chance to fix the budget hole there. So there is a different agenda there.

Senator SANDERS. So you believe that teachers and public employees have the right to engage in collective bargaining.

Secretary DUNCAN. Absolutely.

Senator SANDERS. OK. Let me ask you this: We support the protection in the President's budget to protect the maximum Pell grant award at $5,500. However, I am deeply concerned that the proposed budget eliminates the availability of a second Pell grant in the same award year.

Now, you know and I know, because I get letters to this effect every week, that there are millions of students today who are graduating college or graduate school very deeply in debt, and they are working at low-wage jobs because of the nature of the economy, trying to pay off their debt, and they are falling further and further behind.

Why did you propose the elimination of that second Pell grant when it would do so much harm to so many students?

Secretary DUNCAN. So I really appreciate your concern, and these are very tough and hard and painful cuts. We did that. We had a $20 billion Pell shortfall to fill. We had to make some hard decisions. Our highest priority was maintaining the $5,550 a year for every single student, and to close that $20 billion hole, by eliminating the second Pell that saves about $7.5 billion. So that is not something we do easily or lightly or enjoy doing, but given the magnitude of the Pell shortfall, we felt we——

Senator SANDERS. Well, let me ask you this question. I know this is a little bit beyond your pay grade, but do you think it makes more sense to give tax breaks to billionaires or to make sure that our young people can afford to go to college?

Secretary DUNCAN. Well, I am not the economist in the room here, but I will say that the most important investment we can make in this country is to make sure children have a great pre-K–12 education so they can graduate from college and be competitive in a globally based economy. The most important investment our country can make.

Senator SANDERS. Earlier on, I think both Senator Conrad and Senator Sessions and you yourself raised some interesting questions making the point that in a sense education goes beyond education. These are cultural issues. It is more than what takes place in the classroom.

One of the concerns that I have had for a long time is that the United States has by far the highest rate of childhood poverty in the industrialized world. Many countries in Europe and Scandinavia have 3, 4, 5 percent. We have 20 percent. So when you appropriately talk about so many young people dropping out of high school and ending up with nowhere to go, do you think that that relates to the fact that so many of our children start off in poverty, A; and, B, comment, if you would like, about how our early childhood education system, our child care system, compares with other countries. Do you think that if a kid starts off in poverty, if there is no decent quality child care available, how does that impact the likelihood of that kid to drop out?

Third, our Republican friends are proposing massive cutbacks in Head Start. How do you think that will impact dropout rates?

Secretary DUNCAN. So I do not think we need another study to tell us how critically important early childhood programs are for closing achievement gaps, leveling the playing field, and giving children from poverty, children from disadvantaged communities, a chance to be successful academically. We do not need another study. We just had another one, though, from Vanderbilt University in the past week where the data was absolutely compelling on the huge impact that high-quality early childhood programs have.

When children enter kindergarten, some of whom are reading fluently, some of whom do not know the front of a book from the back of a book, some of whom do not know their names, they have been called a nickname all their life. That is an extraordinarily challenging task for the best of kindergarten teachers in the world to teach that wide disparity. So——

Senator SANDERS. Would you agree—again, and there are a dozen studies to make the point.

Secretary DUNCAN. Hundreds.

Senator SANDERS. I am asking a question that I am sure that you agree with, that if kids enter the school system unprepared, their likelihood of dropping out is going to be much, much greater?

Secretary DUNCAN. Unquestionably. When I met with the NGA this weekend, we are all facing tough budget decisions, and I challenged every single Governor in tough budget times not to scale back on early childhood education.

Senator SANDERS. But yet as a Nation—I am sorry that Senator Cornyn is not here. But I read things. My understanding is that in the State of Texas, for example, which generally has scores not among the highest in the country, they are looking at laying off something like 100,000 educators. And that is just one State. In my State there has been pressure as well.

You have described that our system is in a crisis. I think that is the word that you used. What do you think will happen if all over this country, in order to balance budgets while, again, we are providing huge tax breaks to billionaires, while we lose $100 billion every single year because corporations and the wealthy stash their money in tax havens in the Cayman Islands and in Bermuda, an issue that the Chairman of this Committee has talked about on many occasions, and yet we find ourselves in a difficult budget situation so that States collectively will be laying off hundreds and hundreds of thousands of teachers.

Now, you just said—and everybody seems to agree—we have an educational crisis. Do you think the laying off of hundreds of thousands of educators is going to help us address the educational crisis?

Secretary DUNCAN. Of course not.

Senator SANDERS. Is it adding to the crisis?

Secretary DUNCAN. Anytime we do not—again, I am not saying investment status quo. Anytime we cut back investments in this new vision of education, that hurts our country. I would just go right to the chart that the chairman began with. The cost of the dropout crisis, the cost of the achievement gap, is the economic cost of a permanent economic recession on this country. That is the cost that if we had the will and the courage, we could solve and put our country in a much, much better spot than we are today.

Senator SANDERS. I am running out of time. Let me ask you my last question. In Burlington, Vermont, where I live, we have a school which has a whole lot of immigrant kids. It is in the lowest-income neighborhood in the city. The teacher, because of rules, as you well know, related to No Child Left Behind, was fired because the kids did not perform particularly well on some of the tests. And yet most of the people in that community see this as an outstanding school where the teachers and principal did an extraordinary job.

Do you think it makes sense to judge kids who are from immigrant families, some of whose families do not even speak English, the same way as you would judge an upper-middle-class family who were obviously fluent in English? Does that make sense to you?

Secretary DUNCAN. No, and whether it is a child who does not speak English or a child with severe special needs who cannot comprehend a test, to have them take the same evaluation, the same, you know, rules as a child who has been in the country all their life and—no, it does not make sense.

Senator SANDERS. But why do we do it?

Secretary DUNCAN. Well, we want to fix the No Child Left Behind law and do it together this year.

Senator SANDERS. All right. Well, I just want you to know that in a school in Burlington, Vermont, which many people see as an outstanding success because of the work of the principal, that principal was fired.

Senator SANDERS. Thank you, Mr. Chairman.

Secretary DUNCAN. A big problem is the lack of focus on growth and gain. We need to be looking at improvements for every single child, every child.

Chairman CONRAD. Let me just say, there was a screw-up on the clock, so I gave you some additional time to make up for the screw-up on the clock, for other colleagues who are wondering. We want to be fair when we make a mistake and that it is not coming out of your time.

Senator MERKLEY.

Senator MERKLEY. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for your testimony.

I wanted to echo Senator Thune's concerns about the increase in competitive grants. I can tell you, we have 200 school districts in Oregon. Most of them are very small. They do not have grant writers. There is a systemic disadvantage to small rural school districts that I do not think the administration has taken fully into account. I just want to share with you that, as I do my every county townhalls, it comes up time and time again that these school districts, they cannot even track the opportunities available let alone apply for them. And so we have to consider that in the formulation of fairness to school children all over this country.

Secretary DUNCAN. Yes, sir.

Senator MERKLEY. Second, I wanted to have you talk a little bit more about Pell grants. I thought college was extraordinarily expensive when I went off to college in 1974. Now as a parent with a freshman in high school and an eighth-grader, and I am looking at the cost of college as it compares to the average income of working Americans, what has essentially happened since 1974 is that, inflation adjusted, the wages of working Americans have stayed flat for 35 years. Inflation adjusted, the cost of college has not stayed flat for 5 years. This is a huge, huge challenge, and the result of that challenge is that we are becoming the first generation of parents whose children are getting less education than we got. Extraordinary community failure as a Nation, especially as you noted in a world economy, a world education-based economy, knowledge economy. Even the Pell grants we have in this budget I do not think quite level out the playing field when one compares where we were two decades ago or three decades ago. Just your thoughts about that growing gap and the ability of working families to afford college.

Secretary DUNCAN. So it is real. Again, that is why I am proud that we have had the greatest increase in Pell grants or, you know, college funding and grants since the BI bill. But is there more unmet need out there? Yes. There are studies that show that of those who drop out of college, 52 percent, the majority drop out due to financial reasons. Again, if we think we have to educate our way to a better economy, we have to continue to invest there. And I think we have to continue to find those universities that are holding down costs and being thoughtful about how they provide value for the cost, for the expense, and shine a spotlight there, and continue to use the marketplace to drive students and families to those places who get this and get the stress that families are under today.

Senator MERKLEY. When I look at the modest amount we are investing in our domestic infrastructure, physical infrastructure, and then I look at the failure to keep college affordable, do we have a major challenge as a Nation in which we are spending too much money on foreign wars and foreign bases rather than on domestic infrastructure and domestic education?

Secretary DUNCAN. Well, obviously, again, I just think we have to educate our way to a better economy. We have to continue to invest in education. And whether it is the Pell grants, whether it is investments in community colleges—which have been, I think, an unpolished gem along the education continuum. We are trying to put a huge amount of resources there. The only way our country is going to have a strong and vibrant economy long term is if we have many more folks successful postsecondary.

And to Senator Begich's point, that does not mean just 4—it is 4 years, but it is 2 years, it is trade, technical, vocational training. That has to be the goal for every single young person in our country.

Senator MERKLEY. All points that I agree with, but it does not answer the question. We all keep talking about these same goals, the importance of education, yet we seem to be slipping further behind. Are we as a Nation spending too much on foreign wars and foreign bases rather than on education and infrastructure?

Secretary DUNCAN. Well, again, I am not the Secretary of State, but would I love to see us continue to invest more in education going forward? I think as a country we have to, and the President passionately believes it.

Senator MERKLEY. OK. I will just note that I think until we are ready to have a serious conversation, we are all just repeating the same things, which is education matters, but we are not really getting to the heart of the problem. One example of that would be the President's proposed investment in training STEM teachers, 100,000 over the next 10 years. Do you have any concept of how many math, engineering, technology science teachers are being let go in the current State shortfalls across this Nation over the next 2 years?

Secretary DUNCAN. I do not know the breakdown for math and science teachers specifically. I do not know that number.

Senator MERKLEY. I would be very interested in that because it is very frustrating right now. We have a $3 billion shortfall in Oregon. It is not unlike many other States. We are in better shape than some and in worse shape than others. But while we are talking as a Nation about the importance of education, the reality on the ground is that there are going to be massive cuts in our public education system. It so happens my children are in the same school district that I went to from third grade through twelfth, and, therefore, it is a 40-year gap in between, but it gives me a chance to kind of compare apples to apples over the duration. The classrooms are much larger. The fees for kids to participate in extracurricular activities that keep them in the school are much higher. The range and diversity of activities smaller. In other words, we are not providing the same education to our children that our parents provided to us.

And so it is fabulous to note that we need a lot more teachers in education—a lot more teachers in science and technology and engineering and mathematics. But if we do not provide enough resources to actually be funding K–12 schools across this country, then we are failing, and that is my concern. And I think right now we are losing the teachers. We are not gaining teachers. We are increasing classroom size, not shrinking it. We are losing school days. It is becoming routine for school districts to think about doing a 4-day week than a 5-day week. Isn't that kind of a sign of something massively wrong in our national education system?

Secretary DUNCAN. No question. So obviously these are horrendously tough budget times, but, you know, reducing instructional time might be the worst choice you could make in tough budget times. And so, you know, how Governors and school boards and superintendents make these tough choices in tough budget times says a lot about leadership, and where folks are eliminating time or eliminating days of the week, I cannot think of a worse decision to make in that tough budget time.

Senator MERKLEY. My time is up, so I will followup on Perkins grants. Thank you.

Chairman CONRAD. Thank you, Senator.

I want to go back to something Senator Johnson mentioned because as I evaluate what is happening, one of the things that really jumps out at you is this matter of college tuition, and I have not seen the exact number that Senator Johnson used. I think we are talking about a 400-percent increase in college tuition. Maybe, Senator Johnson, you would want to repeat what that number was.

Senator JOHNSON. This is a Heritage Foundation study, and since 1982, college tuition has increased 439 percent.

Chairman CONRAD. And then you had some comparables for health care, which was 250 percent or——

Senator JOHNSON. Right. I will give you the study. It is 250 percent for health care and 105 percent for just general inflation.

Chairman CONRAD. You know, I tell you, my grandson is about to go to college, so he has been going to schools around the country, and it is stunning. My daughter went to an outstanding university. I did. I look at what has happened to college tuition, and I am not certain how it all works, because the stated college tuition is very high, and then they have financial aid packages, and people get dramatic reductions based on the package that they might qualify for.

Now, obviously, a high-income family is not going to qualify for anything, and that is fine. I do not argue with that.

Has the Department done an analysis of college tuition over this last 20 years? This study is from 1982, as I understand it, so that—so it is comparing—so it is going back to the 1980s. I am just interested, has the Department done an analysis of college tuition? And what are the real increases when financial aid packages are taken into account? What are the real increases that we are seeing? Has the Department done that kind of analysis?

Secretary DUNCAN. I am sure we have. If we have not, it would not be hard to do. So you are looking for the net number. I do not know that off the top of my head.

Chairman CONRAD. Yes, because one thing I have seen as we go through this with our grandson is the stated tuition number, and then you have these financial packages, I would be interested in piercing the veil here and trying to understand what has really happened.

Secretary DUNCAN. I think the Senator's basic premise that these costs have gone up far faster than inflation, I think he is absolutely correct.

Chairman CONRAD. I agree with that as well. That is what my observation would be. But I really want to understand the full effect, not just the stated tuition, but when you take into account the financial packages, what has happened? And then why? Why has this—you know, it is not unusual now to see tuition $40,000, $50,000 a year.

Secretary DUNCAN. We can do some work on that for you and get you what we do——

Chairman CONRAD. I think it would be very helpful to the Committee if the Department were able to do that.

Chairman CONRAD. Now I want to turn just very quickly-because I have to be out of here a few minutes before noon, and I want to give Senator Sessions another chance as well. I want to go back to this question which I did not raise in my time, but you and I have had an exchange. I have written you an extensive letter that I went over in great detail the education community back home: dissatisfaction with No Child Left Behind, which in my State is intense; a very strong feeling that No Child Left Behind—this is not your responsibility. This came in a previous administration, a previous Congress. But what do we do going forward to correct it? Because the education community in my State—and I mean on every level; I am talking teachers, administrators, school board members—tell me the thing just does not relate to rural areas like the one I represent.

Secretary DUNCAN. Rural, urban, suburban—I have heard that everywhere I go. We want to fix the law. Again, we want to fix it before the August recess so we go back in the school year with a better law. We can only fix and only want to work in a bipartisan way to do that. We want a law that is fair, that is flexible and much more focused.

Let me just tell you quickly a couple things I think are wrong with the current law that with a common-sense approach we can fix.

As I said earlier, the current law is far too punitive. There are many, many ways to fail. The only reward for success is you are not labeled a failure.

It is very prescriptive, very top-down from Washington. I always tell the story that I almost had to sue our Department of Education when I ran the Chicago Public Schools for the right to tutor my children after school. I had tens of thousands of disadvantaged children who wanted to work harder, wanted to go to school, and we got in a pitch battle. I won. But why did I have to go to war with the Federal Government to tutor my children after school?

It led—I think this is unintentional, but it absolutely led to a dumbing down of standards, which has huge ramifications, and it led to a narrowing of the curriculum.

So how do we fix all those things? We have to reward success, reward excellence, great teachers, great principals, great schools, districts, States, beating the odds. I went to school in your State, George Hall in Mobile, Alabama, historically struggling school. Amazing job. It shows what is possible. Where we see excellence, we have to shine a spotlight, learn from it, encourage it, incentivize it, let folks know what is possible out there.

We have to look at growth and gain rather than absolute test scores. How much are we improving? How much are we getting better? We need every child, you know, students with disabilities, English language learners, held to the same high standards. We want to know how much are they growing each year.

Chairman CONRAD. Let me stop you on that point because it is one of the things that has been the most—to me it is utterly bizarre. I do not understand why a measure of success is comparing one third grade to another third grade. I always say my brother's third grade was not nearly as bright as mine, so how you can compare the two—that is not quite true. The reverse is true.

But let me just say this: I can understand if we are measuring a student's progress, if we are measuring the progress of an individual class. That makes sense to me. But comparing one third grade against another third grade to judge whether or not the school is performing to me is bizarre.

Secretary DUNCAN. I have not met a teacher or a principal—and I have been to hundreds and hundreds of schools—who are afraid of accountability. They just want it to be fair. They want a level playing field. If we are measuring growth and gain, how much a student is improving each year, you know, holding teachers, schools, districts, States accountable, look at who is raising the bar and who is not, universal support. Raising standards, 41 States are leading the charge, so this is a game changer. I cannot tell you how important this is to have college and career standards for every single child. Huge movement there. And then, finally—this is so important to me—a well-rounded education.

So, yes, reading and math are important, are fundamental, foundational. Science, social studies, dance, drama, art, music, foreign languages, physical education——

Chairman CONRAD. Physical education.

Secretary DUNCAN. Hugely important. I was one of those young boys, I had to run around. I could not still all day. And so we can fix these things in a common-sense approach, fix it together, and I think help lead the country where we need to go. But if we do not, shame on us this year.

Chairman CONRAD. Thank you. Senator Sessions.

Senator SESSIONS. Thank you.

I was on the Education Committee when No Child Left Behind came up. I guess I was one of the last to agree to support it. I had some doubts about it, but I remember reporting at one of the Committee hearings that in Mobile, where George Hall is—it is probably one of those schools that the reporting requirements made them report that some of their schools were remarkably behind others. Some of the inner-city schools were just really not performing well.

They met, they assigned new principals and new teachers, and those schools showed dramatic improvement. I told that story; Senator Kennedy just beamed because that was what he believed and that is what President Bush meant when he said there is a soft bigotry of low expectations. So I do not know what the answer is. It is a tough question to deal with.

I talked to a very fine college president recently, and this is what he expressed to me, and I would ask you to think about this as you develop Pell grant policy. He said, you know, I think it is a mistake to eliminate summer school. He said, I think the problem is we have too many students taking 12 hours and taking 5 and 6 years to graduate. They are running up debt. They are running up burdens on their families when they could graduate in 4 years, and they should be graduating in 4 years. And if they need to do a summer school to get out sooner, they are out working, making money, and costing their family and themselves less debt. He said, So I would limit Pell grants to students who take 16 to 18 hours minimum and allow them to take summer school if that works.

Have you thought about that? And would that be something you would consider?

Secretary DUNCAN. It is a great question. This goes back to your basic premise of we just cannot keep spending. I would have loved to have kept the second Pell grant. That goes, again, from $5,500 a year to $11,000 for each student. With the second Pell grant, we honestly did not see a big jump in the number of students participating in summer school. It was like a 1-percent increase. So in an ideal world, Senator, I would loved to have maintained that. We just——

Senator SESSIONS. Well, let us think about—that is probably correct. I do not want to focus on the summer school. I guess what I would focus on is, Should we emphasize getting students to finish their career in 4 years? Wouldn't it save the Government a lot of money and save them debt? And wouldn't it be better for America?

Secretary DUNCAN. It is a really thoughtful question, and we need to work on that. So in an ideal world, absolutely we would have students graduating in 3 and 4 years. The reality, as you know, Senator, is that we have many folks who are not 18 years old going to college but 28, 29, and they are working a full-time job and they are supporting a family. As much as I would desperately love them to finish in 4 years, 6 or 7 years might be more realistic.

And so we want to speed up completion rates. We want to encourage that. I think your basic point, how do we encourage completion, is one we are focused on and we want to do more on. But the average age for a college student has gone up pretty significantly, and they are dealing with challenges going to college that—you know, I just had to go to school. I did not have children. I was 18. You have, you know, single moms, 28, working 40, 50 hours a week and taking classes at night. And we need——

Senator SESSIONS. Well, that is certainly a mix of students. Could I ask you one more thing?

Secretary DUNCAN. Yes, sir.

Senator SESSIONS. My time is up. Do you agree with the recent report that indicates that our graduates who are graduating with 4-year degrees are less educated and proficient than they were I think 20 years ago, they said; that we are spending the money, and they are going through and getting their degrees, but they have not really accomplished as much learning, and is that a concern?

Secretary DUNCAN. Yes. I have not seen that report, but that is an issue or a concern that has absolutely been raised to me. So I am not informed enough to know that.

If I could add one final thing, Mr. Chairman, this question about college tuition. One thing we are coming out soon with—and just stay tuned and we will get it to you—is a watchlist, and we will be reporting net tuition and ranking schools by sector. So, again, we are trying to use the bully pulpit to drive transparency, and we will get that to you shortly.

Chairman CONRAD. I would be very interested in that because there is something going on here. It is very evident to me that they have these tuitions, but then they have these financial packages, and so really, I would just like to know what is real.

Senator SESSIONS. Could I offer one real explanation for that? I was on the board of trustees in my little liberal arts college. We had an outside speaker who said one of the factors in a college or university being rated by the evaluating is how much the tuition is. I was stunned at that. But it apparently is a very real fact.

Chairman CONRAD. We thank the Secretary. We thank all the colleagues who have participated today.

The Committee will stand in adjournment. We have another hearing tomorrow with another Cabinet Secretary. I thank this Secretary for your first appearance here.

Secretary DUNCAN. Thanks for the thoughtful questions.

[Whereupon, at 12 p.m., the Committee was adjourned.]

QUESTIONS SUBMITTED BY SENATOR MURRAY

HOMELESS CHILDREN AND YOUTH EDUCATION

Question. Did the Department of Education take the increases in enrolled homeless students into account when it proposed level funding for the Education for Homeless Children and Youth program; and, if not, on what other basis did the Administration choose to level fund the Education for Homeless Children and Youth program?

Answer. The Administration's fiscal year 2012 budget request reflects difficult choices. Recognizing the importance of the Education for Homeless Children and Youth program, especially during a period when enrollments of homeless students are increasing, the Administration has proposed preserving this program even while proposing to make significant consolidations and eliminations elsewhere. Further, our ESEA reauthorization proposal would allow districts more flexibility in using Federal funding to serve homeless students, including by allowing funds under Title I, Part A to be used to fund transportation for homeless students. We believe that our funding requests for K-12 education programs, including our proposal to maintain funding for the Homeless Children and Youth Education program, represent an approach that is both fiscally responsible and likely to improve educational outcomes for all students, including homeless students.

The fiscal year 2012 appropriation would fund the first year of operations of the reauthorized program. Under the reauthorization proposal, program funds would be allocated to States based on the most recent State-reported data on the number of homeless children and youth available to the Department of Education, rather than on State shares of Title I, Part A funds as under current statute. With this change, Homeless Children and Youth Education program funds will flow better to States on the basis of need, making more targeted use of these funds and better serving homeless students.

FEDERAL STRATEGIC PLAN TO PREVENT AND END HOMELESSNESS

Question. In May, the Administration released the first Federal Strategic Plan to End Homelessness, with the stated goal of ending family and youth homelessness in 10 years. How does the flat funding request for the Education for Homeless Children and Youth program factor into achieving this goal? Does the Administration believe that this goal can be achieved without increased access to education for homeless children and youth, and without additional resources for schools to meet their needs?

Answer. The Department of Education strongly supports the Federal Strategic Plan to Prevent and End Homelessness and its goal of ending all homelessness in 10 years. As discussed in detail in the Strategic Plan, this goal could be achieved by increasing leadership, collaboration, and engagement on the issue of homelessness and by improving housing access, economic security, and health and stability of people experiencing or at risk of homelessness as well as homeless crisis response systems. With respect to economic security, the Strategic Plan recognizes that access to education can help decrease financial vulnerability and the likelihood of homelessness later in life. Importantly, however, the Strategic Plan does not identify the provision of additional resources for educating homeless students as a strategy for improving economic security. This is reasonable, as homelessness will diminish as more people have stable homes, not when more services are provided to homeless students in school, important as those services may be.

With respect to leadership, collaboration, and engagement on the issue of homelessness, the Department is an active member of the United States Interagency Council on Homelessness and has recently established an intra-agency working group on the education of homeless children, youth, and adults, led by the Assistant Secretary for Elementary and Secondary Education. To advance the goal of ending homelessness, the working group is currently developing a Departmentwide action plan that will include, among other activities, promoting awareness of Department programs that serve homeless students across the Federal agencies and by constituents.

EARLY LEARNING CHALLENGE FUND — COORDINATION WITH DHHS

Question. I am pleased that the President requested $350 million for the Early Learning Challenge Fund. What steps is the Department taking at this time to ensure it will be able to work effectively with the Department of Health and Human Services to manage the Early Learning Challenge Fund should it be funded for the coming fiscal year?

Answer. The Department of Education and the Department of Health and Human Service have built a strong, collaborative relationship focused on helping to ensure that children in the early years of life receive high-quality comprehensive services. For example, the Administration formed the Early Learning Interagency Policy Board in August of 2010 to improve the quality of early learning programs and outcomes for young children; increase the coordination of research, technical assistance and data systems; and advance the effectiveness of the early learning workforce. The Board would be instrumental during the design and implementation of the Early Learning Challenge Fund, and we believe that the positive working relationships that we have established with HHS would continue and strengthen further through the administration of the Fund. The two departments have met frequently over the last six months, and we will continue to collaborate and speak with one unified voice on the Administration's birth-through-third-grade agenda.

Additionally, Jacqueline Jones, Senior Advisor to the Secretary for Early Learning, and Joan Lombardi, Deputy Assistant Secretary and Inter-Departmental Liaison for Early Childhood Development at the Administration for Children and Families at HHS, work together on a regular basis. They have made and will continue to make joint appearances at a number of different events. We believe that it is important to model, at the Federal level, the type of interagency collaboration that will be necessary at the local and State levels to build and support systems that promote high-quality early learning programs that improve child outcomes.

EARLY LEARNING CHALLENGE FUND — TRANSITION TO ELEMENTARY SCHOOL

Question. How would the Department of Education shape the Early Learning Challenge Fund so it has an increased connection to teaching and learning at the early elementary level?

Answer. The Administration is committed to an early learning agenda that begins at birth and continues through third grade, with seamless transitions between preschool and elementary school.

In addition to our efforts to improve the transition for children to elementary school through the Early Learning Challenge Fund, we also want to note that the Department's proposal for reauthorizing the *Elementary and Secondary Education Act* would support these transitions and teaching and learning at the elementary level in a number of ways. Programs supporting educator professional development (including College- and Career-Ready Students and the Effective Teachers and Leaders programs) would include joint professional development activities for school staff and early childhood educators. The Effective Teachers and Leaders program would support activities that expand the knowledge of elementary school principals about appropriate and effective instructional strategies, interventions, and programs for young children. Our proposal also recognizes the importance of a great teacher in every classroom by promoting successful and innovative pathways into teaching and bold approaches to recruiting, developing, retaining, and rewarding effective teachers in high-need schools, including teachers of young children. Our proposal would continue to require districts to coordinate with early learning programs and services to improve school readiness and would allow them to use Title I funds to do so. Our proposal also supports State efforts to develop and strengthen evidence-based comprehensive preschool-through- grade-12 literacy and science, technology, engineering and mathematics (STEM) plans.

Several components of the Early Learning Challenge Fund program – State early learning standards, high-quality comprehensive assessment systems, and effective workforce development systems – would help strengthen the transition from early learning programs to elementary school. Birth-to-kindergarten-entry State early learning standards would not only be evidence-based, address multiple domains, and be developmentally appropriate – but they would be aligned with K-3 standards. For example, valid and reliable school readiness assessments can inform educators in the preschool and early elementary settings by conveying information on children's abilities across a range of domains. Joint professional development for early learning educators who serve preschool- and early-elementary-aged children can increase the strength of the connection between preschool and early elementary school. These are a few of the components of a high-quality early learning infrastructure that the Administration seeks to support under the Early Learning Challenge Fund.

TEACHER AND SCHOOL LEADER EVALUATION SYSTEMS

Question. The Department of Education proposal calls for the development of measures and definitions of effective and highly effective teachers and principals. How would these systems be developed, and what role do you see teachers' organizations playing in these systems, and the development of these systems?

Answer. States receiving funding under the Effective Teachers and Leaders State Grants program would be required to define different levels of teacher and principal performance. Teachers' evaluations would be based in significant part on student growth, along with other measures such as multiple observation-based evaluations of teacher performance. Principals' evaluations would also be based in significant part on student growth, along with other measures such as evidence of providing strong instructional leadership and fostering positive family and community engagement.

Each local educational agency (LEA) that receives a subgrant under this program would need to develop and implement, with teacher and principal involvement, a State-approved evaluation system that would differentiate levels of teacher and principal performance, consistent with the State's definitions; provide meaningful feedback for improvement to teachers and principals on the results of their evaluations; and inform decisions about professional development and retention (including, as applicable, about tenure and about certification or licensure).

The Administration is committed to working with teachers, school leaders, and their representatives to enhance the education profession. Last month, we held the first conference on labor-management collaboration in the history of the Department. Our budget request and Elementary and Secondary Education Act reauthorization proposal similarly reflect our commitment to this goal. The ESEA reauthorization proposal for Title II-A would require States and LEAs to work with teachers, principals, and representatives of these groups in designing and implementing evaluation systems and conducting assessments of LEAs' needs.

CAREER AND TECHNICAL EDUCATION

Question. At a recent event highlighting the release of Harvard University's Pathways to Prosperity report, you said, "First, for far too long, CTE has been the neglected stepchild of education reform. That neglect has to stop. And second, the need to re-imagine and remake career and technical education is urgent. CTE has an enormous if often overlooked impact on students, school systems, and our ability to prosper as a nation." However, your budget cuts funding for these programs by over 20 percent.

What steps has the Department of Education taken to assist schools and districts in offering more high-quality CTE programs?

Answer. The Department has a key role in promoting best practices and in encouraging dissemination of good ideas among States. Unfortunately, the current structure of the Perkins Act does not provide sufficient authority for ensuring that high-quality CTE is the standard among every State that receives Perkins funding. Despite this constraint, the Department uses national activities funding to promote innovation, provide technical assistance, and encourage best practice; activities that help States, districts, and schools improve the quality of their CTE programs. We routinely conduct technical assistance and monitoring activities to help States implement the requirements of the Perkins Career and Technical Education Act and improve the quality of their programs. Our Office of Vocational and Adult Education (OVAE) conducts onsite monitoring visits to approximately 10-12 States a year, and those visits include technical assistance to States on program improvement. In addition, OVAE selects up to 8 States to receive individualized, intensive technical assistance each year.

Further, last year the Department made grant awards to 12 States, totaling about $3 million to date, to implement high-quality "programs of study." Programs of study are coherent sequences of non-duplicative CTE courses that progress from the secondary to the postsecondary level, include rigorous and challenging academic content along with career and technical content, and lead to an industry-recognized credential or certificate at the postsecondary level or to an associate or baccalaureate degree. Because they require alignment between secondary and postsecondary coursework, as well as alignment with requirements for industry-recognized credentials or postsecondary degrees, we believe that they hold great promise for improving the quality of CTE programs across the country and helping all students graduate from high school college- and career-ready. While the Perkins Act requires all local recipients of State Grant funds to implement at least one program of study, these grants will help States ensure that those programs of study are rigorous and that conditions are in place to implement them successfully. OVAE has also worked with States and other stakeholders to develop a framework that further defines what elements are necessary for a high-quality program of study and has disseminated information regarding the framework.

In addition, the Department funds the National Center for Career and Technical Education, which conducts research and disseminates information about what works in CTE. The Center also conducts technical assistance activities that complement the technical assistance provided directly by the Department.

HIGH QUALITY CAREER AND TECHNICAL EDUCATION PROGRAMS

Question. How do you expect schools to offer more high-quality CTE programs with fewer resources?

Answer. The Federal Government will not strengthen CTE by merely providing funding for CTE programs. What leads to quality CTE programs are efforts to ensure that CTE courses integrate both rigorous academic and technical content, align with industry standards, prepare students to succeed in the next level of coursework, and provide students with a postsecondary credential or degree in a field in which the graduate can obtain a well-paying job and embark on a career. Focusing CTE funding on programs that incorporate all these elements will eventually lead to more high-quality CTE programs being available to students, and these are changes that can happen even within the current environment of limited resources.

QUESTIONS SUBMITTED BY SENATOR WYDEN

RURAL SCHOOLS — i3 AND RACE TO THE TOP COMPETITIONS

Question. I'm concerned about maintaining the quality of rural schools. In particular, rural schools don't have access to the same resources as larger school districts and generally are at a disadvantage when funding is allocated through competitive grants. Can you provide more details on how the i3 program will be implemented in a way that gives a priority to helping rural schools, and how the Race to the Top carve out will function?

Answer. The Department would address the needs of rural areas through the i3 and Race to the Top (RTT) programs by ensuring that a portion of funds goes to rural areas in both programs. We are committed to finding the most promising innovations and bringing them to scale, including innovations designed to address the particular needs and challenges of rural schools and communities. We will also consider other strategies to ensure that rural districts can successfully compete in i3 and other programs, including recruiting and training peer reviewers with rural expertise, providing technical assistance to rural districts, and holding pre-application webinars in which rural school districts will be able to participate.

In the new RTT competition for local educational agencies, we will set aside a portion of the money for rural districts and will structure the selection criteria with the needs of those districts in mind. Over the next few months, we will be seeking input from stakeholders, including leaders of rural school systems, on the design of the RTT district competition, in order to ensure that the competition reflects the needs and priorities of rural districts.

RURAL SCHOOLS AND COMPETITIVE GRANT PROGRAMS

Question. Beyond the Race to the Top and i3 programs, are there any other examples of competitive grant programs that will take into account the differences between rural and non-rural schools and help make sure that rural schools don't get left behind?

Answer. As in FY 2010 and planned for FY 2011, Promise Neighborhoods would have an absolute priority for rural applicants. In addition, the FY 2011 SEA competition under the Charter Schools program will provide a competitive priority for proposals that aim to improve high school graduation and college enrollment rates for students in rural LEAs.

In addition, on December 15, 2010, we published a Federal Register notice establishing supplemental priorities for the Department's competitive grant programs. In that notice, we established a priority for projects that aim to improve the achievement and high school graduation rates in areas of need, including local educational agencies in rural areas. We intend to implement this priority aggressively, and in FY 2011 and future years will use it in competitions in various program areas.

SCIENCE, TECHNOLOGY, ENGINEERING AND MATHEMATICS EDUCATION

Question. I believe STEM education is critical to U.S. competitiveness, and I applaud your budget's goal to invest $80 million dollars to prepare new STEM teachers. Clearly the Department has identified STEM education as an area in which the number of U.S. students graduating is not sufficient. Based on the research and studies you've seen, what is your estimation of how large the shortfall is in U.S. students needed to meet the workforce demand for STEM graduates?

Answer. As the National Academies noted in Rising Above the Gathering Storm, Revisited (2010), the issue is not merely the number of students who graduate with STEM degrees or work in STEM-specific jobs, it also involves the lack of mathematics and science proficiency in the general workforce. A 2009 survey by Deloitte Consulting found that nearly one-third of companies surveyed reported worker skills shortages, particularly for production workers, scientists, and engineers, and noted that having a highly skilled, flexible workforce was critical to business success.

Concerns about producing insufficiently skilled workers will only increase in the future due to economic changes that increase the educational requirements of new and existing jobs. The Bureau of Labor Statistics (2009), when projecting employment growth to 2018, predicts that growth will be fastest among occupations that generally require postsecondary education, and many of these occupations are in STEM or STEM-related fields. For example, the BLS predicts rapid growth among computer and mathematical science occupations, which will add 785,700 new jobs over the decade from 2008 to 2018, with additional jobs made available by retirements. Employment growth also will increase for healthcare professionals, with approximately 581,500 new jobs anticipated for registered nurses alone and 1,039,000 anticipated due to both new job creation and replacement needs.

WORKFORCE DEMAND FOR STEM GRADUATES

Question. Currently there is a high demand for foreign graduates with STEM degrees in the U.S. workforce. For example, the annual allotment of H-1B visas for this year was exhausted by the third week of January. With the investment you are making in STEM education, do you anticipate a point at which U.S. graduates will meet the workforce demand, or do you believe foreign students will continue to be needed in the STEM workforce for the foreseeable future?

Answer. While we would anticipate that the increased production of STEM postsecondary graduates will help to meet the existing demand, we would also hope that the influx of new college graduates would result in creative endeavors that expand employment and further increase demand for highly skilled STEM workers. And, we would also expect many students from other countries who have come to America for their university education to want to remain in America, becoming citizens and contributing to our long-term economic well-being, as have many before them.

QUESTIONS SUBMITTED BY SENATOR SESSIONS

PELL GRANT APPROPRIATIONS

Question. In its FY 2011 budget request, the Administration proposed making the Pell Grant program an entitlement. Congress did not embrace this proposal and instead favored keeping the current structure of a maximum award made up of both discretionary and mandatory funding. Using the most up-to-date figures, how much would Congress need to appropriate to ensure that the discretionary portion of the Pell Grant, $4,860, is fully funded for academic year 2011-2012?

Answer. In order to fully fund Pell Grants in award year 2011-2012, a $28.2 billion appropriation would be necessary. Additionally, it is estimated that award year 2012-2013, which is funded through FY 2012 appropriations, will require a $31.2 billion appropriation. These figures assume the policy proposals in the President's FY 2012 budget request, including the elimination of the two Pells policy, are adopted. If the changes proposed in the President's budget are not adopted in full, the funding required for Pell Grants would instead be $31.6 billion in 2011-2012, and $35.4 billion in 2012-2013.

PROJECTED PELL GRANT MANDATORY APPROPRIATIONS

Question. The Healthcare and Education Reconciliation Act of 2010 changed how the mandatory add-on for the Pell Grant program would be determined and funded in the future. Unlike previous years, when specified awards and appropriations were made in statute, the reconciliation bill provided indefinite mandatory appropriations and put a formula in place, beginning in 2013, that would decide the amount of the mandatory add-on based on the previous year's maximum award and the rate of change of CPI. This formula would remain in place until FY 2018, when the mandatory would then remain at FY 2017 levels.

When the reconciliation bill passed last year, it was projected that the maximum award would reach $5,975 (a combined $4,860 from discretionary and $1,115 in mandatory add-on) by FY 2017. Based on your new assumptions, what will the mandatory add-on be for each year of the FY 2012-2021 period?

Answer. The table below displays the Department of Education's projections for the Pell Grant program's mandatory add-on award. It includes the add-on total estimated at the time of enactment of the Health Care and Education Reconciliation Act of 2010, as well as the most current estimates. At the time of enactment the mandatory add-on for FY 2017 was expected to be $1,270; current estimates predict the mandatory add-on will be $1,250 in FY 2017.

Pell Grants Mandatory Add-On (based on $4,860 base)

Academic Year	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022
Time of Enactment	$690	$800	$915	$1,030	$1,150	$1,270	$1,270	$1,270	$1,270	$1,270
Current Estimate	$690	$790	$895	$1,010	$1,125	$1,250	$1,250	$1,250	$1,250	$1,250

CUMULATIVE PELL GRANT PROGRAM COST – FISCAL YEARS 2012-2021

Question. Over the FY 2012-2021 period, how much will we cumulatively spend on the Pell Grant program? Please provide a year-by-year breakdown of projected spending, showing both discretionary and mandatory funding streams.

Answer. The tables included below show expected program costs for the Pell Grant program as estimated under the President's FY 2012 budget request (first table), and estimated program costs under current program conditions (second table).

The President's Budget program cost table provides detailed information split between 'base award' and 'add-on' rather than 'discretionary' and 'mandatory'. This distinction is made because the policy, as proposed in the President's budget, states that mandatory savings from other programs will be appropriated back to the Pell Grant program to help offset discretionary Pell Grant costs. This break-out best depicts what appropriations levels will be necessary to fully fund the program.

PELL GRANT DISCRETIONARY AND MANDATORY PROGRAM COSTS

As displayed below, the total discretionary and mandatory program costs for the Pell Grant program over the next 10 years is estimated to be $410.2 billion under the President's budget. In comparison, baseline program costs for Pell (calculated with no changes in policy) over the same period of time total $467.2 billion.

Pell Program Costs (President's Budget)
(dollars in billions)

Academic Year	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022	10-year Total
Base Award	$31.226	$31.100	$31.575	$31.945	$32.371	$32.795	$33.231	$33.642	$34.133	$34.649	$326.667
Add-On	4.895	5.628	6.528	7.533	8.574	9.723	9.900	10.069	10.243	10.408	83.501
Total	**36.121**	**36.728**	**38.103**	**39.478**	**40.945**	**42.518**	**43.131**	**43.711**	**44.376**	**45.057**	**410.168**

Pell Program Costs (Baseline)
(dollars in billions)

Academic Year	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022	10-year Total
Discretionary	$35.426	$35.382	$35.963	$36.423	$36.949	$37.474	$37.998	$38.500	$39.045	$39.645	$375.805
Mandatory	5.471	6.309	7.328	8.487	9.685	11.008	11.225	11.435	11.634	11.832	94.414
Total	**40.897**	**41.691**	**43.291**	**44.91**	**46.634**	**48.482**	**49.223**	**49.935**	**50.679**	**51.477**	**467.219**

ELIMINATION OF THE INTEREST SUBSIDY FOR GRADUATE STUDENTS

Question. The President's budget request would eliminate the "in-school interest subsidy" on Federal student loans for graduate and professional students. The President's proposal would end the benefit of having subsidized loans, loans on which interest does not accrue until after a student leaves school, arguing that the benefit does not encourage students to attend graduate school and is not well-targeted to borrowers who need extra repayment help. These arguments appear to apply just as well to the in-school interest subsidy for undergraduate students as they do for graduate students. In fact, the President's National Commission on Fiscal Responsibility and Reform agreed and proposed ending subsidized loans for both student populations.

Why has the Administration not followed through on the President's Fiscal Commission's student loan proposal and instead proposed only to eliminate the benefit for graduate students?

Answer. A key purpose for proposing the elimination of interest subsidies to graduate and professional students is the benefit it will provide the Pell Grant program, through the appropriation of realized savings from this policy change to the Pell program. This funding is expected to lead to a reduced discretionary request for the Pell Grant program in future years, and helps to protect the existing $5,550 maximum award.

The Administration feels eliminating the interest subsidy to graduate students is sensible because graduate and professional students are more likely to earn higher salaries after graduating, and thus have the means to pay off the additional interest that accrues from an unsubsidized loan. Additionally, fellowships and other assistantships that reduce a students' need to take out loans to fund their education are more prevalent at the graduate and professional level. Further, undergraduate loan debt is already a growing problem for the Nation. While income-based repayment and public service loan forgiveness make that debt more manageable, loan subsidies for undergraduate students do lower the overall amount borrowed. Given that graduate students are likely to earn more over the course of their career, continued subsidies for these loans is far less defensible in the face of growing needs for low-income students seeking to earn their first degree.

AN EXPANDED PERKINS LOAN PROGRAM

Question. The Administration supports creating an expanded Perkins Loan program that would provide $8.5 billion in new loan volume annually, nearly nine times the current annual Perkins volume. The new Perkins loans would go out to over 3 million students and carry the same interest rate as Unsubsidized Stafford loans, 6.8 percent. According to OMB, this proposal would save $7.4 billion over 10 years.

How does expanding the Perkins Loan program save money?

Answer. Any costs associated with the Perkins Loan program are calculated using standards established in the Federal Credit Reform Act. Under this Act, Perkins Loans (as well as other loan programs) are reflected in the financial statements on a net present value basis. This method discounts all future costs over the period of origination through repayment, reflecting the time value of money, and displays those costs in the year the loan is originated.

FAIR-VALUE SCORING – LOAN PROGRAM COST ESTIMATION

Question. Have the Department of Education and OMB discussed the effects of scoring this legislation with "fair-value" scoring, instead of the deficient credit reform methodology?

Answer. Both the Administration and the Congressional Budget Office estimate loan programs costs using standard loan-valuation procedures mandated by the Federal Credit Reform Act. Through the estimation process the Administration considers current and projected economic conditions when estimating future events such as loan defaults and recovery and loan cancellations. The Administration has confidence in both the savings estimate required by law for student lending and in the methodology used to generate that estimate.

FAIR-VALUE SCORING – PERKINS LOAN PROGRAM

Question. If the "fair-value" scoring showed that expanding the Perkins Loan program actually incurred costs for the Federal Government, would the Department still view it as appropriate to use the false credit reform savings to pay for Pell Grants, as proposed under the Pell Grant Protection Act?

Answer. The Administration believes using the current credit reform process as a basis for cost estimation produces a reasonable savings estimate. Expanding and modernizing the existing Perkins Loan program is a worthwhile pursuit, particularly because it is able to simultaneously achieve two goals: provide additional resources to a greater number of students to help them pay for college; and reinvest savings from the program to continue to provide Pell Grants for those students with greatest need.

QUESTIONS SUBMITTED BY SENATOR CORNYN

EDUCATION JOBS FUNDS

Question. I understand that of the $10 billion that Congress appropriated for the Education Jobs Fund about $975 million remains unobligated. Of this amount, what assurances can you provide that the funds will be available to be allocated to the State of Texas or any other State? What does the Department intend to do with the remaining

Education Jobs funds, if no further awards are made; will the unobligated Education Jobs funds be returned to the Treasury?

Answer. During the period of availability, the Department expects the unobligated funds to be available to be allocated to Texas and South Carolina until those States submit approvable applications or submit a letter to the Department declining the funds. We will continue to work with Texas and South Carolina to deliver these funds to school districts that need them to retain or create education jobs. If no further awards are made, the funds would return to the Treasury at the end of fiscal year 2011.

EDUCATION JOBS FUNDS – TEXAS APPLICATION

Question. The House-passed continuing resolution (HR 1) included an amendment that prohibits the Department from using any funds to implement the special provisions for Texas in the Education Jobs Fund law. If this language is adopted by Congress, is it your opinion that the Governor is still required to provide assurances that he is constitutionally prohibited from making?

Answer. The amendment would not negate the statutory requirements of the Education Jobs Fund. The Department would continue to be required by law to adhere to the requirements of the Education Jobs statute.

Question. Given that the deadline for the State's application has passed, what specific language does the Department require from the Governor in order to disburse the Education Jobs funds under the alternative method?

Answer. The Education Jobs Fund statute requires that the Governor make assurances that the State will: (1) distribute the Education Jobs funds based on local educational agencies' relative shares of funds under part A of title I of the Elementary and Secondary Education Act of 1965 for the most recent fiscal year which data are available, and (2) for fiscal years 2011, 2012, and 2013, maintain State support for elementary and secondary education at a percentage of the total revenues available to the State that is equal to or greater than the percentage provided for such purpose for fiscal year 2011 prior to the enactment of this Act. These requirements apply whether the Governor applies directly to the Department or whether an eligible entity under the alternate distribution language applies for the funds. The Department is bound by this statutory language.

CAROL WHITE PHYSICAL EDUCATION PROGRAM

Question. The Budget request includes a plan to consolidate a number of grant programs, including the Carol White Physical Education program (PEP), into a new "Successful, Safe, and Healthy Students Initiative." Given the Administration's focus on promoting physical fitness and reducing childhood obesity, how does the Department intend to promote physical education opportunities for students and help students make progress toward meeting State standards for physical fitness? Does the Department intend to sustain or exceed the current level of grant funding to local educational agencies (LEAs) and community-based organizations (CBOs) to initiate, expand or enhance physical education programs, including after-school programs, for K-12 students?

Answer. As you indicate, the Administration intends to promote physical education and fitness opportunities for youth through the proposed Successful, Safe, and Healthy Students program. Generally, the same entities that are eligible for PEP grants would be eligible to apply for grants and subgrants to conduct similar activities under this new program, which, in FY 2012, we propose at the same funding level as the FY 2010 total for the programs (including PEP) proposed for consolidation.

We believe the new, consolidated program would not only reduce the application and administrative burden on eligible entities and grantees, but enable States and districts to address issues of physical education, student health, drug and alcohol use, and school climate in a more comprehensive and effective manner. A single funding stream would allow grantees to provide more coordinated services that best reflect the needs of their students and their communities.

TEACHER TRAINING – TEACH FOR AMERICA PROGRAM

Question. In the budget, you have proposed consolidating a number of highly effective national education programs under the new "Teacher and Leader Pathways" program. Among the programs affected by this proposal is Teach For America (TFA), an outstanding program with a demonstrated record of success. It appears that the consolidation shifts funds from programs with a demonstrated record of success to new government programs. How do you propose ensuring that Teach For America and other proven national education programs have access to Federal funding that will enable them to grow and increase their impact?

Answer. Our 2012 budget consolidates 38 existing authorities into 11 new programs that give States and districts more flexibility to use resources to improve outcomes in their communities, and that award competitive grants based on the programs' record of success. The budget requests $3.25 billion for the Excellent Instructional Teams initiative, which would fund States and districts in promoting and enhancing the education profession and improving teacher and principal effectiveness. Under this proposal, Teach For America, which in fiscal year 2010 received an $18 million non-competitive award, would be eligible to compete for $250 million in funding under the new Teacher and Leader Pathways program. This program would fund States, districts, institutions of higher education, and nonprofits in creating or expanding programs that recruit and prepare teachers for high-need schools and subject areas. Awards would be granted based on the quality of the plan and the applicant's record of results.

In addition, Teach For America could compete for $300 million in funding under the Investing in Innovation program, through which Teach For America received $50 million in fiscal year 2010. The Investing in Innovation program awards grants to districts and nonprofits on the basis of their evidence base, with promising programs eligible for smaller awards to develop and refine their model, and programs with strong results eligible for significant expansion funding. Teach For America could also partner with States and districts in their applications for funds under the Race for the Top program, for which $900 million is requested for 2012, and States and districts may also use the funds they receive under the Effective Teachers and Leaders State grants program, for which $2.5 billion is requested, to support Teach For America projects.

I firmly believe that our proposal would not only help States and districts to ensure that effective teachers and principals are equitably distributed among schools throughout the Nation, but would also expand the pool of funds for which nonprofit organizations, including both Teach For America and other effective programs, who commit to helping them achieve this goal could apply. Like you, I appreciate the great work that Teach For America has done placing dedicated, effective teachers in rural and urban school districts across the country. I believe, however, that the fairest and most effective way of allocating scarce Federal funds is through a rigorous, objective process that prioritizes State and local flexibility and evidence-based decision making.

PROGRAM INTEGRITY REGULATIONS

Question. I understand that the Department has issued new program integrity regulations designed to prevent waste, fraud, and abuse in higher education programs. Concerns have been raised by institutions of higher education (IHEs) in a number of States, including Texas, that participate in tuition-sharing agreements with service companies to provide academic programs and services to students. Is it the Administration's intention to prevent tuition-sharing agreements between universities and service companies that provide services relating to enrollment, retention, student success coaching, and similar services; and would you clarify the conditions under which tuition-sharing arrangements are permitted?

Answer. The Department is aware of issues surrounding tuition-sharing that have surfaced in relation to the program integrity regulations. The Department is in the process of developing a Dear Colleague Letter that will address the circumstances where tuition-sharing may be permissible.

QUESTIONS SUBMITTED BY SENATOR GRAHAM

DIRECT LOANS

Question. The projected savings generated by the Direct Loan program seem largely dependent on the actions of borrowers. Will the United States Department of Education actively encourage borrowers to abandon their current loan providers in favor of the Direct Loan program?

Answer. The Administration will continue to encourage those students looking for ways to fund their education to exhaust grant and other aid that does not need to be repaid before taking out a student loan. Existing borrowers who may be eligible for the debt conversion policy will be notified by the Department of Education of their eligibility, but participation in the program will be up to the borrower. It is currently estimated only one-third of those borrowers who are eligible will take part in debt conversion. Borrowers who do not already have at least one loan held by the Department (either a Direct Loan or one acquired through ECASLA) will not be eligible. Loans that are transferred as part of the debt conversion program will not become direct loans; they will, however, be serviced by one of the Department's servicers.

COLLEGE ACCESS AND COMPLETION PROGRAMS

Question. State-based and non-profit student loan providers often have effective and robust college access and completion programs. Will State-based and non-profit student loan providers be able to compete in the Administration's "First in the World" (FITW) proposal?

Answer. Only projects proposing innovative strategies to improve higher education that are authorized under section 741(a) would be eligible for funding under the FITW competition. The objective of the First in the World competition is to spur the field to come up with innovative strategies to improve productivity in higher education while addressing the completion challenge, to build evidence on practices that have been shown to be effective in improving educational outcomes for students, and to scale up successful strategies. The first year of the competition would include priorities for projects that demonstrate the potential to reduce the net price paid by students, improve learning outcomes, reduce time to degree, reduce instructional costs, or improve college access or completion rates.

The competition would be conducted under Title VII, Part B of the HEA, which authorizes the Fund for the Improvement of Postsecondary Education. Under FIPSE, a broad range of institutions would be eligible for FITW grants, including institutions of higher education and other public and private nonprofit institutions and agencies.

DEBT CONVERSION PROGRAM

Question. Does the Direct Loan program offer debt conversion to any Federal Family Education Loan Program (FFEL) loan; or, is debt conversion to the Direct Loan program limited to FFEL loans owned by the Department of Education through the PUT and Participation interest programs?

Answer. Borrowers who are eligible for debt conversion must have at least one FFEL loan and at least one loan held by the Department of Education. The loan held by the Department can be either a Direct Loan or a loan acquired by the Department through the Loan Purchase or Loan Participation Purchase programs. Borrowers whose entire student loan portfolio is FFEL loans held by lenders are not eligible to participate. In this way, the program realizes its goal of creating an easier repayment process – and decreasing their likelihood of borrower default – by allowing borrowers with split servicers to pool their debt into one servicer.

THE PRESIDENT'S FISCAL YEAR 2012 BUDGET REQUEST FOR THE DEPARTMENT OF ENERGY

WEDNESDAY, MARCH 2, 2011

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, Nelson, Stabenow, Cardin, Whitehouse, Merkley, Begich, Sessions, Enzi, Cornyn, Thune, Portman, and Johnson.

Staff present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

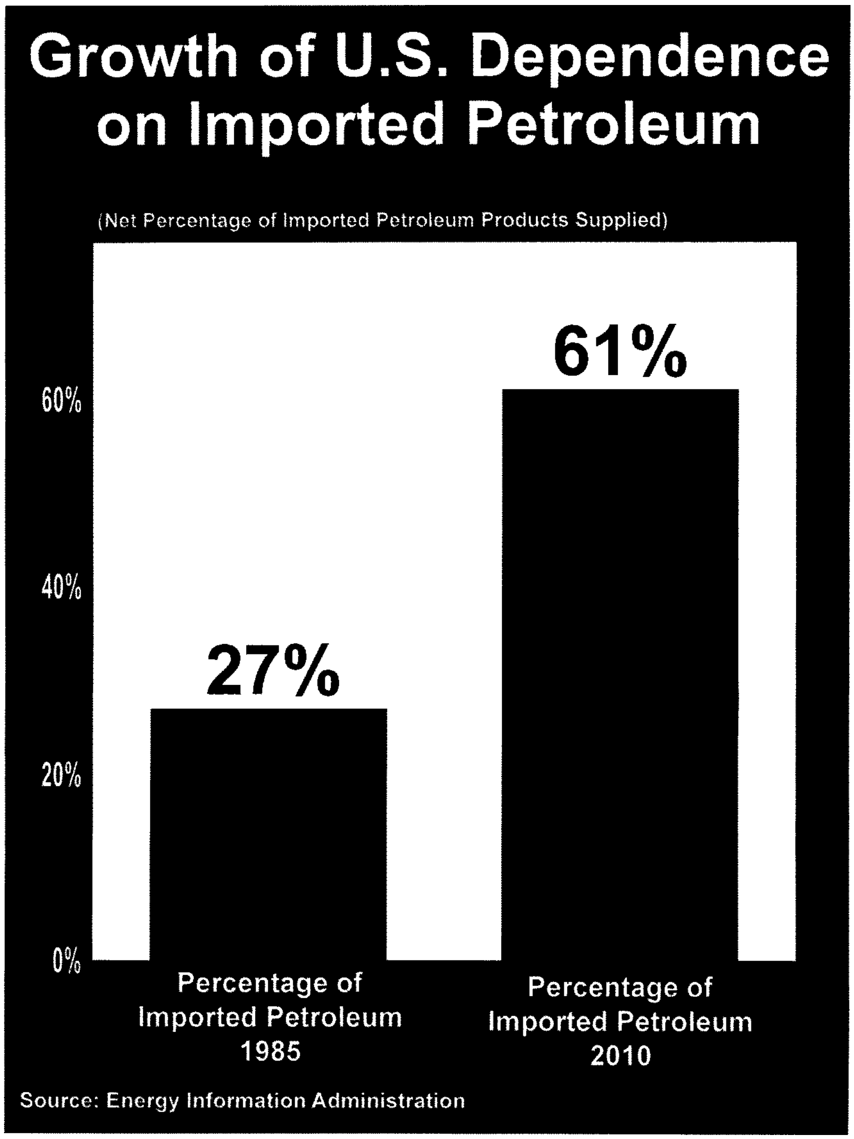
Chairman CONRAD. The Committee will come to order.

I would like to welcome everyone to the Senate Budget Committee this morning. Our witness today is Secretary of Energy Steven Chu, and our focus will be on the energy budget.

Secretary Chu has done, in my judgment, an excellent job leading the Energy Department. We are very lucky to have someone of his capability and character leading that agency at this time, and we are pleased that he could join us and look forward to his testimony.

I believe the two biggest challenges facing the country right now are the rising Federal debt and our dependence on foreign sources of energy. We simply will not be able to remain globally competitive if we fail to address both of these challenges. Our competitors in Asia and Europe are moving quickly to develop and adopt alternative and clean energy technologies. These technologies will be among the biggest industries in the world in the years ahead. We cannot afford to fall behind. The United States should be a leader, not a follower on energy issues.

So even as we look to cut spending to bring down the deficit, something that we must do, we also need to ensure that energy remains a priority. We need to focus resources on energy programs that promote clean energy and energy efficiency and that encourage private sector innovation and the adoption of new technologies. And we need to ensure that every dollar we spend on energy is spent wisely.



The fact is we are dangerously dependent on foreign oil. In 1985, we imported only 27 percent of our petroleum. We now import over 60 percent. As a result, we are increasingly vulnerable to oil supply disruptions and instability in other parts of the world.

The events of recent weeks have demonstrated just how much this dependence can impact our economy as turmoil in North Africa and the Middle East has led to a spike in gas prices and fluctuations in other markets.

This addiction to foreign oil is also a threat to our national security. Many of the countries from which we import petroleum are unstable or in unfriendly regions, and many are becoming more unstable by the day or risk being affected by unrest in neighboring countries.

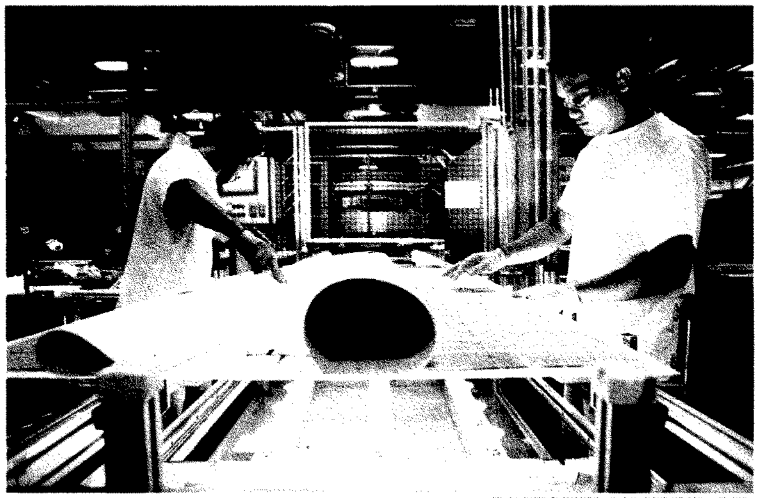
Top 10 Countries Exporting Petroleum to the United States in 2010

	Barrels Per Day
Canada	2,516,000
Mexico	1,272,000
Saudi Arabia	1,094,000
Nigeria	1,021,000
Venezuela	993,000
Russia	620,000
Algeria	509,000
Iraq	421,000
Angola	397,000
Colombia	377,000

Source: Energy Information Administration
Note: Year-to-date through November, 2010

Here is a list of the top ten countries exporting petroleum to the United States in 2010 and the number of barrels we import from those countries in a single day. You can see that we have large quantities of oil from countries like Saudi Arabia, Nigeria, Venezuela, Algeria, Iraq, Angola, and Colombia.

The New York Times
SATURDAY, JANUARY 15, 2011



Evergreen Solar plans to close its main American factory, in Devens, Mass., seen here in September, and lay off 800 workers.

A Better Offer From China

Despite Massachusetts Millions, Solar Panel Maker to Shut Plant

By KEITH BRADSHER

BEIJING — Aided by at least $43 million in assistance from the government of Massachusetts and an innovative solar energy technology, Evergreen Solar emerged in the last three years as the third-largest maker of solar panels in the United States.

But now the company is closing its main American factory, laying off the 800 workers by the end of March and shifting production to a joint venture with a Chinese company in central China. Evergreen cited the much higher government support available in China.

The factory closing in Devens, Mass., which Evergreen announced earlier this week, has set off political recriminations and finger-pointing in Massachusetts. And it comes just as President Hu Jintao of China is scheduled for a state visit next week to Washington, where the agenda is likely to include tensions between the United States and China over trade and energy policy.

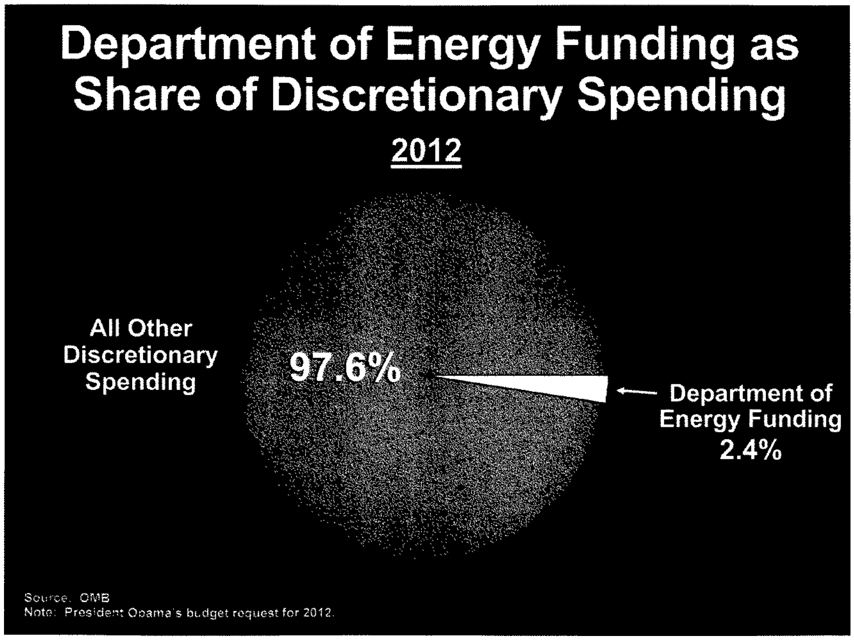
The Obama administration has been investigating whether China has violated the free trade rules of the World Trade Organization with its extensive subsidies to the manufacturers of solar panels and other clean energy products.

While a few types of government subsidies are permitted under international trade agreements, they are not supposed to give special advantages to exports — something that China's critics accuse it of doing. The Chinese government has strongly denied that any of its clean energy policies have violated W.T.O. rules.

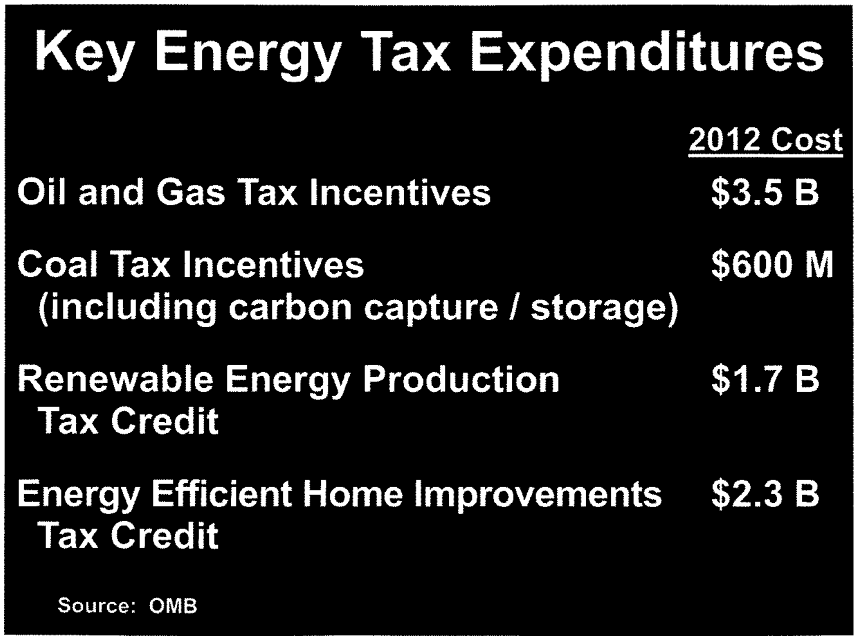
Although solar energy still accounts for only a tiny fraction of American power production, declining prices and concerns about global warming give solar power a prominent place in United States plans for a clean energy future — even if critics say the federal government is still not doing enough

Continued on Page 4

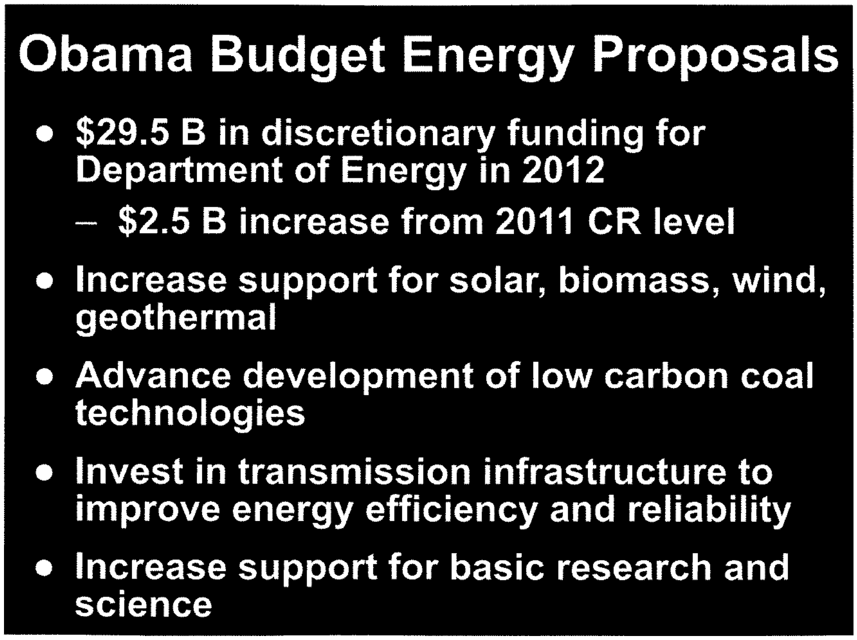
At the same time we are losing ground in the race to develop the clean energy resources of the future. We are being left behind by countries like China and India. Here is a New York Times article from earlier this year about how the third largest manufacturer of solar panels in the United States has packed up, moved its operations, and hundreds of skilled jobs to China. According to the article, the company moved because China provided "much higher government support." That is troubling. We need to keep those jobs here in America.



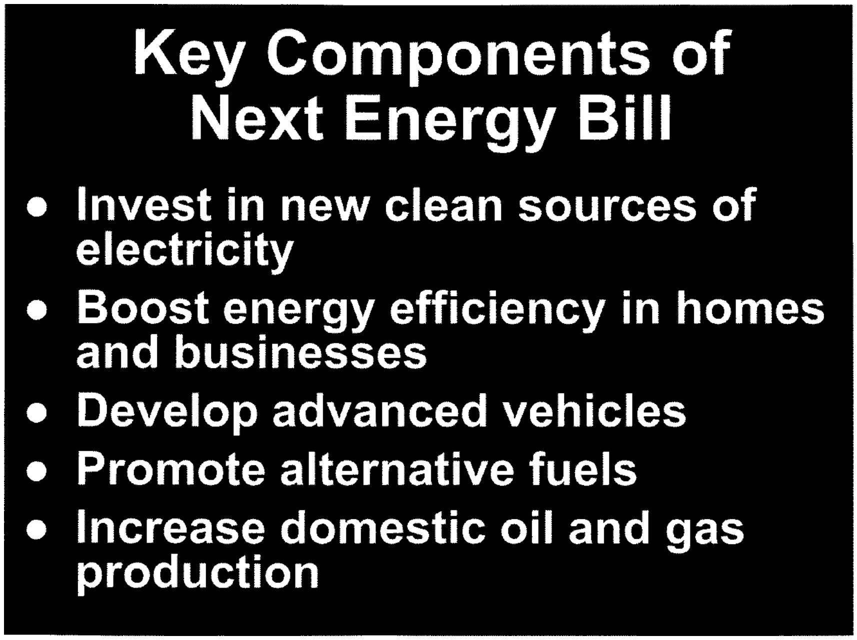
This next chart helps put our energy funding in some perspective. It shows that funding for the Department of Energy represents a small fraction of Federal spending, only 2.4 percent of the discretionary budget. Let me repeat that: 2.4 percent. And roughly two-thirds of that is dedicated to nuclear weapons-related activities. So funding to promote and support new energy technologies represents a tiny fraction of the Federal budget.



But we also spend between $8 and $10 billion a year on energy through the Tax Code by providing certain energy tax incentives and credits. The largest of these include oil and gas tax incentives, coal tax incentives, a renewable energy production tax credit, and an energy-efficient home improvements tax credit. Those are the four big expenditure items in the Tax Code.



This is what the Obama administration has proposed in its budget for energy. Overall, the budget requests $29.5 billion in discretionary funding for the Department of Energy for 2012. This represents a $2.5 billion increase over the 2011 continuing resolution level. Among other things, the President's budget would increase support for clean energy alternatives, such as solar, biomass, wind, and geothermal, advance development of low-carbon coal technologies, invest in the Nation's transmission infrastructure to improve energy efficiency and reliability—something that we clearly need—and increase support for basic research and science.



The President's budget supports many of the same initiatives that I would like to see in the next energy bill. I believe the next energy bill needs to invest in clean sources of electricity, boost energy efficiency in homes and buildings, help reduce our dependence on foreign oil by develop advanced vehicles and promoting alternative fuels, and by increasing domestic oil and gas production.

I believe we have to have a balanced plan. I was part of the group of ten—five Democrats, five Republicans—that proposed a far-reaching, balanced plan to reduce our dependence on foreign energy, including increasing domestic production of oil and gas, clean coal technology, advanced battery technology, a move to use natural gas in our bus and truck fleets, incentives for nuclear plants. We already have over a hundred nuclear plants in this country. We are going to have to have more if we are going to dramatically reduce our dependence on foreign energy. At least that is my belief.

I look forward to working with my colleagues on both sides of the aisle on energy legislation this year. I believe it is absolutely a critical priority. It cannot be allowed to slip another year.

With that, I will turn to Senator Sessions for his opening remarks, and then we look forward to hearing from Secretary Chu.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Mr. Chairman, for your leadership and for this series of hearings. I think it has been very helpful to us.

Secretary Chu, thank you for appearing as we continue to discuss the President's budget, and that is the fundamental question here. We all have views on energy policy, and I share many of your views and have supported a number of energy bills that Senator Conrad has referred to.

You are a man of great accomplishment, and I have appreciated getting to know you. But you now hold the job of Secretary of Energy, and energy at an affordable price is essential to our economic future. It is not a theoretical or academic matter.

Right now we are in the midst of a growing fiscal crisis, and it is crucially important that we have an honest conversation about the challenges we face. The President and his Budget Director tell us their budget plan does not add to the debt, that we are living within our means. But the plain fact is the budget doubles our gross national debt, never once produces an annual deficit of less than $600 billion in its 10 years.

The President's Education Secretary told us that the administration was making tough cuts and difficult choices to make our programs leaner and more productive, but the budget called for another 11-percent spike in education funding following a 68-percent increase over the last 3 years.

Perhaps the most consistent spin is the repeated claim that every cent of new Government spending is an investment in our future. Just because you call something an investment does not make it so, certainly not a good investment. If the administration's argument held true, then even our Nation would be thoroughly enriched by this year's spending spree and the $1.65 trillion deficit.

In reality, the most obvious result of what we have done is this massive surge in Federal spending is a crushing debt burden that has grown the Government at the expense of the private sector.

So while your energy budget increases spending substantially, I reject the idea that you have made an investment necessarily in a better future. To the contrary, instead of wisely investing the taxpayers' money, the plan often would waste it. We have magnificent energy resources in this country from which we can create thousands of jobs without adding to the deficit. And yet these resources remain under lock and key. The American people expect fact- based budgeting that produces more energy, not locking it up. The simple fact is that the nearly 10 percent spending increase you have requested in your budget is not being used to produce larger sources of energy that would actually impact the American economy and reduce costs to the American taxpayer, but to chase after the vision of higher-cost sources of energy in the hopes that somehow we can bring those down, which has not been successful to date.

As we contend with a sluggish economy and high unemployment, the plain truth is the actions of this administration are making things worse. The gas prices are rising rapidly, some say to that dangerous level of $4 a gallon. Yet the Interior Secretary issued only one single deepwater drilling permit this year, and only after being found in contempt of court for keeping the moratorium on.

High gas prices exact a painful toll on American families and have historically done significant damage to the economy. The refusal to drill domestically has cost tens of thousands of high-paying jobs and billions of dollars in lost revenue to the Government, to the U.S. Treasury. Offshore drilling rigs are leaving for foreign shores and taking jobs with them. This administration has in the past 2 years revoked oil and gas leases in Utah, Colorado, and Wyoming, and shuttered the Gulf of Mexico. One of the major producers there just declared bankruptcy because they could not get permits to drill in the shallow waters where we have never had a serious problem.

Permits to mine for coal in West Virginia have been withdrawn, and permitting delays have occurred elsewhere with little or no explanation.

The failure of your Department to advance clean, reasonably priced nuclear power has hurt our Nation. We have talked about it. I believe we could have done more. We have to do more.

An estimated 40 percent of our Nation's uranium deposits in Arizona were unilaterally locked up just 2 years ago, leaving us to import 90 percent of the uranium we use.

And the Green Jobs Program, subsidized by the overburdened taxpayers, has never lived up to those promises that have been made about it. Indeed, the much ballyhooed state-subsidized solar panel plan in Massachusetts, I believe the one you referred to, failed in January, costing 800 jobs. It got $58 million from the State.

The experience in Spain cannot be ignored, and the Solyndra, the $535 million loan that the U.S. Government made, seems to be failing already.

A recent study by Bjorn Lomborg's Copenhagen Consensus Center demonstrates that the higher prices and job losses that are the result of green energy policies significantly outweigh the jobs created. The reason is that costs of renewable energy are higher than standard forms of energy so that when they are mandated on the economy, it means more economic inefficiency, higher manufacturing costs, and less disposable income for the American citizens.

So, in summary, Dr. Chu, the President's plan I think worsens a desperate fiscal circumstance and fails to invest by any honest measure in our Nation's real energy future, the challenges we have. America's vast proven energy reserves that we have are not being unlocked, and they are not being acted on apparently in the pursuit of a failed green jobs stimulus plan that has produced neither energy nor jobs. Instead, the President's plan will produce increased spending, increased taxes, increased regulation, increased reliance on foreign oil, and increased debt.

So this plan is a non-starter, and the budget is a non- starter. We do not have the money. So we need to replace it with a plan that actually does invest in our future by producing more low-cost energy that makes it easier on American families, unlocking the vast energy sources that belong to the American people and keeping dollars and jobs in America, making us stronger and not weaker.

So I look forward to working with you on this. I know you are a good man. I know you want to achieve some of these things, and maybe we will have some breakthroughs. I would support some research and development, but I do not support mandated energy programs that drive up the costs that are not yet competitive economically. We have gone too far in that direction.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Again, Mr. Secretary, welcome to the Budget Committee. We look forward to your testimony. Please proceed.

STATEMENT OF THE HONORABLE STEVEN CHU, PH.D., SECRETARY, U.S. DEPARTMENT ENERGY

Secretary CHU. Thank you, Chairman Conrad, Ranking Member Sessions, and members of the Committee. Thank you for the opportunity to appear before you today to discuss the President's fiscal year 2012 budget request for the Department of Energy.

Before I begin my remarks, I want to take a moment to thank Chairman Conrad for his decades of public service and for his tireless efforts to address the big challenges facing our Nation, especially fiscal and energy issues.

Chairman Conrad, I look forward to working with you over the next 2 years and wish you the best as you start a new chapter in your career.

President Obama has laid out a plan for the United States to win the future by outinnovating, outeducating, outbuilding the rest of the world, while at the same addressing the deficit. Many countries are moving aggressively to lead in clean energy, and we must rev up the great American innovation machine to create jobs, win the clean energy race, and secure our future prosperity.

To that end, President Obama has called for increased investments in clean energy research, development, and deployment. In addition, he has proposed a bold but achievable goal of generating 80 percent of America's electricity from clean sources by 2035.

A clean energy standard will provide a clear, long-term signal to industry to bring capital off the sidelines. It will grow the domestic market for clean energy, creating jobs, driving innovation, and enhancing national security. The most competitive clean energy sources will win in the marketplace. The Government does not need to pick favorites.

The Department of Energy's fiscal year 2012 budget request of $29.5 billion supports the President's goals and strengthens the Nation's economy and security. Through programs to make homes and buildings more energy efficient, we will save money for families and businesses by saving energy. In addition, the budget supports the research, development, and deployment of renewable sources of energy; the modernization of the electric grid and the advancement of carbon capture and sequestration technologies; and it helps reduce our dependence on oil by developing the next generation of biofuels and accelerating electric vehicle research and deployment.

We are also requesting a new credit subsidy which will support approximately $1 billion to $2 billion in loan guarantees for renewable energy and energy efficiency technologies, And we are requesting a credit subsidy for a Better Buildings Pilot Loan Guarantee Initiative.

To jump-start the nuclear industry, the budget requests up to $36 billion in loan guarantee authority, while also investing in advanced nuclear technologies, including small modular reactors. To spur innovation, the President's budget invests in basic and applied research and keeps us on a path to doubling funding for key scientific agencies, including the Department's Office of Science.

The budget invests $550 million in the Advanced Research Projects Agency for Energy, known as ARPA-E. The administration also seeks an additional $100 million for ARPA-E as part of the President's Wireless Innovation and Infrastructure Initiative. This investment will allow ARPA-E to continue promising early stage research projects that aim to deliver game-changing clean energy technologies. ARPA-E's projects are generating excitement both in the Department and in the private sector.

For example, through a combined total of $24 million from ARPA-E, six companies in their first year have been able to advance their research efforts and go back to the private sector and show the potential viability of their cutting-edge research. This extremely valuable early support enabled these companies to achieve R&D milestones that in turn have attracted more than $100 million in private sector funds to the projects. This is precisely the innovation leverage that is needed to win the future.

Another key piece of our research effort is the energy innovation hubs. Through the hubs, we are bringing together our Nation's top scientists and engineers to achieve similar game-changing energy goals, but where a concentrated effort over a longer time horizon is needed to establish innovation leadership. The budget requests $146 million to support the three existing hubs and to establish three new hubs in areas of batteries, energy storage, smart grid technologies, systems, and critical materials. The energy innovation hubs were modeled after the Department's Bioenergy Institutes which have established an outstanding 3-year track record.

Finally, the budget continues to support the Energy Frontier Research Centers, which are mostly university-led teams working to solve specific scientific problems that are blocking clean energy deployment and development. When you think of the EFRCs, think about a collaborative team of scientists, such as Watson and Crick unlocking the secrets of DNA. When you think of ARPA-E, think of the visionary risk takers launching new technologies and startup companies out of their garages. When you think of the hubs, think of large mission-oriented research efforts, such as the Manhattan Project, the development of radar at MIT's radiational laboratory during World War II, and the research in America's great industrial laboratories in their heyday.

To reach our energy goals, we must take a portfolio approach to R&D, pursuing several research strategies that have proven to be successful in the past. But I want to be clear. This is not a kitchen-sink approach. This work is being coordinated and prioritized with a 360-degree view of how the pieces fit together. Taken together, these initiatives will help America lead in innovation.

In addition to strengthening our economy, the budget request also strengthens our security by providing $11.8 billion for the Department's National Nuclear Security Administration. The request of $7.6 billion for weapons activities provides a strong basis for transition to a smaller yet still safe, secure, and effective nuclear stockpile without additional nuclear testing. It also provides much needed resources to strengthen science, technology, and engineering capabilities, and to modernize the physical infrastructure of our nuclear security enterprise.

To support the President's goal of securing all vulnerable nuclear materials around the world in 4 years, the budget invests $2.5 billion in the defense nuclear nonproliferation program. Through our investments we are laying the groundwork for the Nation's future prosperity and security. At the same time we are mindful of our responsibilities to the taxpayer.

We are cutting back in multiple areas, including eliminating unnecessary fossil fuel subsidies. We are streamlining operations. We are making some tough choices, including freezing salaries and bonuses for hard-working national laboratory site and facilities management contractor employees.

The United States faces a tough choice today. Will we lead in innovation and outcompete the rest of the world? Or will we fall behind? To lead the world in clean energy, we must act now. We cannot afford not to.

Thank you, and I am now pleased to answer any questions you might have.

[The prepared statement of Secretary Chu follows:]

Statement of Secretary Steven Chu
U.S. Department of Energy
Before the
Senate Committee on Budget

FY 2012 Budget Hearing
March 2, 2011

Chairman Conrad, Ranking Member Sessions, and Members of the Committee, thank you for the opportunity to appear before you today to discuss the President's Fiscal Year 2012 budget request for the Department of Energy.

In his State of the Union address, President Obama laid out a plan for the United States to win the future by out-innovating, out-educating and out-building the rest of the world, while at the same time addressing the deficit. The President's budget request invests in much-needed programs while cutting back where we can afford to.

Many countries are moving aggressively to develop and deploy the clean energy technologies that the world will demand in the coming years and decades. As the President said, this is our generation's "Sputnik moment."

We must rev up the great American innovation machine to win the clean energy race and secure our future prosperity. To that end, President Obama has called for increased investments in clean energy research, development and deployment. In addition, he has proposed a bold but achievable goal of generating 80 percent of America's electricity from clean sources by 2035.

A Clean Energy Standard will provide a clear, long-term signal to industry to bring capital off the sidelines and into the clean energy sector. It will grow the domestic market for clean sources of energy – creating jobs, driving innovation and enhancing national security. And by drawing on a wide range of energy sources including renewables, nuclear, clean coal and natural gas, it will give utilities the flexibility they need to meet our clean energy goal while protecting consumers in every region of the country.

The Department of Energy's FY 12 budget request of $29.5 billion supports these goals and strengthens the nation's economy and security by investing in the following priorities:

- Supporting groundbreaking basic science, research and innovation to solve our energy challenges and ensure that the United States remains at the forefront of science and technology;

- Leading in the development and deployment of clean and efficient energy technologies to reduce our dependence on oil, accelerate the transition to a clean energy economy and promote economic competitiveness; and

- Strengthening national security by reducing nuclear dangers, maintaining a safe, secure and effective nuclear deterrent and cleaning up our Cold War nuclear legacy.

While we are investing in areas that are critical to our future, we are also rooting out programs that aren't needed and making hard choices to tighten our belt. Additionally, we are improving our management and operations so we function more efficiently and effectively.

Leading in the Global Clean Energy Economy

As the President said in his State of the Union address, investing in clean energy will strengthen our security, protect our planet, and create countless new jobs here at home. The Department's budget request invests $3.2 billion in energy efficiency and renewable energy programs.

Through programs to make homes and buildings more energy efficient, including a new "Better Buildings Initiative" to make commercial buildings 20 percent more efficient over the next decade, we will save money for families and businesses by saving energy. That is money that can be re-invested back into the economy. In addition, the budget supports the research, development and deployment of renewable sources of energy like wind, solar and geothermal. It supports the modernization of the electric grid and the advancement of carbon capture and sequestration technologies. And it helps reduce our dependence on oil by developing the next generation of biofuels and accelerating electric vehicle research and deployment to support the President's goal of putting one million electric vehicles on the road by 2015. This includes a $200 million competitive program to encourage communities to invest in electric vehicle infrastructure.

We're also focused on moving clean energy technologies from the lab to the marketplace. Over the past two years, the Department's loan programs have supported more than $26 billion in loans, loan guarantees, and conditional commitments to guarantee loans for 23 clean energy and enhanced automotive fuel efficiency projects across the country, which the companies estimate will create or save more than 58,000 jobs. Building on this success, we are requesting new credit subsidy that will support approximately $1 billion to $2 billion in loan guarantees for innovative renewable energy and energy efficiency technologies. These deployment efforts build on the substantial investment made in the clean energy sector by the Recovery Act, and are supplemented by tax incentives that have also played an important role in bringing clean energy projects to market, such as the 48C manufacturing tax credits and the 1603 cash grants in lieu of investment tax credits, which the 2012 budget also expands. We are also requesting $100 million in credit subsidy for a new "Better Buildings Pilot Loan Guarantee Initiative for Universities, Schools, and Hospitals," which will guarantee up to $2 billion in loans to support energy efficient retrofits.

Nuclear energy also has an important role to play in our energy portfolio. To jumpstart the domestic nuclear industry, the budget requests up to $36 billion in loan guarantee authority. It also invests in the research and development of advanced nuclear technologies, including small modular reactors.

Supporting Groundbreaking Science

To spur innovation, the President's budget request invests in basic and applied research and keeps us on the path to doubling funding for key science agencies, including the Department's Office of Science. As Norm Augustine, former Chairman of Lockheed Martin and former Under Secretary of the Army, has said, under-funding R&D in a time of austerity is like removing the engine of an aircraft to reduce its weight.

That is why the budget request increases support for the Department's comprehensive research strategy to accelerate energy breakthroughs.

Through $5.4 billion for the Office of Science, we're expanding our investment in basic energy sciences, advanced scientific computing and biological and environmental sciences – all key areas for our future economic competitiveness.

The budget invests $550 million in the Advanced Research Projects Agency-Energy, also known as ARPA-E. The Administration also seeks an additional $100 million for ARPA-E from the Wireless Innovation Fund to support wireless clean energy technologies. This investment will allow ARPA-E to continue the promising early-stage research projects that aim to deliver game-changing clean energy technologies. ARPA-E's projects are generating excitement both in the Department and in the private sector. For example, through a combined total of $24 million from ARPA-E, six companies have been able to advance their research efforts and show the potential viability of their cutting-edge technologies. This extremely valuable early support enabled those companies to achieve R&D milestones that, in turn, have attracted more than $100 million in private sector funds to the projects. This is precisely the innovation leverage that is needed to win the future.

Another key piece of our research effort is the Energy Innovation Hubs. Through the Hubs, we are bringing together our nation's top scientists and engineers to achieve similar game-changing energy goals, but where a concentrated effort over a longer time horizon is needed to establish innovation leadership. The Department has established three Energy Innovation Hubs in the areas of energy efficient buildings, modeling and simulation for nuclear reactors and fuels from sunlight. The budget requests $146 million to support the three existing Hubs and to establish three new Hubs in the areas of batteries and energy storage, smart grid technologies and systems, and critical materials. The Energy Innovation Hubs were modeled after the Department of Energy's BioEnergy Institutes, which have established an outstanding three-year track record.

Finally, the budget continues to support the Energy Frontier Research Centers, which are mostly university-led teams working to solve specific scientific problems that are blocking clean energy development.

The Energy Innovation Hubs, ARPA-E, and EFRCs represent three complementary approaches to advance groundbreaking discovery. When you think of the EFRCs, think about a collaborative team of scientists such as Watson and Crick unlocking the secrets of DNA. When you think of ARPA-E, think about visionary risk-takers launching new technologies and start-up companies out of their garages. When you think of the Hubs, think of large, mission-oriented research efforts such as the Manhattan Project, the development of radar at MIT's Radiation Laboratory during World War II and the research in America's great industrial laboratories in their heyday.

We don't know where the big energy breakthroughs are going to come from. To reach our energy goals, we must take a portfolio approach to R&D: pursuing several research strategies that have proven to be successful in the past. But I want to be clear – this is not a "kitchen sink" approach. This work is being coordinated and prioritized, with a 360-degree view of how these pieces fit together. Taken together, these initiatives will help America lead in science and technology innovation.

Nuclear Safety and Security

In addition to strengthening our economy, the budget request also strengthens our security by providing $11.8 billion for the Department's National Nuclear Security Administration. The five-year FY 12 to FY 16 request of nearly $65 billion for NNSA reflects the President's nuclear security priorities, as well as his commitment to modernize the U.S. nuclear weapons enterprise and sustain a strong nuclear deterrent for the duration of the New START Treaty and beyond.

The request of $7.6 billion for Weapons Activities provides a strong basis for transitioning to a smaller yet still safe, secure and effective nuclear stockpile without additional nuclear testing. It also provides much-needed resources to strengthen science, technology and engineering capabilities and to modernize the physical infrastructure of our nuclear security enterprise.

The President has identified the danger of terrorists getting their hands on nuclear weapons or the material to build them as the greatest threat to global security. To support the President's goal of securing all vulnerable nuclear material around the world in four years, the budget invests $2.5 billion in the NNSA Defense Nuclear Nonproliferation program. This is part of a five-year, $14.2 billion commitment for the program.

The budget also requests $1.2 billion to support the Navy's nuclear powered submarines and aircraft carriers. And it provides $6.1 billion to protect public health and safety by cleaning up the nation's Cold War nuclear legacy.

Fiscal Responsibility

Through our investments, we are laying the groundwork for the nation's future prosperity and security. At the same time, we are mindful of our responsibility to the taxpayer.

We are cutting back in multiple areas, including eliminating unnecessary fossil fuel subsidies, reducing funding for the Fossil Energy program and reducing funding for the hydrogen technology program. We're streamlining operations to reduce administrative costs. And we're making some painful cuts, including ending operation of the Tevatron accelerator and freezing salary and bonuses for hard-working National Laboratory, site and facility management contractor employees.

Finally, we continue to make progress on a management excellence agenda to improve our operations.

The United States faces a choice today: will we lead in innovation and out-compete the rest of the world or will we fall behind? To lead the world in clean energy, we must act now. We can't afford not to.

Thank you, and now I am pleased to answer any questions you may have.

HIGHLIGHTS OF THE FY 2012 BUDGET REQUEST

In his State of the Union address, President Obama said that America faces "our generation's Sputnik moment" and that we need to out-innovate, out-educate and out-build the rest of the world to capture the jobs of the 21st century. "In America, innovation doesn't just change our lives. It's how we make our living." Through innovation in promising areas like clean energy, the United States will win the future and create new industries and new jobs. To lead in the global clean energy economy, we must mobilize America's innovation machine in order to bring technologies from the laboratory to the marketplace. The Department of Energy (DOE) is on the front lines of this effort. To succeed, the Department will pursue game-changing breakthroughs, invest in innovative technologies, and demonstrate commercially viable solutions.

In addition to energy advances that spark economic growth, national security remains fundamental to the Department's mission. Through bipartisan ratification of the New START treaty with Russia, America and its global partners are leading by example in implementing the focused expansion of domestic and international activities to reduce the threat of nuclear weapons, nuclear proliferation, and unsecured or excess weapons-usable materials. The National Nuclear Security Administration (NNSA) supports the international effort to secure all vulnerable nuclear materials around the world within four years. The NNSA also fulfills the President's commitment to modernize the nation's nuclear stockpile until a world without nuclear weapons can be realized.

The Department's Fiscal Year (FY) 2012 budget request is $29.5 billion, an 11.8 percent or $3.1 billion increase from FY 2010 current appropriation levels. The FY 2012 request supports the President's goals to increase America's competitiveness by making strategic investments in our nation's clean energy infrastructure and to strengthen our national security by reducing the global threat of nuclear materials. The President has called for advancing research on clean energy technologies and manufacturing, doubling the share of electricity generated from clean energy supplies by 2035, and putting one million electric vehicles on the road by 2015. The Department's request prepares for a multi-year effort to address these interconnected objectives and prioritizes research and development of renewable energy technologies to expand sustainable energy options for the United States.

The FY 2012 budget builds on the intense planning, execution, and oversight of the $35.2 billion from the American Recovery and Reinvestment Act of 2009. By the end of FY 2010, the Department successfully obligated $32.7 billion of Recovery Act funds, including all funding that was set to expire. In developing the FY 2012 budget request, the Department has taken these investments into account and will oversee execution of these funds with value to the taxpayer in mind. Recovery Act investments are focused on: energy conservation and renewable energy sources ($16.8 billion), environmental cleanup ($6 billion), loan guarantees for renewable energy and electric power transmission projects ($2.4 billion), grid modernization ($4.5 billion), carbon capture and sequestration ($3.4 billion), basic science research ($1.6 billion), and the Advanced Research Projects Agency – Energy ($0.4 billion). The Department's Recovery Act activities are strengthening the economy by providing much-needed investment, saving or creating tens of thousands of jobs, cutting carbon pollution, and reducing U.S. dependence on oil.

The President's FY 2012 Budget supports three strategic priorities:

- **Transformational Energy:** Accelerate the transformation to a clean energy economy and secure U.S. leadership in clean energy technologies.
- **Economic Prosperity:** Strengthen U.S. science and engineering efforts to serve as a cornerstone of our economic prosperity and lead through energy efficiency and secure forms of energy.
- **Nuclear Security:** Enhance nuclear security through defense, nonproliferation, naval reactors, and environmental cleanup efforts.

As the President has articulated, innovation is essential to America's economic competitiveness. To meet the challenge of 'our generation's Sputnik moment,' the Department supports a coordinated strategy for research and development across all of its programs. With every initiative the Department undertakes, sound science is at the core. In FY 2012, we will increasingly emphasize cross-cutting initiatives to link science throughout the Department, specifically with energy and national security programs in order to deliver results to the American taxpayer. In the Office of Science, the Department requests $5.4 billion, a 9.1 percent or $452 million increase over the FY 2010 current appropriation levels, to support an elevated focus on the advancement of the United States' leadership in fundamental research. Advanced Research Projects Agency – Energy (ARPA-E) is building on established gains since its initial funding in FY 2009 through the Recovery Act to perform transformational research and create game-changing breakthroughs for eventual market adoption. The FY 2012 budget request includes $550 million for ARPA-E to sustain investment in new energy technologies.

Energy Innovation Hubs play a key role in solving specific energy challenges by convening and focusing top scientific and engineering talent to focus on those problems. The Hubs bring together multidisciplinary team of researchers in an effort to speed research and shorten the path from scientific discovery to technological development and commercial deployment of highly promising energy-related technologies. The Department is proposing to double its commitment to this research approach by requesting three new Hubs to focus on batteries and energy storage, critical materials, and Smart Grid technologies and systems. The Department will continue funding the three Energy Innovation Hubs introduced in FY 2010 to focus on developing fuels that can be produced directly from sunlight, improving energy efficient building systems design, and using modeling and simulation tools to create a virtual model of an operating advanced nuclear reactor. Complementing the Hubs, the Department plans in FY 2012 to continue coordination with the Office of Science's Energy Frontier Research Centers, which exemplify the pursuits of broad-based science challenges for energy applications.

Energy Security: Promoting America's Energy Security through Reliable, Clean and Affordable Energy

In his State of the Union address, the President outlined clearly to the American people his roadmap for transforming our nation's energy economy to meet the demands of future generations. "Instead of subsidizing yesterday's energy, let's invest in tomorrow's," he said. To meet the President's challenge, the Department must recruit the sharpest research minds and build on its aggressive discovery agenda across all programs to achieve breakthroughs on the most pressing energy challenges facing the United States.

In his address, President Obama laid out a goal for clean energy sources to account for 80 percent of America's electricity by 2035. In FY 2012, the Department requests funds to help achieve this Presidential objective and address many of the energy delivery challenges facing American families and energy providers.

- **Applied Research, Development and Deployment** – Meeting the President's goal of making America the first country to have one million electric vehicles on the road by 2015, the Department will research cost competitive methods to develop electric vehicles, increase the adaptability and capacity of the grid to enable vehicle charging, incentivize communities to invest in electric vehicles and infrastructure and send these vehicles to the nation's roadways. The Department will also launch competitive manufacturing research for breakthrough technologies in energy efficiency diagnostics and retrofits to help business owners around the country save money on energy costs.

- **Loan Guarantees:** The Loan Programs Office (LPO) is a vital tool for promoting innovation in the energy sector across a broad portfolio of clean and efficient energy technologies. In FY 2012, the Department is requesting credit subsidies to support approximately $1 to $2 billion in loan guarantees for renewable energy deployment and up to $36 billion in additional authority to loan guarantees for nuclear power projects. The Department will also continue to streamline and prioritize the issuance of loan guarantees to leverage private sector investment in clean energy and energy efficiency projects that will save and create jobs.

- **Better Buildings Initiative:** Last year, commercial buildings consumed roughly 20 percent of all energy in the U.S. economy. Improving energy efficiency in our buildings can create jobs, save money, reduce our dependence on oil, and make our air cleaner. The President's Better Buildings Initiative will make commercial buildings 20 percent more energy efficient over the next decade through initiatives that include: re-designing the current tax deduction for commercial buildings and upgrades to a credit that is more generous and that will encourage building owners and real estate investment trusts (REITs) to retrofit their properties; improving financing opportunities for retrofits through programs including a new Better Buildings Pilot Loan Guarantee Initiative for Universities, Schools and Hospitals, for which the Department of Energy requests $100 million in credit subsidy to guarantee up to $2 billion in loans for energy efficiency retrofits for these facilities; creating a $100 million Race to Green competitive grant program for state and municipal governments to implement innovative approaches to building codes, performance standards, and regulations so that commercial building efficiency will become the norm in communities across the country; and calling on CEOs and university presidents to join the Department of Energy and other Federal partners in a Better Buildings Challenge to make their organizations leaders in saving energy. The Better Buildings Initiative builds on our investments through the Recovery Act and our continued commitment to passing "HOMESTAR" legislation to encourage American families to make energy saving upgrades in their homes.

- **Electricity Reliability and Energy Management:** Reliable, affordable, efficient, and secure electric power is vital to expanding economic recovery, protecting critical infrastructures, and enabling the transition to renewable energy sources. The FY 2012 request invests $238 million to bring the next generation of grid modernization technologies closer to deployment and commercialization, to assist states and regional partners in grid modernization efforts, and to facilitate recovery from energy supply disruptions when they occur. The request includes a new Smart Grid Technology and Systems Hub that will address the total electricity system, covering applied science, technology, economic, and policy issues that affect our ability to modernize the grid. The FY 2012 request also plans an expansion of the Home Energy Score program that provides homeowners with information on how their homes can be more energy efficient and guidance for saving on home energy costs. This is in addition to the President's support for passage of the Home Star rebate program in 2011.

Investing in energy efficiency, renewable energy generation, and grid modernization are fundamental steps necessary for creating a clean energy economy. We must also invest in the improvement of existing sources of energy that will provide a bridge between current and future technologies. These technologies are already a major segment of the energy mix and will play a critical role in providing a solid foundation that will make possible the creation of a new energy economy.

- **Leadership in Nuclear Energy:** Nuclear energy currently supplies approximately 20 percent of the Nation's electricity and 70 percent of the Nation's clean, non-carbon electricity. The request for the Office of Nuclear Energy includes $380 million for research and development, in addition to key investments in supportive infrastructure. In addition, the Department is engaging in cost-shared activities with industry that may help accelerate commercial deployment of small modular reactors. The request includes funding for cost-shared design certification and licensing activities for small modular reactors, the deployment of which holds promise for vastly increasing the generation of clean energy on a cost competitive basis. The Department will also promote nuclear power through the Loan Guarantee Program, which is requesting up to $36 billion in additional loan guarantee authority in FY 2012.

- **Advanced Fossil Energy: Experience in Carbon Capture and Storage:** The world will continue to rely on coal-fired electrical generation to meet energy demand. It is imperative that the United States develop the technology to ensure that base-load electricity generation is as clean and reliable as possible. The Office of Fossil Energy requests $452.9 million for research and development of advanced coal-fueled power systems and carbon capture and storage technologies. The Budget focuses resources within the fossil energy program on activities that can reduce carbon pollution and have potential benefits for both the existing fleet and new power plants – specifically, post-combustion capture R&D and geologic carbon storage R&D.

- **Ending Tax Subsidies to Fossil Fuel Producers:** In accordance with the President's agreement at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that we can transition to a 21st century energy economy, the Administration proposes to repeal a number of tax preferences available for fossil fuels. Tax subsidies proposed for repeal include, but are not limited to: the credit for oil and gas produced from marginal wells; the deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary oil recovery method; the ability to claim the domestic manufacturing deduction against income derived from the production of oil and gas and coal; and expensing the exploration and development costs for coal.

<u>Economic Security: Sharpening America's Competitive Edge through a Clean Energy Economy</u>

To meet "our generation's Sputnik moment" and promote economic competitiveness, the U.S. must demonstrate leadership in clean energy technologies. "We'll invest in biomedical research, information technology and especially clean energy technology – an investment that will strengthen our security, protect our planet, and create countless new jobs for our people," said President Obama before Congress in the State of the Union address. President Obama outlined his comprehensive vision to lead our nation's clean energy economy and provide economic security to Americans. As the Administration seeks to reduce federal government spending, the Department recognizes its role and has tightened its expenditures in several areas such as oil and natural gas. The FY 2012 budget request acknowledges the Department's missions to achieve these imperative goals while setting forth a clean energy economy for entrepreneurs and manufacturers to reclaim their competitive edge in clean energy innovation.

The Department plans to promote economic security by building on the progress made through the over $32 billion in grants and contracts under the American Recovery and Reinvestment Act of 2009, which made historic investments in the nation's economy and has put the country on target to double renewable energy generation by 2012. The Recovery Act helped create tens of thousands of jobs and, combined with the FY 2012 request, will help the Department accelerate the transition of our nation to a clean energy economy.

The President's FY 2012 Budget supports the plan to rebuild our economy through clean energy research and development by:

- **Expanding ARPA-E to spur innovation –** The President's request proposes $550 million for the Advanced Research Projects Agency – Energy (ARPA-E) program, plus an additional $100 million for the program from the Wireless Innovation and Infrastructure Initiative for a total of $650 million. ARPA-E performs transformational and cutting edge energy research with real-world applications in areas ranging from grid technology and power electronics to batteries and energy storage. The budget also supports programs with significant promise to provide reliable, sustainable energy across the country, such as the SunShot initiative aimed at making solar energy cost competitive. With focused investment in manufacturing innovation and industrial technical efficiencies, the President's proposal will move private sector capital off the shelves and into the marketplace.

- **Targeting investments for future economic growth** – To secure a competitive advantage in high-tech industries and maintain international leadership in scientific computing, we will invest in core research activities for energy technologies, the development of general biological design principles and new synthetic molecular toolkits to improve understanding of natural systems, and core research activities to advance the frontiers of high performance computing. Underlying these investments in research is the education and training of thousands of scientists and engineers who contribute to the skilled scientific workforce needed for a 21st century innovation economy.

- **Doubling the number of Energy Innovation Hubs to solve key challenges** – Innovation breakthroughs occur when scientists collaborate on focused problems. The FY 2012 budget request proposes three new Energy Innovation Hubs that will bring top American scientists to work in teams on critical energy challenges in areas such as critical materials, batteries and energy storage, and Smart Grid technologies. These will join three existing Hubs that focus on fuel generation from sunlight, building efficiency, and nuclear reactor modeling and simulation.

- **Integrating Research & Development:** The Department has identified areas where coordinated work by discovery-oriented science and applied energy technology programs hold the greatest promise for progress in achieving our energy goals. The Energy Systems Simulation to increase the efficiency of the Internal Combustion Engine (ICE) will produce a set of modern, validated computer codes that could be used by design engineers to optimize the next generation of cleaner, more efficient combustion engines. An initiative on extreme environments will close the gap between actual and ideal performance of materials in nuclear environments. And the Department's Exascale Computing initiative will allow the Department to take the lead in developing the next generation of scientific tools and to advance scientific discoveries in solving practical problems.

- **Pursuing the passage of HOMESTAR** – Enactment of this program will create jobs by providing strong short-term incentives for energy efficiency improvements in residential buildings. The HOMESTAR program has the potential to accelerate our economic recovery by boosting demand for energy efficiency products and installation services. The program will provide rebates of $1000 to $3000 per household to encourage immediate investment in energy-efficient appliances, building mechanical systems and insulation, and whole-home energy efficiency retrofits. This program will help middle-class families save hundreds of dollars a year in energy costs while improving the comfort and value of their most important investment – their homes. In addition, the program would help reduce our economy's dependence on fossil fuels and support the development of an energy efficiency services sector in our economy.

- **Extending access to tax credit and tax grant programs** – Two provisions of the American Recovery and Reinvestment Act have been extraordinarily successful in spurring the deployment of renewable energy projects and building advanced manufacturing capabilities: Section 48C Advanced Energy Manufacturing Tax Credit program and the Section 1603 Energy Cash Assistance program. The Administration is pursuing an additional $5 billion in support for the Section 48C program, which, by providing a 30% tax credit for energy manufacturing facilities, will continue to help build a robust high-technology, U.S. manufacturing capacity to supply clean energy projects with U.S. made parts and equipment. The Section 1603 tax grant program has created tens of thousands of jobs in industries such as wind and solar by providing up-front incentives to thousands of projects. The Administration is seeking a one-year extension of this program.

- **Promoting efficient energy use in our everyday lives** - Currently, weatherization of more than 300,000 homes of low income families has been achieved, providing energy cost savings and financial relief to households. The FY 2012 request of $320 million continues residential weatherization, while increasing the focus on new innovative approaches to residential home weatherization.

<u>National Security: Securing Nuclear and Radiological Materials, Maintaining Nuclear Deterrence, and Advancing Responsible Legacy Cleanup</u>

A pillar of President Obama's national security agenda for the United States is to eliminate the global threat posed by nuclear weapons and prevent weapons-usable nuclear material from falling into the hands of terrorists. As part of this agenda, the Administration and Congress worked tirelessly toward the December 2010 bipartisan ratification of the New Strategic Arms Reduction Treaty (New START) with Russia, which cuts the number of strategic nuclear weapons each country can deploy to 1,550. After signing this agreement in April 2010, President Obama said, "In many ways, nuclear weapons represent both the darkest days of the Cold War, and the most troubling threats of our time. Today, we've taken another step forward ... in leaving behind the legacy of the 20th century while building a more secure future for our children. We've turned words into action. We've made progress that is clear and concrete. And we've demonstrated the importance of American leadership -- and American partnership -- on behalf of our own security, and the world's".

The Department's National Nuclear Security Administration (NNSA), through work with global partners and efforts to secure vulnerable nuclear materials, achieved significant milestones during FY 2010 and FY 2011 to reduce the risk of proliferation and leverage science to maintain our nation's nuclear deterrence. Additionally, the Environmental Management program made progress advancing responsible nuclear cleanup from the Cold War. The Department's FY 2012 request seeks to build upon these successes and advance the President's nuclear security agenda.

Reduce the Risk of Proliferation

In 2009, President Obama committed the United States to an international effort to secure vulnerable nuclear material worldwide in four years. To solidify international support for this effort, and to address the threat of nuclear terrorism, the President convened leaders from 47 countries at the Washington Nuclear Security Summit in April 2010. The Summit resulted in a Communiqué which stated, "Nuclear terrorism is one of the most challenging threats to international security, and strong nuclear security measures are the most effective means to prevent terrorists, criminals, or other unauthorized actors from acquiring nuclear materials."

The FY 2012 budget for the NNSA Defense Nuclear Nonproliferation program will help advance further work that is needed to meet the goals of President Obama and the Nuclear Security Summit, recognizing the urgency of the threat and making the full commitment to global cooperation on nonproliferation. The budget provides $2.5 billion in FY 2012, and $14.2 billion through FY 2016 to detect, secure, and dispose of dangerous nuclear and radiological material worldwide. This request is a decrease of 5 percent, or $138 million, from the FY 2011 request, which reflects completion of accelerated efforts to secure vulnerable nuclear materials within the President's stated timeframe. The decrease also reflects our decision to await agreement between the United States and Russia on detailed implementation milestones prior to requesting additional U.S. pledged funding to support Russian plutonium disposition. The FY 2012 budget request follows through on securing vulnerable materials and supports efforts to design new technologies in support of treaty monitoring and verification, which will contribute to implementation of New START. The budget also broadens cooperative nonproliferation initiatives with foreign governments and international organizations in support of the President's objective of a world without nuclear weapons. The budget continues the provision of security upgrades at selected sites, both within the United States and in foreign countries, to address outsider and insider threats, and accelerates the pace of research reactor conversions from use of highly-enriched uranium fuel to low-enriched uranium fuel.

Leverage Science to Maintain Nuclear Deterrence

The FY 2012 budget request advances the Department's commitment to the national security interests of the United States through stewardship of a safe, secure and effective nuclear weapons stockpile without the use of underground nuclear testing. The 2010 Nuclear Posture Review Report calls for the United States to reduce nuclear force levels. As the United States begins the reduction required by New START, the science, technology and engineering capabilities and intellectual capacity within the nuclear security enterprise become more critical to sustaining the U.S. nuclear deterrent. NNSA continues to emphasize these capabilities, including functioning as a national science, technology, and engineering resource to other agencies with national security responsibilities. Through the NNSA, the Department requests $7.6 billion for the Weapons Activities appropriation, an 8.9 percent, or $621 million, increase from the President's FY 2011 request. It also is an 18.9 percent, or $1.205 million increase from the FY 2010 enacted appropriation. This increase reflects an investment strategy that provides a strong basis for transitioning to a smaller yet still safe, secure and effective nuclear stockpile without additional nuclear testing, strengthening the science, technology and engineering base, modernizing the physical infrastructure, and streamlining the enterprise's physical and operational footprint. These investments will further enable the Nuclear Posture Review's comprehensive nuclear defense strategy, based on current and projected global threats that rely less on nuclear weapons, while strengthening the nation's nuclear deterrent through completing major stockpile system life extensions, stabilizing the science, technology and engineering base, and modernizing the infrastructure.

The Naval Reactors program ensures the safe and reliable operation of reactor plants in nuclear-powered submarines and aircraft carriers, constituting 45 percent of the U.S. Navy's combatants. The FY 2012 request for Naval Reactors of $1.2 billion, is an increase of $83.2 million or 7.8 percent over the FY 2011 request and $209 million or 18.1 percent above the FY 2010 enacted appropriation. Funding for this program is ramping up for reactor design and development efforts for the Ohio Class Replacement Submarine ($121 million), refueling of the Land-Based Prototype ($99.5 million), and recapitalization of the naval spent nuclear fuel infrastructure for the Spent Fuel Handling Recapitalization program ($53.8 million) at the Naval Reactors Facility located at the Idaho National Laboratory.

Advance Responsible Environmental Cleanup

The FY 2012 budget includes $6.13 billion for the Office of Environmental Management (EM), to protect public health and safety by cleaning up hazardous, radioactive legacy waste from the Manhattan Project and the Cold War. This funding will allow the program to continue to accelerate cleaning up and closing sites, focusing on activities with the greatest risk reduction. Acceleration of cleaning up sites where funding would have immediate impact was established as the overarching objective of the $6 billion in Recovery Act funding. EM will use the remaining $309 million of Recovery Act funding during FY 2012 as it completes footprint reduction and near-term completion cleanup activities.

As the Department continues to make progress in completing environmental cleanup, the FY 2012 budget request of $170 million for the Office of Legacy Management supports the Department's long-term stewardship responsibilities and payment of pensions and benefits for former contractor workers after site closure.

DEPARTMENT OF ENERGY FY 2012 PROGRAM OFFICE HIGHLIGHTS

Office of Science: Invest in the Building Blocks of American Innovation

The Department of Energy's Office of Science (SC) delivers scientific discoveries and major scientific tools to transform our understanding of energy and matter and advance the energy, economic, and national security of the United States. SC is the largest Federal sponsor of basic research in the physical sciences, supporting programs in areas such as physics, chemistry, biology, environmental sciences, applied mathematics, and computational sciences. In FY 2012, the Department requests $5.4 billion, an increase of 9.1 percent over the FY 2010 current appropriation, to invest in basic research. The FY 2012 request supports the President's *Strategy for American Innovation*, and is consistent with the goal of doubling funding at key basic research agencies, including the Office of Science. The FY 2012 Office of Science budget request supports the following objectives from the *Strategy*, including:

- Unleash a clean energy revolution
- Strengthen and broaden American leadership in fundamental research
- Develop an advanced information technology ecosystem
- Educate the next generation with 21st century skills and create a world-class workforce

In FY 2012, SC continues to support fundamental research for scientific discovery, but today our country needs to move strongly to solve our energy problems. Therefore, the central theme of this year's budget in SC is research in new technologies for a clean energy future that address competing demands on our environment. These efforts, coordinated with the DOE applied technology programs and with input from the scientific community and industry, will emphasize research underpinning advances in non-carbon emitting energy sources, carbon capture and sequestration, transportation and fuel switching, transmission and energy storage, efficiency, and critical materials for energy applications.

In the area of advancing non-carbon energy sources, the FY 2012 budget request will provide for new investments in the science of interfaces and degradation relevant to solar photovoltaics, basic actinide chemistry research related to advanced nuclear fuel cycles, and research in materials under extreme environments relevant to extreme nuclear technology environments, and genomics-based research on biological design principles and synthetic biology tools to underpin bio-based energy solutions. Carbon capture and sequestration research will focus on novel molecular design for materials and multiscale dynamics of flow and plume migration, respectively. SC will initiate an energy systems simulation research effort focused on predictive modeling of combustion in an evolving fuel environment in support of the Department's efforts in transportation and alternative fuels. Also underpinning transportation and fuel switching, as well as energy storage, the FY 2012 request will support an Energy Innovation Hub for Batteries and Energy Storage. The Fuels from Sunlight Hub, established in FY 2010, as well as the Energy Frontier Research Centers and DOE Bioenergy Research Centers also continue. Research in enabling materials sciences will support needs of future electricity transmission systems and novel building materials to improve building efficiencies.

The FY 2012 budget request also provides for foundational science in condensed matter and materials physics, chemistry, biology, climate and environmental sciences, applied mathematics, computational and computer science, high energy physics, nuclear physics, plasma physics, and fusion energy sciences; and provides for research facilities and capabilities that keep U.S. researchers at the forefront of science. The FY 2012 request supports targeted increases in areas such as computational materials and chemistry by design, nanoelectronics, and advanced scientific applications and integrated application-hardware-software co-design for exascale, which position the U.S. to secure a competitive advantage in high-tech industries and maintain international leadership in scientific computing. Underlying these investments is the education and training of thousands of scientists and engineers who contribute to the skilled scientific workforce needed for the 21st century innovation economy.

The Office of Science supports investigators at about 300 academic institutions and from all of the DOE laboratories. Over 26,000 researchers from universities, national laboratories, industry, and international partners are expected to use the Office of Science scientific user facilities in FY 2012.

Advanced Research Projects Agency – Energy: Transformational Research and Development

The FY 2012 budget request includes $550 million for the Advanced Research Projects Agency – Energy (ARPA-E), plus an additional $100 million for the program from the Wireless Innovation and Infrastructure Initiative for a total of $650 million. ARPA-E was launched in FY 2009 to sponsor specific high-risk and high-payoff transformational research and development projects that overcome the long-term technological barriers in the development of energy technologies to meet the Nation's energy challenges, but that industry will not support at such an early stage. An essential component of ARPA-E's culture is an overarching focus on accelerating science to market. Beyond simply funding transformational research creating revolutionary technologies, ARPA-E is dedicated to the market adoption of those new technologies that will fuel the economy, create new jobs, reduce energy imports, improve energy efficiency, reduce energy-related emissions, and ensure that the U.S. maintains a technological lead in developing and deploying advanced energy technologies.

Office of Energy Efficiency and Renewable Energy: Investing in Breakthrough Technology and a Clean Energy Future

The Office of Energy Efficiency and Renewable Energy (EERE) supports research, development, demonstration, and deployment activities on technologies and practices essential for meeting national security goals by reducing dependence on oil, meeting environmental goals by minimizing the emissions associated with energy production and use, and stimulating economic growth and job creation by minimizing the cost of energy services. The EERE portfolio emphasizes work areas where the potential impact is largest, where Federal funds are most critical. It balances investments in high-risk research with partnerships with private firms that speed the translation of innovations into practical business opportunities. The diverse set of technologies supported helps ensure that the U.S. has many options for meeting its energy goals. Program management is designed to identify the best groups in the country to address these challenges and supports work in universities, companies, national laboratories, and consortia.

The FY 2012 budget request of $3.2 billion, the increase of 44.4% over the FY 2010 current appropriation, is aimed at accelerating innovation and change in the Nation's energy economy. The request includes programs associated with meeting the President's goals of investing in the next generation of clean energy technologies, vehicles and fuels, and energy efficiency measures that reduce energy use in Federal agencies and the industrial and building sectors.

Clean, Renewable Energy Generation

The FY 2012 budget request continues to work to transform the Nation's energy infrastructure by investing over $1,164.9 million in a variety of renewable programs including solar ($457.0 million), wind ($126.9 million), water ($38.5 million), hydrogen ($100.5 million), biomass ($340.5 million), and geothermal ($101.5 million). Research, development, and deployment of these technologies will reduce the production of greenhouse gas emissions and revitalize an economy built on the next generation of domestic production. The request includes the solar SunShot program which will invest in transformative research focusing on achieving radical cost reductions in photovoltaic modules, balance of systems, and power electronics.

Energy Efficiency

The Department implements a number of efforts to increase energy efficiency in homes, transportation, and industry. The FY 2012 budget requests $1,805.3 million to accelerate deployment of clean, cost-effective, and rapidly deployable energy efficiency measures in order to reduce energy consumption in residential and commercial buildings, and the industrial and Federal sectors. The Department will invest $470.7 million in the Building Technologies program and $33.0 million for the Federal Energy Management Program. Federal assistance for state-level programs such as State Energy Program ($63.8 million), Tribal ($10.0 million) and Weatherization Assistance Program ($320.0 million) will continue to help citizens implement energy efficiency measures, lower energy costs and greenhouse gas emissions, and build a technical workforce. ($319.8 million) for Industry will provide a balanced portfolio of advanced R&D and pursuit of near-term low cost opportunities with the objectives of increasing U.S. competitiveness, enhancing clean energy manufacturing, and improving energy productivity. There will be a focus on next generation manufacturing processes and materials, activities for clean energy manufacturing, and refocused efforts for Industrial Technical Assistance to achieve greater results with less funding through more effective leveraging of funding for deployment partnerships. A new Energy Innovation Hub on critical materials will be competed through the Industrial Technologies program. The FY 2012 request also includes $588 million to accelerate research, development and deployment of advanced vehicle technologies, working in concert with biomass RD&D to reduce the use of petroleum and greenhouse gas emissions.

Better Buildings Initiative for Commercial Energy Savings – The President's Better Buildings Initiative is focused on achieving a 20 percent improvement in commercial buildings' energy use by 2020. The initiative will include many new components to achieve this goal. The following are supported in the Department's FY 2012 request: launch of the Race to Green competitive grant program for states and municipal governments to encourage higher standards for commercial energy efficiency, which is funded within the Buildings Technologies Program; a new pilot loan guarantee program to support energy efficiency retrofits for buildings that serve as community assets; and increased R&D funding for building technologies. The Department intends to work with the business and academic communities to make their organizations leaders in saving energy.

Office of Electricity Delivery and Energy Reliability: Enabling a Clean Energy Economy

The Office of Electricity Delivery and Energy Reliability (OE) is responsible for leading national efforts to modernize the electric grid, enhance the security of energy infrastructure, and facilitate recovery from disruptions to the energy supply. The Department's FY 2012 budget request for OE of $238 million, a 38% increase over the FY 2010 appropriation, represents a clear and determined effort to accelerate the transformation of one of the Nation's key enablers of a clean energy economy – the electricity delivery system.

The U.S. electricity delivery system was built on technology that was developed early in the 20th century and designed for the demands and challenges of that era. Today, this aging and often congested system is facing many new and complex challenges that require considerable improvements in the physical and technological components of the system. In order to alleviate the stress on the system from increasing demand for electricity and to enable greater use and integration of renewable and distributed resources, all while maintaining the reliability, security, and affordability of electric power, research and development breakthroughs and new energy management approaches are critical in the areas of transmission and distribution, energy storage, and cyber security.

OE's FY 2012 budget request provides $193 million for research and development in these critical areas to bring the next generation of grid technologies closer to deployment and commercialization. The increased investment reflects the President's vision and OE's role in competing in a worldwide technological race. As such, with $20 million in FY 2012, OE will establish a new Energy Innovation Hub, or in the words of President Obama, one of "the Apollo projects of our time." The Smart Grid Technology and Systems Hub will bring together a diverse, multi-disciplinary group to develop an integrated approach to enhancing smart grid technologies and systems. OE will also expand its advanced modeling capabilities to include other system layers in order to provide a more in-depth system understanding. The energy storage program will expand to aggressively support the deployment of grid-scale energy storage technologies with new demonstrations, and the cyber security program will continue to focus on the development and integration of secure control systems.

The budget request continues to support Permitting, Siting, and Analysis (PSA) with $8 million to develop and improve policies, state laws, and programs that facilitate the development of electric infrastructure needed to bring new clean energy projects to market, and to provide technical assistance to states and regions. It also supports Infrastructure Security and Energy Restoration (ISER) with $6.2 million to enhance the reliability and resiliency of critical energy infrastructure and to facilitate recovery from energy supply disruptions.

Office of Environmental Management: Meeting Commitments and Making Progress

The mission of the Office of Environmental Management (EM) is to complete the safe cleanup of the environmental legacy brought about from over six decades of nuclear weapons development, production, and Government-sponsored nuclear energy research. This cleanup effort is the largest in the world, originally involving two million acres at 110 sites in 35 states, dealing with some of the most dangerous materials known to man.

EM continues to pursue its cleanup objectives within the overall framework of achieving the greatest comparative risk reduction benefit and overlaying regulatory compliance commitments and best business practices to maximize cleanup progress. To support this approach, EM has prioritized its cleanup activities:

- Activities to maintain a safe and secure posture in the EM complex
- Radioactive tank waste stabilization, treatment, and disposal
- Spent nuclear fuel storage, receipt, and disposition
- Special nuclear material consolidation, processing, and disposition
- High priority groundwater remediation
- Transuranic and mixed/low-level waste disposition
- Soil and groundwater remediation
- Excess facilities deactivation and decommissioning

The FY 2012 budget request for $6.13 billion will fund activities to maintain a safe and secure posture in the EM complex and make progress against program goals and compliance commitments by reducing the greatest risks to the environment and public health, using science and technology to reduce lifecycle costs, and reducing EM's geographic footprint by 90 percent by 2015. EM continues to move forward with the development of the capability for dispositioning tank waste, nuclear materials, and spent (used) nuclear fuel. The budget request includes the construction and operation of three unique and complex tank waste processing plants to treat approximately 88 million gallons of radioactive tank waste for ultimate disposal. It will also fund the solid waste disposal infrastructure needed to support disposal of transuranic and low-level wastes generated by high-risk activities and the footprint reduction activities.

EM carries out its cleanup activities with the interests of stakeholders in mind. Most importantly, EM will continue to fulfill its responsibilities by conducting cleanup within a "Safety First" culture that integrates environment, safety, and health requirements and controls into all work activities to ensure protection to the workers, public, and the environment, and adheres to sound project and contract management principles. EM is also strengthening its project and planning analyses to better assess existing priorities and identify opportunities to accelerate cleanup work. Working collaboratively with the sites, EM continues to seek aggressive but achievable strategies for accelerating cleanup of discrete sites or segments of work. In addition, functional and cross-site activities such as elimination of specific groundwater contaminants, waste or material processing campaigns, or achievement of interim or final end-states are being evaluated.

After the EM program completes cleanup and closure of sites that no longer have an ongoing DOE mission, post closure stewardship activities are transferred to the Office of Legacy Management (LM). LM also receives sites remediated by the U.S. Army Corps of Engineers (Formerly Utilized Sites Remedial Action Program) and private licensees (Uranium Mill Tailings Radiation Control Act, Title II sites). Post closure stewardship includes long-term surveillance and maintenance activities such as groundwater monitoring, disposal cell maintenance, records management, and management of natural resources at sites where active remediation has been completed. At some sites the program includes management and administration of pension and post-retirement benefits for contractor retirees.

Loan Programs Office: Helping Finance Clean Energy Deployment

Innovative Technology Loan Guarantee Program - To encourage the early commercial deployment of new or significantly improved technologies in energy projects, the Department requests up to $36 billion in loan guarantee authority for nuclear power facilities and $200 million in appropriated credit subsidy to support an estimated $1 to $2 billion in loans for renewable energy system and efficient end-use energy technology projects under section 1703 of the Energy Policy Act of 2005. The additional loan guarantee authority for nuclear power projects will promote deployment of new plants and support an increasing role for private sector financing. The additional credit subsidy will allow for investment in the innovative renewable and efficiency technologies that are critical to meeting the Administration's goals for affordable, clean energy, technical leadership, and global competitiveness.

The FY 2012 budget also requests $38 million to evaluate applications received under the eight solicitations released to date and to ensure efficient and effective management of the Loan Guarantee program. This request is expected to be offset by collections from borrowers authorized under Title XVII of the Energy Policy Act of 2005 (P.L. 109-8).

Advanced Technology Vehicle Manufacturing Program- The Department requests $6 million to support ongoing loan monitoring activities associated with the program mission of making loans to automobile and automobile part manufacturers for the cost of re-equipping, expanding, or establishing manufacturing facilities in the United States to produce advanced technology vehicles or qualified components, and for associated engineering integration costs.

Better Buildings Pilot Loan Guarantee Initiative for Universities, Schools, and Hospitals - To spur investment in energy efficiency retrofits for buildings which serve as assets to our communities, the Department requests $100 million for loan guarantee subsidy costs to support up to $2 billion in loan authority for universities, schools, and hospitals. This pilot program is one component of the President's Better Buildings Initiative and would fund cost-effective technologies and measures to assist universities, schools, and hospitals save on energy usage and associated energy costs. The Department also requests $5 million for administrative expenses to carry out the program. The request is subject to the enactment of legislation authorizing this program.

Office of Nuclear Energy: Investing in Energy Innovation and Technical Leadership

The Department is requesting $852.5 million for the Office of Nuclear Energy (NE) in FY 2012 – a decrease of 0.6 percent from the FY 2010 current appropriation. NE's funding supports the advancement of nuclear power as a resource capable of meeting the Nation's energy, environmental, and national security needs by resolving technical, cost, safety, proliferation resistance, and security barriers through research, development, and demonstration as appropriate.

Currently, nuclear energy supplies approximately 20 percent of the Nation's electricity and over 70 percent of clean, non-carbon producing electricity. Over 100 nuclear power plants are offering reliable and affordable baseload electricity in the United States, and they are doing so without air pollution and greenhouse gas emissions. NE is working to develop innovative and transformative technologies to improve the competitiveness, safety and proliferation resistance of nuclear energy to support its continued use.

The FY 2012 budget supports a balanced set of research, development, and deployment (RD&D) activities. This program is built around exploring, through its R&D: technology and other solutions that can improve the reliability, sustain the safety, and extend the life of current reactors; improvements in the affordability of new reactors to enable nuclear energy to help meet the Administration's energy security and climate change goals; development of sustainable nuclear fuel cycles; and minimization of risks of nuclear proliferation and terrorism.

NE is requesting $125 million for Reactor Concepts Research, Development and Demonstration. This program seeks to develop new and advanced reactor designs and technologies. NE is also requesting $67 million for the Light Weight Reactor SMR Licensing Technical Support program, which will support cost-shared design certification and licensing activities for two light water reactor-based designs. Small modular reactors are a technology that the Department believes has the promise to help meet energy security goals. Work will continue on R&D for the Next Generation Nuclear Plant to support demonstration of gas-cooled reactor technology in the United States. The program also supports research on Generation IV and other advanced designs and efforts to extend the life of existing light water reactors.

The FY 2012 request includes $155 million for Fuel Cycle Research and Development to perform long-term, results-oriented science-based R&D to improve fuel cycle and waste management technologies to enable a safe, secure, and economic fuel cycle. The budget also requests $97.4 million to support the Nuclear Energy Enabling Technologies program, focused on the development of cross-cutting and transformative technologies relevant to multiple reactor and fuel cycle concepts. The Crosscutting Technology Development activity will focus on a variety of areas such as reactor materials, creative approaches to further reduce proliferation risks, and establishing advanced modeling and simulation capabilities to complement physical experimentation. The Transformative Nuclear Concepts R&D activity supports, via an open, competitive solicitation process, investigator-initiated projects that relate to any aspect of nuclear energy generation ensuring that good ideas have sufficient outlet for exploration. Modeling and Simulation Energy Innovation Hub, supported within this program, will apply existing modeling and simulation capabilities to create a "virtual" reactor user environment to simulate an operating reactor and is a prime example of the type of crosscutting, transformative activity that will enhance many research areas within NE. NE will also continue its commitments to investing in university research, international cooperation, and the Nation's nuclear research infrastructure – important foundations to support continued technical advancement.

Office of Fossil Energy: Sustaining American Energy Options through U.S. Ingenuity

The FY 2012 budget request of $521 million for the Office of Fossil Energy (FE) will help ensure that the United States can continue to rely on clean, affordable energy from traditional domestic fuel resources. The United States has 25 percent of the world's coal reserves, and fossil fuels currently supply over 80 percent of the Nation's energy.

The Department is committed to developing technologies and providing technology-based options having public benefits including enhanced economic, environmental and energy security impacts. In FER&D, the emphasis, in keeping with Presidential priorities, is in supporting long-term, high risk initiatives targeted at carbon capture and storage as well as advanced energy systems and on cross-cutting research.

In addition, $122 million of FE's $521 million request will be to provide for national energy security through the continued operations of the Strategic Petroleum Reserve. The budget proposes to sell $500 million of SPR oil in order to provide operational flexibility in managing the Reserve.

The National Nuclear Security Administration: Leading Global Partners on Nonproliferation by Securing Vulnerable Nuclear Materials; Reaffirming Commitment to Stockpile Modernization

The National Nuclear Security Administration (NNSA) continues significant efforts to meet Administration and Secretarial priorities, leveraging science to promote U.S. national security objectives. The FY 2012 President's budget request for NNSA is $11.8 billion; an increase of 5.1 percent from the President's FY 2011 Request. The five-year FY 2012-2016 President's Request for the NNSA reflects the President's global nuclear nonproliferation priorities and his commitment to modernize the U.S. nuclear weapons complex and sustain a strong nuclear deterrent, as described in the 2010 Nuclear Posture

Review (NPR) Report, for the duration of the New START Treaty and beyond. The NNSA's defense and homeland security-related objectives include:

- Ensure that the U.S. nuclear deterrent remains safe, secure and effective while implementing changes called for by the 2010 NPR and the New START Treaty
- Broaden and strengthen the NNSA's science, technology and engineering mission to meet national security needs
- Transform the Nation's Cold-War era weapons complex into a 21st century national security enterprise
- Work with global partners to secure all vulnerable nuclear materials around the world and implement the President's nuclear security agenda expressed in the May 2010 National Security Strategy and the Nuclear Posture Review report
- Provide safe and effective nuclear propulsion for U.S. Navy warships

The FY 2012 budget request of $7.6 billion for the Weapons Activities appropriation provides funding for a wide range of programs. Requested activities include providing direct support for the nuclear weapon stockpile, including stockpile surveillance, annual assessments, life extension programs, and warhead dismantlement. Science, Technology and Engineering programs are focused on long-term vitality in science and engineering, and on performing R&D to sustain current and future stockpile stewardship capabilities without the need for underground nuclear testing. These programs also provide a base capability to support scientific research needed by other elements of the Department, the federal government national security community, and the academic and industrial communities. Infrastructure programs support facilities and operations at the government-owned, contractor-operated sites, including activities to maintain and steward the health of these sites for the long term and construct new facilities that will allow the United States to maintain a credible nuclear deterrent. The unique nuclear security expertise and resources maintained by NNSA are made available through the National Laboratories to other Departmental offices, agencies and to the Nation for security and counterterrorism activities.

The Weapons Activities request is an increase of 8.9 percent over the President's FY 2011 Request. This level is sustained and increased in the later outyears. The multi-year increase is necessary to reflect the President's commitment to maintain the safety, security and effectiveness of the nuclear deterrent without underground nuclear testing, consistent with the principles of the Report on the Plan for the Nuclear Weapons Stockpile, Nuclear Weapons Complex, and Delivery Platforms (known as the "1251 Report") and the Stockpile Management Program as stipulated in Sections 1251 and 3113(a)(2) of the National Defense Authorization Act of Fiscal Year 2010. Increases are provided for direct support of the nuclear weapon stockpile, for scientific, technical and engineering activities related to maintenance assessment and certification capabilities, and for recapitalization of key nuclear facilities. The President's Request provides funding necessary to protect the national resource of human capital at the national laboratories through a stockpile stewardship program that exercises and retains these capabilities.

The FY 2012 request for Defense Nuclear Nonproliferation (DNN) is $2.5 billion; a decrease of 5.1 percent from the President's FY 2011 Request. This decrease reflects completion of long-lead procurements for the Mixed Oxide Fuel Fabrication Facility (MOX) and Waste Solidification Building (WSB). It also reflects our decision to await an agreement between the U.S. and Russia on detailed implementation milestones prior to requesting additional U.S.-pledged funding to support Russian plutonium disposition. The Administration prioritizes U.S. leadership in global nonproliferation initiatives as directed through the National Security Strategy and has advanced this agenda through commitments from global partners during the 2010 Nuclear Security Summit. In addition to the programs funded solely by the NNSA, Defense Nuclear Nonproliferation programs support interagency and international efforts to protect national security by preventing the spread of nuclear weapons and nuclear materials to terrorist organizations and rogue states. These efforts are implemented in part through the International Atomic Energy Agency, the G8 Global Partnership against the Spread of Weapons and Materials of Mass Destruction, and the Global Initiative to Combat Nuclear Terrorism.

DNN supports the President's goal to secure vulnerable nuclear materials around the world within four years. The Global Threat Reduction Initiative's emphasis in FY 2012 is to convert domestic and international nuclear reactors from weapons-usable highly enriched uranium fuel to low-enriched uranium fuel (LEU); while preserving our capability to produce the critically needed Molybdenum 99 isotope. The FY 2012 President's request for International Nuclear Materials Protection and Cooperation reflects selective new security upgrades to buildings and sites in accordance with the President's goal to secure vulnerable nuclear materials around the world within four years, as well as enhancements and sustainability support for previous work. The Fissile Materials Disposition program continues domestic construction of the MOX Fuel Fabrication Facility scheduled to come online in 2016; and design for the pit disassembly and conversion capability to provide it with plutonium oxide feedstock.

The President's request of $1.2 billion for Naval Reactors is an increase of 7.8 percent over the President's FY 2011 Request. The program supports the U.S. Navy's nuclear fleet, comprised of all of the Navy's 72 submarines and 11 aircraft carriers, which constitute 45 percent of the Navy's combatants. The U.S. relies on these ships every day, all over the world, to protect our national interests. The budget provides funding increases for the Ohio Class Replacement submarine to design and develop required submarine reactor plant technologies. R&D is underway now, and funding during this Future Years Nuclear Security Program is critical to support the long manufacturing spans for procurement of reactor plant components in 2017, and ship construction in 2019. Resources are also requested in FY 2012 to support design work for the recapitalization of the spent nuclear fuel handling infrastructure and refueling of the Land-based prototype.

The Office of the Administrator appropriation provides for federal program direction and support for NNSA's Headquarters and field installations. The FY 2012 request is $450.1 million; a 0.4 percent increase over the President's FY 2011 Request. This provides for well-managed, inclusive, responsive, and accountable organization through the strategic management of human capital, enhanced cost-effective utilization of information technology, and integration of budget and performance through transparent financial management practices. The increase reflects additional federal oversight for construction of the Pit Disassembly and Conversion project, the Uranium Processing Facility, and the Chemistry and Metallurgy Research Replacement Facility.

Chairman CONRAD. Thank you for that testimony, Dr. Chu, and thank you for your taking on this assignment. You are a distinguished scientist with a remarkable record of accomplishment of your own.

I would be most interested in what your vision is of what is most exciting on the technological front. As you look across the broad array of initiatives that are underway, both in your agency and in the private sector, what are the emerging technologies that you are most excited about in terms of an opportunity to dramatically reduce our dependence on foreign energy?

Secretary CHU. Well, regarding foreign energy, I would say that in the recent 5 years especially, and even in the recent 2 years, I have seen a quality of ideas and a passion for developing electric vehicles. We are beginning to market the first electric vehicles in the United States that have a 100-mile range, but I see on the very close horizon, perhaps as short as 4 years from today, the testing of automobile batteries where people can drive perhaps 300 or 400 miles on a single charge, where the cost of those batteries can be reduced by as much as 70 percent, 60 percent. And the companies and countries that achieve those type of batteries—and this is close enough that you can really feel. It is not a pie-in-the-sky dream of the future. Those companies and countries that can achieve those type of batteries will have a multi-multi-billion-dollar market. And we really want the United States to be that country.

We have invested in advanced battery manufacturing to deliver by 2014 half a million batteries. This is the first tangible thing that we can do to get us off our dependency on foreign oil.

Chairman CONRAD. And who is our toughest competition?

Secretary CHU. I would say it is the Japanese, the Koreans, and soon the Chinese. This is actually a worldwide race to develop these batteries because it is not like it was 20 years ago where we would say, well, maybe we can do this. You know, as I said, the ideas that we are now investing in in the research labs and in agencies like ARPA–E and in the Department of Energy renewable energy and energy efficiency, they are really where we can bank on 50- percent improvement, a factor of two improvement in the next couple years. But to get to the next steps where it just becomes ubiquitous is very exciting to me. That is one of the things. I think that is going to come to pass very quickly.

I think another thing that is not directly related to our dependence on foreign oil but is also very exciting is we see very rapid developments now in photovoltaics. For a long photovoltaics have been making good progress, but there is still—the energy created by photovoltaics is still too expensive, and there is no doubt about it.

The industry game plan says certainly within the decade they think they can reduce those costs, the full costs, not only of the module but the insulation and everything, by 50 percent.

We started to engage in industry and said, OK, that is good, but if you reduce the costs by 75 percent, then you do not even think anymore. You put it up everywhere. And, again, you have, you know, a tens of billions of dollars world market, because at that point it becomes competitive with the lowest-cost fossil fuel generation today.

So if we can pull this off in 10 years, that would be amazing, and that would be something that would help the United States lead for decades and create prosperity at both home and abroad.

So this is not energy for the sake of clean energy that would last forever on subsidy. We see a pathway now in some of these areas where within a short period of time it could be competitive without any subsidy, and that is very exciting.

Chairman CONRAD. Let me ask you, we have had a major effort underway by Boone Pickens to encourage the country to move toward the use of natural gas for bus and truck fleets, and I think that his advocacy has had a significant impact here in Congress.

What is your assessment of the opportunity to encourage the use of natural gas in our large fleets?

Secretary CHU. I think it is very promising, and we are looking—in fact, we are indeed supporting some of the pilot demonstrations of that. Boone Pickens was thinking that for long-haul trucks that would be very good.

There is an infrastructure issue. We are looking into that. But on the near term, the short term, the medium term, we think that delivery vans in a centralized location where there is a centralized refueling is a no-brainer, and we have supported those demonstrations. UPS is looking very much at that as a way of fueling its delivery trucks. But, again, while UPS looks at natural gas delivery vans, which is, you know, very clean, and natural gas, because of the fracking technologies which, I might add, were first invested in at the Department of Energy in the early 1980s. As soon as industry picked it up by 1992, we got out of the game because Schlumberger picked it up by 1991, and we handed it off to the private sector. That is exactly what we wanted to do. You do the initial research. You prove it. It gets commercial interest, and then you step back and let industry take over.

So that is a very good story. We do not know whether it is going to be electric vehicles. FedEx is going to electric delivery vehicles. They are going to electric delivery vehicles because—it was a hard business decision. I had lunch with Fred Smith, the CEO of FedEx, and he said if you look just a few years into the future, we see only electric vehicles, a total life cycle cost of electric vehicles less than the cost of a diesel.

So, again, nobody was saying that 5 or 10 years ago, and all of a sudden we are in this tipping point. Those are the things that really excite me. So we can really decrease our dependence on imported oil.

Chairman CONRAD. Let me ask you two other quick questions. First of all, clean coal technology. Look, coal is the basis for 50 percent of the electricity in the United States, or thereabouts. What do you see as encouraging developments on clean coal technology?

Secretary CHU. Well, first, one of the most amazing encouraging developments is that countries all around the world have recognized this, most recently China. And although it is not widely known, two major utility companies in the United States, AEP and Duke, are now in agreements with two Chinese companies, Huaneng and ENN in China, to develop clean coal technologies. And, amazingly those pilot projects, co-supported by those four companies, are being done in China.

Now, right now I would say that the clean coal technologies we now have are too expensive for large-scale deployment. And so we have put together a game plan. We co-chaired a clean coal commission that said that it is reasonable to expect by 2020, in 10 years' time, now 9 years' time, that one can begin to get the costs down so you can begin to have significant deployment. But to be fair, it now costs too much money.

Now, we have looked very hard at all the research areas, both in proving in multiple sites that you can sequester safely and economically, but also the technologies for capturing the clean coal, lots of ideas that we think have great promise, but they have to be tested. This is research and development, and it is not ready for prime time where the American public could say, OK, we can deploy this.

There is significant hope, I might say, that now we see countries all around the world realizing that this is a technological hurdle that you have to solve, and then also realizing the country or companies that first solve these technological things can sell worldwide. And I think that is, you know, why China is doing this.

Chairman CONRAD. OK. I have another question, but my time has expired. But I would really like to talk about nuclear power as well before we conclude this hearing.

Senator SESSIONS.

Senator SESSIONS. Thank you. Thank you.

Secretary Chu, Admiral Mullen says our debt is the greatest threat to our national security. Do you agree with that?

Secretary CHU. Whether it is the greatest or not, it is certainly up there. I think the debt, the national debt is something that we have to work hard to bring down.

Senator SESSIONS. Well, you are asking for an additional 9 percent increase for the Department of Energy, and this is the Budget Committee. Do you think that energy should be exempt from the tough choices that everyone says, including the President, that this nation must face on spending?

Secretary CHU. I think the President has made some tough choices. As you know, this budget has put a freeze on non-security discretionary spending and made a commitment to do this for the next 5 years. This stopping the increase is the beginning, and I think—but having done that, the President has said that if you look at what is going to drive, what is going to really be the engine of not only the far term, but the near-term future prosperity in the United States and get Americans back to work and really guarantee that we will be as prosperous in the 21st century as we were in the 20th century, energy was seen as central to that.

Senator SESSIONS. Well, Education was in yesterday with an 11 percent increase. They think they are central. We will have Transportation in tomorrow and they are asking for a bigger increase than you are getting. The State Department has a huge increase. So at some point, we have to ask how we can keep this country on a sound fiscal path, and I believe we are going to have to ask you to do more with less, at least not the kind of increases that are being asked for.

You know, this past week, I was in Winfield, Jemison, Sulligent, Parrish, Haleyville, Glen Allen, and Cullman. I would talk about the budget and great issues of war and peace and the question would go up almost every place, gas prices. This impacts people. It is real to people. I know you have great hopes about these alternative sources. I called you about ethanol, an idea in Alabama I thought was going to work, and now it collapsed. I see this one in Boston, the Solyndra plant, are not successful. We have to understand, I think, that just promising, promising does not mean it is going to necessarily happen.

I know a lot of the focus on solar and wind is for electricity, but I do believe the biggest threat to our economy is the liquid fuel we are using to power our cars, 61 percent of which we are importing. I am willing to support and have supported spending on batteries and research, but I begin to wonder how much we can demand of the economy through forcing technologies that are not yet available, are not yet proven or effective. You have noticed that coal sequestration or carbon sequestration is just not feasible.

What we know is that we are going to be importing a substantial amount of oil for some period of time. I know, Senator Conrad, in North Dakota, I think they have the lowest unemployment in the nation. They are producing a lot of oil and gas. He told me they needed more workers in the oil and gas field. Yet we have laid off people along the Gulf Coast. We are not producing in other areas. We are importing this oil now. People are even discussing selling off some of our Strategic Reserve because of the surge in prices.

Do you not think, as a matter of national energy policy, we need to take more immediate actions to actually produce the oil and gas that we have?

Secretary CHU. I agree with you that we, as part of a national plan to get off of foreign oil dependency, developing further sources of oil and gas in the United States as part of a plan, but it will take five, perhaps even 10 years from now to actually be producing this amount. But it is part of a coherent plan. And I agree with you that the $300 to $400 billion we spend, where money is offshored to bring in oil, is a huge, a huge burden on the American people.

Senator SESSIONS. Well, Reuters just had this article, "Deepwater Rigs Moved Out of the Gulf of Mexico." Diamond would move to Egypt. They would also move another rig to the Republic of Congo. Transocean was moving one to Nigeria. Another, Transocean said, is leaving for Egypt. INSCO said it would work off French Guyana. Pride International was removed to the Mediterranean Sea. Noble Corporation said that the Clyde Boudreaux rig would move to Brazil.

Presumably, we are importing from Nigeria, Saudi Arabia, Brazil, Venezuela. We will be, instead of producing this in our own country, receiving royalties of billions of dollars from the production of that oil that goes to the Treasury, we will be importing that oil. Do you not feel like, that as Energy Secretary, you need to maybe call Secretary Salazar, our friend, and say, watch out what you are doing. We are not ready to produce batteries yet that are going to take over America.

Secretary CHU. Well, at least you have the right Secretary. I think Secretary Salazar——

Senator SESSIONS. You have his phone number, I am sure.

Secretary CHU. Yes. I think Secretary Salazar wants to resume Gulf drilling and deep Gulf drilling. He feels compelled he needs to do it safely, and I, as during the oil spill, I will certainly avail myself and the Department in any way we can.

But going back to the fundamental question, I think today's spike in oil prices is causing great concern, great hardship. The American people, we have a very delicate recovery going on and an increase in prices will make that vulnerable. And so we need both short-term and long-term plans going forward. And as I said, right now, advanced biofuels, I will tell you, is not quite ready for prime time, but I also——

Senator SESSIONS. I had hoped that we would be further along——

Secretary CHU. Yes.

Senator SESSIONS [continuing]. And I shared that with you, but it just has not happened.

Secretary CHU. That is true, but again, what is different in—you know, if you look back in the early 1980s versus now, it is a transformative difference in what is going on. In the last couple of years, again, the proof is going to be in the pudding, but already, people are beginning to pilot advanced biofuels where they think they can sell, for example, diesel at $4 a gallon. Now, that is still higher, but sell at a profit at $4 a gallon. You want to sell at a profit at $3 a gallon. But again, it is a little bit further off, perhaps, in batteries, but it is within grasp. Increased fuel economy, electrification, gas vehicles, gas-powered vehicles, all those things are part of the thing. A single—one single technology will not solve the problem, but also bearing in mind that we do have gas and oil reserves that we can simultaneously develop. All these things are needed.

Senator SESSIONS. Well, we just need more energy at a reasonable cost, and I am afraid our policies seem to be focusing more on higher-cost energy and locking up the energy we have. We have to get away from that direction.

Chairman CONRAD. I thank the Senator.

Senator Stabenow is next.

Senator STABENOW. Thank you, Mr. Chairman and Secretary. Thank you very much for your leadership and vision about the future.

Mr. Chairman, I think this is such an important debate and discussion, frankly, that we need to be having, I think, in a more extended way about what our energy policy is and how we get there.

At the risk of plugging somebody's book, which I am going to do, Andrew Liveris, who wrote Make It In America, I would strongly encourage everyone to read this, my colleagues. He is the CEO of Dow Chemical Company and has many things I know colleagues on both sides of the aisle would agree with. What I think is most powerful about what he talks about, though, is the fact that energy drives the world, and in this, from his vantage point as someone who is in every country around the world, watching what Germany is doing—not exactly a low-wage country or low-tax country—and China and other places talked about, he is extremely concerned about the lack of focus in this country from an innovation and manufacturing standpoint.

One of the things he says—I would just quote one thing he says—“It is ironic, energy independence is closer at hand than it could ever be in the age of oil, but America’s policy inertia suggests that it seems willing to trade one form of dependency for another, to let other countries build the clean energy technologies that we will then buy. It is still within America’s means to be a world leader in clean energy, but only if we wake up to what the rest of the world is doing and to what we must do.”

I raise that because in the book, he really is talking about, and in conversations, many conversations I have had with him, about how we partner with American businesses like every other country is doing. Right now, our companies are competing with countries. When Germany or China or Japan or someone else says, come here, we will build the plant for you or provide you financing or pay for your R&D, we are at a significant disadvantage.

And so I am reminded of what Japan did to help Toyota get a jump on us on batteries, by funding most of the R&D. We are now in a situation where by putting $2 billion into advanced battery innovation and manufacturing—$2 billion in this country—we have unleashed billions of dollars. Over 12 companies in my State now, including Dow, are doing advanced batteries, and we are going—as I understand it, last year, the number was we manufactured 2 billion—or, excuse me, 2 percent of the world’s batteries, and within 4 years, it is going to be 40 percent.

And so to our distinguished Ranking Member, I would say part of the way we get off of these high costs and so on in terms of oil going up is to really create some competition with other alternatives that are not pie in the sky. They are really happening now. We have the Chevy Volt and close to, what, 300 miles on a gallon of gas because of extended range, and the Ford Focus, and, of course, Toyota has been there with the Prius, and we could go on and on. I mean, these are not technologies that are fringe anymore. They are technologies that are here.

And Mr. Chairman, when you said that—we put up your chart about oil and gas subsidies, you know, we started oil and gas subsidies in 1916 and it made sense, industrial revolution, investing in energy policy. But that is 19th century tax policy and energy policy at a time when we need to focus on the 21st.

So my question would be this. First of all, I want to thank you for your support and the President’s support of an idea I put out last year to take up to $7,500 tax credit for consumers to buy these new vehicles, which is already paid for, and front-loading that at the time of sale so more people can purchase them and get the marketplace going.

But one of the other areas that we have been very involved with is doing what other countries are doing in terms of financing, low-cost loans. You and I have talked many times about Section 136, which Senator Bingaman and I authored in the Recovery Act, and I am wondering, as we go forward, we are looking at about 35,000 jobs nationally, thousands in my State that have come from partnering. We actually have Ford bringing back jobs from Mexico to Michigan because of the loan that they received to retool a plant.

But I am concerned continually, Mr. Secretary, about the process taking too long. That is what I hear from the companies and I wonder if you could speak about the process, the hurdles in receiving this financing, which has been so critical to many companies to actually be rebuilding, retooling, and keeping manufacturing here in America.

Secretary CHU. Thank you, Senator. First, I concur. I have read that book, also, and I agree with much of what it says. Its fundamental tenet is that America should not be willing to cede manufacturing to the world. Manufacturing jobs are particularly highly leveraged jobs because they institute supply chains and all the support services for the manufacturing, and finally the services for the workers who are in manufacturing jobs.

Senator STABENOW. Right.

Secretary CHU. So it is an extremely highly leveraged job and we should not even think of ceding manufacturing. We should—you know, I think our slogan should be, invented in America and made in America.

Senator STABENOW. That is right.

Secretary CHU. Now, regarding the foreign competition, I, too, agree with you. If you look at what China and other countries are doing, and the subsidies, tax holidays, very inexpensive money for loans, that they are luring American industries abroad to manufacture in their country. They are also developing a whole market for those products.

China thinks it is mandated by 2020 to be 15 percent renewables and will probably get to 18, perhaps even 20 percent renewables. They are growing their nuclear industry. The reason they are doing this is, in part, because they want to go to a greener economy, but also in part because they see a world market for all these products, whether it is wind or solar or nuclear, you name it, or high-voltage transmission lines. So in that sense, the loan guarantee program is a very important part of how we can help industry get going.

Now, if you consider the history of the loan guarantee program, it was authorized in 2005. I think the first appropriations were at the end of 2006, beginning of 2007. And when this administration came into office, not a single loan——

Senator STABENOW. Right.

Secretary CHU [continuing]. Had been given. And if you consider right now, we have now closed or given conditional commitments to 23 companies, but we are still working to up that rate. We want to more than double it. The OMB and we are working very hard, and Treasury are working very hard to make it smoother. I will be honest, it can be done faster, better. It is an important part of what we need to do.

And this is why we are asking in the 2012 budget for more authorization, particularly in the nuclear industry, in which I think it is very important we start the nuclear industry again, something where we were the leader. But in all the other, the clean, renewable energy sources and fossil energy, all those things could help with that, and we are working very hard with the other agencies.

Chairman CONRAD. Thanks, Senator.

Senator Cornyn.

Senator CORNYN. Thank you, Mr. Chairman.

Mr. Secretary, thank you for being here and thank you for your service. You have had a distinguished career—continue to have a distinguished career. But I want to ask you about the transition to this green energy future that you have described, which all of us, I believe, support from the standpoint of alternative sources of energy and reducing our dependence on imported energy and, hopefully, increasing our dependence on cleaner energy.

How is it—well, let me just ask this question. Currently, the U.S. energy supply is about 83 percent fossil fuels, and the figure I have is that about 51 percent of the oil and gas that we consume in America, we are importing from foreign sources. How long will it take us to get from a situation where 83 percent of our energy supply is fossil fuels to a situation where, let us just say, half of our energy supply will come from fossil fuels, whether domestic or imported? Are we talking about a 1-year, 5-year, 10-year, 20-year, what time table are we looking at?

Secretary CHU. Well, it is not going to be 1 year. I do not——

Senator CORNYN. It is not going to be 5 years, either.

Secretary CHU. It is probably not going to be 5 years. But then beyond that, I think a lot of things will kick in. I think in four or 5 years, I think there is a reasonably good shot a million cars, electric vehicles, but that is just scratching the surface because there are about eight million vehicles being sold now in the United States a year. It would really depend on what happens in battery development, and as mentioned before, for the first time in my career—I have been looking at this for a while, and when I was at Lawrence Berkeley Lab, I was on the scientific board of a new, innovative battery company, so I know a little bit about this—but the first time in the last 3 years, I am seeing things that are saying, you know, this is going to happen.

Senator CORNYN. I hope you are right, but, of course, a lot of our electricity is generated by——

Secretary CHU. Right.

Senator CORNYN [continuing]. Fossil fuels, either coal or natural gas, and we have to—so we cannot say that—we cannot imagine a fantasy world where all of a sudden, we are all going to be driving plug-in cars and we will not need fossil fuels from some source, correct?

Secretary CHU. I absolutely agree with you. For the coming decades, fossil fuel has to be a very important part of—for the next half-century and perhaps beyond, it is going to have to be a very important part of what we do.

Senator CORNYN. So here is my question. How is it, recognizing that we will continue to be dependent on fossil fuels for the near term and mid-term, how does it reduce our dependency on imported energy to raise taxes to the tune of $46 billion on our domestic energy producers, which the President's budget proposes, which this budget proposes?

Secretary CHU. Well, I think the President was calling for an ending of certain tax subsidies on fossil fuels that had its origination in the beginning part of the 20th century and——

Senator CORNYN. But you agree with me, however you want to characterize it, it will increase costs of production for domestic producers, correct?

Secretary CHU. It will be, I believe, a very small part of the total cost of producing oil in the United States.

Senator CORNYN. Well, I think in conjunction with the policies of the administration with regard to the Gulf of Mexico, which has been a job-killer in our part of the world, in Texas and Alabama, the Gulf of Mexico, and reduced revenue to the Federal Government, the royalties from that production, and has made us more dependent on imported energy from abroad.

I worry that, along with the additional tax burden, that an industry which employs 9.2 million people in America right now, by adding $46 billion in additional taxes over the next 10 years by the permitorium we have seen in the Gulf of Mexico—now the moratorium has gone away, but the difficulty of getting permits—and this vision of a green energy future that may occur ten, 20 years out, but it will not occur next year, what does that do to the average consumer that is now paying $3.38 for a gallon of gasoline, and with the geopolitical unrest that we are seeing in the Middle East and elsewhere, if the Suez Canal is blockaded, if the imports from the countries the Chairman mentioned were to occur because of disruption there? Is there not a very real danger of gasoline prices skyrocketing for the average consumer, and what would that do to our fragile economic recovery?

Secretary CHU. Well, we are certainly very concerned about what will be happening to the gasoline prices in the near term, but we also have to keep in perspective the fact that, currently, the United States consumes about 25 percent of the oil produced in the world and we have about two or 3 percent of the known reserves in the world. And if you further consider the fact that within our territories we have scoured that much more than the rest of the world, you know, going to the future, those newer reserves, that fraction will be less.

So while I do support an integrated plan which includes production of oil and gas, we cannot simply say, we can end our dependency on foreign oil by simply drilling our way out of the problem, given those numbers, 25 percent and 3 percent.

Senator CORNYN. Well, and nobody is suggesting that we drill our way out of the problem. I think we all agree we need a plan——

Secretary CHU. Right.

Senator CORNYN [continuing]. Really, what I would love to see is a plan that deals with every element of our energy sources here, and particularly domestic. But you have expressed great hope and optimism about research and development in electric batteries and other alternative sources of clean energy and I share that hope and I really do hope that we develop alternative sources because I think it is going to take all of the above to get us there.

But you also would acknowledge that we have seen a tremendous 14fold increase in the amount of natural gas reserves here in the United States because of the development of new drilling technology and the fracking techniques that you alluded to earlier. So is that not an area that we also ought to continue research and development to see if there are ways we can gain access to domestic energy sources rather than just ignore that altogether and put all of our hope, all our eggs in the basket of something being deployed ten or 20 years in the future?

Secretary CHU. No, we are certainly not ignoring that, and it is a wonderful thing that the development of the technologies that allow us to frac the shale rock to release natural gas. I am certainly looking at what the projected increase in reserves are. I hear estimates all over the map. The EI estimate is much less than that. But that is neither here nor there. I think as we go forward in time, as the extraction methods get better and safer and all those things, I think those estimates will grow. I am not sure it is going to be 14 times.

But it is a good thing that is happening because this is energy produced in our borders and it is a cleaner form of energy and gas will be a transition fuel that we will need in the coming decades, and——

Senator CORNYN. Mr. Chairman, thank you for your indulgence. I would just add that this is jobs here in America, too, right?

Secretary CHU. Right. Absolutely. And that is one of the reasons—all of the electrification, actually, is using energy produced in America to power our vehicles.

Chairman CONRAD. Let me say this to my colleagues. The vote is scheduled for 11. Senator Whitehouse is next on our side, then it comes over to Senator Portman. My intention is to leave now, have Senator Whitehouse proceed, and I think, Senator Portman, if you would leave now, there would be a prospect that you could be back after this vote and have your chance, and then we will just keep going back and forth.

So if, for whatever reason, we are getting on the second seven-and-a-half minutes, Senator Whitehouse, and you are done with your questioning and nobody is here on the other side to proceed with their questioning, you just put the committee in adjournment so that you do not miss the vote, OK?

Senator WHITEHOUSE. Very good.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE [presiding]. Thank you, Chairman, and thank you, Secretary Chu, for being here.

There is an image that I recall of a lineman who has climbed up a telephone pole and he is installing on the top of the telephone pole an array of solar cells. It is a picture that I recall because it was taken the year that I was born, back in 1955, and it is a reminder that America invented solar cell technology.

And yet as you look around, as a country, we are fifth in solar component manufacture now. Only one of the top ten companies in the world that is engaged in solar component manufacturing is an American company. And we seem to have slipped in terms of our competitive advantage in this market—and it is not just in this market, it is true, as well, in wind turbines.

I am from Rhode Island. We have the potential of a very significant wind turbine farm going in offshore. It has considerable prospects for our energy portfolio, for clean energy, for ultimately lower costs, but mostly for the assembly and installation and construction jobs in Rhode Island, which we now desperately need.

So in that context, I would love to get you to talk a little bit more about when it makes sense for the government to take a role in encouraging investment, and in particular, I think you have already described in your testimony that this new clean energy market is a rapidly emerging market and it is also a potentially enormous market. I do not know if you heard John Doerr's testimony. He was one of the most successful investors in the entire tech revolution and he now observes that the energy revolution is going to be six times bigger than the tech revolution in terms of the money at stake.

Is there a particular role where it makes sense for a government to encourage early investment at the beginning stages of what can foreseeably be described as a rapidly emerging technology to protect against foreign competition or protect against being overwhelmed, really, by foreign competition in those markets?

Secretary CHU. Yes, there is a government role, but before I answer that, I might also add, at the institution I used to work at for 9 years, Bell Laboratories, invented that silicon photo cell. To have the leadership slip and the production exports slip from the United States is—even in the mid-1990s, we were the leader in the world——

Senator WHITEHOUSE. Yes.

Secretary CHU [continuing]. And now it is clearly over in Asia and China is clearly—really wants to dominate this market today.

Senator WHITEHOUSE. And how does that work? Is there an economic theory by which the bare investment is justified to try to capture an early emerging market and take a technological lead?

Secretary CHU. Yes. What they and—but it not only China, it is Japan, it is Korea, the EU countries. What they are saying is, OK, we have certain mature technologies, but there are some rapidly growing technologies and their crystal ball says it is highly likely that these technologies will become a dominant growth industry in this next decade, from now until 2020. And they think that this is going to be the place of major economic growth, and they made no bones about it.

And for that reason, you have these, you know, no corporate taxes in Asia type of policies. You have inexpensive money in Asia type of policies. And you have a bevy of engineers being trained in those countries that can work on these things and to drive the processes down. The myth of cheap labor is simply a myth. Most of the cost of these things is in the capital expenditures and in the engineering to drive the quality up, the production costs down. So these are highly roboticized factories.

Senator WHITEHOUSE. So if you had to make a choice, if you were a government and you had to make a choice between subsidizing a mature extractive industry and an emerging clean energy industry, which is more or less the facts that we have before us, justify for me the investment in the clean energy rather than the mature extractive industry.

Secretary CHU. Well, the United States has a history of having government support in emerging industries which it thinks is going to be important.

Senator WHITEHOUSE. Has it worked in the past?

Secretary CHU. It has worked in the past. As mentioned, actually, the oil industry was subsidized in the early 20th century until today.

The airplane industry, even though we invented the airplane, the leadership went very quickly to Europe, and by the end of World

War I, it was noticed that we could not compare in the technology and the United States, beginning with Woodrow Wilson, started an Aeronautics Board and said, we need to support this industry. How can you support this? You get airmail delivery, that the government would sponsor airmail delivery so there was a market to encourage people to build better planes that would solve that need. The military played a huge role in that.

So we rebuilt an air industry that was important for our national defense, important for commercial things. It did not spring out of the private sector alone. There was help from the government. And so——

Senator WHITEHOUSE. So investing in emerging new technologies has a long and successful American pedigree——

Secretary CHU. Right.

Senator WHITEHOUSE [continuing]. Across Republican and Democratic administrations alike.

Secretary CHU. Right. The semiconductor industry, the transistor was invented at Bell Labs. It was a monopoly. It had the wherewithal to invest in this long-term research. It took more than 10 years to develop that technology. But the first transistors were not competitive with tube technology, and for the first two decades, guess what was the first buyer of all the semiconductor material. It was the U.S. military, because they knew full well that they had to nurse this along and nurture it and it became a dominant force in wealth creation in the United States.

So again and again and again, the government said, these are the things—and it was fundamentally a nonpartisan issue, Republican Presidents, Democratic Presidents, Republican Congresses, Democratic Congresses, said that this is what you do in order to nurture a beginning industry which we think will be a dominant force of wealth creation in the future.

The United States did it. Other countries have taken from our playbook and are now doing it. And for us to say, well, we do not want to do this anymore, simply does not make that much sense to me.

Senator WHITEHOUSE. If you compare extractive industries in which demand competes for a diminishing supply with technological industries in which technological advancements and increased demand have a history of lowering cost—I have my BlackBerry right here. I see behind you, you have a staff person with his iPad up. I can remember the days when a simple calculator was a very expensive thing to buy. Now they are so cheap, people give them away. The price of technology, I believe, tends to have a downward curve, whereas the price of extractive industries tends to have an upward curve, inevitable from supply and demand in that case. Is that an additional argument for getting on the side of technology and not just extraction?

Secretary CHU. Yes, I would say that technologies in all areas, including actually oil and gas, actually improved. But with an extractive technology there is something else you are fighting. As the technology improves, as we see ourselves—the multinationals have to go harder-to-access oil, deeper offshore, Arctic regions, much more expensive. A deep offshore rig now costs $2 to $4 billion for a major platform.

So even though their technology is getting better, they are fighting this other thing, that you have to go to more inaccessible oil, and it gets more expensive. And you can compare that to looking around and saying, well, you know, one-hundredth of 1 percent of the energy hitting the sun for a day can power the world for a year, so can we figure out a way to capture a small fraction of that energy, store it when needed? Because if we do, and if we can do this in a decade or two, then we would not be.

Senator WHITEHOUSE. Another potential win big seems to me to be turning what is presently nuclear waste into nuclear power. And I know that there are a few emerging technologies that promise or suggest an ability to take what is now an expensive-to-dispose-of, poisonous, dangerous, potentially proliferation and, you know, dirty bomb, national security-related problem, and through the use of that technology be able to turn that into clean nuclear power. How are you investing in that? Do you see those technologies as credible? And is there an added value to investing in them because it helps solve the problem of the nuclear waste that is now scattered at various power sites around the country?

Secretary CHU. Sure. First, as you know, I am a big supporter of the nuclear industry getting restarted. I think it should be and has to be part of our energy diversity in this century.

What you speak of, the fact that in our standard nuclear power plants we put in the fuel, lightly enriched uranium, and we have right now a once-through cycling, about 1 percent of the energy content of that material is used.

After that, you have a used fuel rod, and just imagine—now, we will naturally evolve, and we are doing short-term research to help the industry double that, which doubling is great, but it is only 2 percent. And so if you can say let us not go from 1 percent to 2 percent, but what do we need to do in order to go from 1 percent to 20, 30, 40, 50 percent? That means for the same amount of nuclear material you get 20, 30, 50 times more electricity.

Senator WHITEHOUSE. Yes.

Secretary CHU. Which means for the same amount, that much less waste. And so we think that it is very important—but this is a tough long-term thing in order to invest in that technology.

I can tell you that right now today we do not have the technologies that we think are cost effective and cost competitive, but there is time to figure it out.

Senator WHITEHOUSE. When you say cost competitive, are you taking into consideration the proliferation hazard that these rods lying around with no purpose and the disposal problems, if they are left with no other use other than to be poisonous, hazardous waste?

Secretary CHU. Yes, but there is also—with today's technology that is being used by France and Japan, notably, the recycling technology they are using, which was invented in the United States, actually presents a proliferation problem, and it is not cost effective either. You know, Japan unfortunately has discovered this because their costs of their current recycling have more than tripled.

Senator WHITEHOUSE. Let me hold a moment because I am getting a different instruction than I had before about the management of this hearing and the vote.

Senator THUNE IS HERE. He is waiting to ask questions. Has the Senator been over and voted?

Senator THUNE. No.

Senator WHITEHOUSE. No. Well, the two choices we have here are either to go to you, and you are going to have a very close run at making the vote, or to wait a few moments longer for somebody to return, and then we can both go vote.

Senator THUNE. I am fine with proceeding. I am happy to make the run to the vote.

Senator WHITEHOUSE. So you would care to proceed now?

Senator THUNE. Yes.

Senator WHITEHOUSE. We will do so, and you can make your dash.

Senator THUNE. Thank you, Mr. Chairman.

Mr. Secretary, thank you so much for being here and, again, for your service and for the work that you do in what is one of the most important areas that we deal with in this country, and that is our energy sector. It has enormous potential to create jobs to grow the economy and reduce the Federal deficit. Unfortunately, if you do not have the right policies in place, you can get the exact opposite outcome, and I fear that sometimes our energy and environmental policies act to destroy jobs and economic growth and are not a good service to our taxpayers at the same time.

I know as we look at your budget for this year, there is a significant proposal in there for an increase, and some of that I know is attributable to the additional demands on account of the new START treaty, but we obviously have to, at a time when everybody else in this country is tightening their belts and trying to do with less spending, make sure that our budgets are following that basically same approach.

But I wanted to raise a couple of issues with you, if I could, and one has to do with—and I know this is not directly under your jurisdiction, but they say that there is as much as $2 trillion in capital sitting on the sidelines right now because of the economic uncertainty that exists today, some of which is being driven by policies coming out of Washington. Much of that is—at least folks that I deal with, small businesses and others, suggest that a lot of that has to do with policies coming out of EPA.

I guess my question has to do with whether or not you believe that the Clean Air Act is the best approach to limiting greenhouse gas emissions.

Secretary CHU. Let me respond by saying that I think the President has—I think in terms of going forward and transitioning to a clean energy economy, which will actually put us on the forefront of being able to export abroad those technologies we develop at home, one would much prefer to have it through the legislative process.

One of the things that has been proposed—I am a very big fan of this—is a clean energy standard that includes, you know, half credit for gas if it is combined cycle gas, again, a very efficient generation of electricity by gas, but it also includes nuclear, it includes wind, solar, new hydro.

If you do that and you give it a long enough leash—and the President proposed 2035—that clean energy standard will allow the development of technologies so that you can be sure that you can build nuclear reactors in a cost-effective way, on budget, on time; that you can further develop the technologies for clean coal and other carbon capture sequestration methods; that just simply saying that this is going to be the goal of what we need, we have seen this in States. When States do this it provides market certainty to that $2 trillion, because then all of a sudden a company says, OK, if I build it—and the Federal Government is not going to pick winners. They could say, you know, if you can do it by wind or if you can do it by solar or if you can do it by nuclear or combined cycle gas, you do this and you get credit for it, that means that the financial institutions can say, OK, we will loan you the money because if you do this, you will have a market.

So the investors will have that certainty. I think the long-term planning—and we have seen this in States that have done this, that all of a sudden there is a much longer-term planning, the electricity transmission and distribution lines, it creates market certainty. And you say if you do the right thing and it is cost competitive, you will have a market.

So we think that that will relieve a lot of the uncertainty that is now—and I agree with you. There is—I do not know whether it is $1 trillion or $2 trillion—a tremendous amount of capital sitting on the sidelines, which means not driving the engine of the United States and jobs.

It is a very light touch. We established this goal; industry, you figure out what is the best solution. And each State and each region can figure out what is the best solution.

Senator THUNE. But the way to accomplish that—I have come back to my original point, and you suggested this—would be some direction from Congress. What EPA is doing today I think is making it very, very difficult for businesses out there to create jobs, and it strikes me at least that if you are concerned about private investment, getting that capital off the sidelines, getting jobs created, and growing the economy, the approach that they are taking right now is completely contrary to that.

You mentioned a clean energy standard. How would you treat gas, clean coal technologies? You mentioned increased hydro. We have a lot of hydro in my State, as does the Chairman. How would those be treated under a clean energy standard in your estimation?

Secretary CHU. Sure. Hydro is clean energy. I think gas, if you look at combined cycle gas, it is more efficient than the most efficient coal plants. It is 55, going to 60 percent efficient in terms of the amount of energy you get out, and it has, by its very nature, less carbon emissions. So as you take the combined cycle gas plant and compare it to a new high-efficiency coal plant, roughly speaking you get twice as much electricity for carbon emission, so we count that as half.

Now, if you come along and develop a technology that grabs 80 percent of the carbon from coal or 90 percent, you just pro rate it that way.

So what that means is if—that is another incentive for the utility companies to begin to invest in pilot demonstrations of clean coal technologies, because they can say, OK, there is going to be a market, and if you are a coal State and there is a lot of abundant coal, you can say we can develop those technologies. Now, the development of those technologies, I firmly feel that the Federal Government has to do a lot of the research to help the companies to develop those technologies. But having said that, if you have those technologies, again, 2035 is a long enough lead time where we are pretty confident they will be developed by then or even—because they have to be actually developed 10 years before then in order to get a business plan going. And so 2025 we think is a long enough lead time where we can dramatically bring down the costs so it looks like a good business investment.

Senator THUNE. Well, and I hope that you consult with Administrator Jackson about that approach and having Congress come to some solution as opposed to having these regulations coming out of EPA, because I talk to groups all the time, and I hear that over and over and over, that what they are doing over there is making it incredibly difficult.

I have to go vote, and thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator MERKLEY.

Senator MERKLEY. Thank you, Mr. Chair, and thank you, Mr. Secretary, for your testimony and your leadership.

Senator Cornyn was talking about the importance of a plan to end our dependence on imported oil, and indeed certainly that echoes a sentiment of mine. We have so many technologies that we are talking about at this point, including electric vehicles, plug-in hybrids, the use of more natural gas for trucks, many technologies that increase the fuel efficiency of trucks, the shift of trucking to rail, et cetera, et cetera, et cetera.

What has been missing, in my thinking, is for the Department of Energy to lay out a plan for how we are going to over a period of some time—because it does take time to, say, shift fleets—end our dependence on foreign oil? Is there any prospect we might see a plan like that from the Department in the course of the coming year?

Secretary CHU. Well, we are beginning—I am so glad you asked that question because this is something where I think in the past we would say, OK, this looks good, we will fund this; that looks good, we will fund that. But we are now going about it in a slightly different way. It is a very hard look. Without Department of Energy help, where is business going? And what is its timeline? What can we do in the Department of Energy to accelerate it? And what price point can we get to at any given time? And it is those price points—because energy, you know, fundamentally the investments in energy and how it is, it is about money, and you have to bring prices down in the new technologies. And what is the timeline you say? You know, can it be done in 5 years, 10 years? Or is this so far—you know, 20 years means, well, we are not really sure.

And so we are developing this. We are looking at this in every sector, and it now cuts across all of the Department. For example, in photovoltaics, we are able to attract a very talented individual—

who happens to be a personal friend of mine, Arun Majumdar, a professor at Berkeley—to say, OK, we have had our Sputnik moment on energy; the equivalent of the moon shot is not a sun shot. What do we need to do in order to bring the price of electricity generation down to—the full cost, what is called the levelized cost down to be competitive with gas or coal? And how far will that be?

And so now all of a sudden this program is going to cut across all the lines within the Department to say what is it we can do. And so we are doing this for every technology—biofuels, coal, transmission and distribution, battery storage, battery storage for vehicles, but also for utility scale. And so we will be developing this plan.

In addition to that, we are working—there was a PCAS report, Presidential Science Commission, that suggested—in fact, it was spurred by requests I made of them, to say what can we do in the Department of Energy to help the country's goals in energy. They made a recommendation that said, Why don't you develop a longer-term plan, what they call a Quadrennial Review, which has been done in the Department of Defense and now in State, and they made that recommendation to the President and we are enthusiastic about it and intend to go forward with that. We are now working with OMB and then soon with relevant agencies within Congress going forward. And we would like to actually do in a very short time scale the first version of that. It is a technology review to address precisely what you want to do.

Senator MERKLEY. Well, thank you. I am very glad to hear that, and it is certainly appropriate to incorporate the vision for how costs will play into this.

Quite frankly, most of our estimates about cost are always a bit of because the world changes in ways we do not anticipate. Certainly the drop in natural gas and the increase in the supply are a good example of that. But, crudely, the projections are that 20 years from now we will be importing between 8 and 9 million barrels per day without our changes in technology.

Four Senators have put out a plan as a bill that lays out a pathway to reducing our consumption of oil by over 8 million barrels per day, which more than exceeds our non-North American imports 20 years out. This is without the sophistication that the expertise of your Department can bring to bear. But I think when you complete this vision of wrestling with the cost lines, I think you will have all the data to do a much more sophisticated version of a 20-year plan or less to end our dependence on foreign oil.

Now, clearly, that does not end our dependence upon or our concern about price shocks because it is a global oil market.

Secretary CHU. Right.

Senator MERKLEY. But it does play a lot into our understanding of our national security challenges from being dependent on overseas oil. So I would really encourage you with considerable enthusiasm to translate all that data into a road map, recognizing the road map will change, because the world will change and we cannot envision accurately all the ups and downs. But I think it would give us a pathway to seize hold of.

We have proposed, the Senators who have put this forward have proposed having a Department of Energy Security that is an ongoing—not a full department but actually a council like the National Security Council—to keep pushing so that between administrations or the transition of administrations we can fulfill a 20-year plan. That, too, I think is part of a plan I would love to see the administration come forward with. Lay out a 20-year vision but then a structure for how we make that vision happen, knowing that we will have to adjust the changing dynamics over time. I just think that sort of understanding—it is like a business positioning itself in a smart way strategically. And we need to position ourselves as a Nation not to be dependent on overseas oil. And in the process it creates a lot of jobs at home and does a lot of good for the environment. So obviously I am spending a lot of time on this just to try to root for it as much as possible.

Secretary CHU. I could not agree with you more. And, in fact, when you said do it like a business, that is exactly the way we are trying to do it. If we think more as, you know, green eyeshades, what are we going to do, you know, it is a competitive world out there. There is going to be a race as to who is going to develop these technologies first, and we want to get them and we want to win this race. So treat it like a business.

So that is why we are saying, OK, the traditional boundary and traditional way of thinking cannot go forward, and it has to be a business plan that looks out into the future, knowing that a technological breakthrough can be totally upended, and that is what we really want. But you also make plans. You know, you do not want to make—sail on on what we are doing hoping out of the blue some miracle might happen. You know, you do not make plans hoping for a miracle. But you make miracles much more likely with a better plan.

Senator MERKLEY. Great. Thank you. My time is up. On your way out, I will give you the copy of the plan that the four Senators put forward, "America Over a Barrel: Solving Our Oil Vulnerability," and I will look forward to when you can hand me back a plan from the administration of a more sophisticated strategy. Thank you.

Chairman CONRAD. Thank you, Senator.

Senator PORTMAN. Thank you, Mr. Chairman.

Dr. Chu, good to see you again and have you before the Committee. I am going to followup on Senator Merkley's comments about a plan and also focus, I hope, on two issues: one is nuclear and natural gas. You just said we are living in a more competitive world, and you are right. Senator Sessions has also reminded us that we are living in a time period of not just more competition but more budget constraints. And to me this means that we need to determine ways to unleash the American potential to create sources of energy right here. And I would associate myself with some of the comments earlier of some of the members on both sides on clean coal and other technologies, but let me focus on nuclear, if I could, because I think that may be one we have not gotten into as deeply.

As you know, I am very concerned about the slow pace on the loan guarantees. I think it is fair to say that nuclear is the only baseload emissions-free option that we have. It is U.S. based. It will create a lot of jobs, and it is critical in terms of our dependency on foreign sources, but also in terms of having cleaner energy. And the infrastructure is aging, as you know. Plants are getting older. They are less efficient. We should certainly be encouraging upgrading our energy infrastructure generally. As you know, I have been specifically involved in the front end of that on the enrichment side. And when you look at the track record since the beginning of this administration, I think there has only been two loan guarantees on the nuclear side. The last one was about a year ago, one of which is conditional. And that, of course, goes to a French-owned company on the front end, which is nuclear, but it is really uranium enrichment.

So I guess my question to you would be—you said earlier your goal was to double renewable loan guarantees. What is your goal on nuclear? And what can we do here in the Congress to get these loan guarantees moving? And then I want to followup with some specific questions about enrichment.

Secretary CHU. Sure. First, in the President's fiscal year 2012 budget, we are asking for an additional $36 billion in loan guarantees. We have made one conditional commitment to the Vogtle plant for two new reactors. We have another three projects before us, and then after that, another four. And so we are actively working on the first three.

I think it requires additional loan guarantees, and it requires other things. A great stimulant to nuclear energy would be a clean energy standard, quite frankly, because that says if you build a nuclear power plant, you get credit for this. And many regions in the United States say this is part of it. So it is a market draw. The loan guarantees will help industry get started, provide the assurance that you can build these reactors on budget, on time.

Then in addition to that, we are helping—we think there is a great opportunity in the United States for the development of small modular reactors, and so instead of reactors that are 1,000, 1,500 megawatts of power, these would be more of the scale of 100 megawatts of power, maybe 200 megawatts, maybe 50 megawatts.

The advantage of that is—well, first, the reason we built these very large reactors is you get an economy of scale. There was a very long licensing period, approval period, things like that, so you built one big one. The only trouble is when you build one humongous one that the full costs could be $8 billion plus, this is a huge asset and so, you know, this is a large fraction of the cap ex of a utility company. So if you build a small or large reactor that can be built in a single factory, the economy of numbers can then compensate for the economy of a single one.

The electricity infrastructure in many parts of the United States could not even accommodate a 1.5 gigawatt reactor. And it is something where we think we can begin to retake back the lead in nuclear technology. We made the first nuclear reactor in the world in the United States. But that lead has gone to France, it has gone to Japan, it has gone to Korea, and now China want to take that lead. So we are no longer major players. GE and Westinghouse are majority owned by Japanese companies. But to be sure, these companies, GE and Westinghouse, many U.S. engineers are still part of this.

So we want to restart the nuclear industry. We also want to start——

Senator PORTMAN. Let us not forget Babcock and Wilcox.

Secretary CHU. Oh, Babcock and Wilcox.

Senator PORTMAN. Modular units like mPower.

Secretary CHU. Right.

Senator PORTMAN. But let me just back up for a second, if I could. It is fine that you are asking for more money for loan guarantees. The question is: You have loan guarantee money in the pipeline; how do we get it out?

I agree with you on modular. It seems to me—you are the expert, literally the scientist on this, but it seems to me it makes sense for a lot of reasons, including commercial reasons. But there has to be a demand for it, and there has to be a clear pathway through the regulatory process. So what can we do to get utilities to move forward and get you to get these loan guarantees out so we can actually begin this nuclear renaissance?

Secretary CHU. Well, I think if you look at the dynamic of what is happening, there is uncertainty. For example, there will not be a price on carbon in the next couple years. The cap and trade is not going to be revived for the next couple of years. And so that is why the clean energy standard is a market draw that allows that to go.

The low price of natural gas also has an influence on economic decisions of investment, and so—but when you build a nuclear reactor, this is a 70-year horizon, and we do not really know what is going to happen to the price of natural gas in 70 years. We know in the next 10 or 20 years it is probably going to be a lot lower than it has been in the past. But it is still a very volatile commodity.

And so that is why we need to diversify our energy supply, and that is why I think nuclear is very important in that. But there are all these other factors, and to the extent that the Federal Government can say, OK, there is a market for clean energy and nuclear counts full, whereas natural gas might count half, we think that that would be a stimulant. But as these companies go through this, we still see a lot of interest in trying to get it going, and we are looking at those companies.

Senator PORTMAN. I would love, if it is all right, to do some followup with you on this, maybe just look on paper at what is exactly your goal on the nuclear side. You mentioned doubling on the renewable loan guarantees. How would you measure your success or failure to get there over the next couple years? And what do we need to do specifically to get some of these loans going?

On enrichment just for a second, do you think we need a U.S. source of enriched uranium?

Secretary CHU. Yes.

Senator PORTMAN. Do you think we need a U.S. sort of tritium, which is so critical to your nuclear arsenal?

Secretary CHU. Yes.

Senator PORTMAN. And any update on the loan guarantee for the Piketon plant? We are, as you know, very concerned about that and particularly concerned that this may be a pivotal time over the next few months in order to keep the project going?

Secretary CHU. Right. I think, you know, we are—specific loan guarantees, as you know, I really cannot talk to you about that, but

I do believe that we do need a domestic enrichment technology. It is important for our national security, let alone our energy security, which are now so intertwined I do not really draw a distinction between our national security and our energy security. And so I do believe it is important that we develop technology, a leading technology in the United States.

Senator PORTMAN. Thank you, Dr. Chu.

Chairman CONRAD. Thank you, Senator.

Senator BEGICH. Thank you, Mr. Chairman.

Thank you, Secretary Chu, and thank you for coming up to Alaska and especially to rural Alaska, and Hooper Bay was one of the locations you went to, and I thank you for that.

I have a couple questions, and just by circumstances and timing, I just finished meeting with Mayor Hopkins of Fairbanks North Slope Borough, and in Alaska, as you saw, the cost of energy is high. In some cases, you can be as low as $4—and I say "low"—for heating fuel to as much as $11 or $12 a gallon for heating fuel. So the economics for some of the projects are important.

I am going to give you a little frustration, but it is really an ask to have you review, and that is, Fairbanks, which is a cold climate area—today I think they are 20 below. The last 60 days they have failed their PM2 air quality 50 times, so EPA, of course, is going to tell them, you know, shame on you, we are going to take highway money away and everything else.

But one of the things they are doing is starting to truck in gas, truck it in, because there is no pipeline access there. In order to do that, they have to have an LNG plant, they have to have storage and so forth. So they are going to be meeting with your folks tomorrow to try to see if there are opportunities for loan guarantees in doing that project.

This is the frustrating part. On the one hand, EPA says clean up your air. So they say, OK, let us use clean-burning gas, but there is no one to help in figuring out this problem. But it is a Federal rule that is telling them they have to do it. So I am hoping that there is some coordination between these kind of activities. They are going to be in your office or with your folks tomorrow. I am just putting the bug in your ear now because it is very frustrating to me when the climate conditions themselves are—we cannot change 30 below. It is what it is. But can we move down the path? Yes, we can with some gas issues, which is a better fuel than some of the stuff they use now. So I would hope at least you would consider that when there is a Federal agency putting the requirement on.

The second part of this is we have strategic military bases there; 4,500 Striker Brigade members are leaving in the next 2 months to go to Afghanistan to fight the war there. But they are stationed right there in Fairbanks. And one of the big issues the military keeps bringing up is air quality. And yet we have a solution, but we cannot get DOD, EPA, Energy Department, who all have—it is all the same pot of money—to figure this out in order to protect our energy resources up there, make it economical to clean the air and make sure we have a very strategic air base and army base continuing to operate.

So this is just kind of a statement. It is a little frustration, I got to tell you, after hearing what I just heard about an hour ago in this meeting. So I would hope you would at least have your folks look at that.

The second piece is—and you talk about gas, and I appreciate it, and this is one I am just going to ask you if you could come back. In the 2012 budget, there is an amount of money, $17 million, that goes into the North Slope. It is a partnership that the Department of Energy has had for many years in developing gas resources and understanding the research, and it is called the Barrow Gas Field. It has been very successful in having that whole community on gas, for example, but also looking at new technologies. But it has been totally eliminated out of your budget, and this is how it reads: "The detailed justification"—that is what it is listed under. It "reads: 'Consistent with the administration policy to phaseout inefficient fossil fuel subsidies.'" That is it. That is the detailed justification.

I would say that gas, which you have mentioned more than once here, as well as others, Secretary of Interior, EPA, the President, is a very important part of the equation in dealing with our long-term energy policy. So if I could get a little more justification, because honestly this is an incredible project that has brought great technology to the field when it comes to gas, oil and gas exploration. It is why in a lot of places—and the Chairman's State is very successful, it is because some of the gas exploration technology, fracking as well other things, were developed in Alaska.

So just help me understand it and why you have cut that from your budget totally, not even lowered it but totally eliminated it.

Secretary CHU. Well, I am not sure which one. I know of one item of gas in Alaska that was shifted from fossil energy to the Office of Science. This is a—it is a cooperative research with, I think, Conoco——

Senator BEGICH. It is Conoco.

Secretary CHU. Yes, OK. So that is the one. So that one is one that is looking at research into whether one can extract gas from methane hydrate formations under the ground. I actually support that, and it has been transferred over into the Office of Science, but we hope to continue—and it is a research thing. It is not a subsidy of oil and gas, and——

Senator BEGICH. Well, I agree with you. The justification seemed——

Secretary CHU. Right. And so—but it has not been killed. That program has been moved over to the Office of Science and what we want to do is we want to do research. Again, if you look back in the fracking, long before, the major oil and gas companies were not interested in that.

Senator BEGICH. That is right.

Secretary CHU. They did not think it would——

Senator BEGICH. Would produce anything.

Secretary CHU. Right. And so in terms of research, we think that there—you know, it is difficult. Methane hydrates, as you may know, they were found because they plugged up oil and gas lines——

Senator BEGICH. That is right.

Secretary CHU [continuing]. Because as you release the pressure, it freezes——

Senator BEGICH. Right.

Secretary CHU [continuing]. As we saw, actually, in the Gulf of Mexico, in the deep Gulf. And so—but there is a tremendous amount of natural gas in methane hydrates, both underground and off the continental shelf. If you think that fracking of natural gas can perhaps double our natural gas supplies, if you can safely, environmentally, responsibly extra methane hydrates——

Senator BEGICH. It is huge.

Secretary CHU [continuing]. It is much bigger.

Senator BEGICH. That is right.

Secretary CHU. And then you can really think of doing things like reforming natural gas to hydrogen and sequestered carbon. There are many opportunities. But it is still research, and——

Senator BEGICH. Good. So I am going to hold you to that, because I have only got about 30 seconds left.

Secretary CHU. OK.

Senator BEGICH. But let me just say that what I hear you saying is it is transferred. It is still happening on some level of research. And the language that was utilized in justification may not have been the most accurate in description of what happened to that.

Secretary CHU. Yes. I have personally known about that program for a couple of years——

Senator BEGICH. Right.

Secretary CHU [continuing]. And I am very positively disposed to it because it is research. It is not—again, it is not underwriting of commercial interests, because right now, the gas companies are staying away from it, quite frankly, the oil and gas companies, because——

Senator BEGICH. But in this case, we have a partner, which is——

Secretary CHU. Well, it is not only a partner. We need this partner because they actually have the equipment that we could not—so they are actually, in a certain sense, loaning us—they are using—ConocoPhillips–BP is loaning us this equipment, if you will, working with us. The program is dictated by the Department of Energy research scientists-——

Senator BEGICH. Right.

Secretary CHU. And they are willing to say, OK, we will partner with you. You can—because we could not afford——

Senator BEGICH. I hear you. Let me end there and just ask one question. Does the President have an energy team that is developing an energy policy for this country, and who are they? And I will leave it at that.

Secretary CHU. Yes, and this was actually in an earlier question, asked before. We have not in the past had a coherent—I would start with, more modestly, first, where we are in energy technology and where the most probable outcomes will be in the coming years and what the cost will be. And so we are embarking—I talked yesterday to the OMB about this and it is set in plans, and my next step would be to Senator Bingaman and Murkowski's committee to talk to them about it, but to be able to start a review of the technologies that would then form a basis for the energy policies. You need sort of a knowledge of the technologies, where they are going, and how might they be accelerated, and then from that you formulate policies, and that is our intent.

Chairman CONRAD. Senator Cardin.

Senator CARDIN. Thank you, Mr. Chairman. Secretary Chu, it is always a pleasure to have you before our committee.

Just following up a little bit on Senator Begich's point, it seems to me, though, that to have an energy policy that is going to be right for America, that three goals must be met, and that is one of energy independence so that we are not held hostage to countries who disagree with our way of life or circumstances that happen globally that disrupt our economy and our security.

And second, we have to do it in a way that is smart for job growth. Clean energy is a way that we can create more jobs here and keep more jobs in America.

And then, of course, third is the environment. This is a serious risk we have on the environment. In your exchange with Senator Portman, you sort of gave up, and I think it is right, that we will not be able to pass a comprehensive bill. We tried that. I think that is regrettable because I think until we have a proper price for pollution, it is going to be very difficult to put in place an energy policy that is right for America.

So I do not want to give up on the pricing of carbon. I do not want to give up on the way of energizing our economy to solve these problems. But I do think we have to look at steps now that are politically realistic, and I think the way that you have presented it is what we will need to do. But do not ever give up where we need to be as a nation, not only for America's security, but for international leadership on a lot of these issues.

I want to ask a specific question, following up on Senator Portman's comments about nuclear energy. As you can tell by my previous comments, I am a strong believer that to solve our energy problems in America, we have to use less energy, we have to develop alternative and renewable energy sources, we have to continue with technology growth, all of the above.

But part of it is obviously, to me, is nuclear power, that we need to move forward with nuclear power, which leads me to the concern that we now have the appetite and need for more loan guarantees than the budget will allow us to move forward with at the current time. Part of it is the fact that we do not have enough money up for loan, enough capacity for loan guarantees, and the second is the manner in which OMB scores these loan guarantees, which at times discriminates against a State based upon its regulatory structure.

I represent Maryland. Maryland is prepared to move forward with a nuclear power plant at Calvert Cliffs and we are in the process, and it is not really aimed at that specific application, because I think that process is moving forward and we thank you for your help in that regard. But if we are going to accomplish the need for nuclear power in America, then we have to sort of get a handle on the realistic cost of this. It is my understanding that the risk factor of these loan guarantees are very minimal, so it actually will be beneficial to our budget and our economy. So it is going to be a plus, not a negative.

So I just urge you as we go through this process of trying to move forward with loan guarantees for nuclear power plant expansions or construction, that we work together as a team here and figure out the problems that OMB might have so that we can get more action for the dollars that are available.

Secretary CHU. Yes, Senator. So what you are—for others in the room, I know you will understand this, but what you are referring to is what is called the credit subsidy in a loan guarantee, that the $36 billion we are asking for is scored by CBO as 1 percent cost, even though we have to prove to OMB that it is zero cost to the taxpayer.

So the credit subsidy is, loosely speaking, what we would call a loan, mortgage insurance, should the project be delayed, something of that nature, and the payment of the loan be delayed, that the government could still recover its investment. And so it is essentially insurance that is then paid to Treasury. And in that amount of money, that comes from the company. It does not come from the Federal Government. And if that amount is too high, then it is prohibitively costly. If, let us say, you want to mortgage, but the mortgage insurance is half the cost of the mortgage, that is pretty high and the mortgage might not be so desirable.

So we are working with OMB. Now, by statute, OMB has the final authority ruling on what that credit subsidy should be. They make a determination of the likelihood that the loan might default and the U.S. Government cannot get its resources back. Therefore, that company has to pay that insurance to the Treasury. It is that probability that that will happen.

And so we certainly are willing to work with OMB to try to figure out what is the best way of assessing the most accurate probability that these loans will not be paid back. I think the nuclear industry—the highest risk is that there would be delay in construction. It is not as though this thing will not work. That, we know. We have done 107 nuclear commercial reactors in the United States. We know they will work. And so the risk is a delay, and then to what extent. So we are working with OMB to try to see if we can have a good assessment of what that risk is.

Senator CARDIN. I appreciate that, and let me just underscore the point. You have to set it at a rate where it will not cost the taxpayers any money, and yet it still gets scored as an issue because of the OMB formula.

Secretary CHU. It is actually a little more—for these type of loans, the nuclear loans, we have to convince the OMB, and it has to be scored as no cost, and then it is a probability of default, so you will not get paid back, or at least the pay-back would be a long period of time. So we have to convince OMB that it costs the taxpayers zero, but then the CBO says, no matter what you do, we will still charge you 1 percent, and that is just the way it is.

Senator CARDIN. Well, I——

Secretary CHU. And so that is beyond my comprehension as a physicist——

[Laughter.]

Senator CARDIN. You know, it is beyond our comprehension, also. But I think what we need to do is to work closely together between Congress, OMB, and DOE, because I think there is a real commitment here to make sure the capacity is there to move forward on approved nuclear reactors, where it has gone through the process and where it is reasonable to expect that the loan guarantee is part of the overall equation.

So I think there is a number that we all should be able to come together with and I very much appreciate the way that you explained it, not only to those who were unfamiliar with this issue, but even those of us who are familiar, because I think you laid it out in the best way. Thank you very much.

Chairman CONRAD. I want to thank the Secretary for your appearance before the Budget Committee today. I also want to thank you for your service. It is so important to the country that people of your quality and your character are willing to serve in these positions, and we very much appreciate it. And we appreciate the time that you have spent with the committee this morning. I think it has been very valuable for the members. It has certainly been valuable for me.

The committee will stand adjourned.

Secretary CHU. Thank you.

[Whereupon, at 11:51 a.m., the committee was adjourned.]

QUESTION FROM SENATOR ENZI

Q1a. The Department of Energy has been bartering uranium from the federal excess uranium stockpiles to pay contractors for services for accelerated cleanup of the Portsmouth Ohio enrichment facility. I am concerned that these barter transactions have an adverse impact on the price of uranium and also make the ability to obtain financing for new mines very difficult. Further, I am concerned that the practice of bartering uranium circumvents the usual appropriations process where Congress determines how much money to appropriate for specific cleanup operations.

Does the Department plan to continue bartering uranium for services, and it so, how much uranium will be transferred for this purpose in FY 2011?

A1a. On March 2, 2011, Secretary Steven Chu issued a Determination of no adverse material impact authorizing uranium transfers to fund accelerated cleanup activities at the Portsmouth Site in Piketon, Ohio from 2011 through the third quarter of 2013. The Determination authorizes the Department to conduct transfers on a quarterly basis, with no more than 450 metric tons (MTU) natural uranium equivalent to be transferred in a quarter and no more than 1,605 MTU natural uranium equivalent per year during calendar year 2011, 2012 and 2013, to fund accelerated cleanup work at Portsmouth.

QUESTION FROM SENATOR ENZI

Q1b. The Department of Energy has been bartering uranium from the federal excess uranium stockpiles to pay contractors for services for accelerated cleanup of the Portsmouth Ohio enrichment facility. I am concerned that these barter transactions have an adverse impact on the price of uranium and also make the ability to obtain financing for new mines very difficult. Further, I am concerned that the practice of bartering uranium circumvents the usual appropriations process where Congress determines how much money to appropriate for specific cleanup operations.

I also understand that when the Department has announced its intent to barter more uranium for services it often causes the market price for uranium to fall. Aren't these bartering practices diminishing the value of this government asset? Wouldn't the Department be able to get more value for excess government uranium if you sold this material into the long term commercial market as the producing industry has urged you to?

A1b. The Department recently reviewed the five transfers to USEC which took place from December 2009 through October 2010 for accelerated cleanup services at the Portsmouth site. The transfers were in amounts of approximately 250 metric tons uranium equivalent (MTU) as uranium hexafluoride (UF_6) for a total of 1123 MTU, and USEC auctioned off the uranium to the highest bidder in an auction run solely by USEC. When the transfers began in December 2009, market prices for UF_6 were trading in a range between \$112 and \$117/kg UF_6, where they remained through June 2010. The price then increased to \$130/kg U through September 2010, the date of the last DOE transfer to USEC. This price trend supports the conclusion that the Department's transfers to its contractor did not have an adverse material impact on the market.

QUESTION FROM SENATOR ENZI

Q2a. The Department of Energy has recently directed the Rocky Mountain Oilfield Testing Center (RMOTC) to require that companies who use RMOTC pay 100 percent of all testing costs as an effort to "phase out all subsidies to the oil and gas industry." This has caused a layoff of more than 25 employees in the Casper, Wyoming area.

Are you aware that non-hydrocarbon related work, including geothermal energy development, is occurring at RMOTC? Do you support continuing that work at RMOTC?

A2a. As is stated in this excerpt from the Congressional Justification materials for the Naval Petroleum and Oil Shale Reserves account:

> The [Office of Fossil Energy] is requesting no funding for RMOTC testing in FY 2012. FY 2012 testing will be comprised only of projects that are funded through 100% fully reimbursable (funds-in) arrangements or fully funded by the Office of Energy Efficiency and Renewable Energy's Geothermal Technology Program to validate co-produced, geopressured, and low-temperature geothermal technologies. RMOTC will continue its collaboration with EERE to continue to provide a testing center in support of the Low-Temperature and Co-Produced Geothermal program.

QUESTION FROM SENATOR ENZI

Q2b. The Department of Energy has recently directed the Rocky Mountain Oilfield Testing Center (RMOTC) to require that companies who use RMOTC pay 100 percent of all testing costs as an effort to "phase out all subsidies to the oil and gas industry." This has caused a layoff of more than 25 employees in the Casper, Wyoming area.

Did you allow for a transition time at RMOTC so that they could smoothly transition to requiring 100 percent of testing costs to come from companies?

A2b. The Department does not believe that a specific transition time is required for transitioning to 100 percent funds-in testing projects. RMOTC has reserved funds to complete the cost-shared projects that were active in FY 2010 and to prepare final reports for those projects. While the number of testing projects that industry, inventors, and academia have proposed has certainly slowed, the Department believes that this new model for testing at RMOTC provides an opportunity to form strategic partnerships and build a sustainable business model necessary to continue testing at RMOTC.

QUESTION FROM SENATOR ENZI

Q3. I am concerned that the fossil energy loan guarantee program is moving far too slowly. There are projects in my state and in states throughout the nation that will create jobs and increase our domestic energy supply in a way that will not cost the taxpayers' money.

What is the Administration doing to ensure that those loan guarantees can get issued in an expeditious manner?

A3. The Department recognizes the importance of advanced fossil projects, and currently has several projects in process that DOE anticipates issuing a draft working term sheet in the near future. Each of these projects has a number of open items that will need to be resolved before DOE can determine, as is required by statute, that there exists "a reasonable prospect of repayment of the principal and interest on the obligation by the borrower." Some of these issues involve local and state legislatures or other governing bodies, for which the loan programs cannot force a timetable.

QUESTION FROM SENATOR ENZI

Q4. The Administration's budget seeks a substantial increase in funding for the Energy Efficiency and Renewable Energy (EERE) program at the same time you request a substantial decrease in funding for the Fossil Energy Program. Instead of picking winners and losers, doesn't it make more sense for the Administration to take a technology neutral approach and let whatever the best technology win out?

A4. The FY 2012 request upholds the President's goals to develop America's competitive edge through strategic investments in our nation's clean energy infrastructure. The need to exercise budget restraint forced some tough decisions across the Department in FY12.

QUESTION FROM SENATOR ENZI

Q5. The FY 2012 budget includes a variety of proposals to eliminate any tax preferences for the oil and gas industry and for the coal industry at the same time it proposes extending tax preferences for renewable energy. To me, this suggests that the Administration is trying to tell Americans what types of energy works best for them. This proposal comes in the wake of the President's supposed desire to see overall corporate tax reform. Why does the Administration seek to punish traditional energy with tax increases at the same time you push for more subsidies for the renewable industry?

A5. Whenever possible, the Administration has advocated energy policies that enhance the economic, environmental and national security interests of the United States, while remaining as technology-neutral as possible. This is one reason why the President has put forward the idea of a broad clean energy standard. Such technology-neutral policies will, over time, reduce the need for subsidies for specific classes of technologies. However, some emerging technologies may temporarily require subsidies in order to catalyze early market penetration. Such policies will make it more likely that the United States will be a global leader in clean technology innovation, manufacturing and export, and will benefit all Americans.

QUESTION FROM SENATOR CORNYN

Fossil Fuels

Q1. EIA figures show that in 2008 dollars per barrel of oil equivalent, the total onshore and offshore cost in the U.S. is $41.03, while the Middle East is $16.93, and the worldwide average is $34.34, making the U.S. a high cost place to conduct oil and gas operations.

Based on your earlier acknowledgement that fossil fuels will be a part of our energy mix for the next half century, how does increasing taxes on American-made oil and gas reduce our dependence on foreign sources?

A1. Rising prices at the pump affect everybody, which is why we need to make ourselves more secure and control our energy future by harnessing all of the resources that we have available and embracing a diverse energy portfolio. When President Obama took office, America imported 11 million barrels of oil a day. He has pledged that by a little more than a decade from now, we will have cut that by one-third, and put forward a plan to secure America's energy future by producing more oil at home and reducing our dependence on oil by leveraging cleaner, alternative fuels and greater efficiency. The Administration's *Blueprint for a Secure Energy Future* outlines the comprehensive national energy policy that this Administration has pursued since day one, and which we will build upon to secure our energy future. It includes a comprehensive program to develop and secure our energy supplies, provide consumers with choices to reduce costs and save energy, and to innovate new and cleaner energy technology.

While there is no silver bullet to address rising gas prices in the short term, there are steps we can take to ensure the American people don't fall victim to skyrocketing gas prices over the long term. One of those steps is to eliminate unwarranted tax breaks to the oil and gas industry and invest that revenue into clean energy to reduce our dependence on foreign oil. Our outdated tax laws currently provide the oil and gas industry more than

$4 billion per year in these subsidies, even though oil prices are high and the industry is projected to report outsized profits this quarter. In fact, in the past CEO's of the major oil companies made it clear that high oil prices provide more than enough profit motive to invest in domestic exploration and production without special tax breaks. As we work together to reduce our deficits, we simply can't afford these wasteful subsidies, and that is why the Administration proposed to eliminate them in the FY11 and FY12 budgets.

QUESTION FROM SENATOR CORNYN

Fossil Fuels

Q2. EIA figures show that in 2008 dollars per barrel of oil equivalent, the total onshore and offshore cost in the U.S. is $41.03, while the Middle East is $16.93, and the worldwide average is $34.34, making the U.S. a high cost place to conduct oil and gas operations.

Has the Administration done any analysis on how these domestic energy tax hikes would impact the 9.2 million jobs that the industry supports?

A2. While the Department has not done an independent analysis of this issue, we would note that the Assistant Secretary for Economic Policy and Chief Economist, U.S. Department of Treasury, Alan B. Krueger, testified before the Senate Committee on Finance, Subcommittee on Energy, Natural Resources, and Infrastructure (September 10, 2009) that the Treasury Department estimated "... that the decrease in domestic production due to these proposals will be less than one half of one percent, even in the long run...[and]... because domestic crude oil production is not expected to change appreciably, employment in the oil extraction sector would likewise not be expected to change by a significant amount." Mr. Krueger also stated that "...it is important to note that the oil and gas industry is about ten times more capital intensive than the U.S. economy as a whole. Consequently, subsidizing oil industry production is not an effective policy for raising labor demand."

In addition, please see the recent Congressional Research Service analysis of the extent to which proposed tax changes on the oil industry are likely to affect domestic gasoline prices (http://democrats.senate.gov/pdfs/20110511-crs-analysis-on-gas-prices.pdf).

QUESTION FROM SENATOR CORNYN

Nuclear Loan Guarantee – South Texas Project

Q1. The President's budget includes $36 billion of additional loan guarantee authority for nuclear power facilities. I appreciate this fact. My state of Texas is no stranger to nuclear power. As some of you know, a nuclear facility is located near Bay City, Texas called the South Texas Project, and it is one of the newest and most productive nuclear power plants nationwide. This twin-reactor facility currently produces 2,700 megawatts of electricity, enough to serve more than two million homes in Texas. Not only will Texas benefit from the energy production; the construction of this nuclear project will create approximately 6,000 jobs and $9 billion of economic activity for Texas.

I understand the project's loan guarantee application is currently in the inter-agency review process and is being evaluated by OMB and Treasury at this time. Do you have a timeline as to when you expect this project to be brought before the Credit Review Board? I would appreciate any assistance you can provide to ensure this project is evaluated in the next few weeks.

A1. The Administration recognizes and supports nuclear energy as a vital part of our national clean energy portfolio. As you are aware, we issued conditional commitments for $8.33 billion in loan guarantees for the expansion of the Alvin W. Vogtle Electric Generating Plant in Burke, Georgia in February 2010. This would mark the first nuclear power plant to begin construction on United States soil in over thirty years.

While DOE is unable to discuss specific, pending applications, I can assure you that we work diligently on every project – including nuclear power projects, which are reviewed by a deeply experienced team of technicians, investment officers, and lawyers - to ensure that they move through our process as quickly as possible.

QUESTION FROM SENATOR MERKLEY

Better Buildings Initiative

Q1. I applaud the Administration's Better Buildings Initiative. You and I have both long advocated that energy efficiency is the cheapest and fastest way to transform our energy economy and reduce pollution. During the current economic downturn, it's also an incredible job creator. I was particularly glad to see that the Administration included loan guarantees for commercial buildings. I strongly support residential energy renovation programs but I think commercial buildings are not being sufficiently addressed in general. I also strongly support your approach of making loans and loan guarantees. Since energy efficiency produces financial savings for building owners, in the form of reduced energy bills, there is a revenue stream that can be used to pay off the loan, and government loans can be leveraged much farther than grants or rebates. I have proposed a bill that would give loan guarantees to financing entities – banks, utilities, or local governments – who could make the loans at a retail level.

How are you proposing to structure the Better Buildings Initiative? Would individual building owners be applying for loan guarantees? If so, are there efficiency challenges in having the Department of Energy work directly with individual building owners? Will you also include onsite renewable energy, such as solar and geothermal heat pumps?

A1. The Better Buildings Initiative incorporates a number of efforts including tax incentives, financing programs, grants, and general challenges along with efforts to improve and expand related workforce training to enhance jobs creation. While the President's budget request includes a provision for loan guarantees as part of the initiative, detailed provisions have not yet been identified yet.

QUESTION FROM SENATOR MERKLEY

Better Buildings Initiative

Q2. I applaud the Administration's focus on community institutions such as schools and hospitals in the Better Buildings Initiative. In Oregon, many communities are finding that these institutions are a very good size to use biomass for heating energy. They don't have to truck in oil or other petroleum products to rural areas that don't have gas and the efficiency and scale of biomass are better-sized to be able to be supplied by local forest materials. Are you open to including biomass boiler replacements in the program?

A2. Yes, we are open to including biomass boiler replacements in the program, however, the technology needs to be cost effective and provide energy efficiency benefits. In some areas, local ordinances or regulations may prohibit the use of biomass boilers.

QUESTION FROM SENATOR MERKLEY

Electric Vehicles

Q3. You are probably aware that Senator Lamar Alexander and I introduced an electric vehicle deployment bill last year. It has a lot in common with the electric vehicles deployment plan the Administration has announced, in particular the focus on competitive grants to communities to deploy electric vehicles. I think this is a key way to accomplish two goals. The first goal is achieving higher levels of market penetration. Given the urgency of our dependence on foreign oil, made even clearer by rising gas prices and turmoil in the Middle East, I believe we need to figure out how to encourage much faster adoption of electric vehicles than hybrids saw. The second goal is to determine best practices for adoption, by allowing multiple communities to experiment with different approaches and determine the best methods.

We have heard some concern that the administration proposal would spread too little money across too many communities, and that we might get more helpful results by focusing on bigger grants to really promote deeper deployment. What are your thoughts on this?

A3. The Department has examined various ways to implement a competitive community grant program supporting electric vehicle infrastructure and reform of regulatory barriers, considering options for the potential number of communities and potential amount of funding per award, among other factors. We believe a plan for awarding up to 30 grants of up to $10 million each is appropriate for several reasons. Among them, these community grants would require strategic partnerships that highly leverage local and private funds, raising the total project amount to $20 million or more, depending on participant cost share – enough for example for thousands of chargers in each region. In addition, auto manufacturers will sell PEVs in cities across the country. Finally, the funding for electric charging infrastructure made available through this program would help to overcome a significant early market barrier and lay the foundation for future PEV market growth, following carefully-developed strategies for locating initial public infrastructure based on local travel patterns, for example. As consumer demand grows and markets transition from early adoption to more mainstream use, private-sector investors should see a business case and an attractive opportunity to invest in additional electric charging infrastructure development.

QUESTION FROM SENATOR SESSIONS

Q1a. For each of the following technologies being subsidized by the Department of Energy, can you estimate when you expect the technology will be commercially available and fully penetrate the relevant market:

- 100% electric vehicles with a range of at least 100 miles.
- Automobile batteries that will run 300 to 400 miles on one charge.

A1a. The Department is investing in the research and development (R&D) of a broad range of advanced vehicle technologies, including advanced combustion, fuels, and materials technologies, as well as electric drive, that can significantly reduce our nation's petroleum consumption and greenhouse gas emissions. We foresee a transportation future with a mix of electric-drive vehicles including battery-electric vehicles (BEVs), plug-in hybrid electric vehicles, and other advanced vehicles that use low carbon fuels such as renewable electricity or biofuels. We do not expect to see BEVs penetrate 100% of the market in the near term.

The Department's R&D is focused on overcoming critical barriers to technology commercialization and subsequent market penetration. It is important to note, however, that the time required for turnover of the nation's fleet is approximately 15 years, and current trends show consumers of both new and used vehicles are holding onto their cars for longer periods of time, potentially lengthening the time required for new technologies to penetrate the market.[1] Electric drive technology has made great progress over the last decade and is commercially available today. For example, Nissan introduced the Leaf, a BEV with an estimated 100-mile range, in late 2010, and other auto manufacturers have announced plans to introduce additional BEVs (as well as other plug-in electric vehicles)

[1] Vehicle Technologies Program Fact of the Week, January 3, 2011, "Consumers Hold Onto Vehicles Longer," http://www1.eere.energy.gov/vehiclesandfuels/facts/2011_fotw656.html

over the next several years. For these vehicles to fully penetrate the market, however, we must reduce the cost of electric-drive technologies, including batteries. The Department's robust battery R&D effort is focused on reducing the cost of lithium-ion batteries from $800/kilowatt-hour (achieved in 2010) to $300/kilowatt-hour by the middle of this decade.

Automobile batteries that enable a 300- to 400-mile vehicle range require a significant technology breakthrough. The Department, through coordinated research programs among the Office of Energy Efficiency and Renewable Energy, Office of Science, and the Advanced Research Projects Agency-Energy (ARPA-E), is examining a variety of battery chemistries and technologies to achieve this ambitious goal.

QUESTION FROM SENATOR SESSIONS

Q1b. For each of the following technologies being subsidized by the Department of Energy, can you estimate when you expect the technology will be commercially available and fully penetrate the relevant market:

- Photovoltaic systems that will meet at least 10 percent of our nation's electricity needs.

A1b. Currently, photovoltaic (PV) systems represent less than 0.1% of the U.S. electricity generation capacity. The goal of the SunShot program is to reduce the cost of solar technologies to be competitive with conventional generation without subsidies by the end of the decade. This would equate to a 75% reduction in installed cost, to approximately \$1/Watt$_{DC}$ for utility scale systems. Achieving this goal would greatly accelerate progress toward meeting 10% of U.S. electricity generation needs from solar energy.

It should be noted that current cost trends reflect significant expenses due to permitting, interconnection, and inspection delays; so-called "soft" balance-of-system costs that are predominantly due to local and state regulation. DOE is aggressively working with states, cities, and other stakeholders to address these issues. DOE is also investing in innovative approaches to cost reduction of conventional "hard" balance-of-system components such as installation labor, mounting hardware, wiring, and power electronics. These costs are over half of total PV system costs and to date have lagged behind reductions in PV modules. Continued strong investment in both of these areas could lead to rapid system cost reduction and combined with continued research, development, and demonstration of PV and concentrated solar power (CSP) technologies – tightly coordinated with ARPA-E and the Office of Science (SC) – is central to the DOE's strategy for meeting the SunShot cost goals and increasing the penetration of solar technologies.

Meeting the SunShot goal will require investments in research, development, and demonstration that are closely linked with the efforts of ARPA-E and SC. The FY12 budget request supports this ambitious program within EERE, and would enable EERE to help address the competitiveness gap that currently exists. The EERE efforts are supported by proposed new SC activities to support new scientific research focused on understanding the fundamental mechanisms of the degradation of photovoltaic materials during use and by ARPA-E projects that focus on "out-of-the-box" transformational energy research that industry by itself cannot or will not support due to its high risk. The SunShot Initiative goals are targeted to be reached within the decade.

QUESTION FROM SENATOR SESSIONS

Q2. Recent analysis shows that less than half of the states with clean energy standards are meeting, or on track to meet, their goals. Also, states with renewable energy mandates have electricity costs that are 40% higher than those who don't. Given the experience of the states, are you confident the goals of a national clean energy standard can be met? Do you view higher electricity costs as an acceptable risk of adopting a national clean energy standard?

A2. The Administration's proposed clean energy standard is defined broadly, such that natural gas, renewables, nuclear and carbon capture and storage technologies could all count toward the standard. Such a broad design will allow the market, rather than the government, to choose technology winners, to allocate capital appropriately and to minimize overall costs to consumers. In addition, the breadth of the standard, which is far greater than a typical renewable energy standard, ensures that the goals can be met; even if one or more technologies does not commercialize at a large scale as quickly as anticipated, the CES goals can be satisfied through a range of other clean technologies. Over time, the CES would transform the power sector in a way that will enhance all Americans' access to clean, safe and affordable energy.

QUESTION FROM SENATOR SESSIONS

Q3. The Administration proposes spending an additional $2.4 billion for FY12 on Department of Energy compared to this year. We will need to borrow every dollar of that increase, half of that will likely come from foreign sources. With this increase, you are proposing we pay another $1 billion more in interest payments to foreign creditors over the next 10 years. Why not freeze the Department's level of spending and use the $2.4 billion you propose to spend to lower the deficit and decrease our payments to foreign creditors?

A3. The President's FY 2012 Budget lays out the policy priorities of the Administration and remains a good starting point for developing funding levels. With the fiscal year 2012 budget request, the Department of Energy will make critical investments in science, research and innovation that will create jobs, grow the economy, and position America to lead the global clean energy economy. Two of the primary engines driving our prosperity are education - particularly science, technology, engineering and mathematics education - and energy. The country that leads the way in this multi-trillion dollar market will benefit enormously. The investments proposed in this budget will pay dividends that outweigh the near-term costs.

QUESTION FROM SENATOR SESSIONS

Q4. GAO continues to identify the Department of Energy's contracting as a high risk of waste, fraud and abuse. This encompasses nearly 60% (over $16 billion) of the Department's budget. GAO noted that nearly one-third of the contracted projected funded by $6 billion in stimulus funds were already experience cost overruns and/or were behind schedule. Shouldn't you get this problem under control before asking for more money for the Department?

A4. In July 2010, the GAO completed a report on Environmental Management's (EM) Recovery Act projects. The report assessed the performance of EM's eighty-four Recovery Act projects through March 2010. It is important to note that EM obligated the majority of its Recovery Act funds by fall 2009, slightly behind its initial plan. As a result, most of the eighty-four Recovery Act project were still ramping up at the end of 2009 and beginning of 2010. In spring and summer 2010, EM added an additional seven projects, bringing the total to ninety-one.

At the time of the report, GAO stated that nearly 1/3 of the eighty-four projects were behind either on cost and/or schedule. However, the questioned status of some of these projects was attributable to the timing of finalizing obligations. If adjusted for the timing of obligations, many of these projects were actually on schedule and in accordance with the implementation timeline. Moreover, some of the questioned projects faced general issues with starting up the projects. EM has addressed these start-up issues, resulting in on average not more than 4-5 projects (4-5%) being behind on scheduled and/or cost at any given time. When looking at EM's portfolio of ninety-one projects, its cumulative Cost Performance Index (CPI) is 1.06 and the Schedule Performance Index (SPI) is 1.01. A CPI and SPI above 1 indicate that EM is efficiently utilizing resources and that its projects are ahead of schedule.

As of April 2010, EM has already completed 21 Recovery Act projects. Moreover, EM anticipates that an additional 56 more will be completed by September 2011, 11 more by September 2012, and the final 3 by end of calendar year 2012. To date EM has paid out over $4.2 billion (71%) out of its $6 billion allocation.

QUESTION FROM SENATOR MURRAY

Q1. Secretary Chu, I'm pleased that the DOE Environmental Management budget has a slight increase, which-as I also told Director Lew-I view as a sign that the Administration recognizes its legal obligations.

I appreciate the time and effort that you have put into making the EM budget compliant for fiscal year 2012. But I'm very concerned that at these funding levels, you're pushing off work across the complex that needs to be done in fiscal year 12 to ensure DOE meets its legal obligations moving forward.

Can you assure that at these proposed funding levels, that the EM program will be compliant in fiscal year 2013? If that is not the case, what is your plan moving forward to ensure compliance in out years?

A1. Thank you for recognizing that our fiscal year (FY) 2012 funding request positions Environmental Management to support completion of all FY 2012 enforceable milestones. Maintaining compliance with agreements and orders derived from federal and state environmental laws and regulations is one of the primary criteria the Department of Energy uses in formulating the Environmental Management budget. The Department will ensure it considers all factors, including meeting its compliance obligations, as it develops its FY 2013 budget.

QUESTION FROM SENATOR MURRAY

Q2. Mr. Secretary, I also appreciate that the Administration is committed to modernizing our nuclear weapons facilities in the coming years, and I noticed that OMB has said it will ensure that future allocations to that effort will occur in the required amounts. As you know, Secretary Chu, it's unusual for the federal government to commit itself to future funds like that.

As I have been saying for years, this is exactly where we need to go with EM budgets. For fundamental legal reasons, and because there is also massive amounts of human and monetary capital wasted when EM doesn't have stable budgets, we need to make sure that the Administration budgets effectively over the long term to meet required compliance deadlines.

How can Congress and this Administration work together to develop a clear and consistent approach to EM budgets over the long term, similar to NNSA?

A2. The Administration has a clear and consistent approach to funding for the Department of Energy's (DOE) Environmental Management program as reflected in the 2012 Budget. The Budget proposes $6.13 billion for the cleanup program, +$83 million more than the 2011 budget request and +$122 million more than the 2010 enacted level. This includes sufficient funds to provide DOE the opportunity to meet all FY 2012 enforceable milestones in its various cleanup agreements, including the Hanford Tri-Party Agreement to protect the Columbia River. The Administration also is concentrating on improvements in management and oversight of the program and activities in EM, with the aim of maximizing performance from the funds we allocate to the program. The Administration recognizes the Department's cleanup obligations and will work with Congress to meet these environmental requirements over the long term in a fiscally responsible manner.

QUESTION FROM SENATOR MURRAY

Q3. Secretary Chu, I find it disconcerting that DOE is reducing funding for fuel cell technologies when many other companies, including those in Europe and Asia, are increasing investments in fuel cell programs. The United States is currently leading the world in this technology, which has great potential to become an export technology. However, without continued investment, we will fall behind other countries. I am concerned by the cuts to the fuel cell program, and in particular the elimination of the market transformation program, which has accelerated deployment of fuel cell technologies. In my home state of Washington, a company called ReliOn has successfully used Market Transformation Program dollars for back-up power to emergency communications equipment, which replaced use of fossil fuel equipment.

Mr. Secretary, I absolutely agree with your view that we should do now what we can do now on fuel cells. Which is why I am surprised that the budget request completely eliminates the Market Transformation Program, which is aimed precisely at moving applications that are available now to commercial markets.

Given the President's focus on investing in innovation, the robust funding proposed for other sources of clean energy alternatives, and the proven success of the Market Transformation Program, what is the justification for elimination of this successful program?

A3. The Department agrees with the importance of continued investment in clean energy technologies, including fuel cells, and recognizes the benefit of market transformation activities. In fact, although not reflected in the FY 2012 budget request, the Department invested $43 million under the Recovery Act to enable the deployment of up to 1,000 fuel cells for early market applications such as forklifts and backup power. This additional funding will allow the Department to collect data on the performance and cost of fuel cells for early market applications, deferring market transformation funding decisions until this data becomes available. A number of domestic companies, including the one mentioned above, were recipients of Recovery Act funding. In the mean time, funding is invested in critical research and development to ensure that domestic companies continue to develop their technologies. Other mechanisms such as the investment tax credit and grants in lieu of tax credit (section 1603) allow companies to take advantage of incentives available for commercial deployments.

QUESTION FROM SENATOR MURRAY

Q4. As DOE builds toward President Obama's clean energy economy, how will DOE evaluate a resource's contribution to and potential to meet these important, ambitious energy and environmental goals? What role does DOE anticipate for hydropower in helping to meet these objectives?

A4. Hydropower generated about 7%[2] of U.S. electricity in 2009, with a peak capacity of 78 GW, corresponding to about 7.5% of U.S. capacity. Hydropower is particularly valuable as a renewable generating resource, as it is well suited for both base-load and variable-load operation. Pumped storage hydropower (PSH) is used for utility-scale energy storage. PSH has the ability to enable greater penetration of other, variable renewable energy resources, such as solar and wind. The current pumped storage hydropower capacity in the U.S. is about 21 GW.

New hydropower development is possible across several different resource types, including (a) capacity upgrades and efficiency improvements at existing hydropower facilities, (b) adding power plants at existing, non-powered dams, and (c) installing new hydropower power capacity on constructed waterways. It is estimated that there is an untapped conventional hydropower resource of approximately 60 GW[3] across these areas of opportunity. As most of the traditional concerns over environmental impacts typically associated with hydropower generation can be effectively mitigated through technology upgrades and sustainable development practices, these opportunities present a low-cost, renewable energy resource that can help meet the Administration's clean energy economy goals. Marine and hydrokinetic (MHK) energy is an emerging industry and

[2] Electric Power Annual, "Electric Power Inudustry 2009: Year in Review", January 4, 2011 <http://www.eia.gov/cneaf/electricity/epa/epa_sum.html>

[3] Electric Power Research Institute, "Assessment of Waterpower Potential and Development Needs", March 2007. <http://www.aaas.org/spp/cstc/docs/07_06_1ERPI_report.pdf>

provides a new suite of technologies capable of capturing the energy of additional water resources along our nation's coastlines.

DOE is currently undertaking detailed resource assessments to better quantify the potential of conventional hydropower, PSH, and marine and hydrokinetic (MHK) resources in the United States. Through conventional hydropower resource assessments, DOE is evaluating the existing hydropower fleet for potential upgrades, powering non-powered dams, and deploying new technologies for new small hydropower, PSH, and constructed waterway sites. For MHK, DOE is evaluating the potential extractable energy for ocean waves, ocean/tidal/river currents, and Ocean Thermal Energy Conversion (OTEC). These advanced water power resources could provide additional renewable energy options for the United States. These resource assessments, which will be completed by the end of FY 12, provide important input to the DOE's decision-making process as we seek to prioritize current and future investments. DOE expects that our resource assessment efforts will identify substantial near-term development opportunities, and we are hopeful that this information will help spur further development of hydropower in the U.S., thus contributing to the goals of the President's clean energy economy.

QUESTION FROM SENATOR MURRAY

Q5. Secretary Chu, as you know, transportation emissions are a significant source of greenhouse gas emissions. This Administration is investing considerably in alternative fuels for energy security and environmental reasons; however, most of those are focused on personal vehicles. As you know, air transportation is solely dependent on jet fuels at this time. What has DOE done to date to advance jet biofuels, including research and development, feedstock development, technology and infrastructure? What is your plan to take an even more proactive approach in this area?

A5. DOE has begun to focus on the production of heavy duty fuels including renewable diesel, and aviation fuels. For example, the Joint BioEnergy Institute led by Lawrence Berkeley National Laboratory is re-engineering microbes to produce hydrocarbon fuels like green gasoline, diesel, and jet fuel. A subset of recently selected DOE Energy Frontiers Research Centers will focus on fundamental research related to producing advanced biofuels, such as bio-oils from microalgae, which are promising intermediates for the production of advanced biofuels, including green jet fuel. The National Renewable Energy Laboratory, Sandia National Laboratory, and other laboratories are also launching research into algal biofuels for the Defense Advanced Research Projects Agency and Air Force Office of Scientific Research. Algae-based fuels are also eligible for both Advanced Research Projects Agency-Energy and DOE Loan Guarantee funding opportunities, as well as those within the Biomass Program.

Additionally, DOE has used Recovery Act funding to support a competitive solicitation for two research consortia aimed at accelerating the development of cost competitive advanced fungible biofuels, which include hydrocarbon fuels, diesel and jet fuel, and algae based biofuels which also include jet fuel.

QUESTION FROM SENATOR THUNE

DEEP UNDERGROUND SCIENCE AND ENGINGEERING LABORATORY

Q1a. Secretary Chu, I'm pleased to see that DOE is continuing its support for the Deep Underground Science and Engineering Laboratory at Homestake in Lead, South Dakota, in its budget request for FY 2012 by including $15 million that would be used to continue necessary operations required to avoid wasting the $250 million of private, state, and federal funds to date.

I understand you are conducting an independent review in addition to the numerous national panels which have previously recommended a deep underground science laboratory, such as the Particle Physics Project Prioritization Panel which saw DUSEL to be a good match to the needs of a long baseline neutrino experiment.

I have been supportive of the National Science Foundation and the Department of Energy's efforts to date to design and develop the future of the worldwide high energy physics program, including new facilities to conduct such research, such as the Deep Underground Science and Engineering Laboratory at Homestake. I would appreciate if you could provide insight regarding the following questions:

Considering the envisioned changes to the model for stewardship of the Deep Underground Science and Engineering Laboratory between NSF and DOE and the accompanying language in the President's FY 2012 budget request, do you feel that there is sufficient support from the Obama Administration and NSF leadership to facilitate an expanded DOE role and successful completion of DUSEL in the future?

A1a. The Administration does not plan to build DUSEL but remains committed to achieving the science goals of the Office of Science High Energy Physics and Nuclear Physics programs. We are assessing options for the Long Baseline Neutrino Experiment far detector, as well as future dark matter and neutrinoless double beta decay experiments. On June 15, 2011, the Office of Science received a report on options for underground science from an independent panel of experts. The report concluded that the cost estimates for the dark matter and double beta decay experiments are still early in their development and are only good to one significant figure. The LBNE cost estimate is at approximately the level of a conceptual design level. The report is being considered and no decisions have been made yet.

QUESTION FROM SENATOR THUNE

DEEP UNDERGROUND SCIENCE AND ENGINGEERING LABORATORY

Q1b. Secretary Chu, I'm pleased to see that DOE is continuing its support for the Deep Underground Science and Engineering Laboratory at Homestake in Lead, South Dakota, in its budget request for FY 2012 by including $15 million that would be used to continue necessary operations required to avoid wasting the $250 million of private, state, and federal funds to date.

I understand you are conducting an independent review in addition to the numerous national panels which have previously recommended a deep underground science laboratory, such as the Particle Physics Project Prioritization Panel which saw DUSEL to be a good match to the needs of a long baseline neutrino experiment.

I have been supportive of the National Science Foundation and the Department of Energy's efforts to date to design and develop the future of the worldwide high energy physics program, including new facilities to conduct such research, such as the Deep Underground Science and Engineering Laboratory at Homestake. I would appreciate if you could provide insight regarding the following questions:

How have DOE and NSF been working together to plan for a smooth transition into a revised stewardship agreement on DUSEL?

A1b. Since the decision by the National Science Board to decline further funding for construction of the DUSEL facility, DOE and NSF have continued to communicate about DOE plans for the Long Baseline Neutrino Experiment far detector, as well as future dark matter and neutrinoless double beta decay experiments. NSF is providing $4,000,000 to bridge an approximately four month funding gap between June and September 2011 to keep the Homestake Mine dry through FY 2011. The Office of Science has requested funds in FY 2012 for continued de-watering and minimal sustaining operations to maintain the viability of the Homestake Mine while the DOE assessment is carried out.

QUESTION FROM SENATOR THUNE

DEEP UNDERGROUND SCIENCE AND ENGINGEERING LABORATORY

Q1c. Secretary Chu, I'm pleased to see that DOE is continuing its support for the Deep Underground Science and Engineering Laboratory at Homestake in Lead, South Dakota, in its budget request for FY 2012 by including $15 million that would be used to continue necessary operations required to avoid wasting the $250 million of private, state, and federal funds to date.

I understand you are conducting an independent review in addition to the numerous national panels which have previously recommended a deep underground science laboratory, such as the Particle Physics Project Prioritization Panel which saw DUSEL to be a good match to the needs of a long baseline neutrino experiment.

I have been supportive of the National Science Foundation and the Department of Energy's efforts to date to design and develop the future of the worldwide high energy physics program, including new facilities to conduct such research, such as the Deep Underground Science and Engineering Laboratory at Homestake. I would appreciate if you could provide insight regarding the following questions:

Does the FY 2012 budget request reflect inter-agency discussions and agreements?

A1c. The Office of Science and NSF have discussed DOE's FY 2012 request to continue dewatering activities and minimal sustaining operations at the Sanford Laboratory while DOE assesses cost effective options to carry out experiments planned by the High Energy Physics and Nuclear Physics programs.

QUESTION FROM SENATOR THUNE

DEEP UNDERGROUND SCIENCE AND ENGINGEERING LABORATORY

Q2. Secretary Chu, I'm pleased to see that DOE is continuing its support for the Deep Underground Science and Engineering Laboratory at Homestake in Lead, South Dakota, in its budget request for FY 2012 by including $15 million that would be used to continue necessary operations required to avoid wasting the $250 million of private, state, and federal funds to date.

I understand you are conducting an independent review in addition to the numerous national panels which have previously recommended a deep underground science laboratory, such as the Particle Physics Project Prioritization Panel which saw DUSEL to be a good match to the needs of a long baseline neutrino experiment.

I have been supportive of the National Science Foundation and the Department of Energy's efforts to date to design and develop the future of the worldwide high energy physics program, including new facilities to conduct such research, such as the Deep Underground Science and Engineering Laboratory at Homestake. I would appreciate if you could provide insight regarding the following questions:

Do you feel that the $15 million you are proposing in FY 2012, despite the NSF's proposal to provide no additional funding, is sufficient to maintain progress on this important national facility, leveraging the more than $250 million invested to date in private, state, and federal funds and preventing the imminent layoffs in South Dakota, California, and Illinois that would result from postponing progress?

A2. The Office of Science requested funds in FY 2012 to continue dewatering activities and minimal sustaining operations at the Homestake Mine in Lead, South Dakota. Before making further investments, DOE must assess whether the Homestake Mine is the most cost effective option for the Long Baseline Neutrino Experiment far detector and future dark matter and neutrinoless double beta decay experiments.

QUESTION FROM SENATOR THUNE

DEEP UNDERGROUND SCIENCE AND ENGINGEERING LABORATORY

Q3. Secretary Chu, I'm pleased to see that DOE is continuing its support for the Deep Underground Science and Engineering Laboratory at Homestake in Lead, South Dakota, in its budget request for FY 2012 by including $15 million that would be used to continue necessary operations required to avoid wasting the $250 million of private, state, and federal funds to date.

I understand you are conducting an independent review in addition to the numerous national panels which have previously recommended a deep underground science laboratory, such as the Particle Physics Project Prioritization Panel which saw DUSEL to be a good match to the needs of a long baseline neutrino experiment.

I have been supportive of the National Science Foundation and the Department of Energy's efforts to date to design and develop the future of the worldwide high energy physics program, including new facilities to conduct such research, such as the Deep Underground Science and Engineering Laboratory at Homestake. I would appreciate if you could provide insight regarding the following questions:

What is DOE prepared to do to ensure that progress and jobs aren't lost in the near term while DOE evaluates its long-term options and plans in high energy physics?

A3. DOE is not currently planning to provide any additional funds towards DUSEL in FY 2011. Before making further investments, DOE must assess whether continued development of the Homestake Mine is cost effective and viable. That assessment will continue through FY 2011.

QUESTION FROM SENATOR THUNE

DEEP UNDERGROUND SCIENCE AND ENGINGEERING LABORATORY

Q4. Secretary Chu, I'm pleased to see that DOE is continuing its support for the Deep Underground Science and Engineering Laboratory at Homestake in Lead, South Dakota, in its budget request for FY 2012 by including $15 million that would be used to continue necessary operations required to avoid wasting the $250 million of private, state, and federal funds to date.

I understand you are conducting an independent review in addition to the numerous national panels which have previously recommended a deep underground science laboratory, such as the Particle Physics Project Prioritization Panel which saw DUSEL to be a good match to the needs of a long baseline neutrino experiment.

I have been supportive of the National Science Foundation and the Department of Energy's efforts to date to design and develop the future of the worldwide high energy physics program, including new facilities to conduct such research, such as the Deep Underground Science and Engineering Laboratory at Homestake. I would appreciate if you could provide insight regarding the following questions:

Is there a contingency plan on how to ensure funding for DUSEL is available should the Fiscal Year 2012 Energy and Water appropriations bill not be completed by the beginning of Fiscal Year 2012 and a continuing resolution is enacted?

A4. Currently, there is no DOE contingency plan should Fiscal Year 2012 begin operating under a continuing resolution (CR). Both DOE and NSF will need to discuss plans under a CR for FY 2012, under which funding from DOE for this activity could constitute a new start.

QUESTION FROM SENATOR THUNE

DEEP UNDERGROUND SCIENCE AND ENGINGEERING LABORATORY

Q5. Secretary Chu, I'm pleased to see that DOE is continuing its support for the Deep Underground Science and Engineering Laboratory at Homestake in Lead, South Dakota, in its budget request for FY 2012 by including $15 million that would be used to continue necessary operations required to avoid wasting the $250 million of private, state, and federal funds to date.

I understand you are conducting an independent review in addition to the numerous national panels which have previously recommended a deep underground science laboratory, such as the Particle Physics Project Prioritization Panel which saw DUSEL to be a good match to the needs of a long baseline neutrino experiment.

I have been supportive of the National Science Foundation and the Department of Energy's efforts to date to design and develop the future of the worldwide high energy physics program, including new facilities to conduct such research, such as the Deep Underground Science and Engineering Laboratory at Homestake. I would appreciate if you could provide insight regarding the following questions:

Has NSF been a strong collaborator to date on DUSEL and do you foresee future collaborations with them on other high priority nationally reviewed science facilities given the difficulties encountered to date?

A5. The National Science Foundation and DOE have a strong partnership in high energy physics and nuclear physics. The National Science Board declined funding to bridge the NSF supported DUSEL Project team between the submission of the DUSEL Preliminary Design Report and approval to begin the DUSEL Final Design Report. Since that time, NSF has not communicated its intentions to DOE concerning further partnering on possible DOE efforts at the Homestake. DOE welcomes continued partnership with NSF on high priority, nationally reviewed science projects.

QUESTION FROM SENATOR THUNE

DEEP UNDERGROUND SCIENCE AND ENGINGEERING LABORATORY

Q6. Secretary Chu, I'm pleased to see that DOE is continuing its support for the Deep Underground Science and Engineering Laboratory at Homestake in Lead, South Dakota, in its budget request for FY 2012 by including $15 million that would be used to continue necessary operations required to avoid wasting the $250 million of private, state, and federal funds to date.

I understand you are conducting an independent review in addition to the numerous national panels which have previously recommended a deep underground science laboratory, such as the Particle Physics Project Prioritization Panel which saw DUSEL to be a good match to the needs of a long baseline neutrino experiment.

I have been supportive of the National Science Foundation and the Department of Energy's efforts to date to design and develop the future of the worldwide high energy physics program, including new facilities to conduct such research, such as the Deep Underground Science and Engineering Laboratory at Homestake. I would appreciate if you could provide insight regarding the following questions:

How is DOE prepared to work with the university community to ensure that the research needs will still be met with any proposed changes to the existing plans for DUSEL?

A6. As part of DOE's assessment of the options for the Long Baseline Neutrino Experiment far detector and future dark matter and neutrinoless double beta decay experiments, reports will be given by DOE stakeholders, including the research community, on the science impacts of different budget and site location scenarios. Based on the findings of this assessment, the Office of Science will seek to develop a cost effective plan that maximizes scientific opportunity for the research community.

QUESTION FROM SENATOR THUNE

TAXES v. ACCESS

Q1. I understand that if you add up the increased taxes on domestic energy production, the Administration budget calls for up to $90 billion in additional energy taxes. I understand that tax policy is outside the jurisdiction of the Department of Energy, but do you believe those new taxes will lower energy prices and create private sector jobs in the United States?

A1. In accordance with the President's agreement at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that we can transition to a 21st century energy economy, the Administration proposes to repeal a number of tax preferences available for fossil fuels. In fiscal year 2012, these preferences are expected to cost tax payers $3.6 billion. The elimination of these preferences will not affect retail energy prices. The Administration has proposed a budget that makes long-term investments in energy that will enhance American competitiveness, create millions of private sector jobs, and ultimately lead to lower energy prices. Clean energy industries continue to create desirable private sector jobs in the United States, and the Administration's investments in innovation and deployment will continue to stimulate market demand for clean energy technologies and the work force that can deliver them.

QUESTION FROM SENATOR THUNE

TAXES v. ACCESS

Q2. In terms of generating revenue to the federal government, do you believe we can raise more revenue through increased taxes on energy companies or increased royalty revenue through increased access to domestic oil and gas supplies?

A2. I believe that we are in a race with the rest of the world for a prosperous future and that the countries that develop advanced energy technologies – technologies like car batteries that go for 300 miles on a single charge and photovoltaic systems with an average installed cost of one dollar per watt – will win that race. These are technologies that can be developed and manufactured here in the US for export around the world, creating millions of new jobs and ensuring American prosperity in the 21st century. The Administration has proposed a budget that makes long-term investments in energy that will enhance American competitiveness, create millions of private sector jobs, and ultimately lead to lower energy prices. A prosperous and competitive economy will generate the revenues needed to pay for government's services to its citizens.

QUESTION FROM SENATOR THUNE

TAXES v. ACCESS

Q3. I have proposed in the past that as new royalty revenue is collected from new areas oil and gas production that some of the new royalties should be dedicated to a federal fund that supports renewable energy research and development at the Department of Energy. Would the administration be supportive of such a proposal?

A3. The Administration supports strong investment in research and development for clean energy technologies at the Department of Energy. The use of public lands for production of oil and gas and the collection of associated royalty revenue is managed by the Department of Interior. The Administration has not proposed that investments in clean energy technologies be dependent on the value of sales of oil and gas produced from new areas. However, the Administration does consider a wide range of new policy proposals, and specific details on the proposal would be welcome.

QUESTION FROM SENATOR THUNE

STIMULUS

Q1. The Department of Energy received over $38 billion in stimulus dollars, which is more than double the Department's annual budget. How much of the stimulus money has been paid out of Department of Energy accounts? Of the accounts that received stimulus dollars at the Department, which accounts are experiencing the slowest spend out rate? Why is this slow spend out the case? Is the Administration requesting funding increases for these accounts for FY 2012?

A1. Overall, Congress entrusted the Department of Energy with $35.2 billion in appropriations, consisting of $32.7 billion in contract and grant authority and $2.5 billion in loan guarantee credit subsidy. The Department of Energy obligated 100 percent of its contract and grant authority by September 30, 2010 and as of April 15th, has paid out over 41% of these stimulus funds to over 5,000 direct recipients to support over 15,000 clean energy projects around the nation.

Invoicing and Payments: A primary focus of the Department over the last two years has been ensuring that our 5,000 Recovery Act recipients are invoicing promptly and delivering on their energy goals. As of the end of March, DOE had paid out $13.3 billion, or 93 percent of its spend plan. The Department's pace of payments has increased five-fold since the end of FY 2009, a breathtaking pace when one considers the scope of the new initiatives undertaken, and that there are roughly 150 Recovery Act funding opportunity announcements comprised of more than 5,000 individual recipients. The Department of Energy (DOE) is on track to deliver on the goals of the Recovery Act. We have steadily ramped up its projects, while minimizing risk to the taxpayers. Last quarter alone, DOE funded more than 40,000 jobs through the Recovery Act.

DOE's Recovery funded programs were designed as a portfolio to ensure some investments created economic revitalization and jobs in the short-term, while at the same time investing in new and emerging technologies that will ensure long-term economic competitiveness of the U.S. While programs such as weatherization and environmental management were able to deploy Recovery Act funds immediately, other Recovery Act projects require extensive design and construction phases.

For example, DOE invested $3.4 billion in clean coal initiatives. With these funds, DOE is making unprecedented investments in commercial scale carbon capture and sequestration technologies. However, these are large-scale infrastructure projects that take three to four years to design and construct. While these projects have already funded hundreds of jobs, spending in this category has been generally slower.

Also, the Department is requesting a funding decrease for Fossil Energy Research and Development. The decrease in funding represents the shift in focus toward technologies that have potential benefits to both existing and new fossil-fueled power plants. In addition, recently obligated Recovery Act funding will ensure that development of gasification technologies and hydrogen turbines will continue to advance on or ahead of schedule.

QUESTION FROM SENATOR THUNE

CLEAN ENERGY STANDARD

Q1. Do you believe a Clean Electricity Standard should be technology neutral? If so, should energy efficiency gains be capped under a Clean Electricity Standard?

A1. As envisioned by the President, a CES would be designed to be technology neutral. By defining clean energy very broadly to include renewables, nuclear power, efficient natural gas, and coal and or natural gas with carbon capture and storage, a CES is consistent with a very large number of possible technological pathways – letting the market, rather than government, select the technologies that can best meet the target. This is a flexible approach that taps American ingenuity and innovation – and channels it toward a clean energy future. Energy efficiency has a central role to play in a clean energy future, which is why the President has proposed a range of programs to promote greater energy efficiency in America's homes, factories, and commercial buildings, including the HOMESTAR program and the Better Buildings Initiative. The Administration is open to working with Congress on additional measures to promote energy efficiency in ways that do not undermine the gains in promoting clean energy deployment and innovation that the Clean Energy Standard would bring.

QUESTION FROM SENATOR THUNE

CELLULOSIC ETHANOL

Q1. I am pleased that the Department of Energy has issued its first loan guarantee for a cellulosic ethanol plant. According to some in the biofuels industry, requirements for multi-year off-take agreements and extensive operating data as part of the loan guarantee program puts cellulosic producers at a disadvantage. How can we work together to improve the loan guarantee program to promote cellulosic ethanol production?

A1. The Department is committed to promoting biofuels and has led in this area through investments under the Recovery Act, our work on E15 testing, and much more. The Loan Guarantee Program is one of several incentives that developers of biofuels can potentially use. As you know, DOE invests heavily in energy research and development and demonstration programs for biofuels, including numerous cost-shared grants. There also are significant tax advantages included in the tax code. Additionally, DOE, USDA and EPA have formed a joint working group, which is investigating ways to support the biofuels industry.

Biomass loan guarantee applications present a number of challenges including, but not limited to, significant technology, production, and commodity price risk. These risks present challenges in structuring projects that comply with the Title XVII requirement that the Secretary determine that there is a "reasonable prospect of repayment" of each loan guaranteed under Title XVII. That being said, the DOE does not require offtake agreements for biofuels projects, although they are desirable and significantly enhance a project's creditworthiness. Despite the challenges presented by biofuels projects, the loan programs currently have several biofuels projects in due diligence and DOE hopes to be able to issue additional conditional commitments to biofuels projects in the near future.

QUESTION FROM SENATOR THUNE

NUCLEAR ARMS REDUCTION

Q1. The President's promise to modernize the nuclear complex was critical to the Senate giving its consent to New START. That consent likely would not have been forthcoming without the nuclear modernization plan. Fully funding the nuclear modernization plan is likely a prerequisite to any congressional support for the President's future arms control efforts. Will you recommend to the President that he veto any appropriations bill that does not fully fund the nuclear modernization plan?

A1. President Obama has made a strong commitment to modernize our nuclear infrastructure. This includes a commitment to invest $85 billion over the next decade to modernize the U.S. nuclear security enterprise that supports our Nation's nuclear deterrent. The President's fiscal year 2012 budget proposal for weapons activities within the National Nuclear Security Administration is essential to this long-term investment plan. It provides needed funding to extend the life of the stockpile, to redress shortfalls for stockpile surveillance activities and stockpile certification through investments in the science, technology, and engineering base, and to maintain and modernize the supporting infrastructure.

I fully endorse this investment plan to ensure the safety, security, and effectiveness of the U.S. nuclear weapons deterrent, and will vigorously support the Administration's efforts to obtain the requisite funding to execute this plan.

QUESTION FROM SENATOR GRAHAM

Q1. I have long been concerned about the cost of DOE pensions. The growing costs could very well impact programmatic work throughout the weapons complex. In FY12, what is the projected pension obligation across the weapons complex?

A1. The Table Below includes the estimated FY 2012 contributions for each NNSA contractor, based on a November 2010 data call.

Contractor Pension Plan Name	FY 2012 NNSA Contributions (S in Thousands)
Savannah River Nuclear Solutions Multiple Employer Pension Plan	57,229
Sandia Corporation Retirement Income Plan	112,813
LANS Defined Benefit Pension Plan	132,782
University of California Retirement Plan - Lawrence Livermore National Laboratory	153,941
Idaho National Laboratory Employee Retirement Plan	10,781
Pension Plan for Employees at ORNL	6,324
BW Y-12 Pension Plan	86,020
University of California Retirement Plan - Los Alamos National Laboratory	70,114
Pension Plan of the Pacific Northwest Laboratories, Battelle Memorial Institute	10,860
Pension Plan for Eligible Bettis Employees and Retirees	54,100
Salaried Employee Pension Plan for KAPL Employees and Retirees	53,700
National Security Technologies, LLC (NSTec) Employee Retirement Plan	24,203
Honeywell Retirement Earnings Plan For Aerospace Employees at the Kansas City Division	18,600
University of California Retirement Plan - Lawrence Berkeley National Laboratory	179
B&W Pantex, Non Bargaining	15,831
The Kansas City Division (Honeywell International Inc.) Hourly Employees Pension Plan	9,550
B&W Pantex, Metal Trades Council	7,406
Pension Plan for KAPL Employees in Participating Bargaining Units	6,400
WSI Pension Plan for Employees at Oak Ridge, TN	2,785
B&W Pantex, Pantex Guards Union	2,480
WSI Las Vegas	1,703
Sandia Corporation Non-Qualified Pension Plan	807
WSI Indep. Guard Assoc. of Nevada	1,332
Bechtel Marine Propulsion Corporation Non-Qualified Plan	623
Savannah River Nuclear Solutions Non-Qualified Pension Plan	88
LLNS 401(a)(17) Restoration Plan	41
LLNS Restoration Plan	12
LANS 401(a)(17) Restoration Plan	6
Battelle Memorial Institute SERP Non-Qualified Plan	2
LANS Restoration Plan	1
Total, FY 2012	**840,713**

QUESTION FROM SENATOR GRAHAM

Q2. I previously proposed language in the Defense Authorization Act that would require DOE and NNSA to report their pension obligations as a line item in the budget. This would give Congress a better sense of the cost of pensions on the complex. Do you support this effort? Why not?

A2. Increased visibility of pension liabilities is a goal the Department supports. However, reporting them as a line item in the budget is not viable due to budget formulation, execution and accounting concerns. To enhance visibility of pension liabilities, the Department included a separate section on pensions in its Congressional Budget Request for both FY 2011 and FY 2012. This section of the budget provides projected contractor defined-benefit (DB) pension plan contributions for FY 2011 and FY 2012 by plan and by Program Office. For the National Nuclear Security Administration, the projected contractor DB pension plan contributions are provided for FY 2010 through FY 2016 by plan.

At the time the Department's budget request is submitted, the Department provides the latest pension contribution estimates available from its contractors. However, the actual amount of the contractors' annual defined benefit pension contributions is not typically known until the third quarter of the year of budget execution. Projections of future pension contributions are highly sensitive to underlying data, economic conditions, and actuarial methods and assumptions. Thus, the final annual actuarial valuation likely will yield different contribution amounts than the amounts estimated at the time of budget submission. For instance, we are currently preparing the budget submission for *FY 2013*. At the same time, our contractors are waiting on the actuaries to complete the various analyses to determine the actual pension costs for *calendar year 2011*. Because the budget formulation cycle occurs so far in advance of the pension plan execution year, directly funding pension obligations through a line item is not desirable.

Further, the current methodology of having the pension liabilities collected through indirect cost pools allows the Department to charge all customers doing business at a site for a portion of the pension liability. If pension liabilities were fully "direct funded," the Department would bear the full costs of the liabilities whereas with the current budget and accounting system permits the Department to recover pension costs through overall indirect costs charged to non-DOE customers.

Another disadvantage of "direct funding" the pension liabilities would be a reduction in the contractors' and the Department's ability to quantify the true cost of the work at the site, inclusive of costs for contractor employees' pension benefits. The result would be the loss of a key self-policing aspect of the current approach to funding pensions. In particular, when the true indirect cost of work, including pension costs, is proportionally shared with each site customer, it creates an incentive for contractors to minimize their overall indirect costs insofar as the contractors must keep indirect costs low to attract work from other agencies or entities. If pensions were "direct funded," this market pressure would be largely absent because a large component of total indirect cost pool would be removed from the indirect costs.

One area where the Department does submit a direct request for pension liabilities is for legacy pension benefits. NNSA has a continuing obligation to reimburse the University of California Retirement Plan to fund retirement benefits for University of California

(UC) retirees from Los Alamos and Lawrence Livermore National Laboratories. NNSA is unable to recover the costs associated with the liability to the UC through indirect cost pools as NNSA does for pension costs associated with benefit plans sponsored by current NNSA contractors. The difference between the two payment methods is a critical and significant difference that requires the disparate treatment in the budget.

QUESTION FROM SENATOR CRAPO

Q1. In November 2010, The President's Council of Advisors on Science and Technology (PCAST) issued a report that addressed how to transform our nation's energy system by deploying new technologies. The PCAST report recommended spending $16 billion per year in federal energy research and development (R&D), which would be divided into $12 billion for R&D and $4 billion for large-scale demonstrations and deployment. Seeing as there has been considerable difficulty in funding a large scale demonstration project for the Next Generation Nuclear Plan (NGNP) within the program at the Office of Nuclear Energy, would it make sense to establish a new budget line that would move the burden of funding these large scale projects from the research program, as is currently the case with NGNP, to another budget like the one suggested in the president's PCAST report?

A1. The PCAST report *Accelerating the Pace of Change in Energy Technologies through an Integrated Federal Energy Policy* makes a number of recommendations on how to transform the energy system within one to two decades, through leadership in energy technology innovation, for reasons of economic competitiveness, environment, and security. With respect to large-scale demonstration projects such as carbon capture and sequestration and next generation nuclear power plants, the report suggests new management models, including a dedicated office with authorities beyond those currently exercised by the applied energy research offices or a quasi-government corporation outside the department. These are suggestions that the Department will consider when the time approaches for such demonstration plants.

QUESTION FROM SENATOR CRAPO

Q2. The Department of Energy's core mission is to help develop technologies that can be deployed by the private industry to reduce our dependence on foreign oil. In the President's FY 2012 budget, there is $5.416 billion for the Office of Science, which is roughly equal to all other DOE budgets (minus weapons activities and cleanup activities - all other budgets - $5.264 billion). In your estimation, does DOE's FY 2012 budget properly balance between basic science and other energy-specific R&D accounts based on other offices within DOE such as NE, FE, EERE, and OE?

A2. Yes, the Department is confident that the balance between basic science and applied science is appropriate. As the President has said, innovation is essential to America's economic competitiveness. To meet the challenge of 'our generation's Sputnik moment,' the Department proposes to support a coordinated strategy for research and development across all of its programs. With every initiative the Department undertakes, sound science is at the core. The Department has identified areas where coordinated work by discovery-oriented science and applied energy technology programs hold great promise for progress in achieving energy goals. For example, the advanced computer models of internal combustion engines will produce a set of modern, validated computer codes that could be used by design engineers to optimize the next generation of cleaner, more efficient engines. An initiative on extreme environments will close the gap between actual and ideal performance of materials in nuclear environments. And the Department's exascale computing initiative will allow the Department to take the lead in developing the next generation of scientific tools and to advance scientific discoveries in solving practical problems. The Energy Innovation Hubs also play a key role in solving specific energy challenges by convening and focusing top scientific and engineering talent to focus on those problems. The Department is proposing to double its commitment to this research approach by requesting three new Hubs—one in the Office of Science and two in the technology offices—to focus on batteries and energy storage, critical materials, and smart grid technologies and systems. Complementing the Hubs, the Department's applied science programs will continue coordination with the Office of Science's Energy Frontier Research Centers, which exemplify the pursuits of broad-based science challenges for energy applications.

THE PRESIDENT'S FISCAL YEAR 2012 BUDGET REQUEST FOR THE U.S. DEPARTMENT OF TRANSPORTATION

THURSDAY, MARCH 3, 2011

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, Wyden, Nelson, Cardin, Sanders, Whitehouse, Warner, Merkley, Coons, Sessions, and Thune.

Staff present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

Chairman CONRAD. The hearing will come to order.

First of all, I want to welcome everyone to the Senate Budget Committee. I especially want to welcome the Secretary and say right at the top that I personally think you are doing an outstanding job. I have had this responsibility for more than 24 years now, and you have done the best job I have ever seen of communicating with members, and that is to your credit.

Before I give my full opening statement, I want to recognize Senator Nelson because he has another commitment and would like a few moments. Then I will give my opening statement, Senator Sessions will give his, then we will go to you, Mr. Secretary, for your statement.

I will recognize a very valuable member of this Committee, my very good friend Senator Nelson.

Senator NELSON. Mr. Chairman, thank you for this courtesy. Mr. Ranking Member, my favorite Republican from Alabama, thank you for your courtesy. Do not tell Senator Shelby that, please.

[Laughter.]

Senator NELSON. I just wanted to say publicly, Mr. Chairman, that I have seen the Secretary on a daily basis perform his duties in the last several weeks as we have been going through the turmoil of, after an awful lot of hard work by a lot of people, including the Secretary, one of the best high-speed rail projects in the country because it is ready to go—the environmental studies, it is the right of way right down the middle of Interstate 4 from Tampa to Orlando, eventually to Miami. The recognition that Interstate 4 and Interstate 95 in 20 to 30 years you can imagine what it is going to be like in that period of time. And here we have an opportunity of an alternate form of transportation where the United

States is 30 years behind Europe, and now high-speed rail is all over Asia.

I just want to sing the praises of the Secretary. He has worked with the State of Florida, despite the Governor of Florida trying to reject the funds, and over and over has worked with us in order to give us time to try to work it out, to show the Governor that his conditions are met, that the State of Florida will have no financial responsibility, that it will all be a privatized matter. And if it were not for the Secretary, this thing would have long been passed. And we now are at the 11th hour with a petition filed by a Republican State senator and a Democratic State senator to the Florida Supreme Court asking for a writ of mandamus to compel the Governor to follow the law of the State of Florida. Oral arguments are this afternoon, and we are expecting—because the Supreme Court took this quickly yesterday, we are expecting an imminent decision. And I just want to thank the Secretary again for his being willing to work with us, to extend the deadline, to try everything possible that we can to make this happen. And so, too, depending on what the decision is of the court, we may come back to him and ask him again for another extension, depending on what the Supreme Court says.

So I wanted to put that on the record to corroborate your kind comments about Secretary LaHood.

Chairman CONRAD. Thank you, Senator Nelson. Let me——

Secretary LAHOOD. Mr. Chairman, can I just offer my thanks to Senator Nelson?

Chairman CONRAD. Certainly.

Secretary LAHOOD. And to you for your very kind comments. Thank you.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. Let me say that the hearing today will focus on the President's transportation budget request. Our witness is the Secretary of Transportation. This is Secretary LaHood's second appearance before the Budget Committee. He reminds me the last time he was here I was the only one here, and I had my little dog, Dakota, with me because, as I recall, we were in the middle of a blizzard, I think. No one else could make it. So it was a very good hearing. I know I got all of my questions answered.

[Laughter.]

Chairman CONRAD. Probably for the first time ever.

So we are pleased that he could be back and look forward to his testimony. I believe personally that the strength of the Nation's transportation infrastructure is one of the most important factors that will determine our future economic success.

Transportation infrastructure is really the foundation for our economic growth, and I recognize absolutely jobs are created in the private sector, but I also recognize that transportation infrastructure is absolutely critical for the economic competitive position of the United States. So even as we look to cut spending to bring down the deficit, which we absolutely must do, we need to ensure that transportation funding remains a priority.

Yes, we have to cut spending, but we have to be smart about where we cut. We cannot afford to cut areas that are critical to future growth. That would be counterproductive.

Investment in transportation can play a critical role in strengthening the economy in the near term because it is clear that transportation funding in the 2009 Recovery Act did help to create jobs and created jobs here in America and jobs that helped strengthen the Nation's economic recovery.

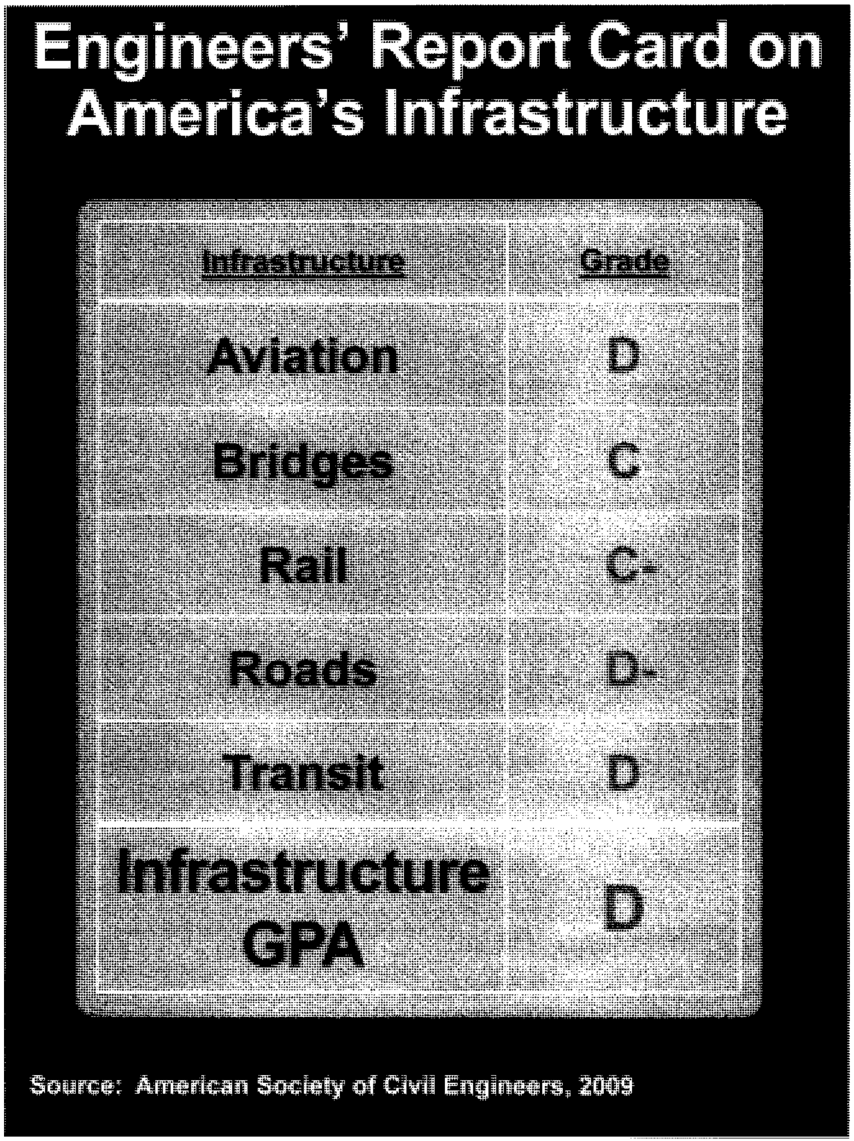
It is also clear that there is a tremendous need for further infrastructure investment. According to the World Economic Forum's Global Competitiveness Report, the United States ranks 23rd in the world in the quality of its overall infrastructure. We even rank behind countries like Barbados and Oman.

U.S. Ranks 23rd in World in Quality of Overall Infrastructure

1. Switzerland
2. Hong Kong
3. Singapore
4. France
5. Iceland
6. Austria
7. Sweden
8. Finland
9. Germany
10. Denmark
11. United Arab Emirates
12. Republic of Korea
13. Canada
14. Portugal
15. Japan
16. Luxembourg
17. Netherlands
18. Barbados
19. Taiwan
20. Belgium
21. Oman
22. Spain
23. **United States**
24. Chile
25. Namibia
26. Bahrain
27. Malaysia
28. Estonia
29. Saudi Arabia
30. Tunisia

Source: World Economic Forum Global Competitiveness Report, 2010-2011
Note: Overall infrastructure includes transport, telecom, and energy.

The American Society of Civil Engineers has created a report card on America's infrastructure. They give our infrastructure an overall grade of D. Aviation they give a D; bridges they give a C; rail, a C-minus; roads, a D-minus; transit, a D. An overall grade of a D from the American Society of Civil Engineers.

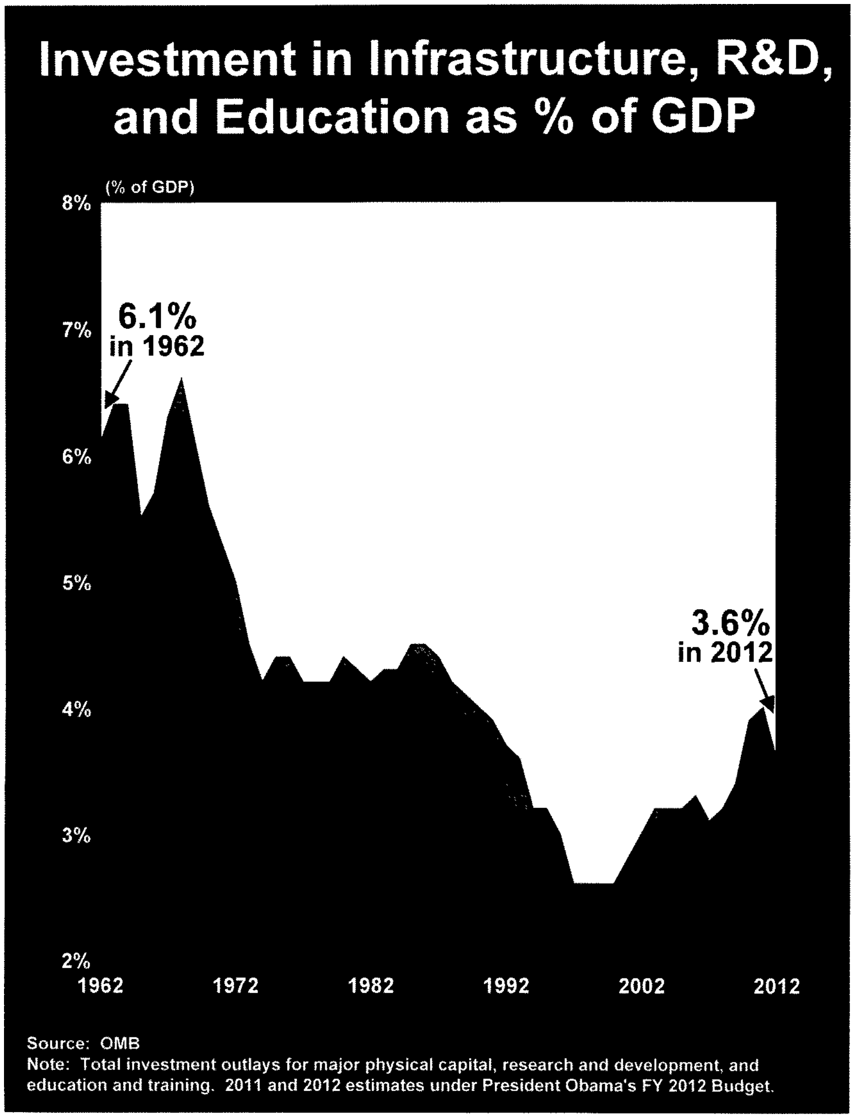


Engineers' Report Card on America's Infrastructure

Infrastructure	Grade
Aviation	D
Bridges	C
Rail	C-
Roads	D-
Transit	D
Infrastructure GPA	D

Source: American Society of Civil Engineers, 2009

The next graph, which was made with data from the President's budget, shows that our combined investment in infrastructure, research and development, and education has fallen as a share of GDP from 6.1 percent in 1962 to 3.6 percent in 2012. So as a share of the economy we are spending a smaller amount on infrastructure and these other critical areas than we did in the 1960s.



There is widespread agreement on the need for further infrastructure investment. I think it is notable that just last month Thomas Donohue, the head of the U.S. Chamber of Commerce, which represents many of the country's largest businesses, joined Richard Trumka, the head of the AFL–CIO, America's largest union, in testifying before the Senate Environment and Public Works Committee on the need for more infrastructure funding.

Here is what Mr. Donohue said: "If we don't change course, over the next 5 years the economy could forgo as much as $336 billion in lost economic growth as transportation networks continue to deteriorate. I am well aware of the fiscal constraints facing this Congress and the Nation," he went on to say, "but we must avoid cutting off our nose to spite our face. Without proper investment and attention to our infrastructure, the United States' economic stability, potential for job growth, global competitiveness, and quality of life are all at risk."

I think Mr. Donohue has it about right.

U.S. Chamber of Commerce on Importance of Infrastructure Funding

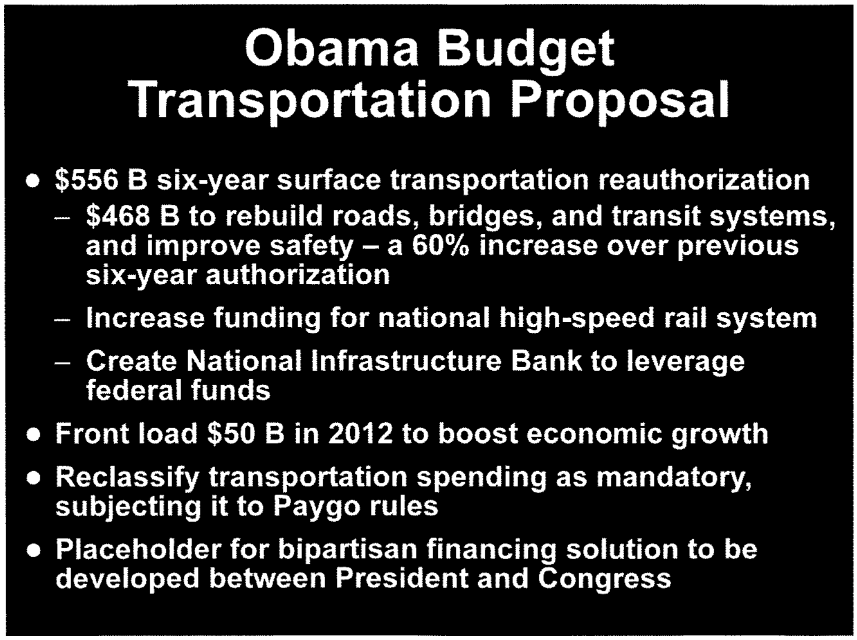
"If we don't change course ... over the next five years, the economy could forego as much as $336 billion in lost economic growth as transportation networks continue to deteriorate....

"I am well aware of the fiscal constraints facing this Congress and the nation. But we must avoid cutting off our nose to spite our face. Without proper investment and attention to our infrastructure, the United States' economic stability, potential for job growth, global competitiveness, and quality of life are all at risk."

– Thomas Donohue
President and CEO of U.S. Chamber of Commerce
Testimony before Senate EPW Committee
February 16, 2011

Here is what the Obama Administration has proposed in its budget for transportation. It proposes $556 billion in a 6-year surface transportation reauthorization. This includes $468 billion to rebuild roads, bridges, and transit systems and improve safety, which represents a 60-percent increase over the previous 6-year authorization bill. It also increases funding for high-speed rail and incorporates rail funding in the Highway Trust Fund, and it creates a National Infrastructure Bank within the trust fund to leverage Federal funds for transportation projects.

The budget proposes front-loading $50 billion in transportation funding in 2012 to help boost economic growth. It reclassifies transportation spending as mandatory spending, subjecting it to PAYGO rules. And it includes a place holder for a bipartisan financing solution to be developed between the President and Congress. I will be interested in hearing more from Secretary LaHood on the Administration's ideas in that regard.

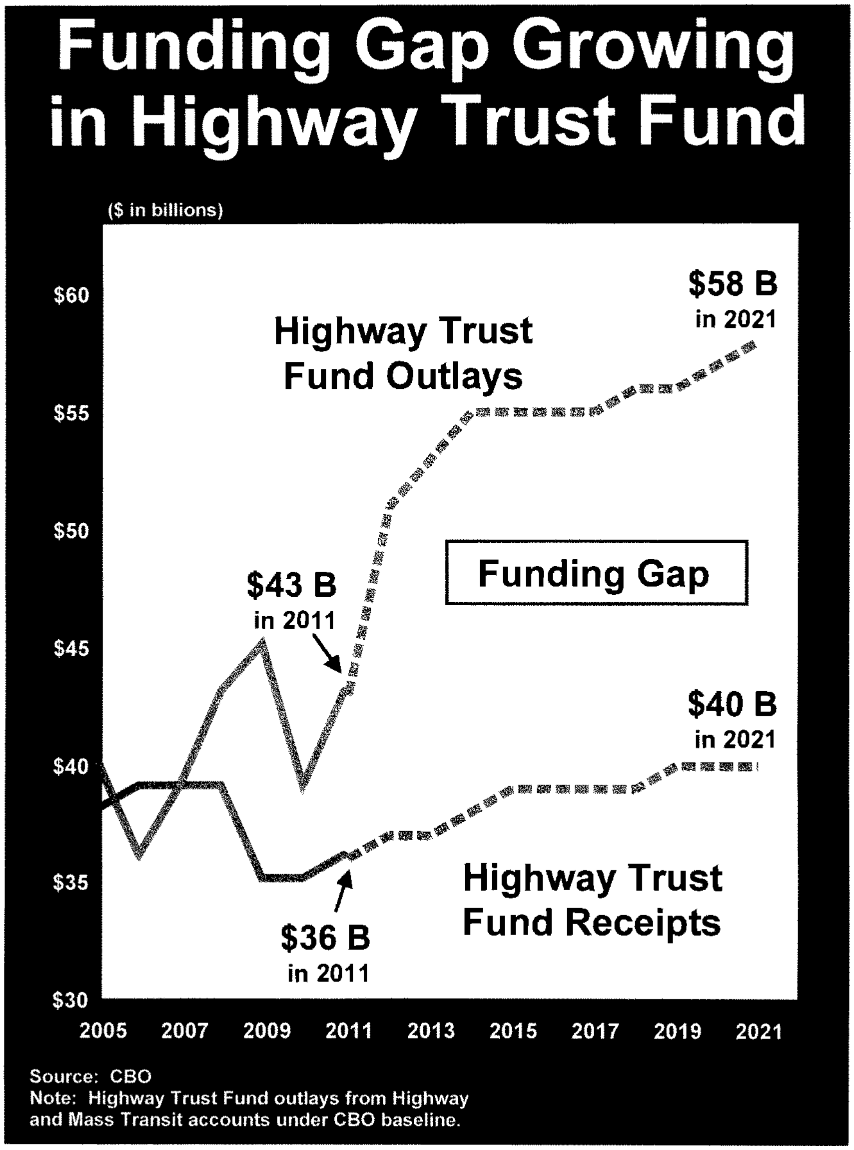


The reality is that even before we factor in the Administration's new transportation request, we already have a very serious shortfall at existing funding levels.

Let me repeat that. At existing funding levels we have a very significant shortfall.

This chart shows that Highway Trust Fund receipts are projected to be far lower than Highway Trust Fund outlays in the years ahead, and under the Administration's request, the funding gap would be far larger.

Now, let me just point out here: The red line is the outlays, the expenditures. The green line is the anticipated Highway Trust Fund receipts. And you can see the gap by the time we get to 2021 is over $18 billion a year. Now, that is at the existing levels.



We have a very big problem here to deal with, and we know that the reality of the trust fund financing is based on the gasoline tax. The gasoline tax is more and more disconnected from the reality of modern transportation. With electric cars, with hybrids, with renewable fuels, with all the rest that is happening to change the way we transit, we have a big problem here between the need and the funding mechanism.

With that, I will turn to Senator Sessions for his opening remarks. I want to thank Senator Sessions for the cooperation of him and his staff as we have scheduled these hearings. We have had a lot of hearings.

Senator SESSIONS. Yes, we have.

Chairman CONRAD. And we have more to go. I just want to thank him for his courtesy and the professionalism of his staff.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you. I appreciate your tough leadership. We have a lot to do. I agree with you. We have to contain spending in this country. We are heading off a cliff with 40 cents out of every dollar being borrowed and our debt surging, on pace under the President's budget to double from $13 trillion to $26 trillion in 10 years, and we know we have a difficulty with transportation.

Secretary LaHood, I share my colleague's comments that you are accessible, and I appreciate you coming by and visiting in my office. That does not often happen, and I think that is very helpful.

I do believe that transportation is a major issue for us. We have to be sure that we maintain the required infrastructure this Nation has to maintain its productivity. But we have problems. We know that our gas tax revenue has been falling below our projected budget for a number of years now. I think we were at 36 billion income and 43 billion spending last year. So that money is filled with Treasury money, and Treasury money is borrowed money.

And so we know we are in this difficult time, and I was looking with great interest on what kind of budget projections we would see. We have seen a Department of Education request on Tuesday for an 11-percent increase. We had the Department of Energy yesterday with a 9.5-percent increase. But I have to say I was flabbergasted to see that the Department of Transportation is asking for a 62-percent increase in spending—at a time when all of us know we have to contain spending and do something about the surging debt we have.

And why is this? Well, because we have crumbling infrastructure. But I remember very well, because I made a number of speeches on the floor about it, that I was disappointed deeply that the stimulus package, which was projected repeatedly as a plan to increase spending for our crumbling infrastructure, only had about 3 percent of the budget for roads and bridges, maybe 5 percent for transportation total out of the $800 billion or so. That was a tragedy. That was an opportunity lost of monumental proportions. We did not do enough to fix the crumbling infrastructure we have, so now we are reduced—having not produced many jobs out of this stimulus package, every penny of that money being borrowed, now we are reduced, I suppose, to coming up with a new plan. And this plan says that we are going to have a tax that is not a gas tax, "a not-gas-tax tax," I guess we will call it. And it is going to raise $435 billion. Well, we have a $300 billion plus hole in our Medicare physician payment that we cannot find the money to fill in that critical area. We have a 200 or so plus hole on the alternative minimum tax that we cannot fill. But now the Administration proposes some tax that we are supposed to assume will arrive in a bipartisan fashion to produce $435 billion so that we can have a massive increase in highway spending. And I just have to say that is unrealistic, Mr. Secretary. I am sure that when you were in the room—I have no idea directly, but I am confident over the stimulus bill that you were advocating for as much for highway infrastructure as you could get. But the final decision was not enough, and we are placing this country at risk. In all honesty, I do not think—if you cannot tell us what kind of tax you think would fund this and prepare to defend it, I think there is zero chance of us passing such a tax as this. And so we are dealing with the question, will we just borrow it again or not have enough? Or what will we do?

Mr. Chairman, I think that is a fairly honest statement of where we are from my perspective, and it leaves us in an unhappy place with regard to transportation infrastructure. I look forward to questions as we go forward.

Chairman CONRAD. Thank you, Senator Sessions.

We will turn now to the Secretary for his opening statement testimony, and then we will go to colleagues for questions.

STATEMENT OF THE HONORABLE RAY LAHOOD, SECRETARY, U.S. DEPARTMENT OF TRANSPORTATION

Secretary LAHOOD. Thank you, Mr. Chairman. Chairman Conrad, Ranking Member Sessions, Senator Wyden, I appreciate the opportunity to discuss President Obama's fiscal year 2012 budget request for the U.S. Department of Transportation. Joining me today is our Chief Financial Officer Chris Bertram, who is an alum of this side of the Capitol.

Just a few weeks ago, President Obama delivered a powerful message in his State of the Union address. He said that for America to win the future, our citizens and companies need the safest, fastest, most reliable ways to move goods and information. He reminded us that if we build it, they will come. If we want businesses to open shop and hire our family and friends and neighbors, we have to invest in our roadways, railways, and runways. We have to invest in 21st century buses, street cars, and transit systems, and we have to invest in next-generation technology for our skies and sidewalks and bike paths that make our streets more livable. And all of this is included in the President's $129 billion 2012 budget for the U.S. Department of Transportation. Designed as the first installment of a bold 6-year, $556 billion reauthorization proposal.

Now, to make room for these essential investments, President Obama's 2012 budget proposes the lowest relative level of domestic spending since President Eisenhower was in office six decades ago. That was ten administrations ago, if you are counting. The simple fact is that we have to cut and consolidate things that are not growing the economy, creating jobs, or making it easier to do business in order to pay for the things that are.

So at the Department of Transportation, President Obama's budget slashes red tape. It consolidates more than 50 programs, and it includes reforms that will accelerate project delivery and empower local communities.

Of course, our major objective is to make investments in tomorrow that expand economic opportunity today, to dream big and to build big. And to illustrate that, if you look at the cover of our budget, you see a picture of a bridge over the Hoover Dam, which several months ago some of us had the privilege of cutting the ribbon on and dedicating. This is thinking big. This is a bold vision. This is a vision that the people who came before us had about transportation. This put thousands of people to work building this bridge. And it is a 21st century opportunity for infrastructure to connect two States and a magnificent structure, and I think it really reflects the big, bold vision that the President has.

Our major objective is to make investments in tomorrow that expand economic opportunity for today, to dream big and build big. That is why the budget keeps us on track toward a national high-speed rail system with an $8 billion investment in 2012 and a $53 billion investment during the next 6 years. It increases resources for highway and bridge improvements by 48 percent and increases funding for affordable, efficient, and sustainable bus, street car, and transit systems by 126 percent. It includes a $50 billion up-front boost to keep our economy moving in the short term and a $30 billion annual infrastructure bank that will finance major projects of national and regional significance over the long run. It also unleashes innovation and competition with a new $32 billion grant program called the Transportation Leadership Awards.

At the same time, safety is and always will be our No. 1 priority. President Obama's budget renews our commitment to prevent traffic crashes with resources for ongoing campaigns against distracted driving, drunk driving, and to promote seat belt use. The President's proposal requests new authority for the Federal Transit Administration to ensure the safety of rail transit riders across America, and it gives the Federal Motor Carrier Safety Administration stronger capacity to keep commercial traffic safe.

Finally, we are dedicated to doing all of this without passing on another dime of debt to our children or grandchildren. For the first time, transportation spending will be subject to PAYGO provisions that ensure that the dollars we give out do not exceed the dollars coming in.

So these are just a few components of the President's plan. They reflect a much larger point. America's transportation system is at a crossroad. Our choice is not between policies on the left or policies on the right. Our choice is whether our economic recovery rolls forward or falls backward. It is up to us whether we lay a new foundation for economic growth, competitiveness, and opportunity, or whether we settle for a status quo that leaves America's next generation of entrepreneurs, our children and grandchildren, with clogged arteries of commerce.

It is up to us whether we do big things or we do nothing. And if we choose wisely, our legacy can be an economy on the move and a future that America is prepared to win.

With that, Mr. Chairman, I will be happy to answer your questions. Thank you very much.

[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

March 3, 2011

Introduction

Chairman Conrad, Ranking Member Sessions, and Members of the Committee, thank you for the opportunity to appear before you today to discuss the Administration's fiscal year (FY) 2012 budget request for the U.S. Department of Transportation. The President is requesting $129 billion for Transportation in FY 2012. This includes the first-year of a bold new six-year $556 billion reauthorization proposal that will transform the way we manage surface transportation for the future.

America is at a transportation crossroads. To compete for the jobs and industries of the future, we must out-innovate and out-build the rest of the world. That is why President Obama called on the nation to repair our existing roadways, bridges, railways, and runways and to build new transportation systems – including a national high-speed intercity rail network – which will safely and efficiently move people and goods. The Administration's Surface Transportation Reauthorization proposal is designed to accomplish precisely this, and is the centerpiece of the President's FY 2012 budget.

It proposes four broad goals: (I) **building for the future**, (II) **spurring innovation**, (III) **ensuring safety**, and (IV) **reforming government and exercising responsibility**.

The FY 2012 proposal includes a $50 billion "Up-Front" economic boost that is designed to jump-start job creation while laying the foundation for future prosperity. This initial funding would finance improvements to the nation's highway, rail, transit, and aviation systems.

I. Building for the Future

America's aging roads, bridges, and transit systems must be addressed. For too long we have put off the improvements needed to keep pace with today's transportation needs. By 2050, the United States will be home to 100 million additional people – the equivalent of another California, Texas, New York, and Florida. More than 80% of them will live in urban areas. Concerns about the need for livable communities will increase as communities tackle the need for transportation choices and access to transportation services. If we settle for the *status quo*, our next generation of entrepreneurs will find America's arteries of commerce impassably clogged and our families and neighbors will fight paralyzing congestion. So the Administration's proposal addresses this challenge in three ways:

1) **Creating a National High-Speed Rail Network:** First, the proposal provides $53 billion over six years to continue construction of a national high-speed rail network. It will place high-speed rail on equal footing with other surface transportation programs; include funding for both Amtrak and new "core express," "regional," and "emerging" corridors; and keep the country on track toward achieving a goal of providing 80 percent of Americans with access to an intercity passenger rail network, featuring high-speed rail within 25 years.

2) **Rebuilding America's Roads and Bridges:** Second, the Administration's proposal will provide a 48 percent funding increase – to $336 billion over six years for road and bridge improvements and construction. A key element expands the current National Highway System to include an additional 220,000 miles of critical arterials. It will also simplify the highway program structure, accelerate project delivery to realize the benefits of highway and bridge investments for the public sooner, and underscore the importance of maintaining existing highway infrastructure in good condition. These investments and reforms will modernize our highway system while creating much-needed jobs.

3) **Investing in Accessible, Affordable Transit Options:** Third, the proposal will provide a 128 percent increase in funding – to $119 billion over six years – for affordable, efficient, and sustainable transit options. It will prioritize projects that rebuild and rehabilitate existing transit systems, including an important new transit safety program, and allow transit authorities (in urbanized areas of 200,000 or more in population) to temporarily use formula funds to cover operating costs.

II. Spurring Innovation

The Administration's Surface Transportation Authorization proposal acknowledges the important role that innovation and modern business tools play in putting our transportation dollars to work wisely. We can no longer afford to continue operating our systems the same way we did 50 years ago, with outdated processes and financial tools that were made for yesterday's economy. Our proposal and the President's FY 2012 request responds to this challenge in several ways.

It establishes an Infrastructure Bank to finance projects of national or regional significance. By working with credit markets and private-sector investors, the Infrastructure Bank will leverage limited resources to achieve maximum return on Federal transportation dollars. The bank will initially receive $30 billion over six years, will reside within the U.S. Department of Transportation, and will be managed by an executive director with a board of officials drawn from other Federal agencies.

Recognizing that competition often drives innovation, the Administration's proposal and the President's FY 2012 budget also includes a $32 billion competitive grant program called the Transportation Leadership Awards. This program's goal is to reward States and local governments that demonstrate transformational policy solutions. Examples include the use of innovative multimodal planning and funding methods, pricing and revenue options, land use guidelines, environmental stewardship measures, economic development strategies, innovation of project delivery, and deployment of technology – just to name a few possibilities.

These new and innovative tools will help us to better meet the transportation needs of America's small towns and rural communities. Increased highway funding will expand access to jobs, education, and health care. Innovative policy solutions will ensure that people can more easily connect with regional and local transit options – and from one mode of transportation to another.

At the same time, our proposal will bolster State and metropolitan planning; award funds to high performing communities; and empower the most capable communities and planning organizations to determine which projects deserve funding.

Innovation must span beyond surface transportation. This is why the President's budget request also includes $3.4 billion for aviation in the $50 billion up-front investment. The budget requests $3.1 billion for airport improvements for runway construction and other airport projects such as Runway Safety Area improvement projects as well as noise mitigation projects. Modernizing our air traffic control systems is critical if we are to meet the needs of the future. The President's FY 2012 budget addresses this by providing $1.24 billion for the Federal Aviation Administration's (FAA) efforts to transition to the Next Generation (NextGen) of Air Traffic Control. This funding will help the FAA move from a ground-based radar surveillance system to a more accurate satellite-based surveillance system – the backbone of a broader effort to reduce delays for passengers and increase fuel efficiency for carriers.

III. Ensuring Safety

Keeping travelers on our transportation systems safe is my top priority. That is why preventing roadway crashes continues to be a major focus at DOT. The Administration's Surface Transportation Reauthorization proposal will provide $330 million for the ongoing campaign against America's distracted driving epidemic. It will also commit $7 billion to promote seatbelt use, get drunk drivers off the road, and ensure that traffic fatality numbers continue falling from current historic lows. In addition, it almost doubles the investment in highway safety, providing $17.5 billion to Federal Highway Administration (FHWA) safety programs. The Department is also taking a fresh approach to interstate bus and truck safety. Compliance, Safety, Accountability (CSA) is a new initiative that will improve safety and use resources more efficiently. The Administration's Surface Transportation Reauthorization Proposal will dedicate $4.9 billion to the Federal Motor Carrier Safety Administration (FMCSA), and give the Department of Transportation new authority to set tougher safety performance goals for states.

Transit safety is another important priority. Our proposal will, for the first time, entrust the Federal Transit Administration with the authority to oversee rail transit safety across America. In light of recent transit-related accidents, I believe this is critical to ensuring the oversight and accountability our transit riders deserve.

Our safety focus must also include the transportation of hazardous materials and our network of pipelines. The Administration's Surface Transportation Reauthorization Proposal will fund the safety programs of the Pipelines and Hazardous Materials Safety Administration (PHMSA) and will enhance its authorities to close regulatory loopholes and improve its safety oversight. The President's FY 2012 budget requests $221 million for PHMSA to help ensure that families, communities, and the environment are unharmed by the transport of chemicals and fuels on which our economy relies.

IV. Reforming Government and Exercising Responsibility

As we move forward together to plan for America's transportation needs, we must also keep in mind the responsibility we all share for using taxpayer dollars wisely. The Administration's Surface Transportation Reauthorization Proposal will cut waste, inefficiency, and bureaucracy so that projects can move forward quickly, while still protecting public safety and the environment.

Our proposal consolidates and streamlines our current Highway and Transit Programs in a major way. The current system of over 55 separate highway programs will be folded into five new categories. Similarly, six transit programs are merged into one "state of good repair" program and one "specialized transportation" program. As a result of these changes, we expect to shorten project delivery and accelerate the deployment of new technologies.

The Administration's Surface Transportation Reauthorization proposal also includes important reforms that change the way we manage our transportation spending. Consistent with the recommendations of the Fiscal Commission, for the first time, the Budget proposes to subject surface transportation spending to "paygo" provisions to make certain that spending does not exceed dedicated revenue. This approach is designed to ensure that our surface transportation program is paid for fully without increasing the deficit. The proposal will also expand the current Highway Trust Fund into a new Transportation Trust Fund with four accounts – one for highways, one for transit, one for high-speed passenger rail, and one for the National Infrastructure Bank.

Other Highlights

The President's FY 2012 request includes some other key transportation priorities as well. These include the $18.7 billion in total funds requested for the FAA. FAA would receive $9.8 billion to fund the operation, maintenance, communications and logistical support of the air traffic control and air navigation systems. An additional $3.1 billion would support FAA's Facilities and Equipment program to fund FAA's capital projects. A total of $5.1 billion in FY 2012 would fund the Airport Improvement Program when funding from the $50 billion up-front investment is included.

The President's request also includes $93 million for the U.S. Merchant Marine Academy (USMMA). $29 million of these funds will be used to support the next phase of the USMMA's Capital Asset Management program and for renovations to selected barracks and the mess hall. These improvements will help ensure that our cadets have the facilities they need to support their education.

Conclusion

Thank you for the opportunity to appear before you to present the President's FY 2012 budget proposal for the Department of Transportation and our Surface Transportation Reauthorization proposal that will help transform transportation programs over the next six-years in ways that will benefit all Americans for years to come. I look forward to working with the Congress to ensure the success of this request.

I will be happy to respond to your questions.

# # #

Chairman CONRAD. Thank you, Mr. Secretary.

Let me begin where I ended, and that is with this chart. Matt, if you can put that up?

This is kind of the harsh reality that we all confront. It is not anybody's fault. It is because of a changing of transportation financing in this country.

The green line is the revenue of the trust fund, and basically it goes from $36 billion a year to $40 billion a year, basically flat for the entire 6 years. And we have a gap before we ever enter this 6-year period, as can be seen in 2011 where the expenditures were $43 billion, which Senator Sessions mentioned, and the income was $36 billion. So we start with a gap of $7 billion, and that gap grows dramatically as we go toward 2021, 10 years out. So a $7 billion gap per year turns into a gap of $18 billion. That is under the baseline. That just takes the current program and extends it. That does not capture what the President is proposing, which is an actual increase.

So the question that we have before us is: What are the options for closing this gap? And what is your assessment of how realistic those various options are? That is really my first question to you. What do you see as the options for closing this gap? And what is your assessment of how realistic those various options are?

Secretary LAHOOD. Well, look, the Highway Trust Fund is deficient. There is no question about it. People are driving less. They are driving more fuel-efficient automobiles. We know that. And as things continue to stay stirred up in the Middle East and countries that produce crude oil, we know that gasoline prices are going to continue to go up, and probably as a result people will be driving maybe even less frequently than they are today. It is probably not going to help us in our collection of the gas tax.

The Highway Trust Fund helped us build a state-of-the-art interstate system. There is no debate about that. We have one of the best interstate systems anywhere in the world, and we want to work with Congress on our way forward.

I think the one thing that people ought to recognize is that our budget is a budget that will put people to work. For the $48 billion that we received in the economic recovery plan, we created 15,000 projects and 65,000 jobs. Our money actually helped people build roads in your States.

We know that the work that we do and that our budget will reflect will increase jobs, increase opportunities to get economies going in the States. And, Mr. Chairman, we want to work with Congress on the way forward. There can be no dispute about the fact this is a big, bold plan. This is a big vision, thanks to the President, because the President recognizes this is a jobs bill. When you all pass a transportation bill or pass our budget, you are going to create jobs. That is the one thing that everybody recognizes. There is no debate about that.

So we want to work with you on trying to find the resources that we know will put our friends and neighbors to work building our infrastructure and creating a 21st century transportation system that really reflects the values for the next generation the way that, you know, others did for our generation.

Chairman CONRAD. Well, I agree with your basic statement here. I mean, there is no question in my mind that these highway funding initiatives, bridge funding initiatives, transit funding initiatives create jobs, create jobs in the United States, and they are also critically important to our competitive position.

Do we have an assessment of what the lost productivity is because of a deficient infrastructure system in terms of transportation?

Secretary LAHOOD. You know, I do not have that figure, but we will see if some of our smart people can get that for you. I have never really heard that articulated in the Department, but I am sure we can find it.

Chairman CONRAD. You know, I would be very interested. I ask the question because any day after 4 o'clock, if you leave here and you go out on the major arteries—395, 295, 95—often as not they are stopped dead. And I see trucks delivering goods across the country. They are idle. They are stopped dead in their tracks. There has to be an economic cost to that. And I believe the economic cost must be substantial because on the east coast and the west coast, these arteries are clogged.

Let me go back to the first question I asked because you answered about the importance of doing what has been proposed. The question we have on this Committee is: how do we pay for it? And, of course, we cannot direct the funding committees on how to raise the money. We can tell them how much money to raise. We cannot tell them how to do it. But we have to give them—to be credible, we have to give them some options. Do we do a gas tax? Do we move to some kind of an assessment that is based on how many miles vehicles go so that we capture revenue from those who are going to be using the roads who are not going to be paying any gas tax or very little with hybrids and electric cars? Do we go to more tolling? I have just had, as I told you, the head of my transportation department back home, Francis Ziegler, in to see me yesterday. He said, "Kent, in North Dakota, tolling does not work at all." It does not make any sense in a big, wide open State like ours, sparsely populated.

What options do you see—are there options that I have not listed there that we should be thinking about?

Secretary LAHOOD. Mr. Chairman, tolling is an option—not in every State. I just met with the two Governors of Oregon and Washington. They are proposing to build a bridge across the Columbia River. It is a great project. It is about as multimodal as you can get. And there is going to be a transit system that runs across that bridge. There is going to be availability if somebody wants to ride their bike across the bridge, and there is going to be availability for people to drive across that bridge. And they are going to pay for part of it with tolling. They are going to pay for part of it with State resources. They are going to pay for part of it with Federal resources. But tolling is a good way for those two States to, you know, think big and dream big for this Columbia River crossing.

Chairman CONRAD. But you would acknowledge that in some States tolling is really not a very viable option.

Secretary LAHOOD. I do not think it probably works in your State, Mr. Chairman, but there are a lot of States where it does work. And you know what? A lot of States are thinking about adding capacity, taking an interstate that was built with taxpayer money, putting a couple additional lanes on it, and tolling that. They have done that in Miami where they call it a "hot lane." They built a lane, and they toll it. And you can raise a lot of money and actually pay for a project like that.

We support that kind of opportunity where you can add capacity and use tolling to help pay for it. And then, you know, leverage that with maybe some money from our Department, leverage it against maybe some private dollars.

Look, our idea is this. The Highway Trust Fund is going to be around. It is deficient. We know that. Tolling, couple it with tolling. We have a TIFIA loan program that people—the President has talked about in his budget the Infrastructure Bank with significant, billions of dollars. You leverage all those together, you can begin to do big things in America. People can then think about dreaming big again.

Does that get us to everything we want or everything that we think is necessary? No. That is why we need your help on this.

Look, I agree with what Senator Sessions said. If some of us had been writing the stimulus bill, there would have been more than $40 billion. We spent every one of those dollars the way that you all directed us. No boondoggles, no earmarks, no sweetheart deals. You have not seen any bad stories written about the $48 billion. And what it did, it created 15,000 projects that put 65,000 people to work over 2 years that would not have had a job if you all had not given us that authority and given us that money. The stimulus worked.

Chairman CONRAD. I can say—and then we will turn to Senator Sessions because my time is over—I remember very well the battle. A group of us proposed a $200 billion transportation package as part of the overall stimulus plan, and we lost that fight. But we did not lose it because you opposed it. You did not oppose it. You were an ally. So I think that should be stated publicly. There were others who did oppose it, and I remember them well.

Senator SESSIONS. Well, we lost. The President and the leadership kept the highway transportation money at a minimum and it was a tragic, tragic thing, because one thing about a road, as you know, Mr. Secretary, once it is built, it can be used for generations. It is an asset that continues to help us be more productive and happier as a society and I think that is important.

So I know you are passionate about roads, but we have a problem now. We had our opportunity and it lost, passed, and now we have a budget that says how we are going to fix this with a $435 billion new phantom tax, the "not gas tax" tax, and I do not believe that is going to be successful and we have to wrestle with how we are going to proceed there.

Another thing I think is important for us to acknowledge, Mr. Chairman, since we are a Budget Committee and we received a budget as required by law from the White House, that this is another huge gimmick in the budget. Since it does not suggest how and where this tax is going to come from, CBO is not going to score it as income as the Administration scores income. They are proposing a spending plan for roads and they are proposing to pay for it with a tax increase they will not even explain what is, and the money is not going to come in. It is just kind of Washington budgeting, this kind of Washington logic that has put us in this financial crisis we are in, and we cannot continue it.

We cannot go forward on the bald assumption that, somehow, we can appropriate and authorize spending based on a tax that is not going to be collected, probably. We have a lot of things in this country we have to raise money for, and I will tell you, the doctors so they take care of our Medicare patients is one of them, and there is a lot of money there.

Well, you have said, Mr. Secretary, that the budget would collect more revenue. It is definitely not a gas tax. So where will the money come from?

Secretary LAHOOD. Well, Senator, as I said earlier, we want to work with Congress on that, and we are happy to work with you. We are happy to be a part of the debate and happy to work with you. I think the President has made it clear that he is not in favor of raising the gas tax when we have 9 percent unemployment in this country and a lousy economy in many places in the country, but look, we are——

Senator SESSIONS. Well, do you have any suggestions?

Secretary LAHOOD. You know, Senator, I think what we need to do is to sit down together and figure this out and we are willing to do that.

Senator SESSIONS. Well, sitting and figuring out is a little late when you have a budget that assumes it is going to be done when it is not going to be done. We just are not going to be able to raise that much tax to meet this need when we have a lot of other departments that have needs, too, particularly when you are talking about a 62 percent increase in spending next year—62 percent, on top of the $48 billion total that went to roads and transportation—$27 billion only actually went to roads, about 3 percent of that total stimulus package. And so I do not think we are going to get there and I think we are fooling ourselves and I think we are putting ourselves, from a budget perspective, do you not, on a dangerous course that could lead to increased spending without any revenue to pay for it.

Secretary LAHOOD. Look, Senator, here is what I think. I think this. I think that what we do in transportation will put our friends and neighbors to work. This is a jobs bill. This is a jobs budget. That is what this will do. And we have—in America, what we have never done is been dissuaded by the fact that we do not have—we are not smart enough to figure out how we get there. If we really want to get the economy going, if we want to build roads and bridges, if we want to really improve infrastructure, there are a lot of smart people previously, other leaders, that have done it. And we can do it, too, and we are willing to do it. We are willing to sit at the table——

Senator SESSIONS. Well, Mr. Secretary, we have been——

Secretary LAHOOD [continuing]. With you and figure it out.

Senator SESSIONS. We have tried this and we have had, I have no doubt, some jobs created with the stimulus package. It is impossible to spend that much money and not create some jobs. I think, percentage-wise, we probably did more jobs per dollar on the highway side than we did on all the other 95 percent that was spent. I am totally confident of that.

But we do not have the money. We are borrowing 40 cents out of every dollar we spend. We do not have the money to go a massive new program. So if we do not have a tax increase, do you propose borrowing the money?

Secretary LAHOOD. Here is what I propose. What I propose is that a budget is a reflection of the Congress's values, and this President's budget on transportation is a realization that if you pass a very strong transportation program, you recognize that it will put people to work. It will get our economy going. It will set priorities. The President has a pretty big view about this.

Senator SESSIONS. Well, we have some priorities and views and one of them is to get the country's fiscal house in order before we go bankrupt and have a debt crisis——

Secretary LAHOOD. Well, look at——

Senator SESSIONS. —Geithner sitting right there a few days ago indicated that not only is this debt that we are increasing dramatically reducing economic growth, and he agreed with the studies that show that, he said it places us at risk of a debt crisis, another fallback, perhaps, to another recession, and this would be a tragic thing for us. So we just—obviously, we cannot unlimitedly borrow money.

Now, the proposal is to double spending on highways over the 10-year period, basically. In this time of financial crisis, are you asserting that education gets a 10-percent a year, I suppose, energy gets an increase, and you all get to double the transportation budget?

Secretary LAHOOD. I think this is a reflection of the President's values. That is what I think. This is a—our budget is a reflection of the idea that if you put people to work, what are they going to do? They are going to pay taxes. Some of those taxes are going to come to the United States. What is that going to do? That is going to improve our fiscal situation here.

Look, you can pay down some debt and the President wants to do that. You can also have transportation priorities that puts Americans to work building American roads and bridges. You can do both, Senator.

Senator SESSIONS. We are not going to pay down a dime of debt. I cannot believe that the President continues to insist that we are going to be paying down debt on this budget. The lowest annual deficit is $600 billion added to the debt. All of this borrowed. This money is going to be borrowed if it is spent because we are not going to have this kind of tax increase, so we have a problem.

I really respect your passion and interest, but I do believe that this Congress has a high priority to have fiscal sanity in this Congress in spending and we have to work at it and it is not going to be easy.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE. Mr. Secretary, thanks for being with us.

Secretary LAHOOD. Good morning.

Senator WHITEHOUSE. Good morning. You have been to Rhode Island to visit Senator Reed and myself and you are aware of our circumstances, how difficult the State budget is there, how difficult our unemployment situation is there. We are still at 11.5 percent unemployment and it has been that way a long time. We have the so-called 99-ers who have run out their 2 years, 99 weeks of unemployment and are stranded now. It is a tough situation.

We have a couple of potential bright spots on the horizon. I want to make sure that they do not get snuffed out. One of them is our TIGER II grant that goes to the Port of Providence to buy new cranes because our cranes are so decrepit, and that will, it has been estimated, add 550 jobs just in Rhode Island, another nearly 1,000 jobs around the country because of the activity that having those cranes in place as infrastructure will generate.

Our predicament is that that is being held up right now, as I understand it, while we get a "Made in America" waiver for the cranes, and my worry is with all the sweeps that are being threatened here, I do not want to be in a situation in which this account gets swept while this money is unobligated because we have not sorted through the waiver when it should be an easy call. We got the waiver already on the TIGER I grant, which was also for a crane down at Quonset, and the reason we got the waiver is because no matter how you slice and dice the information, nobody makes a crane in America any longer. It just cannot be done. That should be a 2-minute discussion, already decided on TIGER I. There ain't no crane out there to buy. Please, if you can do anything you can to expedite this so we can move it through, obligate it, and make sure that we do not lose that funding.

Secretary LAHOOD. Senator, I told our Deputy Secretary to sign the waiver today. It is already—it was signed this morning.

Senator WHITEHOUSE. I am delighted.

Secretary LAHOOD. I knew you were going to bring this up, and I am sorry that we have delayed and caused so much heartburn about this, but it is signed.

Senator WHITEHOUSE. Perfect. Perfect.

The second thing up there is high-speed rail. We have common cause here on high-speed rail. I think we all recognize that when, in the Eisenhower administration, we took a national move to high-speed road and built a national highway system, it was one of the best things ever done for our economy. It exploded growth in shipping, lowered costs, created enormous industry that uses that infrastructure to this day.

So now that we had our high-speed road moment, it would be great to have also a high-speed rail moment, and there is no place that is more important than in the Northeast where that rail corridor gets used so much, creates so much value, is such an important core, spine of transportation infrastructure. What can you tell us about where you are on Northeast corridor high-speed rail?

Secretary LAHOOD. Well, we believe that the Northeast corridor is—not only exists currently as a very viable rail connection for many, many people and takes a lot of cars off the road in the Northeast corridor, we like the plans that take us well beyond, all the way to the Canadian border and further south through the

Carolinas, all the way to Florida. That is our dream. That is our vision. If you look at the President's budget, 50——

Senator WHITEHOUSE. We particularly like that Boston to New York corridor.

Secretary LAHOOD. I have it. We like Boston to New York, also. But if you look at the President's—look, nobody has a bigger, bolder vision of this than President Obama does. We would not be where we are at. We have invested $11 billion already. That is more than has ever been invested in high-speed rail, ever in the history of the country, thanks to the President and the Vice President.

Senator WHITEHOUSE. I appreciate it. I think it is a great thing.

Secretary LAHOOD. And there is $50 billion in the President's budget over the next 6 years for high-speed rail. That is more than has ever been invested. We are with you. We are on the track with you on this.

Senator WHITEHOUSE. Good. And as we have seen some of the newly elected Governors decide that they do not want money from the Federal Government on this, even though it has been allocated to them, when Governors turn back this money, I hope that you will quickly reallocate it to places like the Northeast corridor that do want it and it will have——

Secretary LAHOOD. What we intend to do, Senator, is when States decide they do not want the money, we are going to make it available throughout the country so everybody has a fair shot at it. We think that is the only fair way to do it.

Senator WHITEHOUSE. Good. I appreciate it. And obviously, the quicker that can be turned around and the quicker other States can get access to that, the better, and I am confident that in the Northeast, we will be able to make a compelling presentation as to why——

Secretary LAHOOD. I have no doubt of it.

Senator WHITEHOUSE [continuing]. The Northeast corridor is critical. Thank you very much.

Secretary LAHOOD. Thank you.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Thune.

Senator THUNE. Thank you, Mr. Chairman. Mr. Secretary, great to have you with us.

Secretary LAHOOD. Thank you.

Senator THUNE. Thank you for your service and your spirited answers to these questions today.

I want to—and I do not want to beat a dead horse, because I know it has been talked about already at some length, but I, like my colleagues who have spoken before, am concerned and somewhat mystified at why we did not do more in the area of infrastructure out of the amount of money that the stimulus provided. I mean, you look at just over 5 percent was spent on transportation and what could have been done in terms of addressing these shortfalls that we have and this year over year shortfall that we are now experiencing in the Highway Trust Fund, which is a problem. We are transferring now out of the general fund to the Highway Trust Fund.

And the budget, as I understand it, suggests that significant increases in spending and a highway reauthorization bill, which I hope we can get to this year, but increases 2012 spending on surface transportation by 86 percent over 2010 levels. It also includes a $50 billion front-loaded transportation infrastructure plan for 2012, which, I think, as again is mentioned, sounds more like another stimulus program.

But I guess the question I come back to is the issue that has already been raised. There has not been any—there is not anything in this proposal, and you have said several times your proposal does not include any more revenue raised from the gas tax and that that is not an option the Administration is open to, so where does the increased revenue come from? How do you pay for all this stuff? If you do not tax gasoline, how do we do it?

Secretary LAHOOD. Well, we have to think creatively and we have to figure out ways to pay for this. We think that it can be done the way that things are done around here, when people sit around a table together and put creative ideas on the table, and I think that will be done when the Congress gets around to writing a transportation bill. We hope we are in the room and we hope we can be part of finding the revenue to do it. We think that is the way we get there.

Senator THUNE. Do you have any more specific ideas? Does the Administration have any suggestions that they would like to offer up, because historically, this has always been a—this is a gas tax issue. It is a user fee, basically. And obviously it is not keeping up with the demands. You saw what the Chairman put up in his chart and how big that thing gets to at the end of the decade. It is a $28 billion shortfall. Clearly, that is going to take a significant amount of revenue, and although we all appreciate, I think, the budget and its recognition of the needs that are out there, not having a way of funding it seems like many of the aspects that we have seen in this budget, and that is these proposals just do not have funding sources.

I mean, it seems to me, at least, that the Administration has kicked the can down the road on a lot of the big issues that we are facing. This is one of many. But do you have any ideas? Has there been any discussion on your end of this about how we might—what kind of a funding mechanism or source we might come up with?

Secretary LAHOOD. Well, we have had lots of discussions privately with Members of Congress about this, particularly members who believe that the investments the President is proposing are absolutely critical to continuing the progress. And as the Congress gets serious and really begins to sit down and write a bill, you know, we want to be there. We want to be a part of the discussions and we want to be a part of finding ways to continue to make these investments, to put friends and neighbors around the country to work building roads and building bridges.

Senator THUNE. Let me ask you, and I appreciate the answer, although there is a complete lack of specificity or any hard solutions, in my view, about how we deal with this. The suggestion that we have to be creative is great, but——

Secretary LAHOOD. We like your Build America Bonds program, Senator. I know you and Senator Wyden have promoted that. It has been a good program. It has worked very well. Lots of States have taken advantage of it. I mean, look, that is one way to get some additional money. I talked about tolling. I talked about the fact the President has put the Infrastructure Bank on the table. And so it is not as if you all have not come up—you and Senator Wyden have come up with this very creative way of—and it has worked, and we think the Infrastructure Bank is also another creative way of thinking about funding some of these things. The specific pay-for, we are willing to be in the room and have these discussions and debates.

Senator THUNE. I am not a big fan of the Infrastructure Bank, as you might expect. I think that we are going to see that probably is going to benefit primarily largely metropolitan areas.

But the other thing I wanted to express a concern about is the $53 billion plan on passenger rail investment over the next 6 years. As someone who represents a rural State, the budget proposal is concerning when you look at the much faster growth in proposed spending for transit and passenger rail investment. I, frankly, do not think that if you get west of Boston or east of San Francisco that you are going to see much transit investment, and at the same time, the transit programs within the DOT do not contribute to the Highway Trust Fund when it comes to user fees. And as I understand your proposal, it allows transit systems to use funding for O&M. That, to me, is very concerning, given the fact that transit does not contribute to the Highway Trust Fund.

Secretary LAHOOD. Well——

Senator THUNE. In rural areas of the country, we are not anticipating we are going to see any high-speed rail anytime soon.

Secretary LAHOOD. Well, I hope you also looked at the idea that we increased the spending on highways by 48 percent. In over 6 years, it is $330 billion. We get it. Look, at DOT, we know how to work with our partners in the States to build roads and bridges and the President has asked—requested huge investments and a huge increase to build roads and bridges for States like yours, Senator. We get it. We know that there is crumbling infrastructure. We want to be helpful on that. We have great partners in the States. We worked with those great partners on spending $48 billion, of which $28 billion was for roads and bridges, and we did it the right way because of our friends in the State that have partnered with us on these things. We believe in roads and bridges, and if you look at the increase, it is significant.

Senator THUNE. OK. Well, thank you, and my time is expiring, but again, I just come back to the proposed increases are great, but at some point, the Administration is going to have to lead in figuring out how we pay for this stuff. Thank you.

Chairman CONRAD. I thank the Senator for respecting the time.

Let me just indicate, Senator Wyden is next, then Senator Cardin, Senator Coons, Senator Sanders, Senator Warner.

Senator WYDEN. Thank you, Mr. Chairman, and welcome, Mr. Secretary. I just want to followup on that last point with respect to Build America Bonds, because as you know, they just went out the door like hotcakes. We estimated that, given the fact that we never tried anything like this in our history—Senator Conrad will remember this—in the Finance Committee, I was asked to give an estimate of what we might do in the Build America Bonds area, and I said, oh, maybe $8 or $10 billion, and as you know, it was $181 billion, I mean, something like 18 percent—exceeding an 18-fold increase in terms of expectations.

Now, the question is, where do we go from here, and Senator Thune asked the right question and that is where are we going to look to try to get additional funds. And I think it would be possible to again build a bipartisan coalition for Build America Bonds if we get them to focus only on transportation. And I have talked with a number of my colleagues on both sides of the aisle about this. We are looking at the numbers that have come in so far and it looks like Build America Bonds just for transportation purposes over this experimental period of time exceeded the amount that went out under the Recovery Act. So the Recovery Act was $48 billion and we think—the numbers are still coming in—that it was well over $50 billion just for transportation alone, Build America Bonds.

And for colleagues that are interested in this, in our State, where they really kept track of the numbers, they estimated there was a 10-percent savings associated with this compared to the traditional level of bonds. So a chance to do more work, A, get additional revenue, and save money at the same time.

My question to you, Mr. Secretary, because Senator Thune has been a wonderful partner in it, and, as you know, many Republicans have been involved in this going back to Senator Talent and Senator Dole and Senator Vitter, we have had a whole lot of Republicans involved in this, and I think we could get this again to be a bipartisan program if the Administration would say, look, it has been wildly successful as it related to transportation. New money, savings. We will, for purposes of bringing the Congress together, put it solely to transportation, and I have mentioned to Senator Thune, perhaps we could rebrand this. We could call them TRIPS bonds, Transportation and Regional Infrastructure bonds, so that everybody would walk away and see that we are trying to get a good concept which has been successful confined to transportation and have a chance to answer the question asked by Senator Sessions, asked by Senator Thune, where we have had bipartisan support. What is your take on that in terms of trying to bring folks together once again as we were able to do over the years?

Secretary LAHOOD. Well, as I said, Senator, I congratulate both you and Senator Thune for your leadership on this. I know there are other Senators involved in this. This is a very good stream of funding and we will work with you in any way we possibly can because we think this is one of the options that needs to be out there to pay for all the things we want to do.

Senator WYDEN. What is going to be our challenge in the Administration? Part of it—I discussed this with some of my colleagues on the other side of the aisle—this was so attractive to the private sector that people automatically said, well, let us see if we can look at it for other kinds of approaches, and that is when some of the bipartisan support seemed to drift away, is people just saw it being used in a variety of other kinds of areas. Do you think within the Administration you can get people to say that the transportation need is so great, No. 1, and getting this back to having bipartisan support is just as important, that you can get the Administration to help us as we build a bipartisan coalition, say we will go just with transportation given the fact that the need is so acute?

Secretary LAHOOD. Well, I will commit to say this, Senator. I will work very hard within the Administration to make the strongest case that I possibly can that this ought to be dedicated to transportation. Now, whether I can get there or not, I do not know, but I know this. There is a shortfall. The President has a big vision. We need to find the resources to pay for it. Your Buy America Bonds have been wildly popular, as you knew they would be and Senator Thune knew they would be, and they have provided a great resource to get some significant things done.

Senator WYDEN. I appreciate your willingness to do this because I think Senator Thune and a number of Republicans are very interested in working in a bipartisan way on this issue. We worked through some of the kinks early on. There were questions about fees early on. Now we have seen no one raise concerns about that. The one concern has been, is this going to be used as an open-ended approach to fund all kinds of other services in government, and I hope we can get back to what essentially Senator Talent and a big group of Democrats and Republicans started dreaming about six, 7 years ago.

I think it is clear it has worked, No. 1. I think the other approaches are going to be a huge lift in terms of getting bipartisan support. Colleagues are asking for details about Infrastructure Banks and the like. This is something we know works. We know there are not a lot of rallies outside our offices to raise the gas tax in this kind of economy. We know that to have big league economic growth, you have to do something about little league transportation systems. And my hope is that as you go forward, you can convince the cabinet and the Administration to say that this is the area that will produce the most jobs most quickly.

You have been to Oregon. You can go around our State and see all kinds of folks across the political spectrum, some of our most conservative business leaders working with labor leaders around Build America Bonds because, they say, this is something that has actually made a difference. And if we can get it back to its original focus, I think we will have an answer to Jeff Sessions's questions, the point that Senator Thune was making. I think they were raising logical concerns and we can come together in a bipartisan way and I am grateful for what you have said today.

Secretary LAHOOD. Thank you for your leadership, and to Senator Thune, also.

Senator WYDEN. Mr. Chairman, thank you.

Chairman CONRAD. Senator Cardin.

Senator CARDIN. Well, thank you, Mr. Chairman. Secretary LaHood, it is nice to have you before the Committee.

Secretary LAHOOD. Good morning.

Senator CARDIN. I am going to give you a little different view than Senator Thune on the transit issues, but first let me say that I support the budget, the more robust budget that you come in with for transportation infrastructure. I think that it is critically important for our Nation to be as competitive as we need to be. It is about jobs. It is about outbuilding our competitors. And I think that we need to find a way to make sure we can finance that.

I also want to applaud you on the multimodal approach that you have. Look, we cannot do it by roads alone. We cannot do it by transit alone. We need to invest in smart transportation that allows us to recognize the different needs in rural America and in urban America.

But I just really want to urge you to continue aggressively on the transit funding, and I really want to respond to Senator Thune's point.

You know, it is interesting. In the prospectus that GSA puts out for Government space in this area, a high priority is given to locate a space on a transit line because the Federal Government understands that we do not have the resources to build all the parking lots that we would need in order to take care of people using the highways. If we had all of our Federal workers on the highways, they would never get there because we do not have enough roads.

If you take a look at the dollars—and maybe you should do this for us—as to how much more you would have to spend in highway maintenance if we did not have a transit system to deal with people getting to and from work. You know, we are building a new road in Maryland, the ICC. That is going to cost close to $3 billion. So transit saves us highways and highway maintenance dollars and allows us to have a way that we can bring our communities together.

I would last point out on this argument of rural versus urban, in our State, on the eastern shore and in western Maryland, transit is critically important. They understand that. Now, maybe we could be more effective in rural communities on transit, and we should look at that. But it is important in Salisbury, it is important in Cumberland, Maryland, to have transit to get people to and from work.

So I just want to urge you to keep focused on it, and I have not even gotten to the other issues of our national security, of using less energy and a cleaner environment. So this is an important issue for our Nation, and I just want the Chairman to understand that this Senator is going to continue to fight for adequate infrastructure financing for all the modes of transportation because I think we need—it includes also our bill we just passed for the airports, the port modernization, and rail.

In rail, we need to get to the next generation. Thank you for what you are doing on high-speed rail—I think that is important—for inner city rail. All of the above we are going to need if we are going to be able to have a sensible transit project.

With Senator Warner here, we live in the second most congested area in the country, and we all, I think, have a responsibility because the Federal Government is mainly responsible for the transportation challenges we have in this community. And it is important that the Federal Government maintain its responsible share in dealing with the transit costs. We are going to be talking about that because the House-passed budget did not. And we are going to fight for the Federal Government doing what it is responsible for. We do not want to see newly created unfunded mandates to local governments as a result of what is coming out of the House of Representatives.

Now, I had one question which was dealing with groundwater, storm runoff. I have asked you about this before. I have the honor of chairing the Water and Wildlife Subcommittee on the Environment and Public Works Committee, and we need partner wherever we can. And high construction—and I really do applaud you because we are using the best practices. It can make a major difference on the amount of storm water that runs off in a very inefficient way, or in an efficient way, and the way we do our highways can be critically important.

So I just really want to get your reply as to how you see the priorities in your agency helping us deal with the proper management of storm water.

Mr. LAHOOD. Well, as you know, Senator, we stole away from your State your Secretary of Transportation, John Porcari, and he is our Deputy Secretary now, and he knows these issues intimately, having worked on a number of road projects in your State. We are committed to work with the EPA and work through the environmental impact statements to make sure that whatever responsibilities we have to take in terms of providing the resources to make sure that when the construction takes place there is the right, you know, avenues for water and runoff and all of those things.

You know, our commitment is to work with the other agencies to make sure that it is done correctly and properly and that we provide the resources to do that.

Senator CARDIN. I thank you, because the private sector really looks to what we do in Government, and if we do not set the example—we have done that on our energy standards. We need to do it on our environmental commitments on storm water. It can make a huge difference in getting the type of cooperation we need from the private sector as they develop their buildings and construction to also do the right thing.

Secretary LAHOOD. Right.

Senator CARDIN. We have rules, but if the Federal Government does not set the example, it makes it difficult to get the type of compliance——

Secretary LAHOOD. Right. We are committed to that.

Senator CARDIN. Thank you.

Thank you, Mr. Chairman.

Secretary LAHOOD. Mr. Chairman, could I just respond to Senator Cardin about transit?

Chairman CONRAD. Oh, please do. Certainly.

Secretary LAHOOD. He and Senator Warner have the privilege of representing what I believe is, if not the best, one of the best transit systems in America. And I will tell you why I say that. I was struck when I was on the platform at President Obama's inauguration and saw a couple million people out on The Mall. Almost every one of those persons was delivered there by the Metro system in Washington. It is a magnificent system. It was well designed. It is not without its problems, but it is a great system. And if you think of all the people that it delivers here to Capitol Hill every day and around this region every day, it really is a good system, and we support their efforts to improve. We are going to provide $150 million to, you know, do the fix-up on the infrastructure and help them buy new cars, help them buy safer cars. But this is America's

Metro system, and it is a model for the rest of the country. And we have worked closely with your Metro system because we think it is one of the best, and we want to keep it that way, and we want to make sure it is the safest.

And that is why, if I can put a plug in, Mr. Chairman, last year last year the Banking Committee passed by unanimous consent a transit safety bill that gives to the Department of Transportation some responsibility that we are currently prohibited from doing now, which is looking after safety in transit systems around America. And I hope there will be some Senators this year that will reintroduce that bill, give us that responsibility, because there is nobody in the Government looking after transit safety, and we need that. We need that responsibility. We need the Congress to give us that responsibility. And those of you who represent one of the greatest transit systems in America, I hope you will consider doing that.

Senator CARDIN. Let me just very quickly, Mr. Chairman, agree completely, and that bill, of course, was strongly supported by our delegation here, and we want to see you have that authority. We have had difficulties with safety issues in regards to the Washington Metro system.

Let me also just underscore the point that the $150 million that you have put in the budget, there was a 10-year commitment of $1.5 billion. You have carried out that commitment. Now it is our responsibility to make sure that stays in the budget. It was not in the House-passed budget. We are going to do everything we can to make sure it stays in the budget.

And the last point, I also got to the inaugural through rail coming in from Baltimore, so rail is very important to get into the city.

Thank you.

Chairman CONRAD. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and, Mr. Secretary, it is great to see you.

Secretary LAHOOD. Good morning.

Senator WARNER. There are so many places to hit in 6 minutes and 54 seconds. Let me, first of all, thank you for all of your work, but let me start with associating, affiliating, and whatever other terms we use my comments and questions with my good friend Senator Cardin's. And as a member of that Banking Committee that passed that bill out unanimously, I look forward to working with your office to make sure it gets reintroduced and gets again that kind of support from the Banking Committee.

Secretary LAHOOD. Thank you.

Senator WARNER. Because it is terribly important. The Washington Metro is a great system, but it has had its issues, particularly around safety. As a former Governor, this notion of where the ball lands in terms of safety was something we had never really fully thought through.

But let emphasize again what Senator Cardin has said, is that it has taken—it took a long time for all of the State partners to pony up their share, but we got there. And as we build out some of these extensions and upgrade the facilities on Metro, it is, I think, both for the region irresponsible but from plain business planning purposes to kind of have the rug pulled out the way the

House budget proposes is something that we should not allow to happen. And I look forward to working with Senator Cardin and I hope a united bipartisan Senate on that issue.

Secretary LAHOOD. Senator, let me just say, you are very modest about this, but when you were Governor, you were one of the leaders that made this system what it is today, and you should be congratulated for all of your leadership on making Metro what it is today.

Senator WARNER. Well, thank you. When we first tried to convince our folks in Northern Virginia how we would help pay for that share, I got my tail whipped. I wish you had been Secretary then to give that support.

Let me also echo my good friend the Senator from Rhode Island's comments with one slight amendment.

Senator WHITEHOUSE. Is that the southward amendment?

[Laughter.]

Senator WARNER. One slight amendment. As we have discussed, we were concerned in Virginia—I think it is great that we are moving forward on high-speed rail, but building out pieces in Florida or elsewhere, or to my good friends in North Carolina, building out these segments without a connection, without a connection to the Northeast corridor that starts from Washington up through Boston, to me, you know, did not make necessarily all that much sense. And when we think about a corridor where we do not have the amount of congestion and other issues and more of a straight shot, our Nation's capital, down the 95 corridor through Richmond, connecting with Hampton Roads and down into North Carolina, I cannot think of a better place with higher potential usage and a more willing bipartisan support at this point than the Commonwealth of Virginia.

I know you were able to move very quickly on some of those others dollars that came back from the Midwest, but if those Florida dollars—and I say this with trepidation and Senator Nelson is not here. If those Florida dollars get back in the pot—I love my friends in the Northeast, but if we wanted a great demonstration example of how to do high-speed rail, we look forward to Virginia's application being perhaps more competitive than it was in the first round.

Now let me come to, in my 3 minutes left, something that Senator Sessions and I have talked a lot about, and Senator Whitehouse as well. We have to figure out how we are going to fund transportation, but we have also got to make sure that, within our limited dollars of how we fund, we have better performance metrics. And I want to commend you and your Department for recognizing, I think for the first time in a long time, that we have to have performance metrics in our allocations; that some of the current formulas and some of the current approaches just do not get it.

I am glad that your proposal includes the establishment of performance measures for highway investments and repair investments at the FHA. I do think we need more. As you know, I have been working with the Bipartisan Policy Center about how we make sure that these metrics and data are out there so we do not just have these kinds of arguments back and forth, but we have actually some ability to evaluate.

One of the things I think we have to do, though, is make sure that these metrics go outside of highway but that they are kind of mode neutral. And I would like for you to comment for a moment about the whole sense of metrics, how we make sure that we have some mode neutrality in this, that we really look at moving people and goods as the goal, not simply highway miles traveled, vehicle miles traveled, that we look at——

Secretary LAHOOD. Well, on both of your points, the reason that Virginia is going to be significant in high-speed rail is because of your leadership, meetings that you have called that we have attended. You are really persuading us that there is a lot of leadership in Virginia thanks to you and other members of your delegation.

Senator WARNER. Bipartisan support. Let us make sure we get that on the record again.

Secretary LAHOOD. Absolutely. But, again, you are being a little modest here.

Senator WARNER. That is not something I have often been accused of, Mr. Secretary.

Secretary LAHOOD. I think you have pressed on this, and the reason we have really gone to these performance standards is because of what you have said to us over the last couple of years. We get it. We think it is important. We think it is a way to show the Congress and the country that we are just not spending their money willy nilly, that we are just not spending money because the Congress gave it, but there are performance standards, and it will be multimodal and it will be an opportunity for us to really measure and judge using good metrics to make sure that taxpayer money is being spent in a way that reflects the values of the Congress. And we took our cues from you on that.

Senator WARNER. You are more generous with your comments than the actual record is, but I will take them.

Let me on the last comment just say I am very intrigued with the infrastructure investment bank that you have talked about. I do have some of the concerns that Senator Thune has, that, you know, we have to make the financing work the right way. It is not free money. But some of the existing programs, the TIFIA program and others, they do have a tendency to bias toward highway. How do we make sure we get that mode neutral right in the infrastructure investment bank? My time has expired.

Secretary LAHOOD. We want to work with Congress on this infrastructure bank and make sure we do get it right. And we want to make sure that it is money that can be leveraged with TIFIA, with tolling, with other opportunities from the private sector that want to make investments.

It would not be the sole source of funding. What it would leverage is tolling, TIFIA, private sector money, maybe some State money, maybe some additional Federal money out of highways or something. So it really is—we think it is an opportunity to leverage some additional money and really get some other players involved. And that is the way we see it.

Senator WARNER. My time is up, but do you see this bank being transportation only, or do you see it ultimately migrating to include smart grid and other kinds of infrastructure-related projects?

Secretary LAHOOD. Well, we see it in our proposal for transportation.

Senator WARNER. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Sanders.

Senator SANDERS. Thank you, Mr. Chairman.

Mr. Secretary, thank you very much for the very important work you are doing. Sometimes what gets lost in the shuffle is the disastrous condition of America's infrastructure, the fact that we are falling further and further behind many other countries, and the point that you have made, and made repeatedly, is that if we are serious about pulling ourselves out of this recession and creating decent-paying jobs, investing in the infrastructure—our roads, our bridges, public transportation—is perhaps the fastest way we can do that. So count me in as somebody who supports the thrust of your argument. I think it is exactly right. And to my mind, investing in infrastructure, creating decent-paying jobs frankly is a lot more important than giving tax breaks to millionaires and billionaires for the future of this country. So when our friends ask where the money is coming from, I think some of us know where the money could come from.

Let me just get to a question. In Vermont, we are concerned. We have a new Governor, and I would like the opportunity to chat with you, maybe bring the Governor into that, to talk about transportation needs in Vermont. Is that something that we could do?

Secretary LAHOOD. Absolutely, and I met your Governor at the White House when he was here for the Governors' meeting, and I think he is going to be very progressive on transportation issues.

Senator SANDERS. I think he will, and the problem in our State, as in many rural States, is that people often have no option other than the automobile to get to work. So how we can address some of those needs is important.

Second of all, you received and responded to a letter that the Vermont delegation sent to you requesting that you extend the designation of the Northern New England High-Speed Rail Corridor to include a 120-mile segment between Springfield, Massachusetts, and White River Junction, Vermont. I know it is an issue you are looking at.

Secretary LAHOOD. Yes.

Senator SANDERS. It is an issue we would like your support on, and let us continue talking about that as well.

So I will just end with that and to say that as a Nation, Mr. Chairman, we should be deeply concerned that in China they are building high-speed rail all over the place, and that we—Mr. Secretary, you correct me if I am wrong. Are we the only major nation on Earth that is lacking in real high-speed rail at this point?

Secretary LAHOOD. Well, we are one of a few, that is for sure.

Senator SANDERS. And would you agree with me that if we want to take cars off the road, if we want to lessen the heavy traffic at our airports, high-speed rail is one way to go?

Secretary LAHOOD. High-speed rail will provide thousands of jobs. It will help the economy. It will provide lots of green jobs, and it will provide alternative transportation that does not exist in America today. And this is what Americans want. It is not just President Obama or Vice President Biden or Ray LaHood. This is what Americans want. You have people all over the country that have worked on high-speed rail for over two decades, and 33 States and the District of Columbia have accepted the $11 billion that we have put out so far because they want to connect America with high-speed rail.

Senator SANDERS. And I think others have raised this point. If there are States that choose not to take the Federal money, please put Vermont at the top of the list.

Secretary LAHOOD. Yes, sir. Your Governor made that very clear.

Senator SANDERS. We will take that money. If other States do not want it, that is fine.

Go back to a point you made earlier. In terms of job creation, if we are investing in roads, bridges, tunnels, how many jobs do you see being created in that type of investment?

Secretary LAHOOD. Well, I would just say this. The $48 billion that was in the stimulus program created 15,000 projects and 65,000 jobs. We did that in 24 months, and we did it by the way Congress said to do it. You have not seen any bad stories written about our stimulus—none—because we did it the right way. We did it the way you all told us to do it, and we put 65,000 people to work in 2 years with 15,000 projects.

Senator SANDERS. But you would not deny—and, by the way, I happen to believe that the stimulus package did pretty much what it was supposed to do. It created 2 or 3 million jobs. I agree with those people who say we should have put more money into infrastructure. But let us not ignore the other very good things, and my State opened up a whole lot of other areas. But I will tell you that the stimulus package in Vermont put more money into our roads and bridges than we have ever seen in the history of the State. But you would agree, I think, that that is just the tip of the iceberg.

Secretary LAHOOD. Tip of the iceberg, absolutely.

Senator SANDERS. Give me an idea, give us an idea—and I understand the funding issue. We cannot create money out of our ears here. But if you had your druthers, what would we be investing in infrastructure in America?

Secretary LAHOOD. Over the next 6 years, the President put out a plan for $550 billion. That is as bold as any President—no other President has been that bold. No other President has stepped up with that kind of a plan, $50 billion for high-speed rail. Never that kind of investment. We have increased funding for roads and bridges. It is now over—it will be over $300.

Senator SANDERS. All right. Let me ask you again a question whose answer is obvious, and I speak as a former mayor. If we have a crumbling infrastructure, which I think many people recognize that we do, and you do not invest in that infrastructure, if States all over this country are facing enormously serious fiscal problems and are unable to do that, if you do not invest in infrastructure, does the infrastructure, our roads and bridges, magically get better?

Secretary LAHOOD. They actually become unsafe, Senator.

Senator SANDERS. Not only do they become unsafe, will it cost more money to improve them as they deteriorate——

Secretary LAHOOD. Costs go up every year for infrastructure.

Senator SANDERS. So we are in a situation where, if you do not invest now, you are simply going to have to invest more later. We are in a situation now where we have a horrendously high unemployment rate. Now is the time to invest to create the jobs. The Federal Government has that responsibility. Where do we get the money? Well, I would say to my good friend from Alabama that investing in infrastructure is a lot more important than giving tax breaks to billionaires. He may disagree with that. That is my view.

Mr. Chairman, thanks very much.

Chairman CONRAD. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you, Mr. Secretary.

Secretary LAHOOD. Good morning.

Senator MERKLEY. Good morning, and I know that you will be out in Oregon soon to visit Oregon——

Secretary LAHOOD. Yes, sir.

Senator MERKLEY. —Iron Works and attend a gathering of the Bicycle Transportation Alliance. I am sorry I will not be able to be there with you, but I know you will get a firsthand view of the street cars under construction at Oregon Iron Works and some other good projects. And thank you so much for your support of smart transportation modes.

Secretary LAHOOD. Thank you.

Senator MERKLEY. In the budget from the Department, it notes that the Administration will bolster metropolitan planning, award funds to high-performing communities, and empower most capable communities and planning organizations to determine which projects deserve funding.

When I read those words, they sounded a little bit akin to a concept I have been promoting, and I am not sure they are the same, but I will use this as a chance to ask you if they are. But essentially I have been working on legislation that would encourage communities and States to use performance-based planning where the local community would set goals for how they want to grow on a range of factors from economic development to congestion reduction to a reduction in oil dependence. They would then develop several scenarios to weigh or to compare how they perform against those standards, and this sort of scenario-based planning captures the interaction of different modes of transportation. So that concept, is that akin to what you are talking about in your planning document?

Secretary LAHOOD. One of the things that we learned during the six town meetings or listening sessions, or whatever we were calling them—transportation authorization listening sessions that we held around the country—is that there needed to be some change to incorporate more ideas. And as I said to Senator Warner, we believe these performance standards are critical so that taxpayers know and that you can go back to taxpayers and say, hey, they are using metrics to make sure this money is being spent correctly, and they are basing it on some performance standards.

So I think what you have said is where we are at and what we would like to incorporate in a transportation bill so that we can say to taxpayers this money is being spent according to these metrics and really have some good performance standards.

Senator MERKLEY. Well, thank you. I appreciate that a lot.

Another concept that we have been talking about is practical project design that would empower local communities to plan projects that are more tailored to their local needs, most cost effective. We hear from a number of communities that they get frustrated that the State Departments of Transportation have very rigid design guidelines that increase the project costs, maybe the same large lanes or the same large ramps, regardless of the community context. Is this concept of additional flexibility in design something that fits in with the way you are approaching the transportation——

Secretary LAHOOD. Well, look, we have great partners at the State level. We work with them day in and day out. And we will continue to work with them. We know that sometimes it can be frustrating for local folks to get their projects through the State. We know that the TIGER program was very successful because people with creative ideas brought them forward, and we looked at them and we thought they could be creative and do some creative things. We awarded the money to them, and certainly your State benefited from that program.

We are going to continue to work with our State partners to make sure they understand that we want to get projects done, we want performance standards, and we want to make sure that all the stakeholders are involved in the process.

Senator MERKLEY. Great. Thank you.

One of the other changes that is in your budget is consolidating 55 highway programs into five streamlined ones. How do you see that in terms of the application process for the communities that are seeking funds, any—let me put it this way. A lot of our smaller communities do not have a lot of grant writers, and when I saw this, I thought this is going to make it a little easier for them to track opportunities to apply and find the funds that match their community and easier for us as a congressional office to help them find funds that they can apply for.

Is that part of the thinking that went into this or——

Secretary LAHOOD. Part of the thinking is that we want to follow the President's lead on trying to reform agencies and make sure that the Department of Transportation comes into the 21st century, continue to work with our partners, but really squeeze a lot of programs together. Almost everything now is multimodal. It might involve—you know, the bridge that they are going to build across the Columbia River is certainly multimodal. It involves transit, it involves cars. It involves, you know, the ability of people to bike and walk across the bridge. It involves tolling, and it involves a number of things. And so we want to make sure that we have an organization that is lean but also takes the best talent we have so that we can give people access so they do not have to go through 50 layers of bureaucracy to get done what they want to get done. And we know a lot of things are going to be multimodal, and we have really tried to take the best and the brightest, put it together, and make it certainly more accessible to States around the country.

Senator MERKLEY. Well, I want to applaud the work you are doing on that because I do think that it is exactly the right direction for the reasons that many things are multimodal, and also that in terms of communities being able to understand how and where to apply, it greatly simplifies it.

You mentioned the Columbia River Crossing, and that is a huge regional challenge, including the extension of light rail across the river, pedestrian and bike paths, but having an effective passenger and freight corridor as well. It is just such a huge choke point. I appreciate that you are familiar with it, and we are doing all we can to get all of the community leaders to come together behind a common design, and I will certainly be working with you all on that project.

We have others—the extension of our light rail into the Milwaukie area—and your Department has been extremely helpful in that. And I just in general want to applaud your—you have been a breath of fresh air since you came in in terms of thinking about transportation and making it cost effective and functional. I guess I echo Senator Warner's comments about it is not about how many miles you pave or how many miles you build, but how do you make the transportation system overall work better, and that has been a concept that Oregon has been pursuing for a long time and that I think you have really come to take forward to the benefit of transportation across this country.

Secretary LAHOOD. Well, thank you, Senator. You have some great leadership in your State. I just met with the Governor of your State, and also Washington, and we talked about the multimodal nature of the bridge, the Columbia River Bridge Crossing, and the multiple ways that we are going to fund it. It is very creative. It is going to happen. It is needed, and you have some great leadership in your State.

Senator MERKLEY. Thank you. I look forward to continuing to work with you.

Secretary LAHOOD. Thank you.

Chairman CONRAD. Thank you, Senator.

Mr. Secretary, I would like to now just take a few more minutes and Senator Sessions will take a few more minutes.

Secretary LAHOOD. Sure.

Chairman CONRAD. If Senator Coons has returned by the time we are done, we will have him have time. If not, we will shut it down.

I want to raise the issue that you are very well aware of, Devils Lake, North Dakota. Devils Lake is a lake that has risen more than 30 feet in the last 15 or 16 years. Devils Lake is now three times the size of the District of Columbia. Devils Lake is now forecast—we just have in the last week a most recent forecast from the National Weather Service that the lake is going to go up another three feet this year. That puts it perilously close to an uncontrolled release of water out of the east end of the lake, where the water quality is many times worse than the water quality in the west end of the lake.

As you know, the entire transportation system is compromised in that part of our State. We have already spent $850 million—that is Federal money alone—$850 million dealing with the flood threat in the Devils Lake basin. We have had hundreds of thousands of acres that have been flooded and inundated. People have lost access to their land. We have spent hundreds of millions of dollars raising the road network and building a massive dike—it has been raised three times—protecting the city of Devils Lake. We have a town that is about to be flooded on the west end of the lake, the little town of Minnewaukan. The school is directly threatened. We have $6 million than has just been secured to move that school. We need to move much of that community.

The road and bridge network in the area, as you know, has been raised repeatedly and we require additional work or parts of the road network are going to go under this year, and maybe you could give us an idea of what the plans are in the Department of Transportation to continue to help us with this crisis.

Secretary LAHOOD. Well, Senator, thanks to your leadership and others in your delegation, we will be committed to working with you and others in the State to do whatever is necessary to make sure that the roads and bridges are not compromised, that communities are not compromised. We are committed to doing whatever we can to make sure that we take care of continuing to fix the problem.

Whoever named this Devils Lake named it aptly. I think that this—the devil is responsible for this. I mean, I do not know how else to explain it. It is something that belies belief or belies nature. So I do not know who else to blame but the devil, so that is why his name is on it, I guess. Somebody was prophetic in putting that name on it. This is a natural disaster and we are committed to working with you to do whatever it takes to make sure that roads and bridges and communities are not compromised.

Chairman CONRAD. I appreciate that, and you have been great. You know, I think so many people in the Federal bureaucracy have hoped that this lake was going to just stop going up. We know in 4,000 years of history, this lake has gone through this cycle before, and it is now on its fourth time. And when it has gone through this cycle, it has led to an uncontrolled release of water out of the east end. If it happens this time, now that that part of our State is populated—in the previous times it has happened, there was very little population—this will be a disaster of staggering proportions, absolutely staggering proportions.

And so I wanted to again alert you to this latest forecast that predicts that the lake is going to rise much more than the previous forecast, and so we have an ongoing crisis. And I thank you for the help you have already given and I thank you for the attention that you, I am sure, will give to it in the weeks ahead.

Secretary LAHOOD. Yes, sir.

Chairman CONRAD. Senator Sessions.

Senator SESSIONS. Mr. Secretary, just to push back a little bit on this high-speed rail, the President wants it available to 80 percent of the population. You talk about $53 billion, but there is going to be hundreds of billions if anything like that were to occur. And I would just note that in Tampa, to Florida, the Governor there has rejected that after careful review. I do not think he did that because he wanted to. I think he did it because he felt it was not a defensible matter economically.

Governor Kasich has rejected $385 million for a passenger rail line, Cleveland to Cincinnati through Columbus, Dayton. I am sure they have given great thought to that. It is their State. I am sure there are people there that want to see the free money from Washington.

You have Wisconsin, Governor Walker rejecting an $810 million connection. You have California with a high-speed rail line to nowhere out in the desert, some $5.5 billion on that project. In Minnesota, that plan has controversy, cost concerns, and without the Wisconsin connection, it is probably indefensible.

So I just want to say, what I am hearing about and what I think most of us are hearing about is how to get across the 14th Street Bridge. I mean, there are traffic intersections and problems and headaches all over cities and I just think we have to be realistic. And we will have a tough debate about it, and where it can be defended, I will acknowledge that. In some areas of the Northeast, I think it probably can be. In some other areas, it cannot be.

No. 2, would you look at a situation that I think is systemic dealing with a two-lane intersection improvement in Alabama. Two roads cross, two-lane roads, and they want to fix the intersection and are told they have to have a NEPA review, environmental review, for 30 miles on either side of that intersection. And apparently, this is a systemic problem and I was advised of it by my people yesterday and they asked me if we could seek relief and I will followup in writing with you.

Secretary LAHOOD. Yes, sir. We will look at that.

Mr. Chairman, could I just respond to the high-speed rail?

Chairman CONRAD. Sure.

Secretary LAHOOD. What we are pleased about, Senator Sessions, is that 33 States and the District of Columbia have accepted more than $11 billion because they believe in high-speed inner-city rail. They believe in the President's vision. I have talked to Governor Brown twice about high-speed rail, Governor Jerry Brown of California. They are going to move ahead with their project. Eventually, there will be a connection to the so-called rail line that you claim is going to dead-end somewhere.

I met with Governor Dayton of Minnesota when he was here for the Governors' meeting. He came to my office. I spent an hour with him. He is a very strong advocate of high-speed rail. He asked for our cooperation and we are going to work with him on that.

There are some Governors who, for whatever reasons, believe that, at least in Ohio and Wisconsin, and we are going to hear from the Governor of Florida tomorrow who is going to give us a final decision on high-speed rail, but you are correct about Ohio and Wisconsin. They have decided to go a different direction. But that will not dissuade the other 33 States and the District of Columbia from moving ahead with the investments that we have provided and matched with a lot of local resources. High-speed inner-city rail is coming to America because that is what the people want.

Senator SESSIONS. Well, it may show in polling data, but when the numbers become reality, the support is not so strong. And I just would say we are going to have to look at that closely and I have doubts, as these Governors have indicated. It is hard to turn down free money from Washington, though. A lot of States may find themselves lured into projects that end up costing far more than they expected and doing far less than they expected, so it is a matter of good debate. Thank you, sir.

Secretary LAHOOD. Thank you.

Chairman CONRAD. I thank the Senator.

Senator Coons.

Senator COONS. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for your passionate defense today of the important infrastructure investments that are projected in this year's budget. I think you have been a vital part of the Administration. I think your vision for modernizing and streamlining and investing in infrastructure around transportation is critical.

I just want to ratify some comments that were made earlier. My previous role was as a county executive. We made great use of the Build America Bonds. They were well received by our private sector community. We were able to create jobs with them. I have already spoken with Senator Wyden and hope to speak with Senator Thune. I will join them in whatever way they can to try and move them forward. I think we need creative financing mechanisms like an Infrastructure Bank. Some would say that Delaware is the case study for tolling. We toll everything. We probably collect more per mile of highway tolls than any State in America.

On to high-speed rail, if I might. As our Vice President did for so many years, as my senior Senator Carper does every day, I commute almost every day by rail from my home in Wilmington to Washington and am sold, and have been for years, on the value of inner-city passenger rail, and in particular the promise of high-speed rail. I think it will put people to work. I think it will make us more competitive. I will join Senator Whitehouse in saying, should the Governor of Florida be so foolish as to turn back funds, please reprogram it as swiftly as possible, and it is our hope that the Northeast corridor will be highly competitive in that.

I understand that the FRA is leading a region-wide Environmental Impact Study, and that EIS, the Environmental Impact Statement, for high-speed rail in the Northeast corridor has hit some snags, some delays, there are some challenges, and that that may be part of why we are not seeing as much coming to our region and to the Northeast corridor in funding as could be.

Can you help me understand what I might be able to do, what barriers you see in terms of moving that forward? What do we need to do to get more investment in high-speed rail in the one part of the country where there is already a corridor that benefits from it daily?

Secretary LAHOOD. I think more than anything else, one of the things that we are going to do is include Amtrak as a potential applicant for high-speed rail money. I think we were not able to do that earlier on and we think we can. I think once that happens, I think there will be a lot more opportunities on the Northeast corridor, frankly.

You know, one of the criticisms was that Amtrak was not able to utilize this money and we feel there is a way now for us to include them and we are going to do that, and I think that will enhance the Northeast corridor's ability to really step up and do some of the things that you and others have provided leadership on. So I see that happening in the near term.

Senator COONS. Thank you. If there is anything I can do to be supportive of that move——

Secretary LAHOOD. Thank you.

Senator COONS [continuing]. I would welcome a chance to do so.

I am also very concerned about the potential impact that the House-passed Continuing Resolution would have on Amtrak employment in my home State. I have been to the Bear and the Wilmington shops repeatedly. They have high-quality employees. I think they are critical to the mission of sustaining the train sets that you have in service in Amtrak today and could play a key role in high-speed rail in the future. My understanding is the House-passed CR would cut 215 jobs in Delaware. What is your sense of the impact on transportation were we to, on the Senate side, pass the same level of cuts that the House side has already——

Secretary LAHOOD. Well, I would recommend that the Senate not do what the House did. I would say that. Amtrak is doing as well as it has ever done in the history of Amtrak. They made money last year.

Senator COONS. Yes.

Secretary LAHOOD. People like their service. They are providing on-time service. They are providing good food. They are providing a great form of transportation for people that people can afford to use, and ridership on Amtrak is through the roof. I know I am telling you everything you already know, but—so this idea that you should cut something that is successful is just, to me, not realistic.

This is one form of transportation that takes cars off the road, provides clean, green transportation along a corridor that is one of the most congested corridors in the country, and to a company that now is making money, providing a good service, and should be rewarded by having as many passengers as they possibly can. Cutting their funding will not be helpful. It will be hurtful.

Senator COONS. Can you tell me anything, Mr. Secretary, about the status of Amtrak's application? They applied for an RIF loan for their electric locomotives that would also help them expand their fleet.

Secretary LAHOOD. Mm-hmm.

Senator COONS. What is the status of that?

Secretary LAHOOD. Well, we are working on that and we are reviewing it and, you know, it is sort of in process.

Senator COONS. What I would like to do is work with you as much as I could to make sure that Amtrak achieves the level of service that I think they are capable of delivering, both with the current train sets and with the next generation.

Secretary LAHOOD. Yes, sir. We will do that.

Senator COONS. Also, there are some substantial State of Good Repair needs in the Northeast corridor, as you are well aware. Some of them could fall under the System Preservation account, some under Network Development. How do you see the Northeast corridor fitting into this budget proposal and what sorts of benefits or investments might there be in the——

Secretary LAHOOD. I am going to ask Chris Bertram, our Budget Director, to give you the figures, but look, this Department of Transportation is very high on Amtrak. We think they have good management. We think they have a board that is paying attention. We think they are providing a valuable service. We think that the fact that ridership is up, that they made money last year, is an indication, if you will pardon the pun, they are on the right track.

Senator COONS. They are. They are. I am grateful to hear that from you, Mr. Secretary.

Secretary LAHOOD. Could we just have Chris respond?

Senator COONS. Please. Absolutely.

Mr. BERTRAM. On the Northeast corridor for the State of Good Repair projects, most of those would probably be eligible under the new proposed System Preservation account, and then if there were sort of capacity additions or extensions that Amtrak would be interested in doing, they would be available under the Network Development account.

Senator COONS. And do you think this budget provides adequate capital financing for those sorts of improvements in the corridor?

Mr. BERTRAM. Yes. There will be almost $4 billion available for State of Good Repair, System Preservation type. Most of those probably would be for Amtrak, which would be quite a bit of an increase over 2010.

Senator COONS. One last concern I have. There is a critical, oh, I think it is an eight-mile gap between Delaware and Maryland where there are two rails rather than three and there is a capital investment project that has already been design engineered, applied for, and there is funding, but it is not yet under construction. One of my concerns is that should there be some agreement that leads to recisions of financing or funding for projects like that, that there be particular attention given to that.

The rail line congestion that exists between sort of Baltimore and Philadelphia could be critically advanced by finishing that rail that would allow then SEPTA and MARC to connect. It would make a significant advancement in the sort of variety of passenger rail systems that are accessible to our general community so that Amtrak can do what it does best, be a regional rail carrier, and then MARC and SEPTA can connect right at the Newark train station.

I just want to say how grateful I am——

Secretary LAHOOD. Thank you.

Senator COONS [continuing]. For the energy, the focus, the vigor you bring to this. It is difficult in other parts of the country, I think, for folks to assess effectively just how much high-speed rail can bring to them. I think we have a great work force working for Amtrak, and literally every day, I can tell you, you are right. They have better food, better service, more on-time delivery of a great resource for America. So anything I can do to work with you on rail, I would be grateful for a chance to do so.

And Mr. Chairman, thank you for keeping the hearing open to accommodate my floor speech on patent reform.

Secretary LAHOOD. Thank you for your leadership on this, Senator. We appreciate it and we will work with you.

Senator COONS. Great. Thank you very much, Mr. Secretary.

Chairman CONRAD. Thank you, and thanks, Senator Coons, for coming back quickly so that we could not have a break in the hearing.

Let me just conclude, if I could, on some of what I heard from the committee on high-speed rail, because I hope colleagues will think very carefully about the appropriate test for whether or not high-speed rail should be supported in our country.

If the test is, is it going to be in my State, I do not think that is the right test. High-speed rail is probably not going to be in my State. But I support high-speed rail because I believe it is good for America. Look, I have things in my State that are not in other States that get Federal support. I have two of the largest Air Force bases in the country in my State. They are not in other States. But my colleagues know that those bases have value for America and so they support them.

High-speed rail, it is very clear to me, has value for America, and we are all part of Team America. When I look at what Team Japan is doing, they have high-speed rail. I have ridden on it. I think it goes nearly 200 miles an hour. I have been on high-speed rail in Russia, a train that went almost 200 miles an hour. We see what is happening all across Europe with high-speed rail. If America is not to fall behind, if we are going to be competitive, we are going to have to have high-speed rail, and I believe it is one of those investments that actually will pay dividends in terms of the competitiveness of our country, in terms of attracting tourists to America.

And by the way, I have thousands of people from my State, my little State of North Dakota, who come and ride the rail that is outside of my State. I have people who ride the Metro system here in Washington. Thousands of people from North Dakota have come here every year and ride Metro and ride the Northeast corridor rail.

So we are not the individual States of America. We are the United States of America, and if we are going to be strong, I do not think the best can be, it has to be in my State or I am not going to support its funding. I think the test has to be, is it good for the country. I think we have to apply the additional test now, is it being paid for, because we cannot just add to the charge card when we are borrowing 40 cents of every dollar we spend.

And the hard reality is when we look at the spending of the country today as a share of the GDP, it is the highest it has been in 60 years. The revenue as a share of GDP is the lowest it has been in 60 years. So both sides of that equation are going to have to be worked, but we cannot forget the fundamentals of economic strength and growth. And if we are not investing in infrastructure in America, we are making a big, big mistake.

Mr. Secretary, I want to end as I began. I think you are exceptional.

Secretary LAHOOD. Thank you.

Chairman CONRAD. I have rarely seen a witness who is better prepared or does a better job of defending his position than you do, and I just want to thank you for the leadership you have provided.

Secretary LAHOOD. Thank you, sir. Thank you for your leadership.

Chairman CONRAD. We will stand adjourned.

[Whereupon, at 11:52 a.m., the committee was adjourned.]

Thank you, Secretary LaHood, for joining us today as we examine the president's budget and his request for a stunning 62-percent increase in transportation funding.

As you know, we are faced with a growing fiscal crisis. We are out of money. We're borrowing forty cents of every dollar we spend. Our deficit this year is projected to reach $1.65 trillion. And yet this is the third day in a row that a member of the president's administration has come before this committee to request a substantial increase in his department's budget. These requests are simply disconnected from reality. Listening to them you would think we were experiencing a budget surplus, not a staggering deficit.

All across the country families are tightening their belts in the face of tough economic times. The federal government must do the same. No agency should be exempt. Every department of government must closely examine its budget and find ways to do more with less. Our severe fiscal challenges present an opportunity to make government leaner, more productive, and less expensive. It is an opportunity we must seize.

Unlike so much of what Washington does with taxpayer money, transportation is a legitimate and necessary function of government. Good roads are tangible long-term assets that enhance productivity.

The tragedy is that there was a great opportunity to advance our highway system as part of the so-called stimulus package. Instead, nearly one trillion dollars was frittered away on a failed jobs plan that succeeded only in sinking our nation dramatically deeper into debt.

It is terribly sad that the Obama Administration has only now placed such apparent urgency on transportation spending, given what occurred with the stimulus package. The president said the money would be used to repair our nation's infrastructure. But only a meager five percent of stimulus funds were directed to roads and bridges. Clearly, the stated infrastructure goal was not met.

And now this budget will further undermine America's infrastructure by using foreign loans to pay for costly and unnecessary projects—such as high speed rail—while the Highway Trust Fund remains empty.

Where do you propose to get the funding for these projects? Are we to simply keep borrowing until our credit runs out? Are you truly unable to trim your budget and focus your spending priorities?

We cannot rely on China to pay for roads and bridges in America.

I am aware that the Administration argues that many of the projects in this budget are actually paid for. But these claims rely on a big gimmick.

This year we will spend $43 billion out of the Highway Trust Fund but take in only $36 billion. And over the next ten years, if we just maintain the spending level under the current Continuing Resolution, we expect to spend about $140 billion more than comes in. This means the General

Fund will have to continue to bail out the Highway Trust Fund, just as it has the past few years. Since there is no money for the General Fund, this means more borrowing and more debt.

So, we can't even pay for our baseline, but the Administration proposes a huge spending increase with no real plan to pay for it. You assume $435 billion in new money over the next ten years in magic revenue. You have said this revenue is not from a gas tax increase. Where is it from, then?

This is the sort of Washington-style accounting that got us in this fix in the first place. So let me clear up any confusion: Congress is not going to pass a half-trillion dollar mystery tax increase.

We need fact-based budgeting, not fantasy budgeting. Frankly, I have been troubled by how the White House has continued to spin the plain facts.

Here is how the president described his budget to the American people:

> "What my budget does is to put forward some tough choices, some significant spending cuts so that by the middle of this decade our annual spending will match our annual revenues. We will not be adding more to the national debt."

The reality is the exact opposite: the president's budget increases spending every single year, doubles our national debt, and never once produces a deficit less than $600 billion dollars.

In fact, so much new debt is accumulated under the president's plan that our annual debt interest payments will rise to $844 billion dollars by the end of the decade. We will be spending seven times more on interest than on transportation. These staggering interest payments will crowd out all other priorities. By failing to make tough decisions today we are sacrificing the future, not investing in it. If we follow the president's budget we will leave our children—and the world—with an America that is weaker and diminished.

If we want to strengthen America and create jobs, then we will have to restrain government spending and climb out from under this mountain of debt.

It's not an easy road, but it's the right road. It's the road that leads to a better future.

Statement by Senator John Thune
Budget Committee Hearing to Review the Department of Transportation Fiscal Year 2012 Budget
March 3, 2011

Mr. Chairman, thank you for holding this important hearing. And thank you Secretary LaHood for appearing before the Committee this morning, I look forward to your testimony.

The Administration's budget for 2012 proposes sweeping changes in funding for Department of Transportation programs. At the heart of the budget is a six-year $556 billion surface transportation reauthorization proposal that would increase trust fund spending by $115 billion, and increase 2012 spending on surface transportation by 86% over 2010 levels.

The budget also includes a $50 billion dollar "front loaded" transportation infrastructure plan for 2012 that sounds very much like another stimulus and the proposal that the President outlined last September which we never received legislative language on – including how it was to be paid for.

Unfortunately, the Administration has left unanswered the most obvious question: how do we pay for these huge increases?

I am concerned that this proposal will fail to advance the dialogue on a needed multi-year surface transportation bill, because it does not address critical funding solutions. During a time of tight budgets and fiscal constraint, any increase in spending must be offset. I hope that DOT will share its ideas today, and continue to engage Congress as we move forward.

Beyond the lack of funding for DOT proposals, I have several other specific concerns that I hope are addressed this morning.

I am concerned about the creation of a $30 billion National Infrastructure Bank as part of the new Transportation Trust Fund. I would request a careful review of the policy implications of this program before proceeding. Frankly, I have great reservations about this type of fund, which I believe would principally benefit large metropolitan areas and ignore the needs of rural states like my own.

I also have concerns regarding the $53 billion plan regarding passenger rail investment over the next six years based on how the $8 billion in Stimulus high speed rail money has been utilized – or not utilized in some cases.

As a member who represents a rural state, the budget proposal is very concerning when you look at the much faster growth in proposed spending for transit and passenger rail investment. Keep in mind, the transit programs within the DOT don't contribute to the Highway Trust Fund when it comes to user-fees and in fact your proposal to allow transit systems to use funding for operations and maintenance is very concerning.

Thank you again, Mr. Chairman, and I look forward to today's discussions.

Ron Wyden

Senator Wyden Opening Statement

Senate Committee on the Budget

Hearing on the Department of Transportation FY2012 Budget Request

In his state of the Union, the President discussed the need for investment in transportation. He said, "To attract new businesses to our shores, we need the fastest, most reliable ways to move people, goods, and information."

That means roads, bridges and rail.

You simply cannot have a big league economy with a little league transportation system.

In the Senate, there is widespread consensus that highways, roads, transit systems, and bridges must be fortified.

Furthermore, transportation projects put people to work, which the construction industry needs.

But the big challenge, in my view – the outstanding issue – is how will America pay for improving our transportation system. With $100 a barrel oil further stressing our economic recovery, raising the gas tax is not an appealing option. There haven't been any rallies outside my office for raising the gas tax.

Fortunately, there is a proven way to generate tens of billions of dollars of additional funds for transportation on top of what is raised by the gas tax. It's an idea that for years had widespread bipartisan support.

The idea is Build America Bonds.

So, I want to use this opportunity to walk back through some of what happened with Build America Bonds over the years and to talk about how to win bipartisan support once again for federal tax credit financing of transportation infrastructure.

Eight years ago, I put forward a proposal for transportation funding using federal tax-credit bonding with our former colleague Senator Jim Talent, a Republican from Missouri. We called it Build America Bonds.

Senator Talent and I thought that we needed to find new, innovative and politically viable ways to pay for transportation projects.

We were struck by the fact that the federal government had never bonded before for transportation and sought to work with the private sector to find some way to use federal tax credit bonding to leverage private dollars for investment in infrastructure.

Over the years a number of colleagues on both sides of the aisle joined in this effort.

There's a long list of Republicans who have favored using tax credit bonding as a way to pay for transportation projects, and who cosponsored our legislation.

Just so you can get a sense of how bipartisan this effort was: David Vitter, Elizabeth Dole, John Thune, Susan Collins, Roger Wicker, Norm Coleman – these are just a few on the Republican side.

On the Democratic side, Amy Klobuchar, Mark Dayton, Benjamin Cardin, and John Rockefeller are just a few of those who supported our efforts.

There is an old saying that "there are no Democratic or Republican highways." Well, there aren't any Democratic or Republican transportation bonds either.

In 2009, Congress decided to test out a version of Build America Bonds. Several details of our proposal were changed, but the version included in the American Recovery and Reinvestment Act was still a tax-credit bond program to invest in infrastructure.

The experts estimated that about $10 billion worth of the bonds would be sold.

I was asked in the Finance Committee to estimate how many bonds would be sold, and I said I thought it would probably be 6 to 10 billion dollars worth.

In fact, it exceeded all expectations. They sold like hotcakes.

Between April 2009 and the expiration of the program at the end of last year, there were more than 181 billion dollars in Build America Bonds issuances. Just a little more than 18 times what was predicted.

Unfortunately what was once a thoroughly bipartisan Build America Bonds program is less so today. Some folks had concerns, some valid and some not so valid.

Much of the spending went to non-transportation projects, which was not the original intent of our proposal.

There was also no cap on the number of bonds that could be issued, mostly because no one thought they'd be so popular.

Early on, there were concerns about the fees being charged to issuers, but after a year, the fees for Build America Bonds were comparable to any other kind of municipal bond on the market.

Some folks just thought that spreading out government spending on infrastructure was just not a good idea. But any successful business will tell you that some time you have to take on short term debt to create long term economic growth.

What I hope everyone can agree in is that this test of Build America Bonds clearly showed there's an appetite in the market for federal tax-credit financing of infrastructure projects.

Going to this bipartisan model makes as much sense today as when Jim Talent and I worked on it 8 years ago.

I intend to soon introduce legislation based on my earlier, bipartisan work with Senators Thune and Talent that would create a federal tax-credit bonding program to fund investment in transportation infrastructure. To highlight the focus on transportation, I plan to call the new bond program the Transportation and Regional Infrastructure Project or "TRIP" bonds.

I hope that this legislation, like its earlier counterparts, will be both bipartisan and successful.

I'm hopeful that the administration and folks on both sides of the aisle will join me in working together to come up with new and innovative ways to address the gap we have before us on transportation funding.

Senate Budget Hearing
March 3, 2011
Questions for Secretary LaHood

QUESTIONS SUBMITTED BY SENATOR JEFF SESSIONS

Question 1. My understanding is that the Build America Bonds (BAB) program is a tax subsidy program that increases the deficit and therefore results in more federal borrowing and debt and risk in order to allow state and local government transportation programs to borrow more cheaply.

So if we have to borrow more money to operate the BAB program, how does that help increase the amount of revenue into the HTF and reduce its current shortfall?

Answer. Reauthorizing the BAB program will not increase Highway Trust Fund (HTF) revenues – but it will improve the financial prospects for our state and local partners who co-invest in transportation infrastructure alongside Federal programs that rely upon HTF spending. The Federal Government helps transportation agencies in more ways than HTF spending, which accounts for about 45 percent of capital investment in transportation nationwide. State and local agencies tap many additional funding and financing sources, including low-cost debt as enabled by Federal programs, such as tax-exempt bonds and BABs, authorized under the Internal Revenue Code, and which exist outside of the Department of Transportation (DOT).

Federal tax exemption of interest earned on state and local ("municipal") bonds has a 100-plus-year history. Transportation is only one category of public purposes – others include education, health care and water/sewer – for which municipal tax-exempt bonds can be issued. Because the Federal Government does not collect income tax on the interest earned by purchasers of these bonds ("bond holders"), municipalities can sell them at lower interest rates and save substantial local funds. The BAB program gave these same municipal governments the option to issue taxable (rather than tax-exempt) bonds and then receive direct Federal reimbursement for a portion of their interest payments to bond holders.

And because the market for potential purchasers of taxable BABs – such as pension funds – may be different than the market for tax-exempt bond buyers, issuers may benefit from this alternative marketplace and may obtain even lower borrowing costs. Therefore, since the BABs must be repaid by revenue from taxes and fees, the lower interest payments let municipal governments complement the value of all their funding sources, including the Federal spending financed by the HTF.

QUESTIONS SUBMITTED BY SENATOR CORNYN

Question 1. The TIFIA program is something we can all agree has been a very important kick start for projects around the country. It seems that this program might be wandering away from its mobility focus and slowly shifting toward rather undefined project criteria like "livability," "economic competitiveness," and "sustainability" I understand that instead of changing the rules through a public process, USDOT is using internal guidance that is not subject to public comment. Can you comment on that? Also, is US DOT moving away from large-scale mobility projects?

Answer. Transportation investment provides a wide range of benefits. The goal of the TIFIA program is to accelerate projects of regional and National significance that not only enhance mobility, but also provide environmentally sustainable transportation options and leverage Federal participation with substantial private co-investment. In recognition of this, the Department has made explicit the consideration of livability, environmental sustainability, and economic competitiveness, among other factors, when considering projects for receipt of TIFIA credit support. In particular, in the Notice of Funding Availability (NOFA) published in the Federal Register in December 2009, the Department clarified TIFIA's statutory criteria (Regional and National Significance, Private Participation, Environmental Benefits, Use of Technology, and the extent to which TIFIA participation will lead to Project Acceleration and Reduced Grant Assistance) by explaining how DOT's livability, economic competitiveness, and safety strategic objectives fit in as considerations under the Regional and National Significance criterion, and how DOT's environmental sustainability and state of good repair strategic objectives fit in under the Environmental Benefits criterion. It is also notable that in the most recent TIFIA NOFA published in January 2011, the Department included the use of tolling and pricing to reduce road congestion and manage demand for highway travel as part of the Environmental Benefits criterion. TIFIA continues to advance mobility projects, such as State Highway 161, a new highway in Dallas County, Texas, which expects to achieve financial close in the near future. Capturing livability considerations is consistent with TIFIA's goal to assist in financing projects of regional and national significance and enhances TIFIA's role in innovative transportation finance solutions like Denver Union Station. DOT used its strategic priorities to better define how TIFIA best enhances mobility. Mobility that enhances economic competitiveness, access to opportunity, or quality of life are a good use of taxpayer dollars.

Question 2. I understand that instead of changing the rules through a public process, USDOT is using internal guidance that is not subject to public comment. Can you comment on that?

Answer. Extensive information on the TIFIA competitive selection process has been issued publicly through the Notice of Funding Availability process. In addition, during the summer of 2010, USDOT held a listening session on TIFIA and reauthorization. Industry participants and stakeholders were invited to present their perspectives on how TIFIA could be enhanced to better support the delivery of surface transportation projects. Feedback received at both the listening session and through comments submitted in response to the 2010 NOFA has been carefully considered by the Department and incorporated in the subsequent 2011 NOFA as appropriate.

Question 3. Also, is USDOT moving away from large-scale mobility projects?

Answer. The TIFIA statute includes a minimum project size for eligible projects – $50 million – and Regional and National Significance is one of the statutory selection criteria. In selecting projects for TIFIA credit assistance, USDOT has not deviated from these statutory mandates. The four projects that were most recently invited to submit applications for TIFIA support ranged in total project size from $500 million to over $2 billion. In FY 2010, TIFIA executed five loans totaling almost $2.2 billion in credit assistance for projects representing almost $7.5 billion in total investment.

Question 4. One potent way to stretch limited transportation resources is by finding ways to speed up project approvals. Does USDOT- specifically the Federal Highway Administration- have any plans to improve this process? What can USDOT do to streamline project approvals? Is there any effort to harmonize and streamline approvals across agencies?

Answer. The Federal Highway Administration (FHWA) continues to use various means to streamline project approvals and expedite project delivery. This is true for all projects requiring environmental review, regardless of whether processed through a Categorical Exclusion (CE), Environmental Assessment (EA), or Environmental Impact Statement (EIS).

The time for environmental review varies for each category. The vast majority of projects (approximately 10,000 / year or about 96%) are processed through CEs, with the average time being 6 months or less. Approximately 300 projects / year (about 3%) are processed through an EA, with the majority being completed in the range of 16 – 48 months. FHWA estimates that approximately 30-40 projects / year (about 0.3%) are processed through an EIS, with the average time from Notice of Intent to Record of Decision of 73 months pre-SAFETEA-LU and 43 months post-SAFETEA-LU.

The Administrator's Every Day Counts (EDC) Initiative incorporates a "Shortening Project Delivery Toolkit" to support State and local agencies in use of underutilized existing flexibilities to minimize duplication and reduce delay. The tools identified in this initiative include the following:

- Planning and Environmental Linkages
- Legal Sufficiency Enhancements
- Expanding Use of Programmatic Agreements
- Use of In-Lieu Fee and Mitigation Banking
- Clarifying the Scope of Preliminary Design
- Flexibilities in Right of Way
- Flexibilities in Utility Accommodation and Relocation
- Enhanced Technical Assistance on Delayed Environmental Impact Statements
- Construction Manager / General Contractor
- Design-Build

Following a series of 10 EDC regional summits that occurred this past fall, State Departments of Transportations (DOTs) are developing action plans appropriate to their state for implementation of this initiative. FHWA will be providing the necessary support. Additional information on this Initiative is accessible on the FHWA website at http://www.fhwa.dot.gov/everydaycounts/.

In addition to the EDC Initiative, FHWA continues to implement various provisions from SAFETEA-LU that have improved the environmental review process. These include:

- Section 6002: Established changes to make the environmental review process more efficient and timely including establishing joint lead agency status and identifying participating and cooperating agencies, creating a process to resolve interagency disagreements, and adding an option to invoke a 180-day limitation period for filing lawsuits challenging highway and public transportation capital projects. It also authorized use of federal funds to support staff at Federal and State resource agencies as liaisons to work on expediting transportation project review and delivery. As noted, for the 18 projects completed under the Section 6002 process, the time from Notice of Intent to Record of Decision is an average of 43 months.
- Section 6004: Allowed assignment to DOTs of responsibility for determining whether certain highway projects meet criteria to be classified as categorically excluded from requirements to prepare an environmental assessment or environmental impact statement, and to carry out other unspecified DOT environmental responsibilities for a project. States assigned responsibilities under Section 6004 are Utah, Alaska, and California.
- Section 6005: Established a pilot program to allow assignment of FHWA's responsibilities for highway projects under NEPA and other specified environmental laws. California is the only state that entered into the Pilot Program. To date, no EIS has been initiated and completed under the Pilot though California has suggested time savings in the range of 12 to 17 months for about 50 EAs processed.
- Section 6009: Changed the section 4(f) requirements associated with use of land from publicly owned parks, recreation areas, wildlife and waterfowl refuges, or public and private historical sites, to allow for a streamlined approval process for projects that have *de minimis* impacts.

THE REPORT OF THE NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM

TUESDAY, MARCH 8, 2011

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

The Committee met, pursuant to notice, at 10:03 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Wyden, Nelson, Cardin, Sanders, Whitehouse, Warner, Merkley, Coons, Sessions, Enzi, Crapo, Graham, Thune, Portman, Toomey, and Johnson.

Staff present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

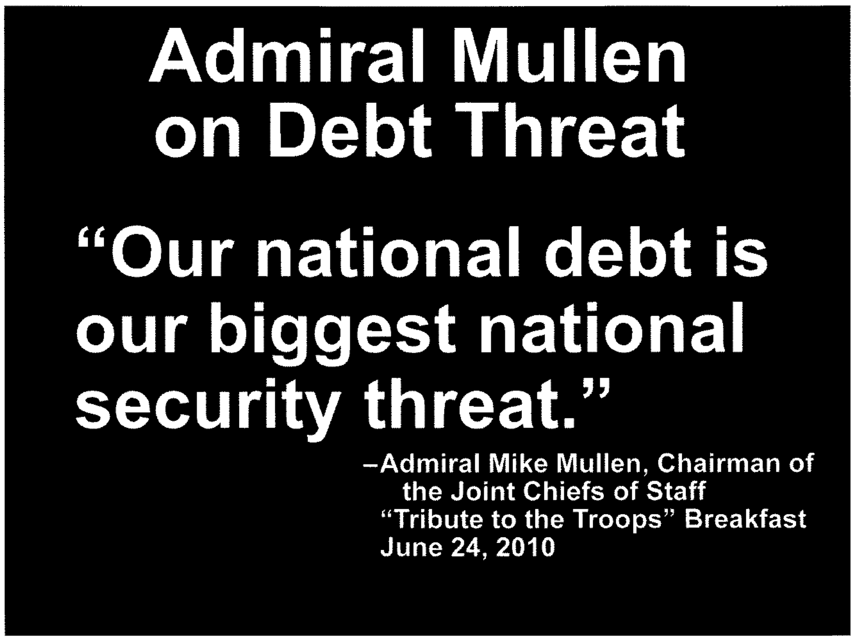
I want to welcome everyone to the Senate Budget Committee today. I particularly want to welcome our two distinguished witnesses today: Erskine Bowles and Senator Alan Simpson, the Co-Chairs of the President's National Commission on Fiscal Responsibility and Reform. Our hearing today will focus on the Commission's plan and how it would address the Nation's long-term debt crisis.

I want to begin by thanking Erskine and Alan for the really outstanding job they did leading the Fiscal Commission. We never would have accomplished as much if it would not have been for their extraordinarily gifted and determined efforts. They made a significant personal sacrifice to come back to Washington to lead this Commission, and we owe them deep gratitude. I believe when the history of this period is written, their names will ring out as being leaders at getting the country back on track.

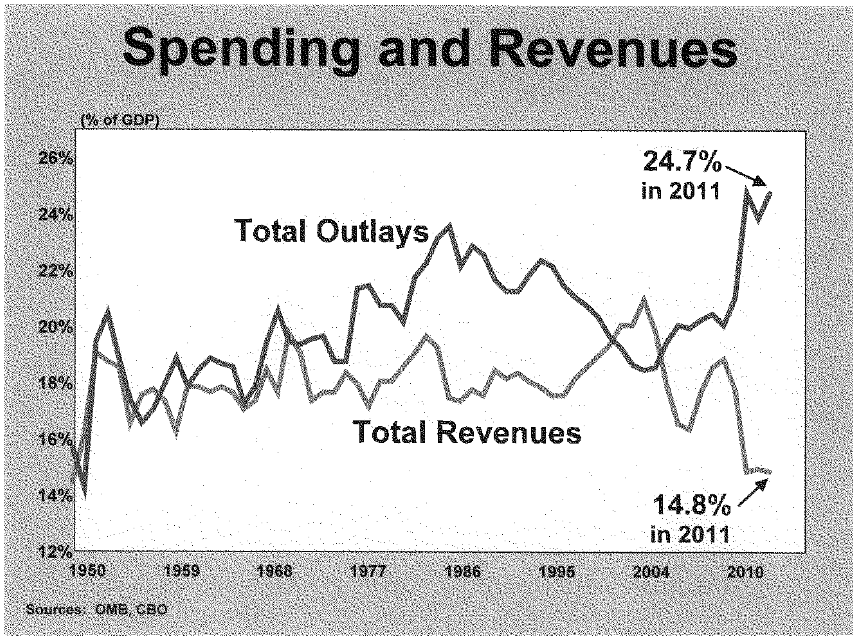
I also want to thank them for starting the Moment of Truth Project, which they are launching today to continue pushing for a bipartisan solution to the debt threat that we confront. The Fiscal Commission succeeded in putting this issue in the national spotlight. There is now a growing consensus on the need to act, and the Commission provided a bipartisan road map for moving forward.

Now, I believe we need to seize this opportunity. I believe we need to act this year. And that is why I have been part of a bipartisan group of Senators who are trying to turn the essence of the Fiscal Commission's plan into legislation. If we can reach some kind of bipartisan agreement in the Senate, we hope it will provide more momentum to move toward a broad agreement this year.

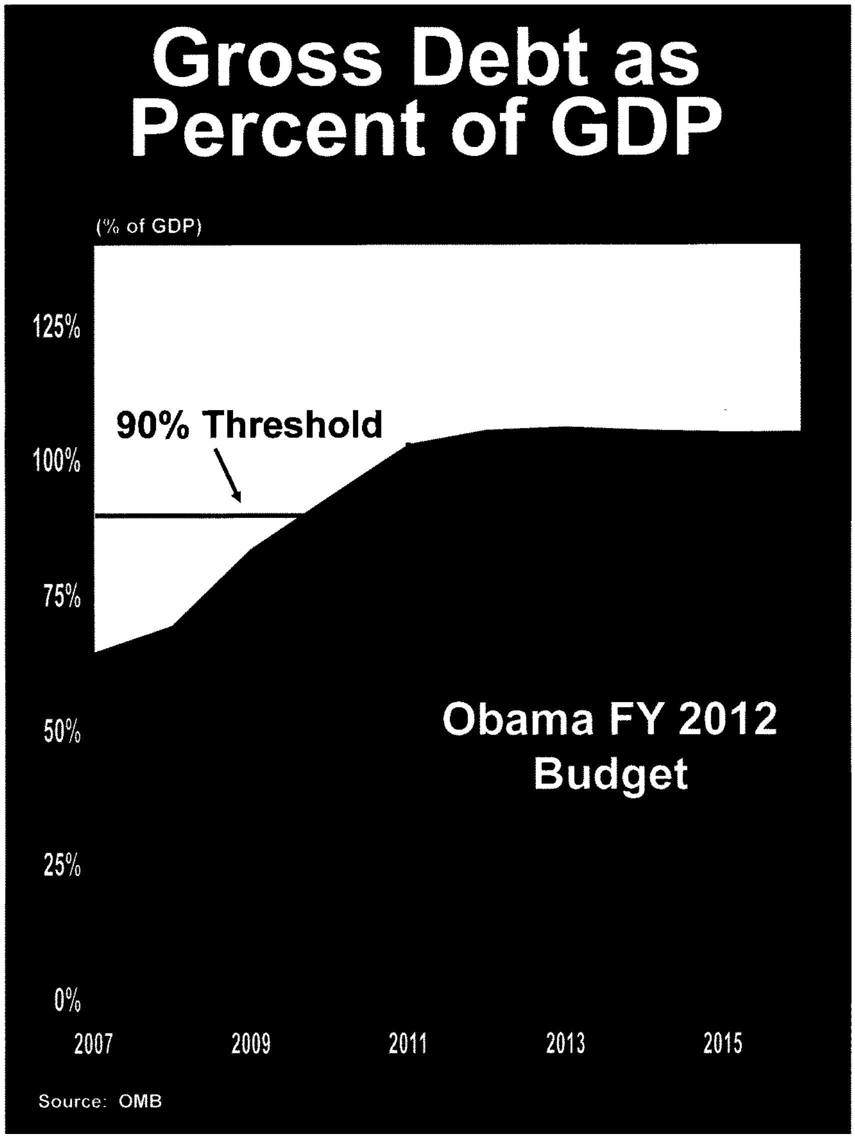
Here is what Admiral Mullen, the Chairman of the Joint Chiefs, said about the debt threat: "Our national debt is our biggest national security threat." That is coming from the Chairman of the Joint Chiefs of Staff.



Make no mistake. We are at a critical juncture. We are borrowing about 40 cents of every dollar that we spend. Spending as a share of our national income is the highest it has been in 60 years. The revenue as a share of our national income is the lowest it has been in 60 years. No wonder we have record deficits.



If we look at the gross debt as a share of the economy, we see that it will reach 100 percent this year, well above the 90-percent threshold that many economists regard as the danger zone. Two of our Nation's leading economists, Carmen Reinhart and Kenneth Rogoff, studied the impact of debt on economies. They looked over a 200-year span at 44 countries, and this is their conclusion: "We examined 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/GDP levels"—above 90 percent gross debt to GDP—those levels "are associated with notably lower growth outcomes." So if people wonder what this is about, this is about our economic future. This is about opportunity, this is about jobs, this is about the economic strength of the Nation.


Gross Debt as Percent of GDP
(% of GDP)
125%
100%
75%
50%
25%
0%
90% Threshold
Obama FY 2012 Budget
2007
2009
2011
2013
2015
Source: OMB

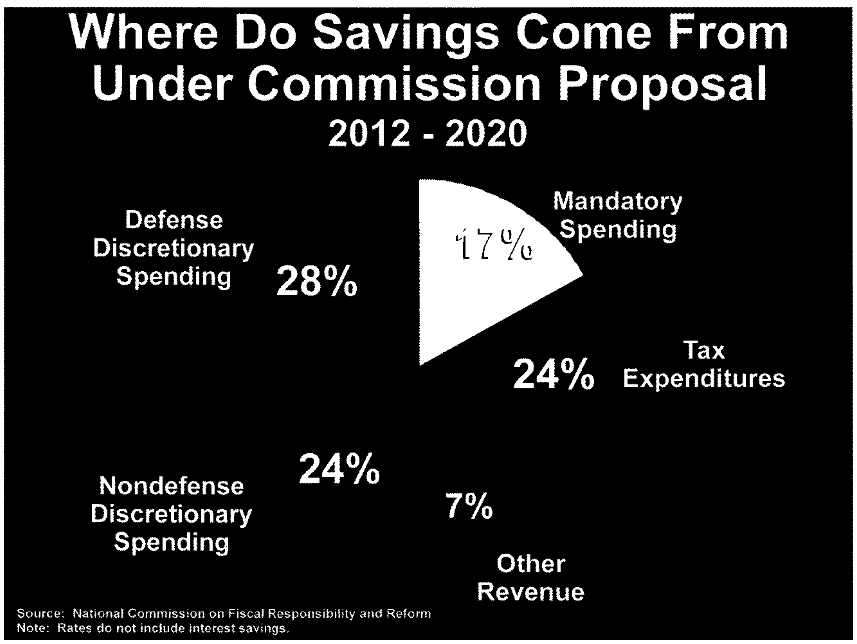
Economists Reinhart and Rogoff on Danger of Gross Debt Above 90 Percent of GDP Threshold

"We examine 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 / GDP levels (90 percent and above) are associated with notably lower growth outcomes."

– Carmen M. Reinhart and Kenneth S. Rogoff
"Growth in a Time of Debt," American Economic Review: Papers & Proceedings
May 2010

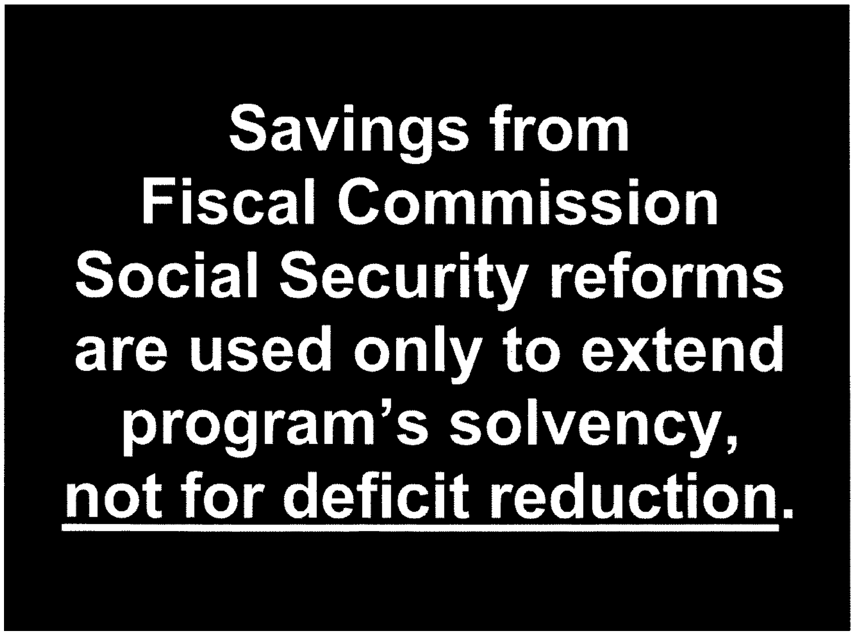
This is not just about numbers on a page. This is not just about bar charts showing deficits and debt. This is about the economic future of America. And the conclusion of the Reinhart-Rogoff study is that when you get a gross debt above 90 percent of GDP, your future economic prospects are compromised, are reduced, and reduced substantially. That is why this matters.

I believe the only way we are going to solve the Nation's long-term fiscal imbalance is by enacting a comprehensive debt reduction plan. We need a plan of the size and scope of what was proposed by the President's Fiscal Commission. The proposal would reduce the debt by $4 trillion over the next decade. It would put us on a course to get the debt stabilized and then brought down as a share of GDP so that we would be in a position to handle future shocks that none of us can anticipate.

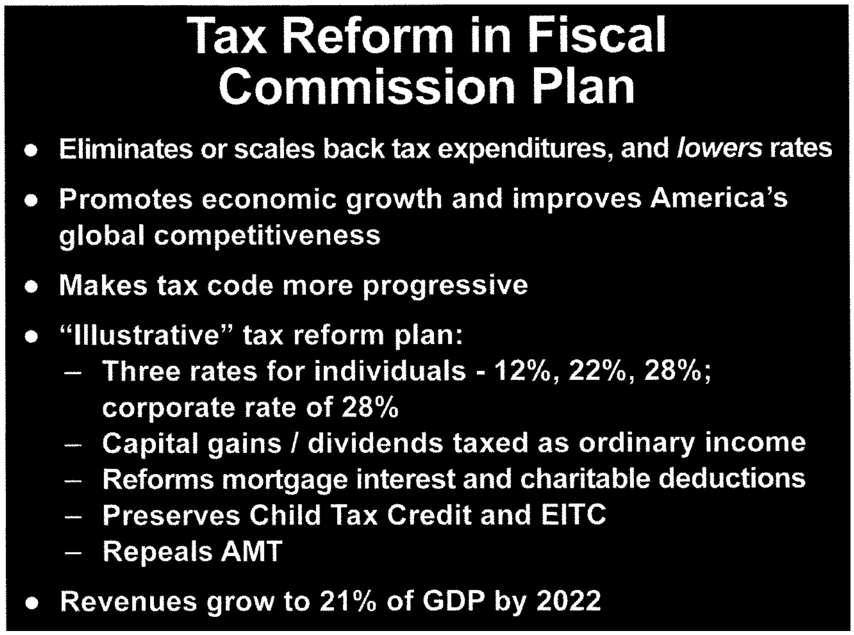


I believe a plan like the Commission plan must include spending cuts, entitlement changes, and fundamental tax reform that simplifies the Tax Code, lowers rates, and raises more revenue. The Commission plan provided such a balanced approach. Its savings come roughly equally from non-defense discretionary, defense discretionary, mandatory spending, and revenue. It is worth emphasizing that savings from Social Security reforms in the Commission plan are used only—and I emphasize "only"—to extend the program's solvency, not for debt reduction.

If there is one message I would like to get out there as clearly as I can, the savings in Social Security were redirected to Social Security to extend its solvency, not for debt reduction.



This chart highlights the key elements of the tax reform included in the plan. The plan eliminates or scales back tax expenditures and lowers tax rates. And, by the way, tax expenditures are now running over $1.1 trillion a year. Tax expenditures are as big as all of regular—that is, non-war related—discretionary spending. And it makes the Tax Code more progressive. It promotes economic growth and improve America's global competitiveness. If we are going to reform the Tax Code, one thing we have to have in mind is the competitive position of the United States. We are no longer so dominant that we do not have to worry about the effect of our Tax Code on the competitive position of the United States.

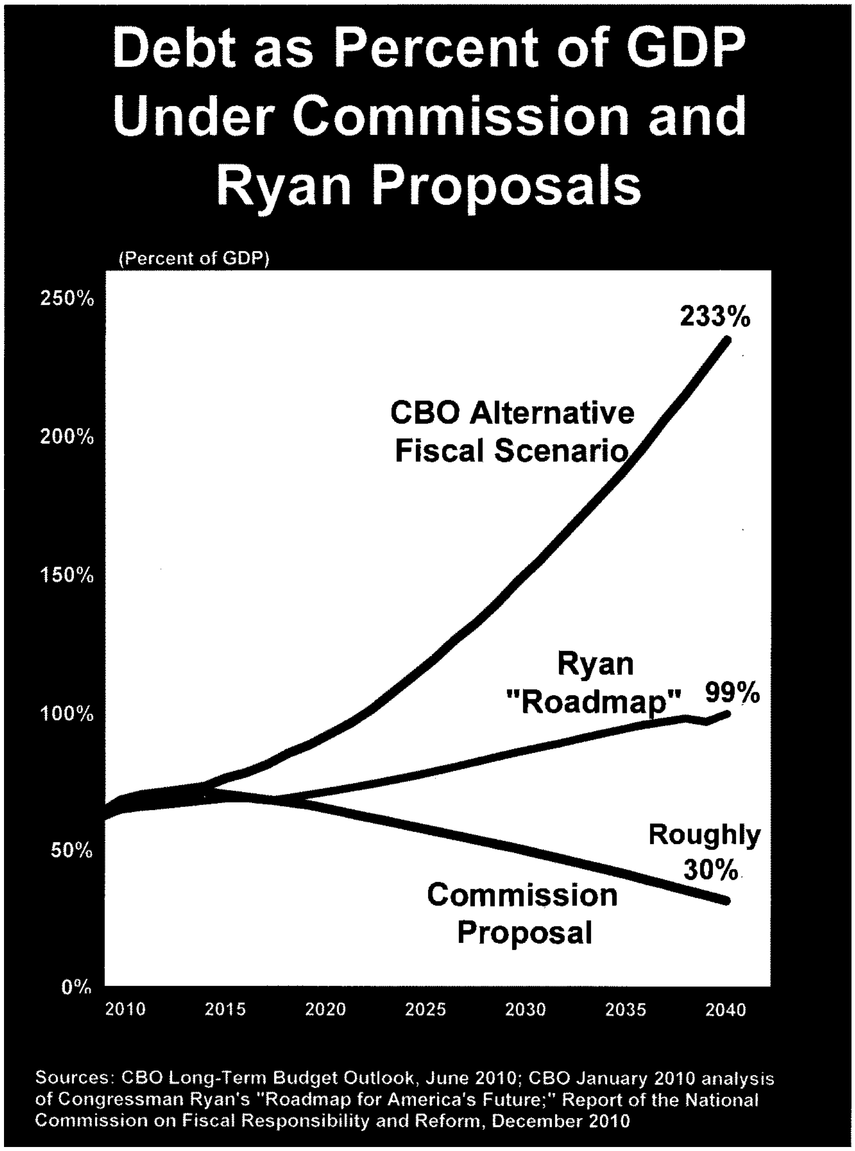


Notably, the Commission's report included an illustrative tax reform plan that demonstrates how eliminating or scaling back tax expenditures can actually lower rates and produce more revenue. Instead of six tax brackets for individuals, the illustrative plan included just three brackets of 12, 22, and 28 percent. The corporate rate would be reduced from 35 to 28. Capital gains and dividends would be taxed as ordinary income. The mortgage interest and charitable deductions would be reformed, better targeting their benefits. The child tax credit and earned income tax credit would be retained to help working families. And the alternative minimum tax would be repealed.

The Commission's plan also increases revenue to 21 percent of GDP by 2022 and over time actually balances the budget. That is the kind of tax reform we will need to adopt. That along with the spending reductions and the entitlement reforms are what is required to actually succeed.

Let me just conclude by showing the different paths forward of the various plans. You can see the course that we are on is going to take us to a debt-to-GDP—and this is publicly held debt now, not gross debt; publicly held debt of 233 percent of GDP on the current course. The Ryan road map takes us to a place I do not think we want to go because that is over 90 percent of GDP for publicly held debt. On a gross debt basis, that would be higher.

The plan by the Commission takes us to publicly held debt of 30 percent of GDP. On a gross debt basis, that would be even higher. That is to me a responsible target, one which would allow us to handle any future shocks that we might experience as a Nation.



So that is why we went a little further than just stabilizing the debt. We actually brought it down markedly as a share of the economy so that we could handle future shocks.

With that, I am going to turn to my excellent colleague Senator Sessions for any opening statement that he wants to make, and then we will go to the witnesses.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Mr. Chairman, for those wise remarks and our challenge to us all.

Senator SIMPSON AND MR. Bowles, thank you for appearing before us and for your very successful report that in a mature, wise, and indisputable fashion affirmed the growing consensus that our Nation is on an unsustainable path of surging debt.

We live in an ordered universe, and the laws of finance are as immutable as the laws of gravity. Nothing comes from nothing. Government debts have the same kind of consequences that individual family debt does. Deficits do matter. They always have and always will. Too much debt has always brought destruction, and it always will.

But some of our great minds have thought they knew better. They mock the green eyeshade folks who worry about debt until, of course, the wolf is at the door, and then they say, well, we did not mean that much debt. Now our financial masters say it is all Congress' fault, and it is a lot of Congress' fault; but you have to clean it up, Congress. And we do. But do not be too quick, be careful, do not go too far, do it just right. For sure do not take any action that might affect my investments or my program or my interests that are there. It is the other programs that are wasteful, not mine.

Your Commission rose above that. For the most part, it was not without compromise. Your recommendations I think should have gone even further. But it was a bipartisan effort, and it left no doubt that our debt problem is not imaginary but very real, even immediate.

When former Chairman of the Federal Reserve Alan Greenspan told the Wall Street Journal a few weeks ago that our Nation has a little better than a 50/50 chance to avoid a debt crisis in 2 to 3 years, surely we can take the hint that something serious must be done. And Moody's said in December that—warning us that they could downgrade our debt in less than 2 years if we do not take action. So the Nation and much of the world is in a serious financial fix.

If you read the comments of Wall Street, the fear there is real. Anger is real among the Wall Street people. Their words combine concern for our Nation's future and short-term self-interest. But our best path I think calls on us to—some of our best people, I would say, are producing contradictory ideas for action, and it is causing some confusion. You have helped us cut through that confusion, in my view.

So the House proposes meaningful spending reductions. Meanwhile, the President continues to advance his investment agenda, declaring against plain fact that his budget calls for us to live within our means and to begin paying down our debt. What world are they living in? Are we now through the looking glass, a post-modern world where words have lost all meaning? If so, our beloved Nation is in greater danger than many think. But I do not think so.

The American people get it. We can do this. This is not impossible. Leadership at this time is most precious and in short supply. It seems to me that when confusion, uncertainty, hard times, even fear abound that good leadership like your report should call us to return to the tried and true—first principles, the old verities. We are vigorous, healthy people. We can accept the truth and get on with fixing problems. The people know, if not the intelligentsia, the bubblized folks in Washington, that the right road will be difficult for a while, but that it will lead to prosperity and progress and preserve our great heritage of freedom and limited Government. The current road just leads to debt and decline.

The first old verity is to start telling the truth, and the truth is this budget we have been presented does not live within our means, but instead doubles the entire gross debt of the United States from $13 trillion to $26 trillion by the end of the decade. It assumes no recession, low interest rates, and no new war or military conflict. It cannot stand. It will not stand.

For the time and effort you have given this cause, we are much obliged. You have worked hard, given us clear picture of the danger we face and the methods available to overcome that danger. Your Nation is once again grateful for your service.

Thank you.

Chairman CONRAD. Thank you so much, Senator Sessions.

We will now turn to our witnesses: Erskine Bowles, Alan Simpson, two people of real courage and character. And I would say to other members, including Senator Crapo who served on the Commission, as did I. The leadership of these two was really textbook. It could not have been done better. And at the end of the day 11 of the 18 members endorsed the findings—five Democrats, five Republicans, and one Independent. That is about as bipartisan as it can be. And so welcome to the Budget Committee. Thank you for your leadership. I do not know who wants to go first.

Senator Simpson, welcome.

STATEMENT OF THE HONORABLE ALAN SIMPSON, CO-CHAIR, NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM

Mr. SIMPSON. Thank you very much, old friend, and Senator Conrad and Senator Sessions. Thank you for your remarks. Thank you for, again, explaining it through those wonderful charts that we have been watching for many months. You have been very helpful, and you are very informative. And it is a great honor and privilege to be here, to be in this chamber, in these offices, this Capitol, and not be always inspired by the democratic experience. If that feeling ever leaves any of you, you want to leave. And it is a great forum.

Erskine and I have left our witness protection program. We make sporadic appearances in various locations, as is today, and the people are waiting for us to go back into sequester when we leave.

Let me just say this: It is a treat to look around this room and see friends of both parties that I thoroughly enjoyed when I was here. And over there is Mike Enzi. He replaced me, and people said, "Thank God" that he did that.

[Laughter.]

Mr. SIMPSON. It was a selfless effort. And he is an old and dear friend, and he and Diana are very dear friends. And this cat over here, Portman, was a staffer when I was on the Select Commission on Immigration and Refugee Policy. Now look at him: suave, a piece of work. Rob Portman, as I say, Ron over there, Bill, I worked with all of them.

But on with the business. I know that it is 5 minutes or something like that.

This forum is where the most frustrating and irritating and cumbersome and sometimes sloppy work of legislating is performed. As an old cowboy said, "It ain't pretty." But as another Western rustic said, "If you hire on to be a cowboy and you draw a bucking bronco, you cannot complain." And Erskine and I drew that critter. And he is a splendid man. He is a remarkable man, a creative and positive fellow with great integrity and an absolute joy to work with. And we have thoroughly enjoyed our time together, and work is what we do. We do work together.

Folks say to us, "Why are you doing this?" And we say, "We have 14 reasons." He has eight grandchildren and I have six. It cannot be simplified any more than that. That is where this is. It is about my grandchildren and yours. It is not about us.

It all started for me when I got this cheerful call from Joe Biden in January. He said, "Al, I got a real deal for you." I said, "Thank you, Joe. Let me get Ann on the phone so she can laugh along with me so that we can get out of this." He said, "No, no. Listen." Joe and I worked together on many, many things when we were here together.

And so I said, "Well, who is the Co-Chair?" And they said, "Erskine Bowles." The first call I get is from Elizabeth Dole and Bob, my Leader. I was the Assistant Majority and Minority Leader. You need to serve in both of those capacities. It is very helpful in legislating if you are in the minority for a while and you are in the majority for a while. It kind of sobers you up.

Anyway, the Doles called and said, "This is one of the finest men we have ever worked with." And so it is, and so it came to pass. But let me tell you, it took us 3 months on this Commission to establish trust. Just plain trust. Trust used to be the coin of the realm around here. Let me tell you, the coin of trust is severely tarnished in this place, which is very sad. I worked with so many on the other side of the aisle, Kennedy and Pryor and Bradley and Bumpers, and Levin, who is still here. Dear Carl and I came here together. And we trusted each other, and I hope that that can come back. It came back in our Commission, and once we got through the initial hammering, which was who was the biggest spending President in the history of the world: George W. Bush, 6–12 years, never vetoed a single spending bill. Then this other side would say, yes, but your guy has outdone him 3:1. Finally, Erskine and I said, "Look, we will just do a two-man report. It will just be the two of us, and it will not be mush." Too much stuff comes out of here which is much.

So off we went, and as they came around, a remarkable group of five Democrats, five Republicans, one Independent—Mike there was on it and, of course, the Chairman. But 60 percent of the Commission bought this. That is pretty good; 60 percent is kind of the big number around this place. It fits well with the filibuster activities, the magic number.

When we go around the country, we just tell people—I do not use charts. This is the numbers guy. You are going to hear from him.

And if you have any numbers or percentages that you wish to probe, this is your man. I do the color, he does the numbers. And it works so far. We still do things together if we can.

Now, I have one more minute. I yield to myself one other, whatever we did there.

What I tell people is very simple, and people in America are way ahead of all of you. They know what is going on because when you say, “Why don’t you go back and think what people are doing at their kitchen table?” I will tell you what they are doing at their kitchen table. They know that if you spend more than you earn, you lose your butt, and they know that if you spend a buck and borrow 40 cents of it, you must be stupid. And they have it figured out that this Government is stupid, to borrow 40 cents for every buck you spend. Forget the charts, forget the GDP and all the rest of it. That is where we are.

The tipping point—I do not know where the tipping point is. Erskine and I would take questions on that. But Durbin kept asking. Give Senator Durbin the Medal of Honor. He stepped right in here, and at the end of his vote, he said his son called him and said, “Thanks, Pop,” because that is what this is about.

So, anyway, the tipping point, I do not know where it is, but at some point it comes when those people that hold our paper say, “We thought these guys had the guts to attack Medicare, Medicaid, the solvency of Social Security.” Do not swallow this business that we are balancing the budget on the backs of poor old Social Security people. That is a fake. It is a phony. It is wrong. It is untrue. We are doing it so it will have its own solvency, and your chart showed it.

So I just want to give you a couple of quotes—and let me just say about Social Security. Do not throw anything. There are people out here. I get that. I have a lot of e-mails that are choice and that I will hope never get into the public venue. Social Security is not a retirement. It was never intended as a retirement. It was an income supplement after the Depression. The average age of life was 63, and that is why they set the retirement age at 65—the beginning of the greatest Ponzi of all time.

Now the life expectancy is 77. There were 16 people paying into this system when I was at the University of Wyoming and one taking out. Then there were 10 paying in. Today there are three people paying in and one taking out. And in 10 years, there will be two people paying in and one taking out. How long do you think that kind of thing can be sustained? And the money has not been stolen by you greedy people. It is all choice stuff, highly—lots of frills and prints on the side, paper. It is paper. They were not going to leave that kind of cash, nor did President Roosevelt want it. That is why the statute said you could get in there and give full faith and credit to take it out.

So, anyway, if you have to go through the myth and the anguish, just remember everything in this place, it was my experience, sadly, that you have to use facts, because you are going to have to beat back emotion, fear, guilt, and racism. Everything I touched was filled with emotion, fear, guilt, or racism, used a death blend either way to get it done or kill it.

Two quotes, and then I will turn it over to the numbers guy.

Cicero—boy, here is a crazy guy—said in 55 B.C.: “The budget should be balanced, the treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and assistance to foreign lands should be curtailed lest Rome become bankrupt.”

Here is what Abe Lincoln said as a young man: “At what point then is the approach of danger to be expected? I answer, if it ever reach us, it must spring up amongst us....If destruction be our lot, we must ourselves be its author and finisher. As a nation of freemen, we must live through all time, or die by suicide.”

And, finally, I do not know where this little baby came up, so I do not want any copyright infringement on it. “Gold is the money of kings; silver is the money of gentlemen; barter is the money of peasants; but debt is the money of slaves.” Go look at Alexander Hamilton. Go look at his statue. Look at what it says on there. Everything this country has meant had to do with getting rid of its debt. And, boy, here is your handful.

So God bless you.

[The prepared statement of Mr. Simpson and Erskine Bowles follows:]

Testimony before the Senate Committee on the Budget
Co-Chairmen of the President's Commission on Fiscal Responsibility and Reform
Erskine Bowles and Senator Alan Simpson

March 8, 2011

Chairman Conrad, Ranking Member Sessions, and Members of the Committee, thank you for inviting us to appear today to discuss the recommendations of the National Commission on Fiscal Responsibility and Reform. We particularly want to thank Chairman Conrad and Senator Crapo for your work on the Fiscal Commission, as well as Senator Warner for the leadership you have provided in keeping the Commission's recommendations at the forefront of the debate in Congress. We hope that the hard work and courage that you have shown will lead the way to serious action.

The need for action

As Co-Chairmen of the National Commission on Fiscal Responsibility and Reform, we spent most of 2010 studying the cold, hard facts concerning our nation's fiscal situation. Every member of our Commission came to the same unavoidable conclusions: The fiscal problems our nation faces are real. The solutions will be painful. There is no easy way out. Everything must be on the table. And Washington must lead.

Over the course of our deliberations, the urgency of our mission became all the more apparent. The contagion of debt that began in Greece and continues to sweep through Europe shows us clearly that no economy will be immune. If the U.S. does not put its fiscal house in order, the reckoning will be sure and the devastation severe.

We believe that if we do not take decisive action our nation faces the most predictable economic crisis in its history. The current fiscal path we are on is simply not sustainable. Spending is rising rapidly, and revenues are failing to keep pace. As a result, the federal government is forced to borrow huge sums each year to make up the difference. In bad economic times, such borrowing might make sense in order to soften the blow of a recession. Our concern is not so much the record deficits we face today, although they do cause us real worry. Our principle concerns are the prospects that borrowing will remain high throughout the decade, and rise substantially as time goes on. Under a reasonable set of assumptions, our national debt will surpass 90 percent of Gross Domestic Project (GDP) by the end of the decade, a level not seen since just after World War II, and a level most economists find problematic.

The demographics are not our friend. Over the long run, as the baby boomers retire and health care costs continue to grow, the situation will become far worse. By some time next decade, revenue will be able to finance only interest payments, Medicare, Medicaid, and Social Security. These mandatory payments will squeeze out funding for all other priorities. Every other federal government activity – from national defense and homeland security to transportation and education – will have to be paid for with borrowed money. Unfortunately, these pressures are no longer just long-term problems; they are increasingly becoming short- and medium-term issues. The Congressional Budget Office reported earlier this year that Social Security outlays exceeded revenues last year, and will remain in the red permanently.

In addition to our debt problems, we have a budget that focuses too much on consumption at the cost of important investments, and a tax code that is grossly inefficient in terms of encouraging work, investment, and global competitiveness. This outdated, inefficient and overly complex tax system is a drag on economic growth and competitiveness. Reforms must be made in a way that would strengthen our competitiveness.

Continued inaction and short term fixes do no represent viable, sustainable options for our country. This kind of uncertainty and avoidance is not an acceptable course of action for a responsible government. If not addressed, burgeoning deficits will eventually lead to a fiscal crisis, at which point the bond markets will force decisions upon us. If we do not act soon to reassure the markets, the risk of a crisis will increase, and the options available to avert or remedy the crisis will both narrow and become more stringent. If we wait ten years, CBO projects our economy could shrink by as much as 2 percent and spending cuts and tax increases needed to plug the hole could nearly double what is needed today.

Predicting exactly what a debt crisis would look like or the precise level of public debt that would trigger such a crisis is difficult, but the consensus of the experts we met with was that the risk will grow as our debt does – particularly if we have no plan to bring it back down, as a share of the economy, in future years.

Summary of Commission Plan

In establishing the Fiscal Commission, President Obama gave us a two-part mission: to bring the budget into primary balance (balance excluding interest costs) by 2015, and to meaningfully improve the long-run fiscal outlook. Our recommendations accomplish both of these goals through an aggressive, fair, balanced, and bipartisan proposal – a proposal as serious as the problems we face.

The Fiscal Commission put forward a comprehensive fiscal plan that included over sixty specific recommendations for reforms of spending programs and the tax code, and many other illustrative options. The plan would achieve nearly $4 trillion in deficit reduction through 2020, more than any effort in history, by going after every sacred cow, while protecting the most vulnerable and prioritizing investments in education, infrastructure, and high value-added R&D. The plan would stabilize the debt beginning in 2014, one year earlier than the President's goal, and reduces debt to 65 percent of GDP by 2020 (and 60 percent by 2023). It cuts our deficit in half by 2015 to 2.3 percent of GDP, surpassing the goal of 3.0 percent. By 2020, our plan cuts the deficit by three-quarters to 1.2 percent of GDP. Over the long-run, the plan makes additional reforms to ensure lasting solvency for Social Security and put in place tools to control federal health care cost growth. Though long-term projections are always far less accurate than short-term ones, we estimate the commission plan would balance the budget and bring the debt down to 40 percent of GDP by 2035. To the extent our plan results in faster than projected economic growth, we could reach a balanced budget sooner.

The plan is built on six responsible, balanced, bipartisan principles:

1) We wanted to make sure we did not do anything that would adversely affect a very fragile economic recovery. Growth is essential to restoring fiscal strength and balance.

That is why we delayed getting spending hack to pre-crisis levels until 2013, when spending in our plan returns to 2008 levels in real terms.

~~1)~~2) We wanted to make sure we protected the truly disadvantaged. We must ensure that this nation has a robust, affordable, fair, and sustainable social safety net. That is why we focused benefits on those who need them the most through policies such as an increase in the minimum benefits under Social Security and a twenty year bump up in Social Security for the very old and long-term disahled. And we did not recommend any fundamental policy changes to income support programs for the most disadvantaged, such as unemployment compensation, food stamps and SSI...

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~~1)~~3) We wanted to make sure we keep the nation secure. But both our nation's economic and national security depend on us putting our fiscal house in order. Admiral Mullen, Chairman of the Joint Chiefs of Staff, has said that our debt is our greatest national security problem. We do not believe this country can continue to spend more than the next fourteen largest countries combined on defense.

4) As President Obama said in his State of the Union Address, our nation must continue to invest in education, infrastructure and high value research if we are to compete in a knowledge based economy. We should cut red tape and unproductive spending that hinders growth and job creation, while at the same time investing in those areas that will help create jobs and keep us globally competitive. But these investments must he done in the context of a fiscally responsible plan. That is why we recommended a 15 cent a gallon increase in the gas tax to pay for transportation spending. It is also why we called for a cut and invest committee to provide resources for education and high value research.

5) The tax code must be reformed to broaden the base, lower rates for individuals and employers and reduce the deficit. We need to reform the corporate tax system to make America the best place to start and grow a business and create jobs. This can be done by eliminating or significantly reducing tax expenditures which are often nothing more than inefficient spending in the tax code. Tax reform should be done through a "zero based budgeting" approach which starts with all tax expenditures wiped out and dramatically lower rates, forcing advocates of certain tax expenditures to justify why they should be added back and how to increase rates to pay for them. If we eliminated all tax expenditures, we could eliminate the Alternative Minimum Tax, bring individual income tax rates down to 8 percent, 14 percent, and 23 percent and the corporate rate to 26 percent while reducing the deficit by $80 billion in 2015.

6) We must end redundant, wasteful, and ineffective federal spending wherever we find it, while demanding productivity in Washington. We must cut spending we cannot afford, with no exceptions. All the talk so far has focused on domestic non-security discretionary spending. We could eliminate all non-security discretionary spending this year and still have a deficit of over $1 trillion. Clearly we must reduce <u>all</u> excess spending – including defense, entitlement spending, and spending in the tax code as well as domestic programs.

The above means that the plan has six major technical components:

- ❖ Discretionary spending caps to force budget discipline and impose significant cuts in both security and non-security spending by cutting low-priority programs and streamlining government operations, plus illustrative examples sufficient to save $200 billion in 2015.

- Tax reform which wipes out or restructures nearly all tax expenditures in order to dramatically lower corporate and individual tax rates and reduce the deficit at the same time.
- Concrete health care reforms which ask for greater contributions from doctors, lawyers, drug companies, and beneficiaries in the medium term, as well as a measure to put federal health spending in a global budget after 2020.
- Other savings from reforming the military and civilian retirement systems, reducing farm subsidies and other mandatory spending, along with a technical correction to provide more accurate indexing of all government programs and the tax code.
- Social Security reform which achieves 75-year sustainable solvency while reducing poverty by establishing a new minimum benefit equal to 125 percent of poverty in 2017 for a full career worker and providing a twenty year bump up in benefits for the old-old and long term disabled. We increased the eligibility age for full benefits to 68 by 2050 and 69 by 2075, with a hardship exemption for those who are in manual labor jobs who need to retire early, We also make progressive changes to the benefit formula and gradually increase the amount of wages subject to payroll taxes back to 90 percent of total wages.
- Tough budget process reforms to ensure the debt remains stable as a share of the economy.

Discretionary Spending

In order to bring down the deficit, Washington will have to rein in discretionary spending. Every aspect of the discretionary budget must be scrutinized, no agency can be off limits, and no program that spends too much or achieves too little can be spared. The federal government can and must adapt to the 21st century by transforming itself into a leaner and more efficient operation. Like its citizens, like the businesses that provide those citizens with jobs, like every state and local government, our federal government must also be willing to do more with less and live within its means.

Any serious attempt to reduce the deficit will require deliberate, planned reductions in both domestic and defense spending. The government will not be able to protect those in need or invest to achieve our nation's long-term potential growth if Washington squanders taxpayer dollars on duplicative or marginal programs with no measurable results.

The proposal we put forward would set limits for discretionary spending that would have a freeze in 2012, a 5 percent cut in 2013, followed by growth at about half inflation through 2020. We applied the same approach to security and non-security. We also required the President to propose limits on war spending consistent with the projected needs under current policies, with the spending levels in the CBO troop drawdown scenario as the starting point.

The Commission proposed locking in those savings by establishing strict, enforceable limits on all discretionary spending. In the 1990s, discretionary spending caps played a large role in bringing the budget into balance. By establishing formidable boundaries to guide spending in future years, Congress and the Administration will be forced to eliminate waste and excess in agency budgets, better target funding toward programs that demonstrate real results, and reduce duplication throughout the federal bureaucracy.

The Commission's proposal would create separate caps for security and non-security discretionary spending so that they would be treated the same. Firewalls ensure that both sides of the discretionary budget are subject to scrutiny and cuts so that neither party can avoid looking for savings in one side of the budget by cutting the other side deeper.

The spending path recommended by the Commission is more than simply numbers on a page. It is a vision for our future reflecting the values and priorities of the American people. We must continue to invest in our future, but must not undermine those investments by leaving generations yet to come with a debt they cannot repay. The Commission's spending limits will necessitate a more efficient government that invests wisely, spends Americans' precious tax dollars well, is transparent and accountable for every dime, and makes hard choices as to what government should and shouldn't do.

We put together an illustrative list of spending cuts totaling $200 billion in savings in 2015 to show how the savings required by the caps could be achieved without undermining our national security or jeopardizing investments in our future. We also recommended a "Cut and Invest" committee to identify low priority or duplicative programs that could be eliminated in order to free up funds for high priority investments. Last week the Government Accountability Office issued the report required by the Coburn Amendment identifying 34 areas of duplication, overlap or fragmented services where reforms could potentially save billions of tax dollars annually and help agencies provide more efficient and effective services. The report also identified another 47 areas where agencies or Congress could take action to either reduce the cost of government operations or enhance revenue collections for the Treasury. This report provides further evidence that Congress and agencies will be able to find cost savings in order to comply with spending limits while still meeting key priorities.

The Commission also recommended several reforms of discretionary spending to improve the transparency and accountability of spending. We proposed budgeting for disaster spending, , placing greater restrictions on the use of emergency funds and establishing strict criteria for war supplementals. Finally we proposed making spending from transportation trust funds mandatory spending, limited to actual dedicated revenues collected by the trust fund in the prior year, and proposed a 15 cent increase in the gas tax to make the trust funds whole.

Comprehensive Tax reform

America's tax code must be reformed. In the quarter century since the last comprehensive tax reform, Washington has riddled the system with countless tax expenditures, which are simply spending by another name. These tax earmarks – amounting to about $1.1 trillion a year of spending in the tax code – not only increase the deficit, but cause tax rates to be too high. Instead of promoting economic growth and competitiveness, our current code drives up health care costs and provides special treatment to special interests.

Rather than tinker around the edges of the existing tax code, the Commission proposed fundamental and comprehensive tax reform that would lower tax rates, reduce the deficit, simplify the tax code, reduce the tax gap, and make America the best place to start a business and create jobs.

The Commission proposed a "zero based budgeting" approach to tax reform of starting with a clean tax code that didn't have any tax expenditures and had much lower rates and then deciding which tax expenditures should be added back and which rates should be increase to pay for them. We estimated that if all tax expenditures were eliminated we could eliminate the Alternative Minimum Tax, bring individual income tax rates down to 8 percent, 14 percent, and 23 percent and reduce the corporate rate to 26 percent while achieving $80 billion in deficit reduction in 2015 and $160 billion in 2020

We realized that it would be impractical to completely eliminate all tax expenditures. However, we concluded that starting with a completely clean tax code and forcing advocates of various tax expenditures to justify why they should be added back and how the costs should be offset would result in a much simpler, efficient tax code than would be possible if we started with the status quo.

The Commission proposed establishing a fast track process for consideration of tax reform, with a tax expenditure haircut that would take effect beginning in 2012 if Congress failed to act. We said that tax reform must reduce the size and number of these tax expenditures, lower marginal tax rates for individuals and corporations and reduce the deficit while maintaining or increasing the progressivity of the tax code. The Commission members agreed that we need to protect the disadvantaged, so we started with the assumption that Congress would add back the EITC and the Child Tax Credit. The commission also agreed that tax reform should preserve some tax incentives to promote work, home ownership, charitable giving, retirement savings, etc. – but in a simplified and better targeted manner, while keeping the top marginal rate at or below 29 percent.

Although we decided that the precise details of tax reform and exact transition rules should be developed by the relevant congressional committees and the Treasury Department with expertise in the tax code, we produced a modified version of the "zero plan" that preserved certain tax expenditures in a modified form while still reducing rates and achieving deficit reduction. The illustrative plan developed by the commission demonstrated that it is possible both to reduce rates dramatically and to achieve significant deficit reduction if tax expenditures are eliminated or scaled back and better targeted. The illustrative plan would set rates at 12 percent, 22 percent, and 28 percent, create a 12 percent credit for mortgage interest and charitable giving, consolidates and limits the size of retirement accounts and gradually phase out the health exclusion, among other changes. The illustrative plan would preserve the EITC and child credit in their current form or an equivalent alternative. The result of this illustrative plan is a tax reform package that is more progressive than current law and achieves the deficit reduction targets in the Commission plan while dramatically reducing marginal tax rates.

The Commission also recommended corporate tax reform to make America the best place to start a business and create jobs. The current tax code saps the competitiveness of U.S. companies. Additionally, the tax code should help U.S.-based multinationals compete abroad in active foreign operations and in acquiring foreign businesses. The Commission recommended corporate tax reforms which would eliminate all tax expenditures for business, establishing a single corporate rate at the same level as the top individual tax rate (between 23 and 29 percent) and provides for a competitive territorial system, thus making America a globally competitive place to start and grow a business and attracting billions of dollars back to the country.

Health care cost containment

Federal health care spending represents our single largest fiscal challenge over the long-run, and presented one of the biggest challenges for our Commission as well. There are very serious philosophical differences about the health care bill enacted last year that need to be debated, but the Commission wasn't going to be able to resolve that debate. We decided it would be far more productive for us to discuss ways that we could build on the cost saving and cost control elements that were in the health care reform bill and look for other ways to achieve savings that were not included in the bill. Our proposal set out a few broad parameters to do that.

The Commission recommended reforming both the formula for physician payments (known as the Sustainable Growth Rate or SGR) and the Community Living and Support Services Act and finding savings throughout the health care system to offset their costs, with additional savings for deficit reduction. The Commission said that the cost of any "doc fix" – must be fully offset, and recommends enforcing this principle by eliminating its exemption in statutory PAYGO.

We proposed paying for the "doc fix" by asking doctors, other providers, lawyers and individuals to share responsibility for controlling costs. That means a doc fix that is a little less generous than what doctors have been receiving but one that provides a better system for paying doctors. It also means getting savings from drug companies and other providers beyond what was included in health reform, changing cost sharing rules to reduce overutilization of care and enacting medical malpractice reform.

We also called for repealing the CLASS Act – the Community Living And Support Services Act – unless reforms are enacted to make the program financially sustainable. Since the CLASS Act would actually bring revenues in over the next decade before starting to pay out benefits, we recommend additional health care savings of $76 billion to replace those revenues. In addition, we recommend additional reforms to reduce federal health spending and slow the growth of health care costs more broadly.

In total, the commission proposed over a dozen very specific policies to achieve savings in Medicare and Medicaid – totaling over $400 billion – in order to fully finance the "Doc Fix," pay for a potential repeal of the CLASS Act, and provide additional funds for deficit reduction.

Among the largest of these reforms is a very specific reform to Medicare cost sharing rules which calls for a "a single combined annual deductible of $550 ... along with [a] 20 percent uniform coinsurance ... [and] catastrophic protection for seniors by reducing the coinsurance rate to 5 percent after costs exceed $5,500 and capping total cost sharing at $7,500" and an equally specific restriction of MediGap. These two policies were estimated by CBO to save $110 billion over ten years.

In addition, the commission recommended comprehensive reforms of medical malpractice rules, extending Medicaid drug rebates to dual eligibles, reducing payments for graduate (and indirect) medical education, limiting the ability of States to manipulate their federal Medicaid matches by taxing providers, turning FEHB into a premium support program, and making a number of specific payment reforms and other changes.

The Commission also called for aggressive implementation of the demonstration projects in Medicare for new delivery systems and payment reforms that have potential for savings. In some instances CMS has the authority to expand the pilot projects if they are successful, in other areas Congress would need to act. We propose shifting the presumption toward going forward with reforms by requiring the Secretary to implement any pilot projects that have shown success in controlling costs without harming the quality of care by 2015, and we proposed expanding them to Medicaid and potentially into the exchanges. We also recommended elimination of the provider carve outs from IPAB, the Independent Payment Advisory Board to broaden the scope of payment reforms IPAB could implement.

Over the longer term (2020 and beyond), the Commission recommended setting targets for the total federal budgetary commitment to health care, limiting growth to one percent above GDP growth and requiring further structural reforms if federal health spending exceeds the program-specific and overall targets. We recognize that controlling federal health spending will be very difficult without reducing the growth of health care costs overall. To that end, the Commission's recommendations on tax reform regarding reducing and potentially eliminating the exclusion for employer-provided health insurance will help decrease growth in health care spending, according to virtually all health economists

If the recommendations made by the commission combined with the new policies enacted by Congress do not slow the rate of growth in the federal budgetary commitment to health care to the rate of GDP plus one percent, more drastic measures have to be considered, such as a premium support plan, increases in the age of eligibility for Medicare, block grants for Medicaid, a robust public option, an all payer system, or giving Medicare the authority to be a more active purchaser of health care services.

Mandatory Savings

Outside of health care and Social Security, the commission also applied scrutiny to other mandatory programs – programs which are not subject to the scrutiny of the annual appropriations process.

Our goal in this area was to reduce low priority or wasteful spending, including subsidies that are poorly targeted or create perverse incentives. We felt that income support programs for the most disadvantaged, such as unemployment compensation, food stamps, and Supplemental Security Income (SSI), should not be touched. These programs provide vital means of support for the disadvantaged, and the commission did not recommend any fundamental policy changes to these programs.

We identified approximately $225 billion in mandatory savings outside of Social Security, health care and safety net programs. Much of this came from reforms to the military and civil servant retirement systems. We heard time and time again that these defense and non-defense "entitlements" are draining money away from the fundamental priorities of government, and so recommended a number of innovations and cost-saving techniques to bring them more closely in line with similar retirement programs from the private sector.

In addition, we proposed reforms to student loan programs and the Pension Benefit Guarantee Corporation (PBGC) – both of which were included in the President's budget proposal. We also recommended reductions in agriculture subsidies, along with a large number of smaller cuts.

The Commission also recommended a technical change in indexing federal programs and tax provisions by adopting the "chain-weighted" Consumer Price Index for Urban Consumers (C-CPI-U) for all provisions that are currently indexed to CPI-U and CPI-W. The Commission did not propose a change in indexing of government programs, but simply recommended using a more accurate measure to implement current policy. This is a technical correction that experts from both sides of the aisle agree on, and the overestimation in the current CPI is something that is costing us a lot of money across the budget.

Social Security Reform

The most popular Social Security reform plan in Washington is the do-nothing plan – a plan which effectively recommends a 22 percent across-the-board benefit cut for all current and future beneficiaries in 2037. That is woefully unacceptable and easily preventable if we act now.

We wanted to make sure the system is sustainable over the long term – to make sure it can continue to provide the foundation for a secure retirement not just for old guys like us, but for our kids and our grandkids. That's why we have focused on 75-year sustainable solvency for Social Security.

Saving Social Security will require shared sacrifice. Those at the top will have to contribute the most, both through higher payroll taxes and lower-than-scheduled benefits. Middle income workers will also have to contribute, but can do so primarily by working a little longer, to the extent they are able. Those who are most vulnerable should actually receive additional protections, in order to make sure Social Security is fulfilling its fundamental mission to keep seniors out of poverty.

The plan developed by the Commission would achieve sustainable solvency – meaning we would continue to have balance in the 75th year – in a way that phases in changes quite gradually while providing greater poverty protections than current law and making the program more progressive. We did not propose reforms of Social Security to reduce the deficit; the Social Security plan would have very little impact on the budget in the near term and we did not count any of those effects in meeting our deficit reduction targets. Rather, we proposed reforms of Social Security to ensure that the program remains strong and financially viable for future generations and to meet our mandate of making recommendations to "meaningfully improv(ing) the long run fiscal outlook."

The Commission's Social Security plan had six basic elements:

First, the plan would index the retirement ages – both early and normal – to account for increases in life expectancy. Effectively, this means the retirement age (which is scheduled to reach 67 under current law in 2027) will reach 68 in about 2050 and 69 in about 2075, just after our grandchildren have retired. Even with this change, future retirees will spend more time in retirement receiving benefits than current beneficiaries. We address the concern for workers who truly can't continue to work past age 62 because of physical limitations by directing the Social Security Administration to establish a hardship exemption and setting aside money to accommodate such a provision.

Second, we made progressive changes in the benefit formula by creating an extra bendpoint at the 50th percentile of wages. Under this change, by 2050, the Social Security replacement factors would go from 90 percent, 32 percent, and 15 percent under current law to 90 percent, 30 percent, 10 percent, and 5 percent. Even with our recommendations, nearly all retirees (including high earners) will receive higher benefits than retirees today do – even adjusted for inflation. So it is hard to talk about these as benefit cuts.

Third, we increased the amount of income subject to the payroll tax by gradually raising the "taxable maximum." In the 1980s, this taxable maximum was high enough to cover 90 percent of wages, but under current law it is projected to cover only 82.5 by the end of the decade. We proposed slightly speeding up the wage-indexed increases in the taxable maximum so that it would again cover 90 percent of wages by 2050.

Fourth, we also included newly hired state and local workers in the Social Security program after 2020. This would give affected workers stronger retirement security, and make the system more efficient; it also makes sense from an honest budgeting perspective, because the most likely outcome is that over time the federal government may be called on to aid ailing state systems.

We also switched the measure of inflation used to calculation cost of living adjustments (COLAs) from the CPI to the more accurate chained-CPI. This was a technical correction which we applied government-wide to a number of tax and spending provisions.

And finally, we provided new protections for vulnerable workers in two ways. First, we created a robust minimum benefit which would guarantee a base benefit equal to 125 percent of the poverty line for someone who had worked for 30 years, and would index that level to wages so it becomes more generous over time. In addition, we created a benefit bump up, equal to 5 percent of the average wage, for the very old and the long-time disabled.

Budget Enforcement

The Commission proposal included recommendations that would achieve enough savings to more than restore primary balance and stabilize the debt under current projections. However, members of the Commission thought that it is important for Congress and the President to remain vigilant to ensure the budget remains on a course to primary balance and a stable debt to GDP ratio. We therefore recommended an enforcement mechanism to ensure the budget achieves primary balance by 2015 and the debt is stabilized thereafter.

The Commission's proposal would require action by the President and Congress on budget stabilization legislation if the budget (excluding interest costs) is projected to be out of primary balance in 2015, or if the debt held by the public has not stabilized thereafter. The debt stabilization process would include fast-track procedures to facilitate changes in law necessary to protect the fiscal health of the federal budget.

Previous budget enforcement mechanisms that placed limits on the deficit failed because they attempted to use budget process as a substitute for the tough choices needed to reduce the deficit. By contrast, this proposal provides a failsafe ensuring the fiscal goals envisioned by the Commission's recommendations actually materialize in the future.

The debt stabilization process recommended by the Fiscal Commission reflects a new standard for the President and the Congress to react in a timely manner to fiscal imbalance. Requiring the President to provide detailed legislative changes in law with his budget, coupled by the enactment of the Congressional budget resolution with directives to committees of jurisdiction to act by a date certain, will provide accountability and transparency to the federal budget process

Lessons from Fiscal Commission

Our experience in the commission provided several lessons which should help policymakers grapple with the challenges they will face with their votes on the debt limit, with necessary appropriations to keep the government running, and with making the budget process work this year.

First, a fiscally responsible plan must be bold and comprehensive. It must restrain spending across the federal budget, reform the tax code, bring down health care costs, and make Social Security solvent and strong for the next 75 years and beyond.

A comprehensive approach is necessary not only to match the magnitude of the problem, but to allow for the tradeoffs and balance necessary to reach a bipartisan agreement. Our strong belief is that there would have been less support on the Commission for a less comprehensive plan that avoided making some of the politically sensitive and difficult choices we had to make to really bring the deficit down and eventually achieve balance. Commission members were willing to accept painful choices in parts of the budget that they cared about only if there were equally painful choices in other parts of the budget important to other members. Taking tax reform or Social Security off the table, for example, would have undermined prospects for agreement.

Second, Washington must lead the way. A realistic plan will require shared sacrifice by all but the most vulnerable in society. In order to ask for such sacrifices, we need to create a more efficient and cost-effective government, and root out waste wherever we find it.

Third, revenues need to be part of the solution, but as part of fundamental tax reform that moves beyond the zero sum argument about the Bush tax cuts that both parties have been fighting for and against over the last decade. The answer instead should focus on reforming revenues through a more efficient tax code that promotes economic growth. Today, we spend over $1.1 trillion a year on "tax expenditures" – credits, deductions, loopholes and exclusions which are really just spending by any other name. If we reform or eliminate these tax breaks, we can dramatically reduce personal and corporate tax rates, improve economic growth, and at the same time reduce the deficit.

Fourth, a plan to reduce the deficit must therefore promote economic growth and not undermine the economic recovery. In order to avoid shocking the fragile economy, the Commission recommended waiting until 2012 to begin enacting programmatic spending cuts, and waiting until fiscal year 2013 before making large nominal cuts. In addition, revenue changes would not begin until calendar year 2013, after spending cuts are already well underway.

A number of economists have argued that putting into place a credible plan to reduce future deficits can have a positive effect on the economy. This so-called "announcement effect" could help to prevent interest rate increases and also mitigate uncertainty among individuals and businesses. In addition, stabilizing the debt will improve the country's long-term growth prospects by reducing the "crowd out" of private investment and by forestalling a potential fiscal crisis.

Finally, and perhaps most importantly, reaching an agreement will require a serious effort on the part of the leaders in Congress and the administration to develop real trust and mutual respect. Building this trust and mutual respect is the critical first step in working together to reach a principled compromise that makes the tough, smart, fiscally responsible choices necessary to achieve real fiscal reform and responsibility. We are hopeful that the discussions being led by Vice President Biden with Congressional leaders in both parties over the appropriations for the remainder of the year will help develop that trust and can serve as a model for work on a broader fiscal package.

Conclusion

None of us likes every element of our plan, and each of us had to tolerate provisions we previously or presently oppose in order to reach a principled compromise. We were willing to put our differences aside to forge a plan because our nation will certainly be lost without one.

We surely do not pretend to have all the answers, and none of the commission members who voted for the plan supports every element of that plan. We fully expect there to be arguments that we went too far in some areas or not far enough in others. That is a debate Congress should have. All we ask is that the debate be guided by the "Becerra Rule" we followed in the Commission – "don't shoot down an idea without putting forward a better idea in its place."

In the weeks and months to come, countless advocacy groups and special interests will try mightily through expensive, dramatic, and heart-wrenching media assaults to exempt themselves from shared sacrifice and common purpose. The national interest, not special interests, must prevail. The nation desperately needs broad, bipartisan agreement based on shared sacrifice, not politics as usual. Americans are counting on us to put politics aside, pull together not pull apart, and agree on a plan to live within our means and make America strong for the long haul.

The political system, by its very nature, moves slowly and sloppily. But this country does not have a lot of time to act if it is to avert fiscal calamity. The American people must join us in demanding that the President and leaders of both parties in both Houses begin the honest negotiations needed to ensure enactment of a comprehensive bipartisan fiscal reform plan by year's end. The Fiscal Commission's plan can serve as the starting point; the ending point must be something equally ambitious, with broad support from both parties to ensure passage.

We believe neither party can fix this problem on its own, and both parties have a responsibility to do their part. The American people are a long way ahead of the political system in recognizing that now is the time to act. We believe that far from penalizing their leaders for making the tough choices, Americans will punish politicians for backing down – and well they should.

Thank you again for inviting us to appear today. We look forward to your questions.

SUMMARY OF COMMISSION RECOMMENDATIONS

Discretionary Spending Cuts

1.1: CAP DISCRETIONARY SPENDING THROUGH 2020. Hold spending in 2012 equal to or lower than spending in 2011, and return spending to pre-crisis 2008 levels in real terms in 2013. Limit future spending growth to half the projected inflation rate through 2020. *(Saves $183 billion in 2015, $1,760 billion through 2020)*

1.2: CUT BOTH SECURITY AND NON-SECURITY SPENDING. Establish firewall between the two categories through 2015, and require equal percentage cuts from both sides.

1.3: ENFORCE CAPS THROUGH TWO MECHANISMS -- POINT OF ORDER AND SEQUESTRATION. Require a separate non-amendable vote in House and 60-vote point of order in Senate to waive spending beyond the caps. Impose across-the-board sequester by the amount appropriations exceed the caps.

1.4: REQUIRE THE PRESIDENT TO PROPOSE ANNUAL LIMITS FOR WAR SPENDING. Create a separate category above the caps for Overseas Contingency Operations (OCO), proposed by the President to reflect the projected needs of war policy.

1.5: ESTABLISH A DISASTER FUND TO BUDGET HONESTLY FOR CATASTROPHES. *(Costs $11 billion per year, $99 billion through 2020)*

1.6: STOP THE ABUSE OF EMERGENCY SPENDING.

1.7: FULLY FUND THE TRANSPORTATION TRUST FUND INSTEAD OF RELYING ON DEFICIT SPENDING. Dedicate a 15-cent increase in the gas tax to transportation funding, and reduce spending to match the revenues the trust fund collects each year.

1.8: UNLEASH AGENCIES TO BEGIN IDENTIFYING SAVINGS.

1.9: ESTABLISH CUT-AND-INVEST COMMITTEE TO CUT LOW-PRIORITY SPENDING, INCREASE HIGH-PRIORITY INVESTMENT, AND CONSOLIDATE DUPLICATIVE FEDERAL PROGRAMS.

1.10: ADOPT IMMEDIATE REFORMS TO REDUCE SPÉNDING AND MAKE THE FEDERAL GOVERNMENT MORE EFFICIENT. *(Saves $50+ billion)*

- **1.10.1** Reduce Congressional & White House Budgets by 15 Percent ($0.8B)
- **1.10.2** Impose Three-Year Freeze on Member Pay
- **1.10.3** Impose Three-Year Pay Freeze on Federal Workers and Defense Department Civilians ($20.4B)
- **1.10.4** Reduce Size of the Federal Workforce Through Attrition ($13.2B)
- **1.10.5** Reduce Federal Travel, Printing, and Vehicle Budgets ($1.1B)
- **1.10.6** Sell Excess Federal Property ($0.1B)
- **1.10.7** Eliminate All Congressional Earmarks ($16B)

Tax Reform

2.1: ENACT FUNDAMENTAL TAX REFORM BY 2012 TO LOWER RATES, REDUCE DEFICITS, AND SIMPLIFY THE CODE. Eliminate all tax expenditures, dedicate a portion of the additional revenue to deficit reduction and use the remaining revenue to lower rates and add back necessary expenditures and credits.

> **2.1.1** Cut rates across the board, and reduce the top rate to between 25 and 29 percent.
> **2.1.2** Dedicate $80 billion to deficit reduction in 2015 and $180 billion in 2020.
> **2.1.3** Simplify key provisions to promote work, homes, health, charity, and savings while increasing or maintaining progressivity.

2.2: ENACT CORPORATE REFORM TO LOWER RATES, CLOSE LOOPHOLES, AND MOVE TO A TERRITORIAL SYSTEM.

> **2.2.1** Establish single corporate tax rate between 25% and 29%.
> **2.2.2** Eliminate all tax expenditures in the corporate code.
> **2.2.3** Move to a competitive territorial tax system.

2.3: PUT FAILSAFE IN PLACE TO ENSURE SWIFT PASSAGE OF TAX REFORM.

Health Care Savings

3.1: REFORM THE MEDICARE SUSTAINABLE GROWTH RATE. Reform Medicare Sustainable Growth Rate ("doc fix") for physicians and require the fix to be offset. *(Saves $3 billion in 2015, $22 billion through 2020, relative to a freeze)*

3.2: REFORM OR REPEAL THE CLASS ACT. *(Costs $11 billion in 2015, $76 billion through 2020)*

3.3: PAY FOR 'DOC FIX' AND CLASS ACT REFORM. Enact specific health savings to offset the costs of the Sustainable Growth Rate (SGR) fix and the lost receipts from repealing or reforming the CLASS Act.

> **3.3.1** Increase authority and funding to reduce Medicare fraud. *(Saves $1 billion in 2015, $9 billion through 2020)*
>
> **3.3.2** Reform Medicare cost-sharing rules. *(Saves $10 billion in 2015, $110 billion through 2020)*
>
> **3.3.3** Restrict first-dollar coverage in Medicare supplemental insurance. *(Medigap savings included in previous option, additional savings total $4 billion in 2015 and $38 billion through 2020)*
>
> **3.3.4** Extend Medicaid drug rebate to dual eligibles in Part D. *(Saves $7 billion in 2015, $49 billion through 2020)*

3.3.5 Reduce excess payments to hospitals for medical education. *(Saves $6 billion in 2015, $60 billion through 2020)*

3.3.6 Cut Medicare payments for bad debts. *(Saves $3 billion in 2015, $23 billion through 2020)*

3.3.7 Accelerate home health savings in ACA. *(Saves $2 billion in 2015, $9 billion through 2020)*

3.3.8 Eliminate state gaming of Medicaid tax gimmick. *(Saves $5 billion in 2015, $44 billion through 2020)*

3.3.9 Place dual eligibles in Medicaid managed care. *(Saves $1 billion in 2015, $12 billion through 2020)*

3.3.10 Reduce funding for Medicaid administrative costs. *(Saves less than $260 million in 2015, $2 billion through 2020)*

3.3.11 Medical malpractice reform. *(Saves $2 billion in 2015, $17 billion through 2020)*

3.3.12 Pilot premium support through FEHB. *(Saves $2 billion in 2015, $18 billion through 2020)*

3.4: AGGRESSIVELY IMPLEMENT AND EXPAND PAYMENT REFORM PILOTS. Direct CMS to design and begin implementation of Medicare payment reform pilots, demonstrations and programs as rapidly as possible and allow successful programs to be expanded without further Congressional action.

3.5: ELIMINATE PROVIDER CARVE OUTS IN IPAB. Give the Independent Payment Advisory Board (IPAB) authority to make recommendations regarding hospitals and other exempted providers.

3.5: ESTABLISH LONG-TERM GLOBAL BUDGET FOR TOTAL HEALTH CARE COSTS. Establish a global budget for total federal health care costs and limit the growth to GDP plus 1 percent.

Other Mandatory Savings

4.1: REVIEW AND REFORM FEDERAL WORKFORCE RETIREMENT PROGRAMS. Create a federal workforce entitlement task force to re-evaluate civil service and military health and retirement programs and recommend savings of $70 billion over ten years.

Use the highest five years of earnings to calculate civil service pension benefits for new retirees (CSRS and FERS) rather than highest three years prescribed under current law, to bring the benefit calculation in line with the private sector standard.
Savings in 2015: $500 million. Savings through 2020: $5 billion.

Defer COLA for retirees in the current system until age 62, including for civilian and military retirees who retire well before a conventional retirement age. In place of annual increases, provide a one-time catch-up adjustment at age 62 to increase the benefit to the amount that would have been payable had full COLAs been in effect.
Savings in 2015: $5 billion. Savings through 2020: $17 billion.

Adjust the ratio of employer/employee contributions to federal employee pension plans to equalize contributions.
Savings in 2015: $4 billion. Savings through 2020: $51 billion.

4.2: REDUCE AGRICULTURE PROGRAM SPENDING THROUGH 2020. Reduce net spending on mandatory agriculture programs by $10 billion from 2012 through 2020 with additional savings to fund an extension of the agriculture disaster fund and allow the Agriculture Committees to reallocate funds as necessary according to their priorities in the upcoming Farm Bill. *Savings in 2015: $1 billion. Savings through 2020: $10 billion.*

4.3: ELIMINATE IN-SCHOOL SUBSIDIES IN FEDERAL STUDENT LOAN PROGRAMS. Eliminate income-based subsidies for federal student loan borrowers in favor of better targeted hardship relief for loan repayment. *Savings in 2015: $5 billion. Savings through 2020: $43 billion.*

4.5: GIVE PENSION BENEFIT GUARANTEE BOARD AUTHORITY TO INCREASE PREMIUMS. *Savings in 2015: $2 billion. Savings through 2020: $16 billion.*

4.6: ELIMINATE PAYMENTS TO STATES FOR ABANDONED MINES.

4.7: EXTEND FCC SPECTRUM AUCTION AUTHORITY.

4.8: INDEX MANDATORY USER FEES TO INFLATION.

4.9: RESTRUCTURE THE POWER MARKETING ADMINISTRATIONS TO CHARGE MARKET RATES.

4.10: REQUIRE TENNESSEE VALLEY AUTHORITY TO IMPOSE TRANSMISSION SURCHARGE.

4.11: GIVE POST OFFICE GREATER MANAGEMENT AUTONOMY.

4.6-4.11 *Savings in 2015: $1 billion. Savings through 2020: $8 billion.*

Social Security Reform

5.1: MAKE RETIREMENT BENEFIT FORMULA MORE PROGRESSIVE. Modify the current three-bracket formula to a more progressive four-bracket formula, with changes phased in slowly. Change the current bend point factors of 90%|32%|15% to 90%|30%|10%|5% by 2050, with the new bend point added at median lifetime income.

5.2: REDUCE POVERTY BY PROVIDING AN ENHANCED MINIMUM BENEFIT FOR LOW-WAGE WORKERS. Create a new special minimum benefit that provides full career workers with a benefit no less than 125 percent of the poverty line in 2017 and indexed to wages thereafter.

5.3: ENHANCE BENEFITS FOR THE VERY OLD AND THE LONG-TIME DISABLED. Add a new "20-year benefit bump up" to protect those Social Security recipients who have potentially outlived their personal retirement resources.

5.4: GRADUALLY INCREASE EARLY AND FULL RETIREMENT AGES, BASED ON INCREASES IN LIFE EXPENCTANCY. After the Normal Retirement Age (NRA) reaches 67 in 2027 under current law, index both the NRA and Early Eligibility Age (EEA) to increases in life expectancy, effectively increasing the NRA to 68 by about 2050 and 69 by about 2075, and the EEA to 63 and 64 in lock step.

5.5: GIVE RETIREES MORE FLEXIBILITY IN CLAIMING BENEFITS AND CREATE A HARDSHIP EXEMPTION FOR THOSE WHO CANNOT WORK BEYOND 62. Allow Social Security beneficiaries to collect half of their benefits as early as age 62, and the other half at a later age. Also, direct the Social Security Administration to design a hardship exemption for those who cannot work past 62 but who do not qualify for disability benefits.

5.6: GRADUALLY INCREASE THE TAXABLE MAXIMUM TO COVER 90 PERCENT OF WAGES BY 2050.

5.7: ADOPT IMPROVED MEASURE OF CPI. Use the chained CPI, a more accurate measure of inflation, to calculate the Cost of Living Adjustment for Social Security beneficiaries.

5.8: COVER NEWLY HIRED STATE AND LOCAL WORKERS AFTER 2020. After 2020, mandate that all newly hired state and local workers be covered under Social Security, and require state and local pension plans to share data with Social Security.

5.9: DIRECT SSA TO BETTER INFORM FUTURE BENEFICIARIES ON RETIREMENT OPTIONS. Direct the Social Security Administration to improve information on retirement choices, better inform future beneficiaries on the financial implications of early retirement, and promote greater retirement savings.

Budget Process Reforms

6.1: SWITCH TO A MORE ACCURATE MEASURE OF INFLATION FOR INDEXED PROVISIONS. Rely on chained CPI to index all CPI-linked provisions across government.

6.2: ESTABLISH A DEBT STABILIZATION PROCESS TO ENFORCE DEFICIT REDUCTION TARGETS. Establish a debt stabilization process to provide a backstop to enforce savings and keep the federal budget on path to achieve long term targets.

6.3: GIVE THE PRESIDENT THE POWER OF EXPEDITED RESCISSION.

6.4: ALLOW CAP ADJUSTMENTS FOR PROGRAM INTEGRITY EFFORTS.

6.5: CONDUCT REVIEW OF BUDGET CONCEPTS TO MORE ACCURATELY REFLECT GOVERNMENT LIABILITIES.

Chairman CONRAD. Thank you, Senator Simpson.

Erskine Bowles, good to have you here.

STATEMENT OF THE HONORABLE ERSKINE BOWLES, CO-CHAIR, NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM

Mr. BOWLES. Thank you, sir. I spent a long time trying to get here. I sometimes thank God for unanswered prayers.

[Laughter.]

Mr. BOWLES. I want to thank Senator Conrad, and he is not here but Senator Gregg. Without their leadership none of us would be here today to talk about this, so I thank you for having the courage, you and the group that stood up some years ago and said we are not going forward unless we have some Commission to deal with this. It simply would not have happened without you.

Senator Sessions, thank you for meeting with us this morning and thank you for your kind words.

I also want to thank Senator Crapo, Senator Coburn, and Senator Durbin for having the courage to support what is a politically very, very difficult plan to support. And I want to thank Senators Warner and Chambliss for your yeoman's work in trying to turn what is a 67-page plan in plain English into legislative language and bring together a bipartisan group to make this happen.

I am not going to use any notes today. I am just going to talk to you. And I am really concerned. I think we face the most predictable economic crisis in history. A lot of us sitting in this room did not see this last crisis as it came upon us, but this one is really easy to see. The fiscal path we are on today is simply not sustainable. This debt and these deficits that we are incurring on an annual basis are like a cancer, and they are truly going to destroy this country from within unless we have the common sense to do something about it.

I was with former Senator Kerrey, Bob Kerrey, about a year ago exactly, and he said, "Erskine, look at the Nation's current income statement, and let me tell you what you will see. You will see that 100 percent of the revenues that this Nation produces today are being consumed by our mandatory spending and the interest on the debt." That means that every single dollar that we spend today on these two wars, on our military, on national security, on homeland security, on education, on infrastructure, on high-value-added research is borrowed, and half of that is borrowed from foreign countries. That is a formula for failure. And if we do nothing, if we just take the ostrich theory in this room, then we will be spending $1 trillion a year in interest costs alone by the year 2020.

Think about that. That is $1 trillion that will not educate our children. It is $1 trillion that will not build a highway or will not bring broadband infrastructure to rural South Carolina. That is $1 trillion that will not create the next new thing in this country. It is $1 trillion that is going to create the next new thing somewhere over there from the people we are borrowing money from. It is crazy.

And this is not a problem we can grow our way out of. You could have double-digit growth for the next two decades and not solve this problem. So do not think we can grow our way out of it.

And this is not a problem we can tax our way out of. Raising taxes does not do a darn thing to slow the rate of growth of health care or to change the demographics of the country. And, in fact, if you want to try to solve this with just taxes, you will have to raise the highest marginal rate to around 70 percent, the corporate rate to 80 percent, the capital gains and dividends rate to 50 percent. And what kind of country will we have? You are not going to have any businesses started or businesses growing with that kind of tax structure. So we cannot simply tax our way out.

And we cannot simply cut our way out of this problem. You know, when I see people go on the Sunday shows and they say, "Oh, look, we are going to cut our way out of this problem, but we are not going to touch Medicare and we are not going to deal with Medicaid and we are not going to mess with Social Security, and for sure we have to stay safe and secure so we are not taking a dollar out of difference, and, oh, by the way, we have to pay the interest on the debt—well, you know, if we exclude all those things, you have to cut everything else by 65 to 75 percent. That is not going to happen. That is not a realistic world.

So what Al and I tried to do was to present a realistic plan, a balanced plan, a plan that turned out to be a bipartisan plan. And it is based on six basic principles.

The first is we did not want to do anything that would disrupt a very fragile economic recovery, and the economy is in a recovery. This growth is real today. But, boy, we can lose it and lose it quickly.

So when we looked at cutting spending, as Senator Crapo knows, most of our spending cuts come in 2013. That is where we get back to 2008 levels in real terms to the pre-crisis level, which I believe we can do.

Now, I expect that the Republicans will be for getting back to 2008 levels in 2012. We simply were afraid to do that because we did not want to disrupt what is a very fragile economic recovery. We have real cuts in 2012, but we get back to 2008 levels in real terms in 2013.

Second principle, we did not want to do anything that would harm the truly disadvantaged, and that is why if you look at the cuts we made in mandatory spending, we did not touch things like food stamps or unemployment or SSI. We left that off the table, the income supplement plans. And when you look at Medicare, we did a couple of things that made our job more difficult. We increased the minimum payment up to 125 percent of poverty to protect the truly disadvantaged, and we gave that 1-percent bump-up a year to what is called the "older old," people between 81 and 86. Both of those cost money, and in our plan we paid for that. But we wanted to do the right thing. And when we, yes, raised the retirement age, we did put in a hardship provision to protect those people that had those back- breaking jobs, those manual labor jobs, that really cannot work as long as we raised the retirement age. So we really did—our second principle, we tried to protect the truly disadvantaged.

Third, we do want to keep this country safe and secure. Now, I am not personally one that believes we can afford to be the world's policeman. But I will put it in more basic terms. I do not think this country can afford to spend more on national defense than the next 14 largest countries combined—and have enough money to invest in education, infrastructure, and high-value research, which we have to do in order to be competitive in a knowledge-based global economy that we all compete in today.

Fourthly, I do think we have to make these investments in education, infrastructure, and high-value-added research. It does not mean we have to spend money willy nilly. I just finished 5 years as president of the University of North Carolina. It is a 17-university system, and so I saw where some of your research dollars go. Today we have 375,000 research projects that you all are funding on 3,000 separate university campuses. Now, all of that is not great research. Some of it keeps us from going down a lane and, you know, it ends up dying, but it is good research because it keeps you from making a bad decision. And some of it actually ends up in something that is great. But some of it is not high-value research. In a time of limited resources, we have to spend our money more wisely.

Fifth, for God's sake, let us reform the Tax Code. The Tax Code is archaic. It was created when America dominated the world. We live in a global economy today. You saw it every day when you were at USTR. It is a fact. What we proposed was broadening the base, simplifying the Code, eliminating or greatly reducing these tax expenditures, bringing down rates, and using some money to reduce the deficit.

We went to what is called a "zero-based plan," and if you eliminate all of these $1.1 trillion worth of tax expenditures—I call them "tax earmarks." You all have been so bold to get rid of the $16 billion of earmarks in the spending part of the budget. But we have $1.1 trillion that we are spending in the Tax Code, and it is just spending by another name. But if you eliminate those, you could actually take rates to 8 percent up to $70,000, 14 percent up to $210,000, and a maximum rate of 23 percent, you could take the corporate rate to 26 percent, and you could go to a territorial system which will bring all of those trillions of dollars or billions of dollars back to the country that are captured overseas and create jobs over here. So I hope we will reform the Tax Code.

Last, we, too, have to cut spending, and we have to cut spending wherever we find it. We cannot just deal with domestic discretionary spending. You know, the Democrats, as near as I can tell from reading the paper or talking about cuts of $10.5 billion in discretionary spending and the Republicans are basically talking about $61 billion worth of cuts. Well, let me tell you something. Sixty-one billion dollars out of a $3.7 trillion budget is 1.6 percent. I can cut my budget 1.6 percent tonight, by tomorrow morning. I took $625 million out of a $3 billion budget at the University of North Carolina. The 1.6 percent is nothing. The problem is that you all are focusing on taking 1.6 percent out of a very narrow part of a budget, out of 12 percent of a budget, so some of the cuts are having a disproportionately adverse effect on certain groups of people. But if you are talking about the gross amount of $61 billion, hey, it is nothing. You know, we take $1.7 trillion out of discretionary spending, we take $430 billion out of health care spending, we take $215 billion out of other mandatory spending, and we get

Social Security solvent for 75 years. Our plan reduces the deficit by $4 trillion. It takes the debt-to-GDP ratio to 65 percent by 2020 and to 60 percent by 2023. It cuts the deficit in half by 2015 to 2.3 percent of GDP. The President asked us to get to 3 percent of GDP. And it takes us to 1.2 percent of GDP by 2020 and eventually to balance.

I came here today simply to ask you to act. I know these cuts are politically difficult, but this is not a decision we can postpone. We have to act and we have to act now. And if we do, the future of this country has never been brighter. We can compete with anybody. But we have to get our fiscal house in order.

Thank you, Mr. Chairman, for allowing me to come.

Chairman CONRAD. Thank you. I think you have made the case about as clearly and persuasively as it can be made. And I want to thank you both for, again, the leadership that you have provided.

Let me ask you this: What happens if this does not get done? In other words, Erskine—and I did not give all the bona fides of Erskine Bowles when I introduced him, but this is a man who was Chief of Staff to the President of the United States, headed the Small Business Administration, has been the administrator for the college system, the university system in the State of North Carolina. A pretty good set of bona fides. And at every place he has served, he has produced results.

Let me ask it again. So what happens in your judgment to the United States if we fail to get an agreement in the range of what the Commission concluded was necessary?

Mr. BOWLES. Hearing what he said about me reminds me of when my Uncle Sam died in North Carolina, and the obituary editor of the Greensboro Daily News called up to ask about him. And my aunt kind of went on and on about all the things he had done, and finally he said, "Now, Mrs. Bowles, you do know we now charge $5 a word for every word we put in the paper." She said, "Oh, no, no. I did not know that." She said, "In that case just put in there 'Sam died.'"

[Laughter.]

Mr. SIMPSON. I thought you were going to say the one about look in the casket and see if that really is your old man.

[Laughter.]

Mr. BOWLES. You know, Al said and I used to say that I got into this thing for my grandchildren. I have eight grandchildren under 5 years old. I will have one more in a week. And my life is wonderful and it is wild. But this problem is going to happen long before my grandchildren grow up. This problem is going to happen like the former Chairman of the Fed said or Moody's said, this is a problem we are going to have to face up to. It may be 2 years, you know, it may be a little less, it may be a little more. But if our bankers over there in Asia begin to believe that we are not going to be solid on our debt, that we are not going to be able to meet our obligations, just stop and think for a minute what happens if they just stop buying our debt. What happens to interest rates? And what happens to the U.S. economy?

The markets will absolutely devastate us if we do not step up to this problem. The problem is real, the solutions are painful, and we have to act.

Chairman CONRAD. Alan, do you want to add to that?

Mr. SIMPSON. I would just say—and I know it is repetitive—if you can understand here what the people of America—as we travel around and we do stuff, we go to the business councils, we go to the conservative group in Dallas, the policy institutes, the Panetta Institute, the Economic Club of New York, and wherever we go people get it. And then we tell them that if they just draw, pick, go to the Internet and go www.fiscalcommission.gov, it is 67 pages. If we leave that out, they will never read it, you see, because they will say, oh, my God, they worked for a year, must be as high as this box. It is not. And it was not written for pedants or politicians or panderers. It was written for the American people, and I uses terms like "going broke" and "shared sacrifice."

Let me tell you what was stunning for us. There has never been any sacrifice required of the American people since World War II—except for our military, God bless them, and that is the sacrifice. And they chose to do it. They are volunteers.

And so when someone says, well, you cannot use that word, well, the American people are using that word. It is called "shared sacrifice." And it is a puzzling thing. It is the right and the left. They are not involved in social issues deeply. Now this has risen to No. 1: jobs, very important, and this No. 1 or No. 2 is the debt. They understand debt, because in their own home they have been wiped out by debt.

The first thing that anyone did during this crash that had any brains at all was to gather their loved ones around and say, "We have to get out of debt." That is first. And you know my wife, Ann, and Lucy has saved you many times. She said, "Pay it off, Al. You guys from Cody are on credit cards. In Grable, we paid cash." So I said, "OK, it is a deal."

I think it will come before 2 years. I think that when the people that hold this paper look around and all you have done is cut waste, fraud, and abuse, foreign aid, Air Force One, Pelosi's aircraft, and all this and Congress pay, that they know that you did not get anywhere. You got to 5 or 6 percent of the whole, and they are going to say, "You did not do it." And then, of course, when the debt limit extension comes up, you have about 85 guys over there saying, "Hey, I am never voting for that under any circumstances." And they say, "Wait a minute," and then you will hear the cracking of knuckles and elbows as they say, "If you do not do this, you are going to impair the full faith and credit of the U.S. and might even have to shut the Government." And some of them are going to say, "That is why I came here." And at that point, there will be a sound of bone against flesh. But at that point, too, if they—I cannot imagine shutting the Government. Our party tried that once. It was just about the biggest disaster that I have ever seen.

So I am just saying that at some point, I think within a year, at the end of the year if they just thought we were playing with fluff, 5, 6, 7 percent of this whole, they are going to say, "I want some money for my paper." And if there is anything money guys love, it is money. And the money guys, when they start losing money, panic. And let me tell you, they will and it will not matter what the Government does. They will say, "I want my money. I have a better place for it." Who knows? Stabilize the euro, do this, do that, whatever. I am just saying, to me it will not be a year.

Mr. BOWLES. You know, I do not see how we cannot face up to it. You showed a chart, Senator Conrad, from Admiral Mullen. Admiral Mullen says it is our greatest national security problem. Think about that. You know, if you believe in investing in education and infrastructure and high-value research to be competitive in today's global marketplace, if you do not want those people creating that next new thing over there but creating it over here, there is not going to be any money for it. And if you are a business guy like me, you know, small businesses cannot grow and cannot create jobs without money. And, you know, they will be starved for capital if this budget continues to grow as it is today.

Chairman CONRAD. Thank you. My time has expired.

Let me just say we are going to go to 5-minute rounds, make an exception for Senator Sessions, but 5-minute rounds because of the number of people we have.

Senator SESSIONS. Well, the remarks you have just made are very sobering. It goes beyond the academic or theoretical to a warning of an immediate and dangerous threat that is before us. The language you used in your written statement, I noticed that it was pretty stark, and you used it, Mr. Bowles: "We believe that if we do not take decisive action, our Nation faces the most predictable crisis in history."

And I really, I cannot dispute that. The more I read about it, the more I believe that is true, and, therefore, I believe we need to take action.

Let me ask you to just share with us your thoughts about the President's budget, if you have had a chance to see it and if you think that is sufficiently decisive to alter the trajectory we are on.

Mr. BOWLES. I guess you want me to do that.

Mr. SIMPSON. I do, I do.

Mr. BOWLES. The president's budget, I think, on the domestic discretionary spending does a pretty good job if you look at it over an 8-year period. It has some gaps in it, like they talk about investing in transportation, but they do not tell you how they are going to pay for it. We said you have even got to cut transportation spending back to the level of income coming in, or if you are going to spend to the level you are today, then we proposed a 15-cent gas tax to pay for it. Your choice.

The total deficit reduction in the President's plan is somewhere between $1 and $2 billion. It is hard to tell. We propose $4 billion worth of cuts, so it was much less than what we proposed.

Chairman CONRAD. Trillion.

Mr. BOWLES. Trillion, excuse me. And I think that is about the minimum amount that should be done.

If you look at health care, we cut health care spending by $430 billion. His budget cuts it by $310 billion, but only $50 billion of that is specifics; the other is $250 billion worth of unnamed cuts. But I do not know where it is coming from. We did say how we would pay for all $430 billion of our cuts.

On other mandatory spending, we had about a $215 billion cut or 11.2 percent over that time period. In his cuts, he has about $60 billion for waste, fraud, and abuse, and we could not find anybody who could support more than $20 billion for that. So I do not know where that other $40 billion is going to come from.

On Social Security, we have a real plan that leads to 75-year solvency, and they talk about us doing something for solvency and also making sure that we up the minimum payment and we protect the basic payment and we get it solvent in the long run. And, of course, our plan does exactly that.

And on revenue, they, too, eliminate some tax expenditures, but they spend the money that they create by eliminating those tax expenditures. We take those tax expenditures, and the vast majority of it we use to reduce rates and to lower the deficit. So the overall effect of the President's plan I think falls short of what the country needs to do right now.

Now, I think the President has done a lot of good things. I think appointing this Commission was a bold step. I think in the State of the Union he showed us a little leg of some of the things he would cut. I think in the budget he went a little bit further. My hope is that he will show strong support to what Senators Chambliss and Warner are now trying to do. But we have to do more, and it is going to take the leadership of both Houses of Congress; it is going to take it from both parties; and it is going to take it from the President.

Senator SESSIONS. Well, the way we calculate it, it is not a $4 trillion reduction as you propose, but one basically as the President declares, and then we think that is incorrect scoring, and CBO will probably score the budget as not having reduced spending at all. So I really think it is insignificant there.

With regard to discretionary, I just want to push back a little bit. The $61 billion, we have calculated this out over—reducing the baseline $61 billion over 10 years plus the interest saved, assuming some steady growth or no growth or however you calculate it, but taking that baseline down 60 would result in a save of $850 billion, pushing $1 trillion. You proposed $1.7 trillion. I notice you shared with me the rather significant reductions you had to undertake at the University of North Carolina, 30 percent or some figure such as that. The $61 billion would amount to, as you noticed, 1.6 percent of the overall budget. And if you take it only on discretionary, it is about 6 percent. So I do not think that is harsh or extreme, especially in light of the fact that the administration has achieved a 23-percent increase in discretionary spending baseline in the last 2 years.

So I believe you are on the right track. I believe you are sharing with us the fundamental truth of the financial condition we are in. I do believe that the American people who benefit from Social Security and Medicare want to see us bring the wasteful Washington spending under control, too, that it should not be off the table. It should be on the table, and it results in real trillions of dollars in savings if we work at it. And if you combine that with the entitlement reforms that could take place, we would do pretty well, I think, in altering the trajectory.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you,

Senator WYDEN.

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Bowles, you correctly say that you cannot do serious deficit reduction just by cutting, and you cannot do serious deficit reduction just by taxing. What I want to do is make sure that as part of this debate we see that to really drive the deficit down, you have to do some serious growing. And to me, that is what the tax reform debate is all about.

In the 2 years after the 1986 tax reform bill was passed, we created 6.3 million non-farm jobs, twice as many as were created between 2001 and 2008. So we are clear—and you all have done an excellent job—isn't the heart of your interest in tax reform, that it will help us create more good-paying jobs and it is key to growth?

Mr. BOWLES. Unequivocally, yes. As you know, our plan has been called "Reagan on steroids." It was modeled after the Wyden-Gregg bill. And I believe that if we take such steps and we get rid of some of the inefficiencies in the Tax Code and bring down rates and reduce the corporate rate and get rid of this—get to a territorial system, then I think we have a chance to really create a lot of jobs in this country.

Senator WYDEN. Let me ask the two of you a technical question, and I am very appreciative of all the work that you have done with Senator Gregg and myself. You all propose an important budget enforcement mechanism—this is something I have talked about with the Chairman and colleagues in the past—but you did not include a mechanism that would keep us from backsliding on tax reform. And what concerns me is when you go back and look at the history of 1986, practically as soon as the ink was dry, as soon as Democrats and Ronald Reagan came to this historic kind of compromise, what you saw is the lobbyists went back to work and they kept packing in break after break after break, and pretty soon it added up to 15,000 new breaks added to the Tax Code between 1986 and 2005.

Do the two of you agree that this time as part of tax reform it is going to be important to have a mechanism in place to no longer have this easy backsliding so that a few years after you have put in place major historic tax reform you are not back in the same boat? I will let either one of you take a crack at that.

Mr. SIMPSON. Well, I agree with that totally, Senator Wyden. It has been so interesting to talk to people about the Tax Code, and we have people who—one person came and testified that Ronald Reagan was his hero, and I said, "Well, that is good because he is kind of my hero, too." And I knew him very well. This man was Grover Norquist. He has a job to do, and he does it beautifully.

I said, "Well, Ronald Reagan raised taxes 11 times in his 8 years." He said, "I did not like that at all." I said, "It is not whether you liked it or not. Why do you think he did it?" "Well, I do not know, but I am very disappointed." I said, "He did it to make the country run."

Now, we have to put triggers in there. We have to do things. But let me tell you what happened. People were talking about a VAT tax. I cannot understand how distorted things can get as if we were going to put a VAT tax on top of the present Tax Code, and that is the word. That was the word, the Bible said. They are talking about a VAT tax on top of this atrocity. If you did a VAT tax, you have to scrub everything off the board.

It was very difficult to deal with a VAT tax when the U.S. Senate, by a vote of 84–15 or something, said there will never be a VAT tax in the history of the world. The Rivlin-Domenici group talked about a VAT tax, and they probably get hammered a lot on that. But at some point these—we found that only 2 percent of the American people, the wealthiest in America, the connected, are using these 180 tax expenditures. That is who is using them. The little guy does not even know what they are. If he does a standard deduction, he has no concept of—well, I will mention this. I mean, bombs will fall: oil depletion allowance, mine land reclamation. I am from Wyoming. You know, if we were a country, we would be the largest coal-producing country in the world.

So we all took a terrible bite out of our ankles, and we are here. But unless you do something, these things are like the zombies that rise from the graves because this city is lined with people who make big bucks to go get it back. But this time they will not be bringing home the bacon. The pig is dead.

Senator WYDEN. Thank you.

Mr. Bowles, a mechanism to make sure that we have essentially tax enforcement from backsliding like we are going to do on budgets.

Mr. BOWLES. Absolutely. If you do not, you will end up right back where we are today. The top 400 taxpayers in the country pay a marginal rate of 16 percent. You know, Warren Buffett talks about he pays a lower rate than his secretary does. That is what will happen. The people that benefit from these tax expenditures are, by and large, people in the upper-income brackets.

Senator WYDEN. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator ENZI. Thank you, Mr. Chairman. It was about 37 years ago that Senator Simpson told me that I needed to put my money where my mouth was on this leadership stuff and get into politics, and I ran for mayor as a result of that. And God has winked a number of times, and I wind up here. He has been a tremendous mentor to me over the years, and I appreciate that both he and Mr. Bowles were willing to take on this task. And I appreciate the results that they haveten and the way that they have promoted it across the country. It needed to be done.

I was one of the cosponsors of the Conrad-Gregg bill and thought that that was essential and was disappointed when that did not pass and was elated when the President decided to do it anyway, and I thought that was a good step.

I have to say I was a little disappointed when the President missed the opportunity in the State of the Union speech to say exactly what you have been saying here today, to inform the people of this country of just how desperate the situation is so that we could take some positive action on it. And I was disappointed when the budget proposal came out because I think that was another opportunity for him to show exactly what you have been saying and to put some of those things into effect. And the biggest thing he did in there was take the tax expenditures and use them for new programs instead of reducing the corporate debt.

The American people have figured it out with your help, and they are getting it clearer and clearer every day. We have to get Congress to catch up. But, yes, there is a question in there somewhere.

[Laughter.]

Senator ENZI. My question is: You broke your recommendations into six areas: discretionary, taxation, health care, mandatory spending, process reforms, and Social Security. Now, I know that your task was to have a single vote on all of that, but given the fact that Congress has trouble doing comprehensive legislation, well, would it make sense for us to break that into six areas separately? Or do you think we have to do it in one big piece of legislation?

Mr. BOWLES. Alan can probably speak to that better than I can. What I can tell you is based on what our experience was. Before I do that, I want to address one of the things you said, that we had shown how desperate the situation is. It is only desperate if we do not act. If we do act, the future of this country is so bright, I cannot believe it. So if we just have the guts and the courage to stand up and do something that is real today in all six of those areas, then the future could not be brighter.

We originally started out thinking that one of the easiest things to do, since it was part of the President's request, was Social Security because you can kind of figure out how to get it to 75-year solvency and make it safe over the next 75 years. And we thought that was morally important.

Second, we thought we could do some of the discretionary stuff and thought we could make some progress there.

But as we went on through this process, we found that the bipartisan group really did coalesce around doing something that was comprehensive, and we got more support rather than less support when we were bolder and did something more comprehensive rather than trying to break it up into individual pieces.

Mr. SIMPSON. I think that we also felt that—you know, it is tough to keep anything together here. I remember that so well. But if we could just stabilize the situation, just stabilize things so that they know that it is just not on automatic pilot, that alone would be worth everything. I know that is—you would not challenge that, would you? No, I do not think. Of course you would not. You would try. But you would not.

Let me just say this: If you cannot get Social Security solvent for 75 years and this Congress cannot do that, you can forget everything. You will never get to Medicare, Medicaid, and defense. You will have failed what we see is the easiest thing to do, which is to restore solvency of Social Security for 75 years. Very clear what we do. We do not privatize it. We are not stealing from the old people. We are not putting people—throwing bedpans out of hospitals. That is not what we are doing. And people who use that are involved in massive fakery, at worst. And I do not use those words. I have many, many other words. Just as salty as Bernie can be. I have always respected him. I hope he comes back and asks some questions. We want to answer his questions about Social Security.

But if you cannot solve that, you are gone. Forget the rest of it. It will not work. It just will not work. It will not touch it with a stick.

Senator ENZI. I did appreciate your comments in the report about when we were doing the tax reform to have transition rules in there. I think that will make it possible to get it done. I am anxious to work on all of the ideas that you put forward and see a way to get them done.

Mr. BOWLES. But if we only do Social Security, we have not come close to solving the problem. It is just like if we only do domestic discretionary spending, you can get rid of all domestic discretionary spending, and you have still got a $1 trillion deficit this year. You really do have to do a comprehensive look at it. And I think you have to look at both revenue and spending in order to really solve the problem we face.

Senator ENZI. I think we do have to do all of them, but I still think we will have to do them kind of one at a time with agreement to do all of them so that we can get the trust of the American people. They do not think we are going to do anything.

My time has expired.

Mr. SIMPSON. But, Mike, with your skills at bipartisan work—and I saw how you worked with Ted Kennedy. You two did about 35 or 40 pieces of legislation. Nobody realized that. You always worked with the other side. Your gifts will be heavily called upon.

Senator ENZI. Thank you.

Chairman CONRAD. I thank the Senator. I first thank Senator Enzi because he has been a key ally in trying to advance a Commission approach. So, too, has Senator Nelson. In fact, after Judd and I lost the vote on our proposal—we got 53 votes, but we needed 60, and I was called to the Vice President's residence to negotiate the Executive Order Commission. Bill, Senator Nelson, volunteered to go with me, and I readily accepted. And I just want to say we would not haveten the Executive Order Commission without Bill Nelson's hanging in there and being tough. Also, I will forever be grateful for his assistance in negotiating the Executive Order Commission because that was a pretty tough negotiation as well.

Senator NELSON.

Senator NELSON. Well, thank you, Mr. Chairman.

Senator Enzi, the problem is that if we try to do these things one at a time, we will not get it done. You have to take that comprehensive approach. And I do not know how bad it has to get before we can get everybody to the point of being all willing to pull up and hitch up their belts to do a comprehensive approach.

Now, let me give you an example. You mentioned the six things, the six major components. Well, you know, one of them was health care cost containment. Well, you know, why should Medicare be paying the premium price for drugs instead of the discounts that the U.S. Government gets in the drugs for Medicaid? Well, we know why.

Why are there royalty payments that are not being paid for the extraction of oil from the Gulf of Mexico? That is a tax expenditure. Well, we know why.

So if you try to take individually items on, you are not going to be able to get—you are going to get beat because the powerful interests are there that can always beat you on an individual basis.

Now I want to ask a question. You all have put Social Security as part of this overall reform, and I agree that it has to be. But you also are quick to point out that nothing in the way of Social Security savings here goes to help the deficit. So other than the symbolic value of tackling Social Security for the long term, which is a notable goal—and which, by the way, was one of the finest achievements of the U.S. Government back in 1983 when Social Security was down to about 6 months before going into cardiac arrest. Everybody came together in a bipartisan way, and two old Irishmen, one named Reagan and one named O'Neill, got it done.

My question is: Other than Social Security, why does that have to be so much a part of it since it is not actually helping the deficit—which is what we are trying to get to right here—other than the symbolic value?

Mr. BOWLES. I think it is a lot more than symbolic. First of all, we had no choice. If you look at the President's two-part mandate, the second part of that mandate required us to look at the long-term entitlements and the effects they have on the country.

In addition, we really felt like we had a moral obligation to face up to Social Security. You know, we are not making this up. Social Security really does—the trust fund is exhausted—all of the interest earned on the trust fund for the funds that are lent to the general fund are exhausted in 2037—probably before that now because of what we did at the end of last year. And benefits will have to be cut by 22 percent. That is under current law. That is not something that we made up. It happens.

In addition, it is a fact that—I think I will just leave it at that. You know, we have made promises as a country that we cannot meet, and what we tried to do was to restore the solvency of Social Security for 75 years while protecting the most disadvantaged and, in fact, giving them a higher benefit so they could have some kind of quality of life.

Mr. SIMPSON. I think, too, that we have seen—at least I saw in my 18 years here—sometimes for budgetary purposes or, you know, gimmick figures, they will use the $2.5 trillion of Social Security as not counting it against the budget. And then sometimes they will count it. And when you have a figure of $2.5 trillion in surplus and people are saying that you stole it and all the drama that goes with that, it just seemed to us to let people know that if you do nothing and the howling and shrieking by these interest groups—and do not think we did not believe we would be savaged—savaged—in this country by what we propose by groups, and I will name only one. I was not the only living person that ever had a hearing on the AARP. They are still looking for me. But you cannot play games with it unless you just want to go up to all these toughies on the other side who are saying, "You rotten finks, you are going to touch my precious Social Security." Great, pal. Waddle up to the window. Your relatives in the year 2037 get 22 percent less and downhill the rest of the way. And there is no way to avoid that—you can appeal, you can pull out the Constitution—because it pays only payable benefits. It will not pay scheduled benefits.

And if everybody can wake up and figure that the thing they get from the Social Security, when you are 65, here is your scheduled benefit, it will not be there because you did nothing.

Chairman CONRAD. I thank the Senator.

Senator GRAHAM.

Senator GRAHAM. Thank you both. I really do appreciate what you have done for the country, and if we are wise, we will take some parts of what you have done, add it with some of our wisdom, if we can muster any, and do something. And if we are politicians who are not wise, we will all get beat. I think America really, really wants us to do something.

Can you imagine a budget being generated by a Republican or Democrat that does not have meaningful entitlement reform and that would be a serious effort to solve our financial difficulties?

Mr. BOWLES. No.

Senator GRAHAM. Can you imagine any scenario where we can save Social Security from impending massive cuts, 30 percent in 2037 or maybe more, or any entitlement program without adjusting the age for eligibility? Is there any sensible way to do it without adjusting the age?

Mr. BOWLES. You can do it without adjusting the age mathematically, so yes. But we thought you should adjust the age.

As you know, you are not eligible for Social Security at 65 today. You are eligible at 66. And under current law it goes to 67 in 2027.

Senator GRAHAM. Senator Simpson, can you imagine any scenario of saving Social Security and Medicare or getting our debt situation in better standing without adjusting the age of eligibility?

Mr. SIMPSON. Well, I think it is impossible. The average age is 77. It is going to go to 80. As I say, 63 was the life expectancy and 65 was the retirement. Now you can retire at—you used to be able to retire on Social Security and you might live 3 or 4 years. Now you retire on Social Security and you may live 20. So how is that supposed to be when there were 16 people paying in and now there are only two people paying in, in 10 years.

I tell people, read the trustees' report on Social Security. It has been done by Democrats and Republicans for years.

Senator GRAHAM. Now let us build on this. Can you imagine a scenario of saving Social Security from bankruptcy or major cuts without some forms of means-testing of benefits?

Mr. BOWLES. Again, arithmetically, you can do it, but it is not what we would recommend.

Senator GRAHAM. Now, both of you talk about sacrifice. The one thing we like around here is patting ourselves on the back, how brave we all are. I would argue that nobody in this room, including both of you all, is doing anything near like going to Afghanistan. So let us put this in perspective.

All we are asking people to do is to do things that make sense. The sooner you do it, the better off we all are, because if you do it sooner, that means the solutions are not as draconian. So let us talk about means-testing and sacrifice.

If you took an idea that said that if you make $50,000 or less in income, including Social Security, you would not have your benefits adjusted, what would that mean for the people that make over

$50,000? You would have to have your benefits reduce somewhat. Is that correct, Mr. Bowles?

Mr. BOWLES. You would probably have to slow the rate of growth win the benefit.

Senator GRAHAM. Right. For a guy like me——

Mr. BOWLES. You really would not have to have the benefits reduced.

Senator GRAHAM. You know, when I was 21 my mom died, when I was 22 my dad died. My sister was 13. Social Security Survivor benefits came to my sister. It made the world of difference. I am 55. I do not have any kids. I am making 170,000 bucks a year. I am going to have a military retirement, hopefully a congressional retirement. What would it mean for someone in my income level in actual—the difference between what is being promised and what would be paid? Do you have any idea how much it would affect my benefits if we did a means test for people in my income level?

Mr. BOWLES. I do not know exactly.

Senator GRAHAM. Would it be $100 a month, $200 a month?

Mr. BOWLES. I cannot tell you exactly.

Senator GRAHAM. Could you get me that number?

Mr. BOWLES. Sure.

Senator GRAHAM. Because I believe it is going to be very small.

Mr. BOWLES. And one of the things I can tell you is that your benefit actually would not be cut. The rate of growth in your benefit would be at a slower rate.

Senator GRAHAM. So means-testing is not cutting anything. It is paying people what you actually can afford.

Mr. BOWLES. Yes. What it does, it grows it at the rate of inflation rather than at a higher rate.

Senator GRAHAM. So you have a progressive price indexing.

Mr. BOWLES. Yes.

Senator GRAHAM. Senator Simpson, do you think that is a smart idea for us to embrace?

Mr. SIMPSON. Well, I think anything—what I tell people is this: I am 79, and so I see these people in the room, you know, with their signs and all sorts of activity. I say, "Wait a minute, pal." I put $5 bucks in it when I was 15 and worked at the Cody Bakery. I was in the army, and you did put it in when you were in the army. Not now. And for the most productive years of my life practicing law in Cody, I never put in over 874 bucks a year and neither did any other guy in the United States. This is fakery. Then I got stuck for $1,200, $1,400, $2,000, $4,000, $5,000, finally on up. But let me tell you, you are going to get it all back. In 1983, we found that the guy who got out got everything back plus 6 percent interest in 3–1/2 years.

Senator GRAHAM. Would both of you urge the Congress to take up Social Security reform as part of this effort to bring about fiscal sanity?

Mr. SIMPSON. Without question.

Mr. BOWLES. Absolutely, unequivocally, yes.

Mr. SIMPSON. Got to.

Senator GRAHAM. Thank you.

Chairman CONRAD. I thank the Senator. I thank him for respecting the time as well. I appreciate that very much.

Senator CARDIN.

Senator CARDIN. Well, thank you, Mr. Chairman, and let me thank both of you for your work.

I think you have the right formula, and each element will be controversial. We understand that. So let me deal, in the limited time that I have, with the one dealing with the revenues. And I know that you have already had some discussion in regards to consumption taxes, but I want to carry it to—make a point here.

We get around to tax reform, if we are lucky, about every 25 years, so it is important we get this right and that we have a goal in your report to have revenues equal to about 21 percent of our economy. That is a revenue goal that could be achieved through the reforms in the income tax that you have outlined, or it could be by using some consumption taxes as well as using our income tax. But the revenues would be the same.

Now, I mention that because since we passed the last major tax reform in 1986, our Chairman frequently points out that there are now 140 provisions in the Tax Code that have been added, that have been added temporarily and need to be reviewed for extensions on a regular basis.

My concern is that if we were to pass the recommendations of the Commission, it is unlikely that that would stand for very long before Congress would once again, for reasons of political expediency, us the Tax Code rather than the revenue code in order to carry out some policy. I think we are safer if we use less income tax revenues and we have more consumption revenues to equal the dollars that we want to bring in.

And I also point out the realities of competitiveness and the fact that during the best of times this Nation did not save enough, and our policies need to reward savings. Senator Portman and I worked together in the House to try to encourage more savings for Americans, and our Tax Code certainly has not been terribly helpful in rewarding savings.

And, last, we know that the income taxes, the corporate income taxes are not border-adjusted, whereas the consumption taxes are border-adjusted in international trade, which puts American manufacturers and producers at a disadvantage.

The argument I hear the most against consumption taxes is progressivity, but we can make a consumption tax progressive, and we have ways of doing it. One of my goals is to make sure that at the end of the day we bring in revenues in a more progressive way, not a less progressive way, than we currently bring in the revenues of this Nation.

So having said all that and knowing full well that you all really did your best to put forward the policy objectives that this Nation needs, we are certainly realistic to know that your proposals are going to be politically controversial wherever you went.

Could you just share with me why we should not be considering as a matter of policy less reliance on income and more on consumption, knowing full well the history of Congress in changing the Tax Code?

Mr. BOWLES. I will be glad to do that. Let me tell you why it is not in our plan. It is pretty simple. About a week before we started, the U.S. Senate voted I think 85–14 and it did not look to me like the odds were too great we were going to have a consumption tax. Second——

Senator CARDIN. Well, you know, I am going to stop you on that because a lot of us were tempted to put in similar resolutions on Social Security, similar resolutions on every one of your proposals, and I daresay we could haveten 85 votes on the floor of the Senate on each one of those individual recommendations. I think it was terribly irresponsible for the Senate to take up that resolution.

Mr. BOWLES. I am just telling you why we did not do it.

Senator CARDIN. I understand.

Mr. BOWLES. There was no opposition on the Commission, as near as I could tell, to a VAT tax or a consumption tax in theory. In theory. Most people believe that it is much better to tax consumption if you can do it on a progressive basis than it is to tax wages or investments or savings. You have to make it progressive, but there was not a lot of opposition in theory on either side of the aisle.

Where there was enormous concern was that we would end up with two engines of revenue. We would end up with an income tax that would be escalated, and we would end up with a consumption tax, and you would have two engines out there fueling revenue and fueling the tax rate. And that is why there was not support for it in our Commission. It was not the theory that it is better to take consumption.

Senator CARDIN. Well, I feel better getting that explanation because—and I would just conclude on this point. We want the best policy objectives. Future Congresses are going to act regardless of what we do in this Congress on these recommendations. I just think we are safer having a Tax Code that is less likely to be changed in the future for social reasons than we currently do under the income tax.

Mr. SIMPSON. I think take a good look at the Domenici-Rivlin report because they had the courage to put that out there. And we talked together, we visited with them, but we felt because of that resolution in the Senate we were just ramming our heads into the wall.

Chairman CONRAD. Let me just say on this point, exercise the privilege of the Chair for a minute. I argued strenuously for a VAT tax or a consumption tax in whatever form to be part of the package. And I do so in part based on the recommendations the Commission received. We brought in the best tax experts in the country, Republicans and Democrats, progressives and conservatives. Their recommendation to us was to go to a hybrid system—part income tax, part consumption tax—not layer one on top of the other in the sense of adding additional revenue as a result, but displacing part of the income tax system so that we could lower rates, especially corporate rates, to help America be more competitive. And we had the proposal from Mr. Graetz to adopt a hybrid system with part of it being consumption tax and to take 100 million Americans off of income tax rolls completely. A hundred million people no longer would have to file income tax returns at all, and you would achieve the same amount of revenue that is in the Commission plan, but you would do it with a hybrid system.

So, look, we understand the politics of it, but I did want to take this moment to explain the position that at least I took.

Senator Portman.

Senator PORTMAN. Thank you, Mr. Chairman, and I want to thank both of you for your service on behalf of the people I represent in Ohio and on behalf of our country. You know, most Commission reports end up collecting dust on a shelf somewhere, and there is an opportunity here for this to be a seminal report, to really change the direction of our country. It depends on what Congress does. And you have given us the opportunity to make these necessary changes.

To Alan Simpson, he mentioned that I worked for him at one point. He inspired me to take a shot at elected office, which means you are going to be blamed for even something additional now.

Mr. SIMPSON. Both of you now.

Senator PORTMAN. That witness protection program will have to be even better. And, Erskine, thank you for your service. When you were Chief of Staff at the White House, we worked closely together. Ben Cardin and I did some work on increasing savings and helping in retirement, and I do not think it ever would have been enacted into law without your intervention. I recall that and your willingness to step out of the partisanship and into solutions. And that is what you have done in this report, so thank you.

Because you always spent so much time on this, I have three quick questions for you, just to get your thinking on it. Two we have already discussed briefly—tax reform and Social Security—but just on tax reform quickly, do you think from all the testimony you heard that the proposals that you have will not just have the impact that CBO and the Joint Committee on Taxation would indicate from the scoring but also will make our economy competitive?

Mr. BOWLES. Yes, no question.

Senator PORTMAN. So that is an intangible that is really not represented in the numbers that you are providing which can help to grow the economy and, therefore, to grow revenues.

On Social Security, we will hear later today, I am sure, and we have heard all along that Social Security is not adding a dime to the deficit and it is in good financial condition. Do you agree with that?

Mr. BOWLES. Well, it is $45 billion cash negative today, and it is expected to stay cash negative for the foreseeable future.

Senator PORTMAN. That is based on the Congressional Budget Office report recently?

Mr. BOWLES. Yes, sir. What people sometimes forget is that when somebody my age goes to collect on their Social Security, I want money, cash. And I go to present that obligation to the Social Security Trust Fund, and it does not have cash. What it has is the Government IOUs there, which are as good as gold. But the Government has to go out into the marketplace and borrow the money.

Senator PORTMAN. Borrow the money.

Mr. BOWLES. And so it increases the national debt. So, in essence, what we are doing, since half the money is borrowed from foreign countries, at least half the money I am getting is coming from some foreign country to pay my Social Security.

Senator PORTMAN. That is a very good way to put it. I think that is the reality. I am glad you addressed the issue in the report and also talked about it today because it is adding to our debt.

The final one is the toughest one of all, which is: What is the economic impact of all this? There are some folks out there, as you know, who study this who have said recently that if we reduce discretionary spending it will result in job loss. It is called a Keynesian model where Government spending being reduced equals a certain amount of less economic activity, therefore job losses. These are the same folks, you will recall, who looked at the stimulus package and said that roughly $800 billion—over $1 trillion when you add interest on the debt that had to be paid for because we had to borrow money for it. But those folks said that our unemployment would be 8 percent last year and would be 7 percent this year. Now, that has not happened, but now they are saying that if we reduce spending by the 1.6 percent that you mentioned earlier, Erskine, there would be a great loss of jobs.

You have looked at this carefully, and earlier you talked about the potential of financial crisis. You talked about small businesses being starved for capital if we do not do something. What do you think the economic impact would be of reducing spending along the lines that you have recommended?

Mr. BOWLES. I am not an economist and do not want to pretend that I am. What I am is a pretty decent business guy, and what I can tell you from a career as a business person and from heading the Small Business Administration, small businesses cannot grow and cannot create jobs without money. And if we do not tackle this fiscal mess that we have today, then small businesses will be crowded out of the marketplace, and there will be fewer jobs, not more jobs.

If you are really concerned about jobs, then we have to tackle this fiscal problem at home.

Mr. SIMPSON. And we did realize throughout the fragile nature of an emerging economy which seems to be happening, except, of course, the jobs do not meet the expectations. But people, I do not think, when you are all through with what we have done, will say that this was a failed Commission like all Commissions, because you, Senator Portman, were involved deeply with the Select Commission on Immigration and Refugee Policy, and we did two major pieces of legislation—legal immigration and illegal immigration—and with that bill brought 2.9 million people out of the dark to obtain legal status in America.

I was on the Iraq Study Group. That was not a failure. This last administration did not accept maybe four or five but 50-some of those 79 recommendations have been adopted. These are not feckless things. And this one ain't going away. This is a stink bomb in the garden party.

Senator PORTMAN. Thanks for your good work.

Chairman CONRAD. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you all for your work on the Commission.

I wanted to ask some questions about an area I do not think anyone has touched on. If they have, I apologize. But addressing really the health care provisions and the steady elimination of the deductibility for businesses of the costs they spend on health care. I believe the way you have laid it out is that the deductibility be limited to the 75th percentile in 2014, stay steady for 4 years, and then be phased out over the following 20 years.

The first concern I have is that I can imagine immediate response in which employers say, Well, we are going to reduce the size of our package down to the area that is tax deductible, and to do that we are going to have employees pick up a lot higher co-pays, a lot higher share of their insurance and so forth, which sounds an awful lot like an immediate, very regressive tax on working Americans. And so I just wondered if you all could touch on that for a moment.

Mr. BOWLES. I do not think that is the case. What I think you will see is, first of all, every business in the world, whether it is a small or large business, has raised the deductible, raised the co-pay, reduce the benefits in order to offset the increased costs. And that is a fact of life that we have all had to live with during the last—you know, at least as long as I have been in the business world. And I do not know any business that has wanted to do it but it has been forced to do it. So I think if we do nothing and we take the ostrich theory, then I think you will see that continue into the future.

Health care is the biggest single problem that we face from a fiscal viewpoint. If you just look at Medicare and Medicaid and the CHIP program, it is about 6 percent of GDP today, and it is going to go to 10 percent before you know it. And that does not even count the $276 billion it takes to do the doc fix or the $76 billion to fix the CLASS Act.

We think we are going to have to stand up to that, and we have proposed some pretty aggressive proposals as it relates to Medicare, Medicaid, to the tax deductibility, as you mentioned, that we felt were responsible in order to meet the fiscal challenges that the Nation faces. The problem is we have made promises we just cannot deliver on.

Senator MERKLEY. Well, I am not sure you have really made me feel any better about this, because I think what I have described is kind of the reaction of a normal business. If you increase the cost of providing that particular benefit to their workers, they are likely to decrease it. And the way that they have done that is to increase the co-pays and the share that is being picked up by the employees.

But the other reason I am very concerned about this is that, in the context of health care reform, there was a premise of companies continuing to provide health care. And if indeed you set up a situation where employers say, hey, without the tax deductibility of these benefits, we are simply going to shut that down; we will provide benefits to our employees in other ways, that results in a huge cost shift from the private sector to the public sector, actually increasing the size of the deficit.

So I am wondering if you have modeled this out into the future, because it sure looks like something that is going to increase public deficits and public debt into the future rather than reducing them.

Mr. SIMPSON. Senator, let me wade in. This was a monster, and we could not even wrap our arms around it. That is where health care is. All you have to do is think of things in your own family or in the family down the street where, in the last 10 years of life, there is air flight, there is hospice, and maybe in 2 weeks you can run up a bill for $400,000. That is just Cody, Wyoming.

There is a way to do this. You cut providers and you reduce physicians' fees, you increase co-pays for patients, and you begin to affluence test those. And you get one set of books in a hospital instead of tow, and you do tort reform by the use of health courts. And we have recommended all those things. Now, is that tough. You will not want any of that. But let me tell you, leave it like it is and it will eat a hole through everything you love in the discretionary budget.

Senator MERKLEY. My time is up, but I will just mention that there are a number of concepts, including the House-passed bill, to get rid of the exemption from antitrust that health care currently employs. There was a lot of discussion of a public option. A public option in Oregon in workers' comp decreased the costs by half, and my colleague from Rhode Island said that when they adopted it in Rhode Island it had the same impact. The ability to negotiate the prices of drugs in Medicare on the same rhythm that we do in veterans would save $60 billion over 10 years. So there are many, many approaches other than a short-term transfer onto the working Americans of health care costs.

Thanks.

Chairman CONRAD. I thank the Senator.

Senator THUNE.

Senator THUNE. Thank you, Mr. Chairman, and I want to thank you, Mr. Bowles, and, Senator Simpson, welcome back. You did a terrific service with your work, and although I did not agree with every piece of it, the body of work I think was exceptional, and I think you gave us, if we want to follow it, at least a pathway to start to get this fiscal situation under control. And because you were attacked by both the right and the left, I assume you were trying to find the spot right there in the middle that might be able to attract a level of support that would be necessary to actually enact something around here.

I do want to ask a couple of questions—and I think it has been talked about a little bit already, but maybe get you to elaborate a little bit on it. If we were to adopt—the President's budget this year did not address what many of us thought it should have, and that is, some of these issues of entitlement reform. If we were to adopt the President's budget, how does that address the long-term structural issues and problems that you have identified in your work and seem to be—some of the recommendations that were included in your work seem to be absent from the President's proposals?

Mr. BOWLES. I can answer that pretty straightforwardly. First of all, I do not think anybody on our Commission agreed with every part of the Commission report. I sure did not; Al did not. I know that the Chairman did not. So we all kind of held our nose and swallowed some of the things that are in the Commission report for the good of the country.

The President's budget, again, as I said earlier, I think does a relatively good job of dealing with the domestic discretionary spending cuts, but it does not step up to, nearly to the extent I believe it should, the defense cuts that are necessary or the cuts that are needed in health care or reforming Social Security so it is solvent for the next 75 years.

Mr. SIMPSON. I think, Senator Thune, it is much like the Republican response, which both of them are just light budget efforts.

Senator THUNE. I do not know if this has been mentioned, but former Fed Reserve Chairman Greenspan recently said the U.S. could face a bond market crisis if politicians do not act soon to start cutting the Nation's debt. And he remarked that the probability of that happening in the U.S. in the next 2 to 3 years is 50 percent. Do you agree with that assessment?

Mr. BOWLES. I do not know what the percent is, but let me just tell you how crazy our situation is today. We have this treaty where we are supposed to—if China were to attack Taiwan, we are supposed to support Taiwan. The only problem is we would have to borrow the money from China in order to do it.

You know, this is a real mess we are in today, and we can either take the ostrich theory and put our heads in the sand, or we can decide we are going to step up and do something about. But I can tell you, bankers are not going to continue to finance something that they are not sure they are going to get paid back. And the less sure they are, the more they are going to charge you at first, and then they are going to cut you off. And we are borrowing half of our money from foreign countries.

Senator THUNE. How do we translate that—and a lot of times when we talk about these things here, we talk about it sort of in the abstract. How do we translate that, the American people personalize it so that they in their personal lives or family lives understand what the implications and impacts of our not acting are? Because I think in many cases they respond to the attacks that are made that this program is going to be cut or this program is going to be cut, and it is hard, once you focus on the specifics, to get the kind of support that you might get when you are talking in the general term about the need to reduce spending and debt.

How do we translate this into terms? What does this mean to the average American family if we do not take steps to fix this mess?

Mr. SIMPSON. Senator Thune, they have already got it, because here on this level we or you or I used to talk and say, How are the people handling this at the kitchen table. Well, I will tell you how they are handling it. They do not need any charts, nothing. They just say if you spend more than you earn, you lose your butt; and if you spend a buck and borrow 40 cents of it, you must be stupid. And that is what they know, and that is why they are with us.

When we travel this country, they understand this because that is all you have to say. You are borrowing 40 cents for every buck you spend. And they know that if they did that in their own home, they are out, you know, in the bow wows. It is over. I do not know. They get it.

Senator THUNE. All right. My time has expired, Mr. Chairman. Thank you.

Chairman CONRAD. Thank you, Senator Thune, and thanks for respecting the time.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Chairman. Thank you, gentlemen.

Back to health care for a minute, health care consumes about 18 percent of America's GDP right now, and the closest country is at about 12 percent, the worst. So we are half again as bad as the worst country in terms of the efficiency with which we deliver health care. We do not get better outcomes for it. The rate of increase is—it is not just going up. The rate is accelerating. So it strikes me that we have a real problem on our hands in health care, and it is not just an entitlement problem. It is a health care system problem, because the cost increases in our health care system are clobbering the private sector just as strenuously as they are clobbering the public programs.

And so I do not think we can entirely fix the health care system just by trying to cut benefits in the health care programs that Government supports. There is an underlying cost problem in our health care system that I think has a lot to do with our sort of Rube Goldberg design of the health care system, although it is worse because Rube Goldberg's was kind of accidental. In this Rube Goldberg diagram, every party has a motive.

So I think there is a lot of work being done to try to correct and reform the system as it goes. The areas that are obvious are the quality improvement movement that is out there. We spend $2.5 billion a year treating what should be completely avoidable hospital-acquired infections. You could zero that out if you could get rid of those. If we could figure out which prevention methods actually save money, we could invest in those and that would save costs overall. A really robust information technology platform can make a huge difference and, frankly, generate new private industries. We can start paying doctors better for results instead of just for amassing as many procedures as possible. And the overhead can be driven down a lot. There is a great deal of overhead that goes into the totally unproductive warfare between insurers and doctors over getting paid. They now have armies of consultants and staffers who fight with each other over getting paid. That is all on the health care system, and it does not provide a nickel's worth of health care value.

You stack all of those up, there is quite a lot going on. And there are some very big outfits that are pursuing this stuff and have a lot of confidence in it—Kaiser, Geisinger, Intermountain, Gundersen Lutheran, Mayo—and they are seeing real cost reductions, and they are seeing real quality improvements.

If you look at the President's Council on Economic Advisers report, they have calculated that the savings available from this is about $700 billion a year. New England Health Care Institute puts it at $850 billion a year. Secretary O'Neill, working with the Lewin Group, has calculated it at $1 trillion a year. Do we know the exact number? But it looks like it is a really, really big number.

So if you agree with that, I would urge you, as you are discussing this issue, to really focus on this question of delivery system reform and the win-win that is possible from improved care, improved efficiency, and improved experience of care, all lowering costs. It has one big flaw, and that is that CBO and OMB cannot predict it because it is a process of learning and experimentation, as Dr.

Gawande has said. We know there is good stuff to be done out there. We can have confidence in our ability to get there, but we cannot predict the dollars.

So when you get down to a budget discussion, my fear is that this incredibly significant opportunity gets shoved off the table because nobody says, ah, I can put this dollar figure at it, and you all in generating your reports need to be able to put a dollar figure on it.

So I guess my appeal is do not give up on that just because it is not cost-able. It is probably the biggest and the best thing that we can do for our worst and most severe long-term budget problem, which is the health care piece of the system. And, unfortunately, I do not see as much as I would like to about that in your report. Even if you put it in as a footnote saying, look, we cannot measure this, we understand why we cannot measure this, but it has a huge potential, and we should focus on that potential, because it worries me we are not getting that.

Probably one of the best people in the world on this is act Don Berwick, and yet he is under constant attack right now because he did not come here and get confirmed properly. Well, fine, but we have a national emergency in this area. We have the chance for a huge win-win by reducing the costs in these big numbers. Let us not throw that baby out with the bath water just because we do not have a number. And the more you ignore it, the more things like attacking Don Berwick begin to seem like an OK idea instead of a really suicidal step. So I urge you to consider that as you go forward.

I am sorry to speechify during the question time, but I just think it is so important and so frequently overlooked, and it is a constant frustration, and I hope, if you agree, you will give it a little bit more air time.

Mr. BOWLES. I actually do agree, and I have actually done it.

Mr. SIMPSON. I do, too.

Mr. BOWLES. I was vice chairman of Carolinas Medical Center, the seventh largest publicly held hospital company in the country. After that, I headed the University of North Carolina's public health care system, the largest provider. What you are saying is exactly right. It is not, unfortunately, scorable, and that is why it is not in our report.

Senator WHITEHOUSE. Thank you.

Mr. SIMPSON. And when I was here, Senator, we had a bipartisan group of John Chafee and John Breaux and Nancy Kassebaum and Dave Pryor, and we worked for months, and the problem was—and it is a terrible thing to say, but nobody ever understood it. And that is why it is like this. You go to the floor, and you do an amendment, and it is something good. Somebody sticks it on and nobody understands the impact. But I agree with what you are saying. You have gone to the core of it. I think those figures are correct, 4800 billion. But, wow, we—there are people who use terms hoping that you will feel inferior enough not to ask any questions.

Chairman CONRAD. Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman, and I would like to thank both of you for putting forward a serious proposal. I think it is absolutely essential that we mobilize the American public so they understand how urgent the problem is. And I think one of the ways we do that is—and we hear this term "debt crisis" all the time. Can you describe in layman's terms what a debt crisis is going to feel like? How is it going to affect a family, an individual? Not just in theory but in layman's terms, what is that going to do to a family?

Mr. BOWLES. Their interest costs in every single thing they have are going to rise and rise relatively rapidly. The quality of education that they can provide their schools is going to erode. Their university systems are going to—the research they do is going to evaporate, and, therefore, the likelihood of that creativity creating the next new thing here rather than somewhere overseas is less, so, therefore, less likelihood that there will be a new job, even if you are trained for that new job down the road, less likelihood that the training funds will be there to train them. Their roads, their bridges, their highways will be less. There will be fewer cops on the street. It will affect them in every way possible.

Senator JOHNSON. It is not going to be pretty.

Mr. SIMPSON. And, excuse me, Senator, the guy who gets hurt the worst will be the little guy that everybody always talks about. That is who is going to get hammered when that happens.

Senator JOHNSON. I do not think we can make that point loudly enough.

You touched on one question I wanted to ask in terms of how do we redeem these Social Security bonds. I mean, we talk about the system is solvent to 2037, but that is by redeeming these bonds. In your fix, did you fix that on a cash-flow basis? Or how is the $2.5 trillion that we are either going to have to tax the American people again for or borrow from China, how is that accounted for?

Mr. BOWLES. We did a couple of things. On the revenue side, we raised the minimum payment that somebody would be taxed upon. Today it is capped at $106,800. Naturally it will grow to $168,000 by 2020. We took it to $190,000 by 2020. So you would pay that tax on the differential, on $22,000. And we reduced the rate of growth in benefits being paid to people at the higher levels because we changed what is called the BIN rate, and we changed the eligibility age, and we also changed the rate of inflation to what is called chained CPI, which is a slightly lower rate of inflation than the regular CPI.

Senator JOHNSON. So, again, you did account for the fact that $2.5 trillion needs to be raised in some way, shape, or form, and you have accounted for that dollar amount?

Mr. BOWLES. Yes. It has to be.

Senator JOHNSON. OK. You know, you are projecting or you are proposing that we increase revenue to 21 percent of GDP. In the President's 2012 budget, we have only—we have never hit 21 percent of GDP in terms of revenue. We have hit it close three times: in 1944, in 1945, and I think the year 2000. I kind of subscribe to Hauser's Law that says no matter what the tax rates are, we are going to get about 18.8 percent of GDP in terms of revenue. How do you overcome that? Again, I am kind of a reality-based guy. You know, I am one who looks at real factors and figure.

Mr. BOWLES. Me, too. I looked at the forecast. I saw that revenue was forecast in 2020, I think, to be approximately 19 percent of

GDP. Spending was about 25 percent of GDP. That was 6-percent gap. I have had to figure out how in the world are we going to close this gap. I wanted to close the vast majority of it on the spending side, so we took somewhere between two-thirds and three quarters out of spending. Therefore, we had to—I wanted to get to a balanced budget. I had to do some on the revenue side. Historically, we have balanced the budget always, you know, as you said, at a level below 21 percent of GDP. And so I thought that was the maximum level we could get to, and I also thought it was probably one of the lowest levels we could get spending down to.

Senator JOHNSON. But no matter what the rates we have taxed people at, we have never raised on average more than about—well, never raised 21 percent.

Mr. BOWLES. Right. That is why we said that ought to be the maximum level, I think is what our report says.

Senator JOHNSON. OK. I guess one final question. I do not subscribe to the theory that it has to be comprehensive reform. I mean, I think the American people want single-issue bills. They want to be able to understand what we are trying to do here. So with that in mind, did you make any attempt to prioritize the components of this in terms—you know, obviously Social Security is No. 1, I think, in your book. But did you prioritize the other recommendations if we did this in a piecemeal fashion?

Mr. BOWLES. We did Social Security separately because we thought we were doing that not for deficit reduction but for 75-year solvency to save Social Security. We did not prioritize the others. We looked at it in a comprehensive basis, because I believe you have to do all of it, you know, not just one little bit of it, if, in fact, you are going to deal with this $1.6 trillion deficit in a fiscally responsible manner.

Senator JOHNSON. Thank you.

Chairman CONRAD. Thank you. Senator Coons.

Senator COONS. Thank you, Mr. Chairman, and I just want to start, as has every other member of this panel, by thanking you for your service to the country in previous administrations and in the Senate and for your willingness to take on this thankless task, but one that, as you said at the outset, you took on for your grandchildren, for your communities, for our country. I think all of us agree that we are in a debt and deficit crisis and one that I would welcome your elucidating a little bit further just what the consequences would be for, as you put it, Senator, the little guy, because I am convinced that if we do not tackle this in the next 2 years, the consequences for the American economy, for our competitiveness, and for our long-term future are drastic.

I want to commend you for tackling six different significant areas and for your core principles, with which I agree. And Tax Code reform is the piece that I am going to focus on and that I am interested in. It is my hope that part of your assumption is that if we made this significant changes, the zero-based budgeting approach to sort of scraping clean all the tax expenditures, lower the rates, that there would be greater growth and some possibility of higher receipts than the 18.8 percent referenced by Senator Johnson.

Please tell me, if you would, three things. First, give us a picture in a little more detail about how it might unfold if we fail to take these steps. How would it unwind that rates would go through the roof and the consequences for the average folks of America would be felt? And how do we stay on top of a sense of when that is going to happen? Because my sense is it may happen very suddenly and without a great deal of warning. First.

Second, we talked earlier about the need for a long-term mechanism to restrict not just growth in spending but to also prevent the re-emergence of a lot of tax expenditures, doing all the hard work of fixing the Tax Code, some mechanism that would prevent it from then being undone. Any suggestions in that field would be welcome.

And then if we have a minute or two left, something about the health reform ideas. You have a significant amount of cuts here, more than $430 billion, that have not been touched on in the two previous senators who have asked specifically about the health portion of it, if you would.

Mr. SIMPSON. Well, Senator, let me just address the tipping point, because your colleague, our colleague—I think it was a colleague, he was of ours—in the Commission, Senator Durbin—kept asking, Where is the tipping point? And we kept saying, We do not know. But some say 2 years, some say three.

I happen to say it all depends on how far the Congress goes in getting to the meat of reducing a $14 trillion, which will be $300 billion, $14 trillion $300 billion debt, and the deficit of $1.6 trillion or $1.7 trillion. It depends on that, because the people who hold our paper are not going to be patient and they are going to say, You did not have the guts to do anything, you romanced the stone again, you did not do what you are supposed to do, and we want some money for our paper.

It is my experience that big guys take care of themselves and they will take care of themselves. That is how we got in this huge slosh of a recession. The fat cats took care of themselves, and the little guy will get stung. That is all I know and that is what I keep talking about. It does not make any sense to anybody when you talk about getting the paper for the money, but that is what it is, and the bondholders are not just gentle people.

Senator COONS. And what kind——

Mr. SIMPSON. And he can handle the tough question.

Senator COONS. What kind of mechanism might we put in place to keep tax expenditures from ballooning once again?

Mr. BOWLES. We did a couple things. We put a fail-safe in there on the tax side that said if Congress does not act by 2012, then you have an automatic, across-the-board reduction in tax expenditures. I think that would get you to move.

We also had another fail-safe in there that if the deficit to GDP was greater than what is called primary balance, which is 3 percent, that the President had to submit a proposal to get it to 3 percent. This was by 2015. That was his date he picked, so that is why we went with that. Or if the debt became unstabilized, after that it began to grow again, then the President would have to act.

On health care cuts, we have, in our plan—we did not just willy nilly say that there ought to be cuts in health care. We have every single cut absolutely spelled out for and paid for. Again, I had to gore my own opportunities to do this. I did cut the funds that go to hospital for medical education, but again, I thought it was one of the areas we could.

We took away some of the trickery and gaming that goes on in Medicaid. One of the things you can see that some of the states do is they will raise the cost of a tax that they have on providers, and then the providers will then be allowed by the state to raise their fees.

So it is kind of a wash for the provider. But, oh, by the way, when the providers can raise their fees, then the feds have to match it, the taxpayers, two to one. It ends up costing us, over that same time period, about $44 billion. We cut out that kind of gaming.

Senator COONS. I see I am over my time. I just want to close by thanking you again for your very hard work, and I am hopeful, with the leadership of the Chairman and Ranking Minority Member, that this Committee will step up to the task. Thank you.

Chairman CONRAD. Senator Sanders.

Senator SANDERS. Thank you very much, Mr. Chairman, and thank you, Senator Simpson and Mr. Bowles for being with us. Five minutes is not a whole lot of time, so I just want to make a few points and then maybe ask a few questions.

I think one of the problems that we have when we just focus on deficit reduction, as significant an issue as it is, we lose the broad context of what is happening in this country, which is not just deficit reduction. The other reality that is happening in this country is that for many years the middle class has been collapsing. Poverty has been increasing.

We now have, by far, the most unequal distribution of wealth and income of any major country. So while the middle class shrinks and poverty increases, the wealthiest people for many years have become much wealthier. So that you now have a situation, if you can believe it, where the top 400 families in America own more wealth than half of the families in America. Where you have the top 1 percent earning more income than the bottom 50 percent.

So when you talk about moving toward deficit reduction, which we all appreciate is an important issue, the question is, well, on whom should that burden fall? Should we really, as our Republican friends have recently suggested, throw 200,000 children off of Headstart? Should we cut back on the Social Security Administration? Should we cut back on Pell grants with middle class families finding it harder and harder to be able to afford college? How do you deal with that?

So to my mind, the first question that I would ask, and I am going to have to request very brief answers because I want to get to Social Security, I want to get to health care as well. At a time when we have such a grotesquely unequal distribution of income and wealth, where over a recent 25-year period, 80 percent of all income in this country went to the top 1 percent, why, in your proposal, did you suggest that three-quarters of the movement toward deficit reduction come from spending cuts, only 25 percent from revenue?

Why didn't you ask the wealthiest people in this country to start paying—I know you did some of it—but in a much more significant way their fair share of taxes?

Mr. BOWLES. First of all, I think we have a significant spending problem in this country. Second, I think we did exactly what you said. In every single case, we tried to protect the truly disadvantaged. If you look at all of our cuts in the other mandatory category, which is about 20 percent of the other mandatory category, we did not touch a single one of those.

Senator SANDERS. I would respectfully disagree with that.

Mr. BOWLES. It is a fact we did not touch food stamps, we did not touch unemployment, we did not touch SSI. We left them all alone. If you look at——

Senator SANDERS. But answer my question. Answer my question. If you are earning——

Mr. BOWLES. I am answering your question and I will continue to.

Senator SANDERS. We do not have a lot of time.

Mr. BOWLES. Well——

Senator SANDERS. How 400 people in this——

Mr. SIMPSON. We will take some more time.

Mr. BOWLES. That is because the tax expenditures actually go to those people. Those are the people who benefit from this. The top 400 people pay an average tax of about 16 percent.

Senator SANDERS. That is correct.

Mr. BOWLES. Why do they do that? Because they have all these tax expenditures. We got rid of tax expenditures. That is why of a rate of increase the taxes of the top 1 percent or the top 1/10th of 1 percent is about 155 times what it is for somebody at the bottom. That is the right thing to do.

Senator SANDERS. But Mr. Chairman, at the end of the day, in your movement toward deficit reduction, three- quarters of your plan talks about cutting spending. And I ticked off, how do you feel about throwing 200,000 kids off of Headstart? That is a cut in spending. Good idea?

Mr. BOWLES. I do not think we recommended that, sir, so I do not believe——

Senator SANDERS. I know, but this is the result. When you talk about cuts in spending, Pell grants and so on—all right. Let me go on. We do not have a whole lot of time and I apologize.

Mr. SIMPSON. What about your President offering to cover LIHEAP at 50 percent?

Senator SANDERS. Terrible idea.

Mr. SIMPSON. I did not do that.

Senator SANDERS. And it was a terrible idea, no question about it. But let me go to Social Security. Social Security, to my mind, has been an enormously successful program for the past 75 years, taken a whole lot of elderly people out of poverty, people with disabilities, widows and orphans, paid out every nickle owed to every eligible American.

Now, I found it interesting. You just made a point, which I think is right, Mr. Bowles. You said, When we dealt with Social Security, we did not do it from a deficit reduction perspective. We did it to try to strengthen Social Security.

President Obama, during his campaign, also had an idea. His idea was to raise the taxable income level at $250,000. Remember that? People earning more than $250,000, that cap would be removed. I thought that was a pretty sensible idea. What do you think about it?

Mr. BOWLES. I am on the record. I have said many, many times that I did not think that people in my income bracket needed a tax cut.

Mr. SIMPSON. I was part of a group of Dave Pryor and Jack Danforth that met years ago with Paul Simon and agreed to take that lid completely off. That is me—

Senator SANDERS. Is that your view today?

Mr. SIMPSON. You can do anything you want. I am not——

Senator SANDERS. No, not what I could do, but do your recommend to the Congress that we——

Mr. SIMPSON. I do not know. You are the guy——

Senator SANDERS. Well, I agree with President Obama, that at $250,000 or more that cap be removed. Do you agree with that proposal from the President? Any comments? You guys just did a long report.

Mr. BOWLES. I have already said, you know, I did not believe that the top 2 percent of taxpayers need a tax cut.

Senator SANDERS. I asked a fairly simple question. Do you agree with President Obama, that above $250,000 we should remove the cap? Yes or no?

Mr. BOWLES. Should remove what cap?

Senator SANDERS. The cap on taxable income for Social Security.

Mr. BOWLES. Well, actually——

Senator SANDERS. Right now it is at $106,000.

Mr. BOWLES. $106,800. We actually did raise that.

Senator SANDERS. I know you did, I know you did. But the President went a lot further than you did.

Mr. BOWLES. No. I believe what we recommended, we took it to 90 percent, which was what it originally was.

Senator SANDERS. But you are not——

Mr. BOWLES. Which means when, in 2020, instead of going to $168,000, it goes to $190,000.

Senator SANDERS. The President said——

Mr. BOWLES. Or you will pay taxes on an additional 22 percent.

Senator SANDERS. But the President said we should start very shortly by removing the cap for people over $250,000. I am not hearing your opinion on that.

Mr. BOWLES. No, no, I am happy to give you my opinion. My opinion is what we would recommend.

Senator SANDERS. So you do not agree with the President?

Mr. BOWLES. I do not.

Senator SANDERS. OK, that is fine, that is fine. In terms of health care——

Mr. SIMPSON. I do not think you would ever agree with us either, so it does not make much difference.

Senator SANDERS. In terms of health care, at the end of the day, the United States spends almost twice as much per capita on health care as any other nation. We are the only nation in the industrialized world that allows private insurance companies to play a significant role in health care. Other countries have national health care programs without private insurance companies. Would you suggest that one way to get below the cost of health care is to——

Chairman CONRAD. Senator, Senator, in fairness to colleagues, you have now gone over——

Senator SANDERS. You are right.

Chairman CONRAD [continuing]. Well over, so I think we have to end it there, in fairness to colleagues.

Senator SANDERS. All right.

Chairman CONRAD. When there is a flow of a conversation, I have permitted both sides to go up to a minute over, but now we are at 2 minutes. So honestly, I do not think it is fair.

Let me go to a point that Senator Johnson raised, because I think it is a critically important point and we discussed this in the Commission. If we just use the historical average for revenues, at no time in the last 40 years would we have balanced the budget, not one time.

So I do not think that is going to work. If we look at the five times the budget has been in surplus, what has been the revenue? And there you can see, every time we have actually balanced the budget, revenue has been nearly 20 percent of GDP. In 1969, 19.7. 1998, 19.9. 1999, 19.8. 2000, 20.6. 2001, 19.5.

And we have a different circumstance we are dealing with and the different circumstance we are dealing with is the baby boom generation, which is going to double the number of people that are eligible for these programs.

So when we looked at that, and we are at 25 percent of GDP on spending now, we decided, and I wish Senator Sanders was still here, that we had to do more on the spending cuts side of the ledger, substantially more, but that we also had to do something on the revenue side if we are going to bell this cat in some kind of fair way, because we are borrowing 40 cents of every dollar we spend.

If we did that all on the spending side, we would have to cut every single thing. The Federal Government spends 40 percent across the board. Social Security, 40 percent. Medicare, 40 percent. Defense, 40 percent. I do not think that is reasonable. There has to be some revenue in this equation.

Now, some will say, Well, revenue is going to return to the norm. Right now revenue is about 15 percent of GDP, the lowest it has been in 60 years. In fact, very close to being the lowest it has been in 80 years. Now, as the economy recovers, we will get back to close to the average, because we know that in economics, there is a return to the mean. We see it in the markets all the time, a return to the mean.

We can expect that here, too. But the reality is, a return to the mean is not going to balance this budget. It is not going to balance this budget. And so, we concluded we have to have some revenue, although much more of it has to be done on the spending side of the equation.

I want to just end my questioning without a question, to again say thank you. I know that, Alan, you could have been out there with Ann in Wyoming, and for those that do not know, Alan married up. His wife is spectacular. Of course, she is tough on him, too. She does not cut him a wide swath. You took on a tough assignment and we appreciate it.

Erskine, I will tell you, there are very few people I have more confidence in to deal with something like this than I have confidence in you. And, boy, you proved it in spades, the two of you working together on this Commission, because I think the result—look, there are all kinds of things in here I dislike intensely. If I were going to do this, I would do this very differently.

Dick Durbin called me the night before the vote. He said, Kent, what are you going to do? I said, I am voting yes. He said, Well, why? I said, The only thing worse than being for this is being against it, because the country is in deep, deep trouble. I do not know what could be more clear. This thing is headed for the cliff.

And we say, Well, we do not know when we are going to hit the cliff. That is true. There is not a single person that can honestly tell you they know with certainty when we are going to hit the cliff. The one thing we know for sure is we are hurdling toward it. That is one thing we know with certainty.

So I would say to colleagues, please, whatever your ideology, whatever your philosophy—I will tell you, I put mine on the back burner because I deeply believe we have to do something like this, and the only plan out there I see that has bipartisan support is this one, as much as I dislike it, and I do dislike it. I would do this very differently.

But hey, what matters to the country is getting a result, because failure is not an option. Senator Sessions.

Senator SESSIONS. Thank you. We appreciate your work and we will continue to pursue bringing this Government to fiscal sanity. I have no doubt that we need to start cutting this year. I do not think $61 billion out of $3.7 billion is going to put us in an economic slowdown. I know politically the Administration is opposing any of those kind of cuts, but I think that they can be done and can be done wisely and will add up to over $800 billion if we were to execute it.

So I am saying, let's get busy now. And I do not shut the door on entitlement reform because obviously they are unsustainable. There are on an actuarially unsound basis and when you have that, you have just got to face up to it. It goes without saying, I think the world financial markets and our own economy would respond if we put ourselves on a sound course rather than an unsound course.

You have given us good suggestions. Many of them, I think, are within the realm of achievability and let's see if we can't make some progress, Mr. Chairman. I look forward to working with you and thank you for your leadership.

Chairman CONRAD. Thank you. I thank all of the colleagues who participated here today, and special thanks to the witnesses. Thanks for your contribution. You have done something very important. I hope the country is paying close attention. I especially hope my colleagues are.

Mr. SIMPSON. Mr. Chairman, let me just say thank you for your consistency. You came here when I was here, you stuck right with your guns on the budget all the way. I thank Mike Enzi and Senator Sessions, and if we can just remember one thing, one thing. We are Americans first, not Republicans or Democrats, and if we cannot get out of that rut, we will never get out of the rut.

Chairman CONRAD. Amen. Thank you both.
[Whereupon, the committee was adjourned at 12:20 p.m.]

Ron Wyden

Questions for the Record
from Senator Wyden
for Chairmen Bowles and Simpson
Report of the National Commission on Fiscal Responsibility and Reform
March 7, 2011
Senate Budget Committee

Question #1:

In the last year, Secretary Gates has made some progress in eliminating unwanted or inefficient weapons systems, and eliminating some redundancies. But most folks acknowledge that far more needs to be done.

Military spending accounts for a larger percentage of the budget than all discretionary spending combined. It is nearly impossible to meaningfully reduce the deficit without reforming military spending.

In your recommendations, you suggest reducing personnel deployed at overseas bases in Europe, replacing servicemembers performing clearly commercial jobs with much cheaper civilians, as well as other initiatives to find staffing efficiencies. However, you do not directly advocate for a reduction in military end strength.

Question #1:

- The Bipartisan Policy Center recently issued a report that called for reducing active-duty end strength by 275,000. Do you think a reduction of that size is appropriate?

Question #2:

- Do you think that by increasing the end strength of the National Guard, which has much lower lifetime costs, we could further reduce active-duty end strength?

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Responses to Questions Submitted For The Record By Senator Ron Wyden

Erskine Bowles and Alan Simpson

Question 1 The Bipartisan Policy Center recently issued a report that called for reducing active duty end strength by 275,000. Do you think a reduction of that size is appropriate?

Answer: We strongly agree that military spending reforms must be part of a serious deficit reduction effort. One of the Commission's guiding principles is that everything must be on the table. The ability of the United States to keep our country secure over time depends on restoring fiscal restraint today, and that restraint must apply to defense spending along withal other parts of the budget. As the Chairman of the Joint Chiefs of Staff, Admiral Mike Mullen, has noted, the most significant threat to our national security is our debt.

The final report of the Commission stated that, "In order to achieve real spending discipline, Congress and the President must be willing to cut excess spending wherever they find it." In order to enforce that principle, the Commission recommended discretionary spending limits with firewalls between security and non-security spending in 2015 and required equal percentage reductions in each category.

The Commission did not make specific recommendations about how to achieve the reductions in discretionary spending necessary to comply with those caps, because those decisions will be made by Congress and the President in the annual appropriations process. Setting strict limits on how much can be appropriated, however, will force policymakers to review all government programs and activities and make tough decisions to set priorities.

Neither of us, nor the Commission as a whole, had the expertise necessary to make recommendations about our nation's defense strategy, nor did we believe it would have been appropriate for us to do so. Therefore we did not make recommendations regarding force structure or our overall military posture as the Domenici-Rivlin report issued by the Bipartisan Policy Center did. Decisions about our defense strategy and the appropriate force structure should be made by Congress and the President based on recommendations from military commanders. However, the decisions about our defense strategy and the missions we give to our military must be made with recognition that we have limited resources and must set priorities.

We believe that America cannot afford to be the world's policeman. We must evaluate our military commitments and missions to focus on those that are vital to our national security and keeping our nation strong and secure. A reduction in active duty end strength may very well be the result of such an evaluation, but we are not in a position to say what the appropriate reduction would be.

Question: Do you think that by increasing the end strength of the National Guard, which has much lower lifetime costs, we could further reduce active-duty end strength.

Answer: As we said in response to the previous question, we do not have the expertise to make recommendations about the best structure for our military forces and did not attempt to do so in the report. However, the Commission did find that the defense entitlements such as lifetime health and pension costs associated with active duty personnel after they retire are one of the fastest growing parts of the defense budget and are placing increasing pressure on the defense budget. Therefore we believe that a greater emphasis on the National Guard, which does not involve the same degree of long term financial obligation as active duty personnel, could be an important part of meeting our military needs in a more cost effective manner, along with reforms of defense entitlements.

Robert Greenstein's Answers to Senator Begich's questions for the record:

1) I believe three metrics are particularly useful: economic efficiency, equity, and deficit reduction. As the Congress turns to tax reform in the context of long-term deficit reduction, tax expenditures that are "upside down" stand out as an area in need of reform.

   These tax expenditures are designed to promote activities that provide benefits not just to the specific taxpayer but to communities and society generally. For example, incentives for retirement savings, if successful, boost national savings and help fund productive investment.

   The value of many of these tax expenditures, which tend to come in the form of deductions or exclusions from taxable income, is tied to a taxpayer's marginal rate. This means that high income households receive a larger tax incentive or subsidy, even they often would have taken the desired action (e.g., putting aside some income for retirement) with *or without* the tax incentive and are likely to be people on whom the incentive has only a small effect.

   Consider how the tax code affects two differently-situated households with respect to their decisions to purchase a new home. An affluent investment banker who lives in a large house, has a $1 million mortgage, and pays $40,000 in mortgage interest each year will receive a housing subsidy of $14,000 annually. In other words, the banker pays 65 cents of every dollar of mortgage interest, with taxpayers, in effect, picking up the remaining 35 cents. A typical middle class family, by contrast — say a welder or a nurse making $60,000 a year — might pay $10,000 a year in mortgage interest on their more modest homes. They would receive housing subsidies worth just 15 percent of their $10,000 interest payments, or $1,500 annually.

   There is no reason to believe that the banker requires a larger subsidy to be enticed to become a homeowner — if anything, one would expect the opposite to be true. Further, it is doubtful that society benefits more from the banker's owning a home than from the nurse or welder doing so. For these reasons, the design of this tax subsidy is economically inefficient. (It also scores low on equity grounds.)

   The tax code includes many similarly structured provisions that are quite costly. Guided by the metrics of efficiency, equity, and budget any savings, many tax expenditures are ripe for reform.

2) The United States is on an unsustainable fiscal path. It is essential, therefore, that any tax reform contribute significantly to deficit reduction. Addressing our long-term fiscal imbalances will require difficult changes in federal programs, but our budget math cannot be solved on the spending side alone.

   This is a widely shared view. Bipartisan majorities on each of the major recent deficit reduction panels — the Bowles-Simpson commission, the Rivlin-Domenici commission, and a panel convened by the National Academy of Sciences — agreed that a balanced approach consisting of both program and tax reforms, each of which contribute to deficit reduction, will be required to restore long-term fiscal balance. This has been done before: the last big bipartisan deficit-reduction agreement signed into law — the 1990 budget agreement reached by President George

H.W. Bush and Congressional leaders of both parties — was a balanced mix of program reductions and new tax revenues.

This means that while the 1986 Tax Reform Act represented sound tax policy, its bottom line of revenue-neutrality is not one we should seek to replicate now. By broadening the tax base, tax reform will remove many deficit-reduction targets from the tax code, likely making it harder to secure revenue contributions to deficit reduction in the future. It thus is essential that tax reform done now make a significant deficit-reduction contribution. Given our fiscal situation, we cannot afford to do otherwise.

DISTRIBUTION AND EFFICIENCY OF SPENDING IN THE TAX CODE

WEDNESDAY, MARCH 9, 2011

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

The Committee met, pursuant to notice, at 10:01 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Wyden, Sanders, Whitehouse, Begich, Sessions, Thune, Portman and Johnson.

Staff present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

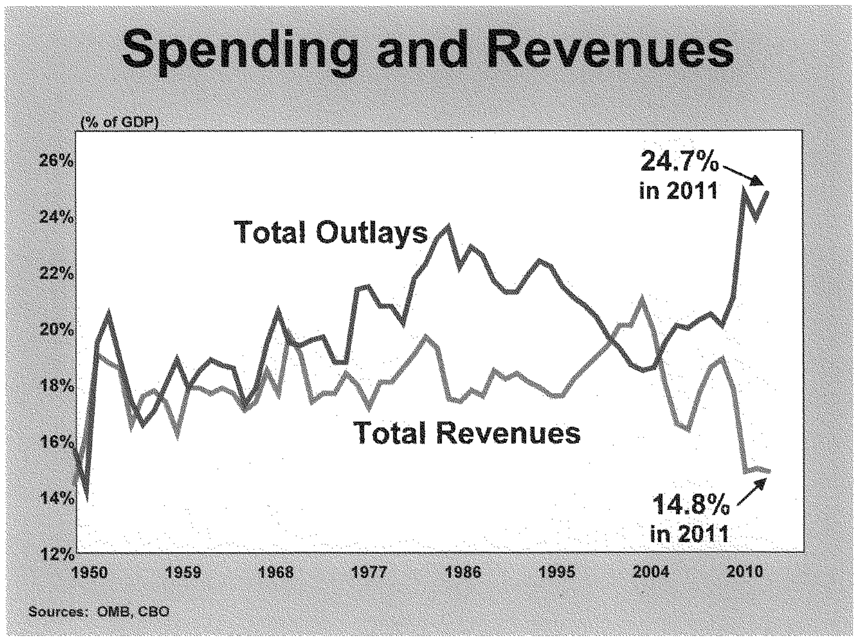
OPENING STATEMENT OF CHAIRMAN CONRAD

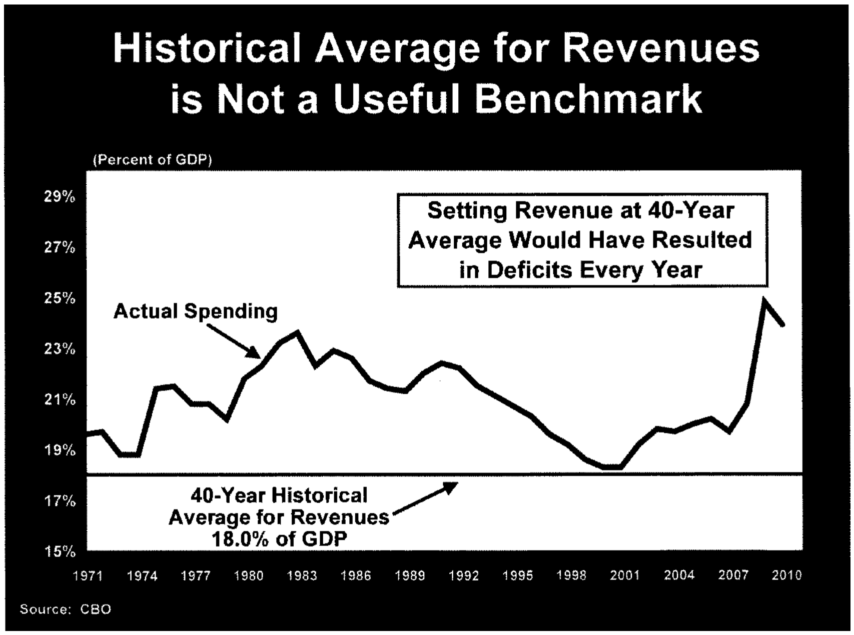
Chairman CONRAD. The hearing will come to order.

I want to welcome everyone to the Senate Budget Committee today. Today we are going to focus on spending in the Tax Code, or tax expenditures, as they are known. These are the countless credits, deductions, and exclusions that riddle and complicate the Tax Code. Specifically, we will examine the distribution of benefits and the efficiency of tax expenditures.

Our distinguished witnesses today are: Robert Greenstein, the president of the Center on Budget and Policy Priorities; Robert McIntyre, the director of Citizens for Tax Justice; and Scott Hodge, the president of the Tax Foundation. Thank you all for being here. We look forward to your testimony.

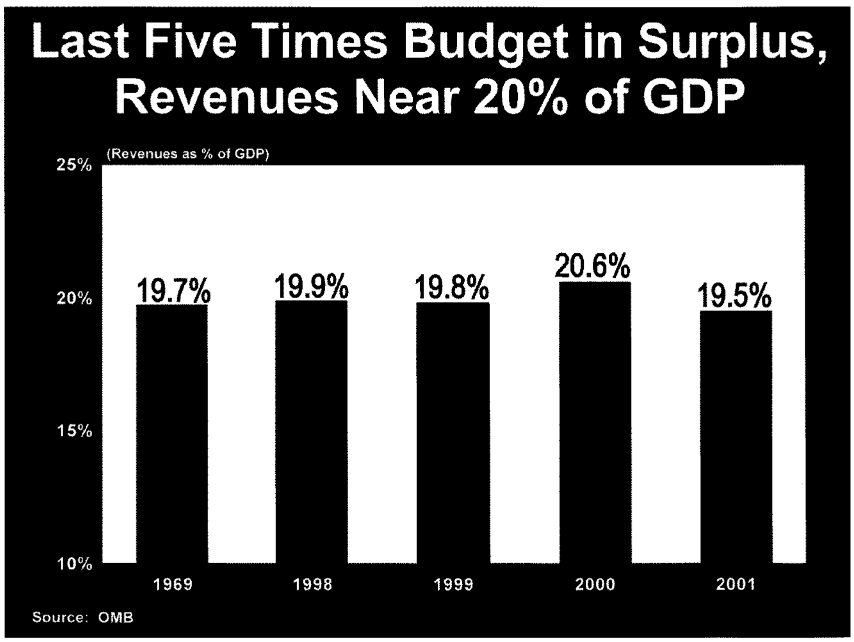
Our Nation is at a critical juncture. We are borrowing about 40 cents of every dollar that we spend. Spending is at the highest level as a share of our economy in more than 60 years. Revenue is the lowest it has been in 60 years as a share of the economy. Both sides of the ledger are part of the problem, I believe, and both have to be part of the solution.


Spending and Revenues
(% of GDP)
26%
24%
22%
20%
18%
16%
14%
12%
1950
1959
1968
1977
1986
1995
2004
2010
Total Outlays
Total Revenues
24.7%
in 2011
14.8%
in 2011
Sources: OMB, CBO



Historical Average for Revenues
is Not a Useful Benchmark
(Percent of GDP)
29%
27%
25%
23%
21%
19%
17%
15%
Setting Revenue at 40-Year
Average Would Have Resulted
in Deficits Every Year
Actual Spending
40-Year Historical
Average for Revenues
18.0% of GDP
1971
1974
1977
1980
1983
1986
1989
1992
1995
1998
2001
2004
2007
2010
Source: CBO

Looking at revenues in isolation has led some to argue that revenues should be held to the historical level over the past 40 years, about 18 percent of GDP. But revenues at that level would not have produced a single balanced budget in 40 years. In fact, on the five occasions when the budget has been balanced or in surplus since 1969, revenues have ranged between 19.5 percent and 20.6 percent of GDP. It is this higher level of revenue that provides, I believe, a more useful guidepost for what is needed if we hope to dig ourselves out of this fiscal hole and set the budget on a sustainable path.



Unlike in previous years, the country now faces an unprecedented demographic challenge which will put a tremendous added strain on the budget going forward. I believe that tax reform has to be part of the solution to addressing our fiscal problems coupled with spending cuts. The current state of the Tax Code is simply indefensible. Our Tax Code is out of date and hurting U.S. competitiveness. It is hemorrhaging revenue to offshore tax havens and abusive tax shelters. The Tax Code is riddled with expiring provisions. This creates enormous uncertainty for citizens and businesses alike, making it very difficult for them to plan ahead.

If we took steps to simplify and reform the Tax Code, we could reduce tax rates below where they are today, and tax reform would also allow us to raise more revenue to help address the very serious debt threat hanging over America.

Eliminating or scaling back tax expenditures should be at the heart of any tax reform we consider. This year, we will spend $1.1 trillion on tax expenditure. That is as much as all of domestic spending, including defense. That is roughly equivalent to the size of our deficit. The deficit this year is going to be $1.5 trillion; the tax expenditures are $1.1 trillion. It is a staggering sum by any measure, and these tax expenditures receive far too little scrutiny. I am a member of the Finance Committee, and I can tell you, as a member of that Committee, the tax expenditures have not received the attention that they deserve.

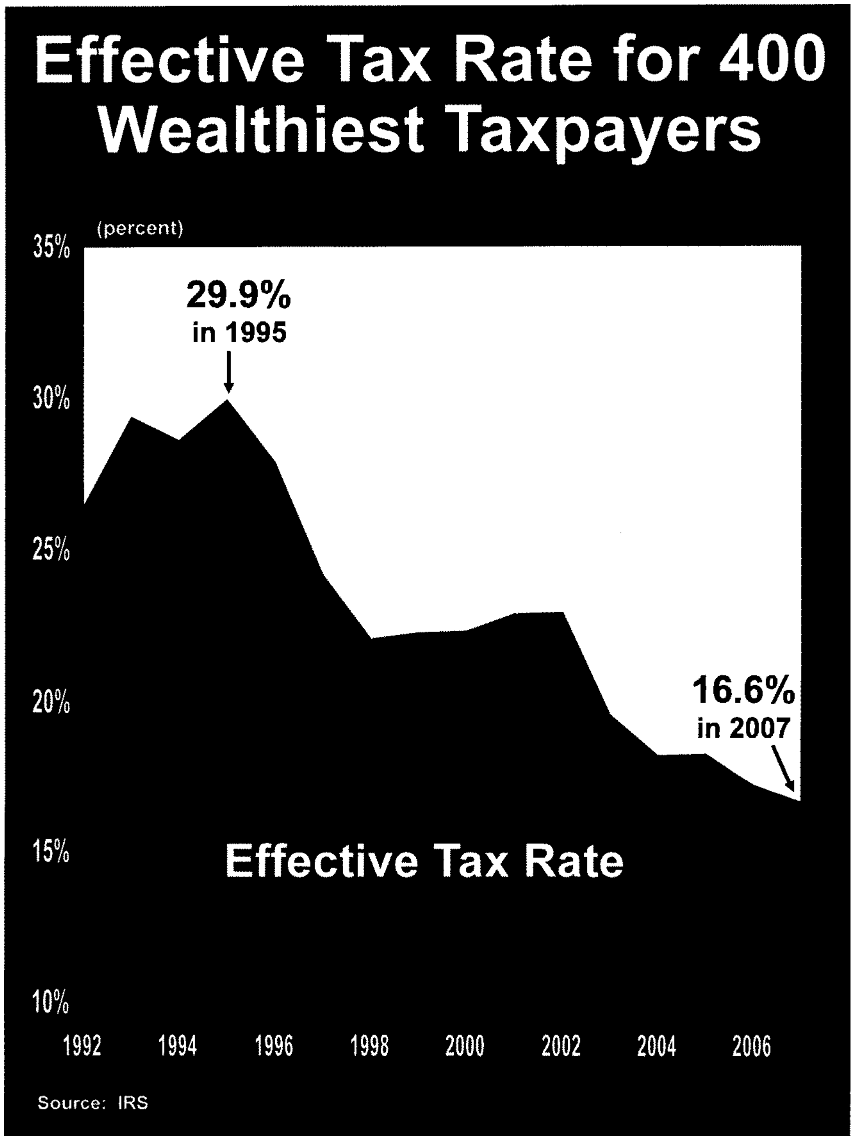
Economist Feldstein on Need to Reduce Tax Expenditures

"Cutting tax expenditures is really the best way to reduce government spending.... [E]liminating tax expenditures does not increase marginal tax rates or reduce the reward for saving, investment or risk-taking. It would also increase overall economic efficiency by removing incentives that distort private spending decisions. And eliminating or consolidating the large number of overlapping tax-based subsidies would also greatly simplify tax filing. In short, cutting tax expenditures is not at all like other ways of raising revenue."

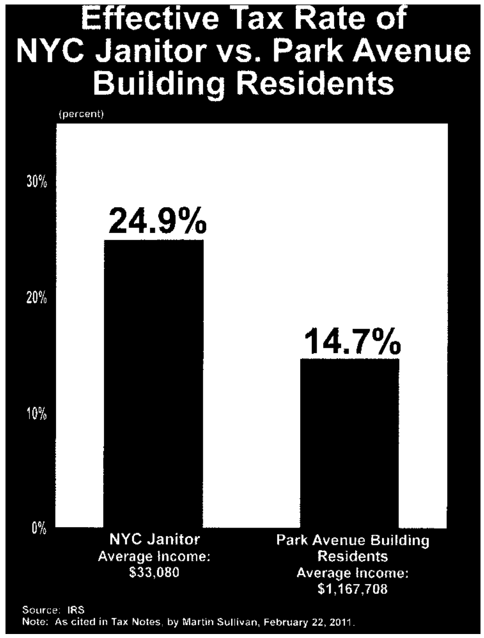
– Martin Feldstein
Professor of Economics at Harvard University
Chairman of Council of Economic Advisers under President Reagan
"The 'Tax Expenditure' Solution for Our National Debt,"
Wall Street Journal
July 20, 2010

Here is how well-known conservative economist Martin Feldstein described tax expenditures in a recent op-ed in the Wall Street Journal. He said, and I quote: "Cutting tax expenditures is really the best way to reduce government spending."

Let me repeat that: "Cutting tax expenditures," according to Martin Feldstein, "is really the best way to reduce government spending. Eliminating tax expenditures does not increase marginal tax rates or reduce the reward for saving, investment, or risk taking. It would also increase overall economic efficiency by removing incentives that distort private investing and spending decisions. And eliminating or consolidating the large number of overlapping tax-based subsidies would also greatly simplify tax filing. In short, cutting tax expenditures is not at all like other ways of raising revenue." That is from an economic perspective and from a conservative economist.



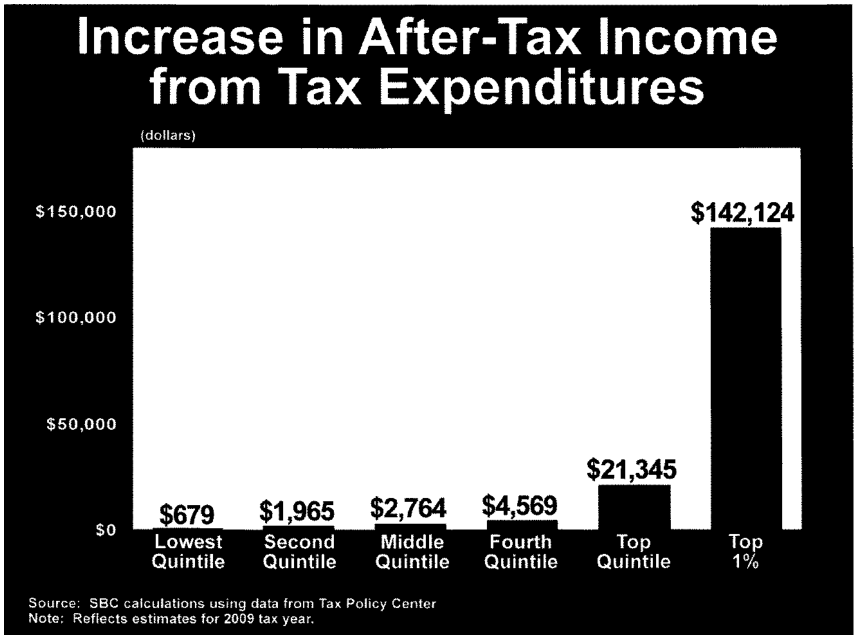
As we consider ways to reform the Tax Code, it is important to keep in mind who is benefiting from the status quo. In recent years, the effective tax rate for the wealthiest in this country, the rate actually paid after factoring in exclusions, deductions, credits, and other preferential treatment, has fallen dramatically. In fact, the effective tax rate for the 400 wealthiest taxpayers fell from almost 30 percent in 1995 to 16.6 percent in 2007.



This trend was highlighted in a recent article in Tax Notes by tax expert Martin Sullivan. The article uses IRS data to compare the average effective tax rates for the residents of one Park Avenue building in New York City where the average income is more than $1.1 million. They compared that to the average effective tax rate for a typical New York City janitor, someone who might work in that very building, with an average income of $33,000. The data show that the average effective tax rate for the building residents was 14.7 percent—those are the people with an average income of $1.1 million—while the rate for the janitor was 24.9 percent; his income, $33,000.

I do not know how anybody can defend or justify that kind of tax burden. It is not right.

The reason for this disparity, of course, is that almost all of the janitor's income comes from wages, which are taxed at the regular income and payroll tax rates. The Park Avenue building residents, however, receive almost two-thirds of their income from investments, which are taxed at lower capital gains and dividends rates. In addition, the Park Avenue building residents receive a greater benefit from tax breaks because they itemize their deductions.



Tax expenditures are clearly worsening the disparity between how the wealthy are taxed compared to everyone else. If we look at the increase in after-tax income from tax expenditures, we can see the top 1 percent received more than $142,000 from tax expenditures in 2009. The middle quintile received less than $2,800.

Tax Reform in Fiscal Commission Plan

- Eliminates or scales back tax expenditures, and *lowers* rates
- Promotes economic growth and improves America's global competitiveness
- Makes tax code more progressive
- "Illustrative" tax reform plan:
  - Three rates for individuals - 12%, 22%, 28%; corporate rate of 28%
  - Capital gains / dividends taxed as ordinary income
  - Reforms mortgage interest and charitable deductions
  - Preserves Child Tax Credit and EITC
  - Repeals AMT
- Revenues grow to 21% of GDP by 2022

The President's Fiscal Commission included the kind of tax reform I believe will be needed. It demonstrated that by eliminating or scaling back tax expenditures, we can simplify the Tax Code, actually lower rates, and still raise more revenue. Here are the key elements of tax reform that were included in the Commission's plan:

One, it eliminates or scales back tax expenditures and lowers tax rates. It promotes economic growth and improves America's competitive position. It makes the Tax Code more progressive. Under the Commission's illustrative tax reform plan, instead of six tax brackets there are three: 12 percent, 22 percent, and 28 percent. The corporate rate would be reduced from 35 to 28. Capital gains and dividends would be taxed as ordinary income. That would raise the effective tax rate of those people in the Park Avenue building because they are paying an effective tax rate of 16 percent. They would go up to 28 percent.

The mortgage interest and charitable deductions would be reformed, better targeting their benefits. The child tax credit and the EITC would be preserved to help working families. And the alternative minimum tax would be repealed. The Commission's plan also increases revenue to 21 percent of GDP by 2022.

We simply will not be able to solve our Nation's long-term fiscal and economic problems without fundamental tax reform—tax reform that improves our economic efficiency while also bringing in more revenue. And addressing tax expenditures has to be the heart of that tax reform.

With that, we will turn to Senator Sessions, my able colleague, for his opening comments, and then we will turn to our excellent panel, really outstanding panel, for their comments. And then we will open it to questions from our colleagues.

Senator Sessions.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Mr. Chairman, I do think the Commission's report on tax reform is very valuable, and it has a lot of suggestions that are critical that we could make and take and make our economy more productive and make the tax system more effective in producing a fair source of revenue. I would note that one reason, I assume, that the top 400 taxpayers have seen a major drop in their income, one reason is—in their taxes that they pay is because they are making less money. We have skewed the tax rate to very high income taxpayers whose incomes are volatile. They are not certain. And when you depend on that for your income, that is how, I think, we are down to 14.9 percent of GDP in income, is because the profits are not there, and if you do not make profits, you do not pay taxes. If you sell your stock or your real estate properties for a loss, you take losses instead of show incomes. And I do think that is a factor in the problem we have with having a steady source of income.

Mr. McIntyre thinks that is funny. Maybe I am wrong on that. Maybe upper-income people are making as much in the last 2 years as they were during the boom period. I do not think so.

I will just note this with regard to the actual share of wealth being paid in taxes: The top 20 percent pay 70 percent of the taxes in America, all taxes—payroll, excise, corporate, income taxes. According to CBO, between 1979 and 2007, the average tax rate for Federal taxes combined declined for all interest groups. The average rate declined for all. The average income tax rate also declined over those years. The largest decrease occurred for the fifth of the population with the lowest income. They got the biggest reduction. Those taxpayers in the top income quintile, the top 20 percent, in 2007 paid an average tax rate of 25 percent, a rate 6 times higher than those in the bottom quintile. The top 1 percent earned 19 percent of the Nation's income but paid nearly 30 percent of the Nation's Federal taxes.

According to CBO, in 2007 households in the highest quintile earned 55 percent before-tax income—they earned 55 percent, the top 20 percent, before-tax income and paid almost 70 percent of the Federal taxes. For all other quintiles, the share of Federal taxes was less than their share of the national income.

In comparison to the tax rates in effect under President Clinton, low-income earners pay a smaller share under the current income tax structure while higher-income earners pay a larger share. In President Clinton's last year in office, those in the bottom income quintile paid a negative 1.6 percent share of all income tax—a negative share results from their receiving tax credits—while those at the top paid 81 percent. In 2007, the last year available, the share of income taxes paid by the bottom 20 percent became even more negative, while the share paid by the top 10 percent increased to 86 percent.

The Tax Code is already highly progressive. An effort to eliminate credits, deductions, and exclusions without corresponding reductions in marginal rates will sacrifice economic growth. An average wealthy person, let us say, making $400,000 a year, they would pay under President Obama's plan to increase taxes 39.6 percent. The health care bill added an almost 1.9 percent payroll tax increase to them. We have added another 3.8 percent for our investment income. Alabama has a 5-percent income tax, State tax. Other States have lower and many have higher. So you are around 50 percent of a person's upper-income people subject to tax, a marginal rate. I mean, how much more do you do without damaging the economy? I think it is a dangerous trend to think we can just continue to drive up the tax rates and there will be no consequences. There will be consequences for it, and it is not all good.

With regard to tax expenditures, the way I understand that, your charitable deductions count as tax expenditures. Every deduction virtually is scored as a tax expenditure. I am not sure every deduction is bad. I am not sure every deduction should be scored in that fashion. If you gave a $10,000 contribution to some charitable enterprise and you only pay taxes on—you get to deduct that and you do not pay taxes on it. It saves you some of that money. But most of it is the contribution that went to the charitable enterprise; 40 percent or whatever for the upper-income people would be saved, but 60 percent is out of their pocket of the charitable contribution.

So I think we just need to simplify the Tax Code. I look forward to hearing these witnesses discuss it. You are exactly right, Mr. Chairman. You and the Commission raised this question of taxes. Are they serving our national interest? I do not think so. I do not know how to fix it. We need to get our arms around it, and if we—because we have to work with the Finance Committee and all. I know they are looking at this. But more than the deficit, getting your arms around the tax policy in America is exceedingly hard. I know there are a lot of suggestions, and I am open to them, and I am open to reform, that is for sure.

Thank you.

Chairman CONRAD. Thank you, Senator Sessions, and I agree entirely with your last comment. Look, tax reform is essential. We do have a circumstance in which if you—what I was referring to in terms of the effective top rate dropping for the wealthiest 400 referred to actual income received. Clearly, many of those people have had a reduction. Some have not. Some have had huge increases even though there was an economic downturn. But the effective tax rate I was referencing was based on what they pay on their actual income, and that effective tax rate has dropped, and it has dropped because we have changed the tax law. We have made capital gains and dividends preferentially treated in a way that Warren Buffett says he pays an effective tax rate of 16 percent. The woman who is his executive assistant pays a much higher effective tax rate. And that is really the disparity that I was referencing, that the difference between the people who live in that Park Avenue building that we know exactly what their tax responsibility is because IRS reports it—we do not know who the individuals are; we now what their effective income is; we know what their effective tax rate it. They are paying a tax rate of 16 percent, and yet the janitor who may work in that same building, a much lower income, is paying a much higher effective tax rate.

So the message from the Commission on tax expenditures was much as what Martin Feldstein said, a conservative economist, that the tax expenditures are really in many of the elements—not all. I would say to the Senator charitable contributions, that is something we have to think very carefully about. But what we have done in Congress—and I am on the Finance Committee, so, you know, I am part of the process. I have a responsibility here, too. You know, it is becoming——

Senator SESSIONS. You are a real master of the universe.

[Laughter.]

Chairman CONRAD. It has become a back-door way of spending money, of spending Federal money.

Senator SESSIONS. Mr. Feldstein made that point in the article, and he was critical of some of the Democratic criticisms that ignore the fact that one way to spend money is to do it through the Tax Code, on certain lower-income groups also through the earned income tax credit, which is one of our largest expenditures. But you are correct. Let us look at this. We have a good panel, and I look forward to hearing their comments.

Chairman CONRAD. I appreciate that.

We will start with Mr. Greenstein, who has testified before this Committee on many occasions, has as high level of credibility here as president of the Center on Budget and Policy Priorities. Welcome. Please proceed with your testimony.

STATEMENT OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES

Mr. GREENSTEIN. Thank you, Mr. Chairman. As you know, bipartisan majorities on all of the major deficit reduction panels have agreed that to reduce the deficit, we need a balanced approach that consists of both program and tax reforms, both contributing to deficit reduction. Both taxes and programs are implicated in the fiscal problems we face, and both need to be part of the solution.

Tax expenditures offer a particular target of opportunity. I still recall the moment in 1994 when Alan Greenspan was testifying before the Kerrey-Danforth Deficit Commission, on which I had the honor of serving, and Greenspan told us that we needed to look at what he called—these were his words—"tax entitlements." And indeed a number of tax expenditures are essentially spending entitlements delivered through the Tax Code.

Take child care as an example. If you are a low- or moderate-income person, you may get a subsidy to help cover your child care costs through a spending program. But if you are higher on the income scale, you still get a Government subsidy that reduces your child care costs, but it is delivered through the Tax Code via a credit. Moreover, if you are a low- or moderate-income parent with child care costs, you might miss out because the spending programs that provide child care subsidies are not open-ended. They are capped, and when you reach the cap, people have to go on waiting lists. But if you are a higher-income household, your child care subsidy is guaranteed because the tax subsidy operates as an open-ended entitlement.

As the Chairman noted, tax expenditures now total nearly $1.1 trillion a year. This substantially exceeds the cost of Medicare and Medicaid combined (a little over $700 billion), Social Security (about $70 billion), and non-security discretionary programs, (less than $600 billion).

Both the Bowles-Simpson and Rivlin-Domenici Commissions contained a focus on tax expenditures, and as you noted, Martin Feldstein—I have a different quote from the same article. He said, "If Congress is serious about cutting government spending, it has to go after many of these tax expenditures."

You might also note that in the GAO report that just came out on overlap and duplication, there is a whole section in that report on tax expenditures where the GAO says improving tax expenditure performance could reduce revenue loss potentially by billions of dollars.

Now, a particular issue here is that tax expenditures are not just costly; they are often—not always, but often—economically inefficient. Many tax expenditures are incentives designed to subsidized and encourage certain desired activities, but they often do so in inefficient ways. They do so often by distorting investment or other economic decisions, as Feldstein has noted, and adding to the inefficiency is the fact that many tax expenditures—principally those that are deductions, exemptions, and exclusions—tie the tax subsidies, the tax incentives they provide to the marginal tax rate of the beneficiary so that the amount of the tax subsidy increases with income and the wealthiest households get the largest subsidies.

Now, from an economic perspective, such a structure does make sense if but only if higher-income people need a substantially greater monetary incentive to take the desired action and would not take it in the absence of the tax incentive. But the reality is often the reverse. High-income households would generally send their children to college, make sure they have enough assets for retirement, and buy a home with or without the current costly tax incentives, and that is why a number of liberal, conservative, and centrist experts alike have characterized key parts of our tax incentive structure as being upside down. We spend money providing the largest incentives to people in the top brackets despite the fact that the incentives generally have a smaller effect on whether they will send their children to college, become homebuyers, and put aside money for retirement than those incentives have for people lower down on the income scale.

In fact, in that regard, tax credits differ significantly from deductions and exclusions. They reduce the price of the desired activity by an equal percentage for most households. Reformers view them in many of these areas as increasing economic efficiency, and both Bowles-Simpson and Rivlin-Domenici propose to convert some of the tax deductions into credits.

Now, my point here is that the economic efficiency weaknesses in the structure of various tax incentives offer you an opportunity. By converting various deductions into flat-percentage tax credits, policymakers can improve economic efficiency by increasing the effectiveness of the tax incentives in boosting things like national saving, college attendance, and the like, even as you achieve deficit reduction and improve the progressivity of the Tax Code.

Let me talk for a moment about progressivity. There was a fascinating recent article by economist Kenneth Rogoff. In this article, Rogoff warned of the consequences of widening a historic levels and historic levels of inequality in income, wealth, and opportunity throughout a number of countries. He cautioned that the ability of countries to address inequality could be the key factor that, and I am quoting Rogoff, "could separate the winners and losers in the next round of globalization" and could emerge as, his words "the big wildcard in the next decade of global growth."

And the Bowles-Simpson report sets forth a basic principle here. It states, and I am quoting, "Though reducing the deficit will require shared sacrifice, those of us who are best off will need to contribute the most. Tax reform must continue to protect those who are most vulnerable and eliminate tax loopholes favoring those who need help least."

Which brings me to my final point. Bowles and Simpson, as you noted, Mr. Chairman, on one of your slides, called for deficit reduction that protects low-income families and indicated it should protect the earned income credit and the child tax credit. These credits are vital to the standard of living of low-income working families, to "making work pay," and to promoting work over welfare.

Furthermore, those credits lower marginal tax rates for many low-income workers who otherwise face some of the highest marginal tax rates of any group of Americans, because they receive other means-tested benefits that phase down as their income rises. This is why, in calling for various tax expenditures to be curbed, Martin Feldstein wrote that he was not including the EITC in this list, which, Feldstein explained and I am quoting from Feldstein, "acts largely as a tax rate reduction." And numerous academic studies have shown that the EITC has a powerful effect in increasing work, reducing welfare use, particularly among single parents with children.

There has been a longstanding bipartisan principle in this town that people, parents who work full time should not have to raise their children in poverty. The only reason we comply with that principle and policy today is because of the earned income credit and the child tax credit.

Finally, all past deficit reduction measures of recent decades—1990, 1993, 1997, the Gramm-Rudman-Hollings Act in 1985—all reflected a commitment to protecting low-income households in general and the EITC in particular.

Thank you.

[The prepared statement of Mr. Greenstein follows:]

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Testimony of Robert Greenstein
President, Center on Budget and Policy Priorities
Before the Senate Committee on Budget

March 9, 2011

Chairman Conrad, Ranking Member Sessions and members of the Budget Committee, thank you for the opportunity to appear before you today to discuss tax expenditures, tax reform, and what role they might play in deficit reduction. I am Robert Greenstein, president of the Center on Budget and Policy Priorities, a policy institute here in Washington. I also had the privilege of serving as a commissioner on the Bipartisan Commission on Entitlement and Tax Reform chaired by then-Senators Kerrey and Danforth in 1994.

As you all know, the budget is on an unsustainable path. If we continue current policies, the national debt will grow to nearly the size of the economy by the end of the decade and continue to rise after that. The question for policymakers to consider is not *whether* to address our fiscal problems — we clearly need to do so — but *how* to do that in a way that is effective, responsible and equitable.

How Did We Get Here?

To understand the difficult choices that will be required to right our fiscal ship, it is useful to recall how we arrived at our current situation. Ten years ago, various policymakers — and even the Federal Reserve chairman — appeared before Congressional committees warning that our projected budget *surpluses* were too large. They knew of the aging of the population and the rise in health care costs, but even after taking those factors into account, the Congressional Budget Office and the Office of Management and Budget projected large surpluses for decades to come.

Many factors have led to the sharp reversal in our fiscal fortunes. Tax policy was one of them and played a significant role. The tax cuts enacted over the past decade contributed to a marked decline in federal tax revenues, which, even before the recession, had fallen to their lowest level as a share of the economy in a half century. Moreover, the tax cuts — along with increases in expenditures — have led to large increases in the national debt and hence to the rising interest costs that play a major role in putting us on an unsustainable path.

Whatever one's view on the continuation of the current tax cuts after 2012, there can be little question that they have a large fiscal impact. Alan Greenspan, Martin Feldstein, and Peter Orszag all have recommended that the tax cuts enacted in 2001 and 2003 be allowed to expire on schedule at the end of 2012 — or that policymakers pay for any of these tax cuts which they wish to extend —

because of the difficult fiscal situation we face, as well as the large improvement in the fiscal outlook such a step would make. The latest Congressional Budget Office projections show this one step alone would nearly halt the growth in the debt as a share of the economy over the coming decade.

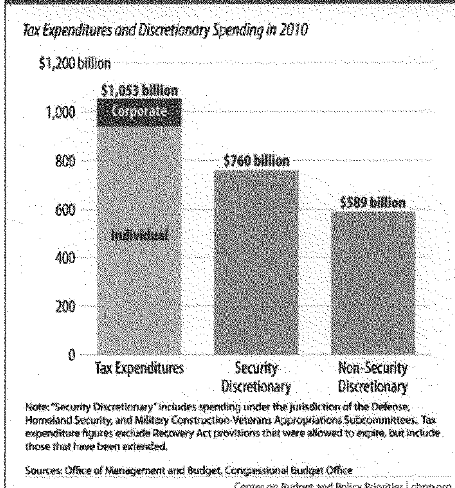
The CBO estimates show if all current policies remain in effect — the tax cuts, AMT relief, SGR relief, etc. — and no deficit reduction measures are taken, the deficit will stand at 6.1% of GDP in 2021. Allowing the tax cuts to expire — or paying for those we wish to extend — would slice the projected deficit nearly in half to 3.6% of GDP in 2021, not a sufficiently low level itself but one that would, in conjunction with other deficit reduction measures, get us to primary budget balance and stabilize the debt. Of course, beyond the coming decade, the relative impact of the tax cuts will be overtaken by rapidly rising health care and debt service costs as the major drivers of federal budget deficits, and substantial additional steps would be needed, especially steps to slow the growth of health care costs throughout the U.S. health care system.

Everything On the Table

I raise this simply to note that *both* taxes *and* spending are implicated in the fiscal problems we face. Both will need to be part of the solution. Addressing our long-term fiscal imbalances will require difficult changes in federal programs. But our budget math cannot be solved on the spending side alone.

This is a widely shared view. Bipartisan majorities on each of the major recent deficit reduction panels — the Bowles-Simpson commission, the Rivlin-Domenici commission, and a panel convened by the National Academy of Sciences — agreed that a balanced approach consisting of both program and tax reforms, each of which contributes to deficit reduction, will be required. This has been done before; the last big bipartisan deficit-reduction agreement signed into law — the 1990 budget agreement reached by President George H.W. Bush and Congressional leaders of both parties — was a balanced mix of program reductions and new tax revenues.

FIGURE 1: Tax Expenditures are Substantial



Source: Office of Management and Budget, Congressional Budget Office.

Tax Expenditures: A Target of Opportunity

As this testimony will discuss, tax expenditures offer a particular target of opportunity. I recall the moment in 1994 when Alan Greenspan testified to the Commission that, in examining entitlements, we needed to look at what he called the "tax entitlements." Greenspan's terminology was illuminating; many tax expenditures are, essentially, spending entitlements that are delivered through the tax code.

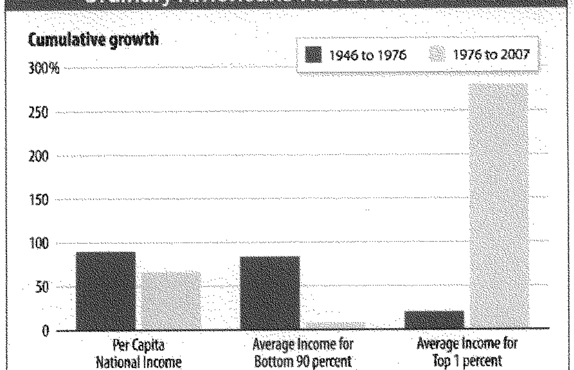
Take child care as an example. If you are low- or moderate-income, you may get a subsidy to help cover your child care costs, and the subsidy is provided through a spending program. If you are higher on the income scale, you still get a government subsidy that reduces your child care costs, but it is delivered through the tax code via a tax credit. Moreover, if you are a low or modest income parent with child care costs, you may miss out because the spending programs that provide child care subsidies are *not* open ended and can only serve as many people as their capped funding allows. By contrast, if you are a higher income household (and there is no limit on how high your income can be), your child care subsidy is *guaranteed*, because the tax subsidy you get operates as an open-ended entitlement. It doesn't make much sense to make the tax-code subsidy sacrosanct and the program subsidy a deficit reduction target merely because one is delivered through a "spending" program and the other is delivered through the code.

The costs of tax expenditures are large. In 2010, individual tax expenditures totaled nearly $1 trillion, and *total* tax expenditures — both individual and corporate — amounted to $1.05 trillion. This greatly exceeded the cost of Medicare and Medicaid combined ($719 billion), Social Security ($701 billion), and non-security discretionary programs, which stood at $589 billion, a little over half of the cost of tax expenditures.

Keeping the Goal of Shared Prosperity in Mind

As we work to address the nation's fiscal challenges, we should keep in mind a key economic development of recent decades. Since the mid-1970s, as a result of various factors (mostly unrelated to government policy), the benefits of economic growth have not been shared in the way they used to be. Between 1976 and 2007, the U.S. gross domestic product (GDP) grew 66 percent per person, adjusted for inflation. But the average income for the top 1 percent of Americans increased by 280 percent, in inflation-adjusted terms, while the average income of the bottom 90 percent of Americans stagnated, growing just 8 percent over this 30-year period.

FIGURE 2:
The Relationship Between National Income and Living Standards of Ordinary Americans Has Broken Down



Source: CBPP calculations based on data from Piketty & Saez, BEA, and the Census Bureau.

The economist Kenneth Rogoff recently warned of the consequences of widening and historic inequalities of income, wealth, and opportunity. Rogoff cautioned that the ability of countries to create opportunities for their citizens and to address inequality could be the key factor that "could separate the winners and losers in the next round of globalization" and could emerge as the "big wildcard in the next decade of global growth."[1]

Public policy in general and tax policy in particular have a role in helping to mitigate the human consequences of the global trends that have played a large role in suppressing wage growth among lower- and middle-class Americans. Unfortunately, our country's recent record on this matter has not been stellar. For example, under the tax cuts enacted in 2001 and 2003, people making over $1 million a year are receiving an average tax cut of more than $125,000 a year, according to the Urban Institute-Brookings Tax Policy Center. This is more than 140 times the average tax cut that households in the middle 20 percent of the income scale are receiving.

The Bowles-Simpson report set forth a basic principle here, stating that "Though reducing the deficit will require shared sacrifice, those of us who are best off will need to contribute the most. Tax reform must continue to protect those who are most vulnerable and eliminate tax loopholes favoring those who need help least."

A Closer Look at Tax Expenditures

Consistent with the goals of reducing budget deficits, increasing economic efficiency and growth, and protecting our most vulnerable citizens, both the Bowles-Simpson and the Rivlin-Domenici proposals place their focus in the revenue area on reforming and scaling back tax expenditures.

The Budget Act of 1974 defines tax expenditures as revenue losses attributable to any provisions in federal tax law that provide special benefits to particular taxpayers or groups of taxpayers. Although accomplished through the tax code, most experts believe these provisions should actually be viewed as a form of government spending. According to the Joint Committee on Taxation, tax expenditures "may be considered to be analogous to direct outlay programs, and the two can be considered as alternative means of accomplishing similar budget policy objectives." In addition, as tax expert Leonard Burman and others have pointed out, tax expenditures impose the same "opportunity costs" as federal spending programs in terms of higher tax rates, reduced federal resources for national priorities, and/or higher deficits and national debt.

If these provisions were classified as spending rather than as tax benefits, tax expenditures would constitute the single largest category of federal spending. As noted, they consume more resources annually than Social Security, than Medicare and Medicaid combined, and than either security or non-security discretionary spending. Martin Feldstein, a former Chairman of the Council of Economic Advisers under President Reagan, wrote in the *Wall Street Journal* last summer that "If Congress is serious about cutting government spending, it has to go after many of these [tax expenditures]." Feldstein added "Cutting tax expenditures is really the best way to reduce government spending."

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[1] Kenneth Rogoff, "The Inequality Wildcard," Project Syndicate, February 14, 2011 <http://www.project-syndicate.org/commentary/rogoff77/English>

GAO Recommends Scrutinizing Tax Expenditures

The much-discussed GAO report released last week on overlap and duplication in government programs highlights tax expenditures as an area in which policymakers can find significant savings.[a] The GAO report states:

> "Improving tax expenditure performance or eliminating tax expenditures could reduce revenue losses, potentially by billions of dollars. For example, improved designs may enable individual tax expenditures to achieve better results for the same revenue loss or the same results with less revenue loss. Also, reductions in revenue losses from eliminating ineffective or redundant tax expenditures could be substantial depending on the size of the eliminated provisions."

The GAO adds that "tax expenditures do not compete overtly with other priorities in the annual budget, and spending embedded in the tax code is effectively funded before discretionary spending is considered. Many tax expenditures are not subject to Congressional reauthorization. Therefore, Congress lacks the opportunity to regularly review their effectiveness."

[a] Government Accountability Office, "Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue," March 2010 <http://www.gao.gov/new.items/d11318sp.pdf>

One reason Feldstein reached this conclusion is that tax expenditures are not only costly, but often also economically inefficient. Although some tax expenditures are intended to adjust the amount of taxable income so as to better measure economic income or to reflect differences in ability to pay taxes, most tax expenditures are designed for another purpose — to subsidize certain desired activities — and often do so in inefficient ways that can *detract* from economic growth.

In cases where certain economic actions are believed to generate benefits shared by society at large, there may be strong arguments for designing the tax code to actively encourage these activities. But there are numerous ways to incentivize various desired activities, and the efficiency of any given tax incentive is heavily affected by how it is designed. Existing tax expenditures vary greatly in their effects on economic efficiency; some reduce economic efficiency by distorting investment or other economic decisions. Feldstein has observed that curbing various tax expenditures "would also increase overall economic efficiency by removing incentives that distort private spending decisions."

Adding to their inefficiency, many tax expenditure provisions — principally deductions, exemptions, and exclusions — tie the tax subsidies they provide to the marginal tax rate of the beneficiary. The amount of the tax benefit provided increases with income, with the wealthiest households receiving the largest tax subsidies.

From an economic perspective, such a structure makes sense only if higher-income people need a substantially greater monetary incentive to take the desired action and wouldn't take it without the tax incentive. Yet, as a number of tax experts and economists from across the political spectrum have explained, the reality is frequently the reverse; high-income families generally would send their children to college, make sure they have assets for retirement, and buy a home ***with or without*** the current costly tax incentives. Financially constrained families, by contrast, often would fail to engage in the socially desired activity without significant financial incentives.

That is why a number of liberal, conservative, and centrist experts alike have characterized key parts of our tax incentive structure as being "upside down" — we spend money providing the largest tax incentives to people in the top income tax brackets despite the fact that tax incentives generally have a much smaller effect on whether those individuals will send their children to college, become homebuyers, and put income aside for retirement. As tax experts Lily Batchelder (an NYU tax expert who now serves as chief tax counsel for the Senate Finance Committee), Fred Goldberg (who served as Assistant Secretary of the Treasury for Tax Policy and IRS Commissioner under President George H. W. Bush) and former OMB director Peter Orszag wrote in 2006, "[P]roviding a larger incentive to higher-income households is economically inefficient unless policymakers have specific knowledge that such households are more responsive to the incentive or that their engaging in the behavior generates larger social benefits."[2]

Table 1:
Regressivity of Tax Expenditures Varies by Category

	Lower rates on capital gains and dividends	Itemized deductions	Tax Exclusions	Above-the-line deductions	Non-refundable credits	Refundable credits	All Provisions
Bottom 20 percent	0.00%	0.02%	0.54%	0.01%	0.05%	5.49%	**6.52%**
Second 20 percent	0.01%	0.11%	2.99%	0.06%	0.28%	5.00%	**8.16%**
Middle 20 percent	0.04%	0.38%	3.79%	0.09%	0.33%	2.20%	**6.76%**
Fourth 20 percent	0.12%	1.09%	3.68%	0.11%	0.23%	1.99%	**6.79%**
Top 20 percent	2.11%	2.91%	4.74%	0.08%	0.06%	0.25%	**11.36%**
Top 1 percent	5.87%	3.24%	2.90%	0.06%	0.00%	0.00%	**13.53%**
Bottom 20 percent	0.00%	0.02%	0.54%	0.01%	0.05%	5.49%	**6.52%**
Total Cost	$96 billion	$154 billion	$326 billion	$6 billion	$8 billion	$89 billion	**$761 billion***

* Takes into account interaction among individual tax expenditure provisions

Source: Leonard Burman, Eric Toder, Christopher Geissler, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?" December 2008.

In this respect, tax *credits* differ significantly from tax deductions and exclusions. Credits reduce the price of the desired activity by an equal amount for most households, although tax credits that are not refundable aren't available to the roughly one third of American families who owe no individual income taxes during that year. (These households generally do have positive tax liability when other forms of individual taxation — including payroll taxes, state and local taxes, and excise taxes — are considered, and even more so when tax liabilities are considered over periods longer than a single year.) Tax credits that are refundable provide the same price adjustment to all households that engage in the desired behavior, regardless of their income or tax liability during the year in question.

Because tax credits do *not* link the tax incentive to households' marginal tax brackets and generally reduce tbe costs of the economically desired activity by an equal percentage for all affected

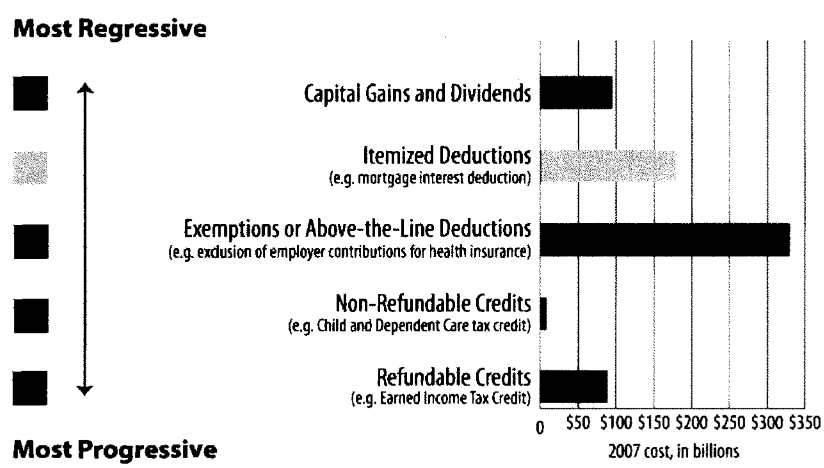
[2] Lily L. Batchelder, Fred T. Goldberg Jr., Peter R. Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," *Stanford Law Review*, Vol. 59, No. 23, 2006

households, they are often more economically efficient than deductions. Batchelder, Goldberg, and Orszag concluded that refundable tax credits often would be the most efficient type of tax expenditure: "If policymakers wish to use the tax system to create incentives for certain socially-valued behavior, it makes no sense to exclude more than a third of American individuals and families from their reach ... absent evidence that those Americans would be relatively unresponsive [to the tax incentive] or that their behavior generates fewer societal benefits."

Despite the economic efficiency advantages of flat-percentage tax credits, the large majority of tax expenditures operate today through tax deductions, exemptions, or exclusions and thereby provide tax subsidies that mount sharply as income rises. Approximately 70 percent of the amount we spend every year on individual tax expenditures is provided through deductions, exemptions, or exclusions that link the value of the tax break to an individual's marginal tax bracket.

Our tax code provides this benefit structure despite that fact that many of the activities that tax expenditures are designed to encourage involve costs that are borne most easily by wealthier families even in the absence of the tax break.

FIGURE 3:
The Regressivity of Tax Expenditures Varies by Category



Source: Leonard Burman, Eric Toder, Christopher Geissler, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?" December 2008.

Moreover, it is dubious whether many Americans would think that if the government is to provide a subsidy to individuals and families, it should provide the biggest subsidies to those who need them least. Consider, for example, how the tax code affects two different households with respect to a decision to buy a new home. The government effectively pays 35 percent of the interest costs on the first $1 million of the mortgage on an investment banker's home. In contrast, a nurse or a welder receives a subsidy that defrays only 15 percent of the mortgage interest he or she pays on the modest home that he or she owns.

Another example involves the tax treatment of retirement saving. Under current law, employer and employee contributions to qualified pension plans are excluded from taxable income until they are paid out in retirement. This tax preference is designed to encourage retirement saving by reducing the marginal cost of contributions to retirement accounts. But as is the case with the mortgage interest deduction, high-income individuals receive the largest immediate benefit of the exclusion even though they are the people most likely to save anyway in the absence of a government tax subsidy.

Economists William Gale, Jonathan Gruber, and Peter Orszag have noted that high-income individuals are often able to respond to current retirement tax incentives "by reshuffling their existing assets ... to take advantage of the tax breaks, rather than by increasing their overall level of saving."[3] In Congressional testimony, Orszag added that our current tax expenditures for retirement saving provide the strongest monetary incentives to higher-income households "who are the most likely to use pensions as a tax shelter rather than a vehicle to raise saving." Similarly, the Congressional Research Service has reported that "because higher earners would save much of their income even without tax incentives to do so, a substantial share of the revenue lost through the deduction for contributions to retirement plans does not result in a net increase in national saving."[4]

Middle-income families receive significantly smaller subsidies for retirement saving and families with no federal income tax liability receive *no* tax incentive to put aside money for retirement. In 2007, just 17 percent of workers in the bottom quartile participated in a defined contribution retirement plan.[5]

If policymakers intend to increase overall national saving rather than simply to provide windfall gains for saving that would have occurred anyway, it would seem that current pension tax preferences are, in fact, upside down.

These weaknesses in the structure of various tax incentives offer policymakers an opportunity. By converting various tax deductions into flat-percentage credits, policymakers can improve economic efficiency by increasing the effectiveness of the tax incentives in boosting national saving, college attendance, and the like, even as they achieve deficit reduction and improve the progressivity of the tax code.

[3] William Gale, Jonathan Gruber, and Peter R. Orszag, "Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households," Hamilton Project Discussion Paper, April 2006. Gale, Gruber, and Orszag wrote: "By providing incentives for contributions through tax provisions that are linked to the marginal tax rates that people owe, current incentives deliver their largest immediate benefits to higher-income individuals in the highest tax brackets. These high-income individuals are precisely the ones who can respond to such tax incentives by reshuffling their existing assets into these accounts to take advantage of the tax breaks, rather than by increasing their overall level of saving. As a result, the tens of billions of dollars in tax expenditures associated each year with 401(k) and IRA contributions could be targeted more effectively to increase overall savings."

[4] Congressional Research Service, "401(k) Plans and Retirement Savings: Issues for Congress," January 2011

[5] Congressional Research Service, 2011

The Earned Income Tax Credit and the Child Tax Credit

Erskine Bowles and Alan Simpson have called for deficit reduction to improve economic efficiency and to protect low-income families and have strongly indicated that tax reform should protect the Earned Income Tax Credit and the refundable portion of the Child Tax Credit.[6] These credits are vital to the standard of living of low-income working families, to "making work pay," and to promoting work over welfare.

Furthermore, these credits lower marginal tax rates for many low-income workers who otherwise face some of the highest marginal tax rates of any group of Americans (because they receive benefits from means-tested programs that are phased down as income increases). This is why, in calling for various tax expenditures to be curbed, Feldstein wrote that he was *not* including the EITC, "which," he explained "acts largely as a tax rate reduction." Numerous academic studies have shown that the EITC has a powerful effect in increasing work, particularly among single parents with children.[7]

There is a longstanding bipartisan principle in this town that people who work full time should not have to raise their children in poverty. There are two main ways to accomplish this: the minimum wage and the Earned Income Tax Credit (EITC). The best course is to use a balanced combination of the two. Relying too heavily on the minimum wage would be burdensome for employers, particularly small businesses, and likely have negative effects on employment. Relying too heavily on the EITC and other tax credits would be burdensome for the government. By balancing these two approaches, as federal policy now does, policymakers can ensure that people who work full time can be protected from poverty without placing too much pressure on either private employers or taxpayers.

Accordingly, in past deficit reduction negotiations, there has been a commitment to protecting low-income households — and to shielding the EITC. In fact, the EITC was *expanded* as part of the 1990 bipartisan deficit reduction agreement, and the Child Tax Credit was itself established as part of the bipartisan 1997 agreement. Both the Bowles-Simpson and Rivlin-Domenici commissions, as well, would protect these credits. Congress should maintain this commitment and assure that the benefits that the EITC and refundable Child Tax Credit provide are protected in any agreements on deficit reduction and tax reform.

Thanks to the combined effect of these refundable tax credits and the minimum wage, full-time workers with children are no longer taxed into, or deeper into, poverty. However, low-wage workers who are *not* raising minor children face a different story. They receive no Child Tax Credit and only a very small EITC at best. The maximum EITC for childless workers is less than one-sixth the maximum credit for workers with a child, and childless workers who work full time at the minimum wage are *ineligible* for the credit altogether because they earn too much. The result is that childless workers are the one group of American workers below the poverty line who can owe net federal taxes based on employment and who thus can be taxed into, or deeper into, poverty.

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6 Chairman's Mark, p. 5, http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/CoChair_Draft.pdf.

7 For a review of this literature, see John Karl Scholz, "The Earned Income Tax Credit and the U.S. Low-Wage Labor Market," Economic and Social Research Institute, June 2010.

Conclusion

Recent policy developments suggest a growing view that tax expenditures should be scrutinized and reformed. Both the Bowles-Simpson and Rivlin-Domenici panels — as well as President Bush's 2005 tax reform panel — called for bold reforms of itemized deductions and other tax expenditures.

Furthermore, as long as we continue to use the tax code as a vehicle for advancing social policy, we should take steps to ensure that the tax incentives provided through the code are efficient, effective, and fair. And if we are going to step up to the plate and pursue deficit reduction, *all* parts of the budget — including the tax code — should be on the table and should contribute. As the Bowles-Simpson and Rivlin-Domenici plans indicate, given the gravity of the fiscal challenges we face, tax reform *cannot* be deficit-neutral today.

Finally, if we seek to reduce less-efficient government spending, tax expenditures are a key place to focus. If done responsibly and well, tax expenditure reform has the potential to reduce budget deficits, promote economic efficiency, and make the tax code more progressive at the same time.

Chairman CONRAD. Thank you.

Next we will hear from Mr. McIntyre. Robert McIntyre is the director of the Citizens for Tax Justice and has also testified on many occasions before this Committee. Welcome back.

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE

Mr. MCINTYRE. Thank you, Mr. Chairman. Well, today is the first day of Lent. It is an opportunity to take a resolution and maybe give up, not just until Easter but maybe even longer, what has become a great deal of enthusiasm in the Congress among both parties for providing subsidies to American businesses, and foreign businesses sometimes, in programs that are administered by Congress's favorite agency, loved beyond any other, the Internal Revenue Service. I do not know why you like it so much, but you do.

You know, a quarter of a century ago, President Reagan took on these business subsidies that had grown into the tax code—some of them he actually had put in there—but he took them on in 1986 and he passed a big tax reform bill that, among other things, raised corporate tax payments by more than a third, and the money was used to help fund individual tax reductions. But President Reagan was not afraid to do that, to raise taxes on corporations in the sense of taking away subsidies that they did not deserve. He did not think there was anything wrong with that at all. That may not be the current thinking here, but I am going to try to talk you out of the current thinking.

In our view, as you know, the lobbyists have been back. They have worked their magic and the corporate and personal business side of the tax code is a mess again. We have three complaints. One is about what the current system does to hurt us. These subsidies, $365 billion in this fiscal year alone for business income, tax subsidies for business income, both corporate and personal, they cost that much money. It would make a huge step toward deficit reduction if we could recover some or all of that, and we strongly disagree with President Obama on his idea that corporate tax reform should be revenue neutral. That would defeat one of the main points of reform, and that point is that we need to deal with our deficit over the long term.

And, you know, if there is one thing the public likes in terms of deficit reduction, it is asking American corporations to pay their taxes again. They do not like Social Security cuts. They do not like Medicare cuts. They do not like cuts in any program they have actually ever heard of. But they do like making American companies pay at least as much taxes as they are, which is not true now.

Now, you get bonuses out of corporate tax reform done right because the current subsidies, as any economist will tell you, are designed to make companies do things that do not make any sense economically. That is the program. We want them to not invest in what is the highest rate of return or what the customers want to buy. We want them to do things that you very, very smart Senators and the smart people over in the House of Representatives think are better, sort of Soviet-style socialism, you could call it if you were a mean person. Not me.

Well, if you tell companies to do things that are uneconomical, mostly, they will not because that is not where the money is. In fact, that is not what they lobby for. I mean, think about this for a minute. I am a steel company. I come in. Senator Conrad, I would like a tax break to make aluminum. No. I am asking for a tax break to make steel, because that is what I do. That is what I will do. But if you want to pay me to do it, so much the better.

So that is the good news about the tax breaks, is most of them are a complete and utter useless waste. But sometimes they make a difference. We have a system where the aerospace industry pays 1 percent in taxes and the retail industry pays 27 percent, and in between the rates are all over the place, too. I mean, that has to have some effect in getting investors to move to one place or another and that distorts behavior. Some effect.

I will tell you where the real effect is, though, the real worst effect, and that is our international system, which right now we pay our companies to either artificially shift their profits offshore or, in some cases, move things offshore and really do business offshore instead of here in the United States. We have tilted the playing field with tax breaks so that you can make more money after tax in China than you can in the United States, even if before tax you make the same thing, and that seems to me to be nuts. So very economically harmful.

The third point that I worry about is that, as you have pointed out, Senator Conrad, the disparity between taxes on capital income and taxes on wages has grown larger and larger. And if you look at what we could do about that, well, yes, capital gains and dividends breaks are part of it. But most capital gains are not overtaxed and neither are most dividends.

The one place we could do something about this inequality in taxes and lack of progressivity compared to the olden days in the tax system is on the corporate side, where the income is earned. If we can get some taxes out of the capital income at the source, which is what the corporate income tax is supposed to do, because we all know most dividends are not taxed, most capital gains are not, then we would have a more progressive and a fairer tax system and that would be a good thing, I think. Now, we can argue about whether it is good, but I think it is good.

So in conclusion, you on this committee are going to play a major role in trying to design a plan to reduce the long-term budget deficits and you do not want to do it in a way that endangers our very fragile economy, so you are going to do it gradually, I hope, and you are going to do it well and you are going to make great choices.

We urge you to make reduction or elimination of business tax subsidies your highest priority here, because doing so, you can not just cut the deficit and therefore retain some important programs. You can make the economy more efficient. You can add jobs. And you can make America a better society.

Thank you.

[The prepared statement of Mr. McIntyre follows:]

CTJ Citizens for Tax Justice

Statement of Robert S. McIntyre
Director, Citizens for Tax Justice
Before the Senate Budget Committee
Regarding Business Tax Subsidies Administered by the Internal Revenue Service
March 9, 2011

Thank you for the opportunity to testify today. As you may know, Citizens for Tax Justice has a long history of analyzing and trying to curb unwarranted business subsidies. Our research on corporate tax subsidies, for example, has been widely credited with playing a key role in the enactment of the Tax Reform Act of 1986. We have continued our work in this area ever since.

Today is the first day of Lent, and I'd like to suggest that members of Congress consider giving something up, not just until Easter, but perhaps until the federal budget is balanced (and even thereafter). What I hope you'll give up is your enthusiasm for providing subsidies to those who don't need them, in particular, for business subsidies administered by what seems to have become Congress's favorite agency, the Internal Revenue Service.

A quarter of a century ago, President Ronald Reagan took on business tax subsidies in the Tax Reform Act of 1986. Among other things, Reagan's tax act curbed offshore corporate profit shifting, leasing tax shelters and numerous industry-specific tax breaks, and despite a reduction in the statutory corporate tax rate, increased corporate tax payments by 34 percent. Reagan also equalized the personal income tax treatment of wages and realized capital gains, and he made the tax system more progressive overall.

But lobbyists for corporations and wealthy individuals didn't give up after 1986. They worked hard to regain and expand the tax subsidies that Reagan had taken away. In the 1990s, the lobbyists persuaded the Clinton administration and the Congress to eviscerate the corporate Alternative Minimum Tax (designed to curb the huge tax advantages that go to highly-leveraged activities such as equipment leasing), adopt the so-called "check the box" and "active-financing" rules that vastly expanded offshore corporate tax-sheltering opportunities, and reestablish preferential tax rates on realized capital gains. During the George W. Bush administration, business and investment tax breaks were expanded considerably further. Both political parties are at fault in this sad repudiation of President Reagan's tax legacy.

By the early 2000s, corporate subsidies had risen so much that the average effective U.S. federal corporate tax rate paid by America's largest and most profitable corporations on their U.S. profits had fallen to only 18.4 percent — barely over half the 35 percent statutory rate.[1] Those tax subsidies have grown even larger since then.

Our complaints about business tax subsidies fall into three categories. (1) They are hugely expensive. (2) They are often economically harmful. And (3) they conflict with fundamental tax fairness.

[1] Our study of 2001-03 corporate tax subsidies, *Corporate Income Taxes in the Bush Years*, was published in 2004.

1. The high cost of business tax subsidies

In fiscal 2011, the Treasury Department's official, but incomplete list of tax subsidies for corporations, business owners and business investors comes with an estimated annual cost of a staggering $365 billion.

These business tax subsidies are a major factor in creating the deficits that everyone agrees we need to address over the long term. We believe that eliminating or significantly reducing these subsidies ought to be a key part of any prudent deficit reduction program.

Thus, we think that President Obama is seriously off track in proposing to devote all the savings that can be gained from curbing business tax subsidies not to deficit reduction, but rather to lowering the statutory corporate tax rate.

Treasury's official (but incomplete) list of tax subsidies for C corporations, business owners & business investors in fiscal 2011 ($-billion)

C corporation tax subsidies (corporate income tax)	$ 159.2
Tax subsidies for business owners & business investors (personal income tax)	205.4
Total	**$ 364.5**

Notable items	Corporate Inc. Tax	Personal Inc. Tax	Total
Subsidies for foreign activities & offshore profit-shifting	$ 49.5	$ —	**$ 49.5**
Accelerated depreciation and expensing of equipment	34.1	45.6	**79.7**
Energy subsidies (business)	17.7	0.8	**18.5**
Subsidies for "research and experimentation"	14.0	0.5	**14.4**
Domestic production deduction	10.5	3.3	**13.8**
Subsidies for business investors (non-industry specific)	—	132.3	**132.3**
All other business tax subsidies	33.4	22.9	**56.3**
Total	**$ 159.2**	**$ 205.4**	**$ 364.5**

Note: Figures include the effects of the biggest subsidies extended in the Dec. 2010 agreement.

Imagine if, despite our deficit problem, someone called for big cuts in direct spending programs, but then proposed using all the money to cut tax rates. Most of us would call that crazy. But it seems just as crazy to do so when it comes to cracking down on subsidies that happen to be administered by the IRS.

2. Misallocation of capital and exporting jobs

High cost is not the only problem with business tax subsidies. They also often hurt our economy.

To be sure, to a large degree, business tax subsidies are simply an economically useless waste of resources. That's because companies don't ask for subsidies that would force them to change their behavior. Why would they? Instead, they ask for subsidies to reward them for doing what they would do anyway.

- Take for example, Boeing. This fine American company was just awarded a $35 billion contract to build new airborne tankers for the Air Force. That seems all well and good. After all, the contract was subject to competitive bidding, and Boeing won. And for its $35 billion, the Pentagon will get the planes it says it needs. But on top of that lucrative contract, Boeing gets a bonus. Over the past three years, Boeing reported $9.7 billion in pretax U.S. profits. But instead of paying the 35 percent corporate tax rate on those profits, Boeing received $3.5 billion in tax subsidies. As a result, it paid no federal income tax at all over those three years. But Boeing doesn't need such subsidies to build planes. It just needs someone who wants to buy them, such as occurred with the tanker deal.

Over the years, my group has done numerous studies on corporate tax subsidies and their effect on corporate investment behavior and job creation. In all of these studies, we found no positive correlation between the amount of subsidies that companies received and their investment and jobs performance.[2] That's not shocking. After all, corporate executives (as opposed to their lobbyists) often insist that tax subsidies are not the basis for their investment decisions. Other things, they say, usually matter much more, including infrastructure, wage levels, access to markets, the quality of the workforce and so forth.

a. Misallocation of capital

Useless waste is bad enough. But sometime tax subsidies, if they're big enough, do influence business decisions. And when they do, they generally cause harm, by reducing productivity, jobs, and economic growth. At least that's what one would conclude if one believes that market forces are usually a better way to allocate business capital than government "incentives" to do something else.

The range of effective corporate tax rates across different industries is striking. Periodically, my group analyzes the U.S. profits and U.S. taxes of a large sample of major American corporations. We expect to have a new report out this coming summer. Until then, we can look at our most recent report, which covered 275 highly profitable corporations over the 2001-03 period. During those three years, federal effective corporate tax rates on the 275 companies' domestic profits ranged from a low of 1.6 percent for aerospace and defense companies up to a high of 27.7 percent on retail and wholesale trade firms. Without doubt, such wide disparities continue today.

Effective Corporate Tax Rates for 275 Major American Corporations 2001-03, by Industry

$-millions	2001-03 Totals		
Industry & Company	**Profit**	**Tax**	**Rate**
Aerospace & defense	$ 17,684	$ 285	1.6%
Transportation	14,309	619	4.3%
Industrial and farm equipment	6,489	406	6.2%
Telecommunications	73,203	5,465	7.5%
Electronics, electrical equipment	47,023	5,095	10.8%
Petroleum & pipelines	42,530	5,652	13.3%
Miscellaneous services	61,378	8,855	14.4%
Utilities, gas and electric	53,794	7,767	14.4%
Computers, office equip, software, data	74,904	11,949	16.0%
Metals & metal products	7,814	1,362	17.4%
Financial	285,589	56,222	19.7%
Chemicals	5,424	1,129	20.8%
Pharmaceuticals & medical products	71,010	15,339	21.6%
Miscellaneous manufacturing	27,319	6,043	22.1%
Health care	25,432	5,674	22.3%
Publishing, printing	11,103	2,551	23.0%
Motor vehicles and parts	6,097	1,418	23.3%
Food & beverages & tobacco	74,024	17,589	23.8%
Household & personal products	19,354	4,688	24.2%
Retail & wholesale trade	132,558	36,692	27.7%
ALL INDUSTRIES	$ 1,057,038	$ 194,799	18.4%

At least on the margin, such a wide range of effective corporate tax rates among industries has to have some bad effects in misallocating America's capital resources. The same is true for the range of effective tax rates among corporations in the same industry.

The disparities in effective U.S. tax rates among industries just cited are largely due to tax subsidies that are supposed to encourage domestic investment and job creation. As noted above, our research has found these domestic subsidies to be either ineffective or economically harmful.

[2] In fact, we found that the opposite was true. See, e.g., *The Failure of Corporate Tax Incentives* (1985); *Money for Nothing* (1986), and *Corporate Income Taxes in the Bush Years* (2004).

But whatever you think of these kinds of subsidies, there is another category of corporate tax subsidies that are even worse: ones that tilt the playing field to favor foreign activities over U.S. investment and jobs.

b. Offshore profit shifting and export of jobs

A major way that business tax subsidies hurt our economy and jobs is that some of the largest subsidies encourage corporations to shift profits, and sometimes jobs, offshore.

Let's start with some background. The primary goal of our international corporate tax rules should be to assure that profits earned in the United States are subject to U.S. corporate income tax — whether those profits are earned by American-based or foreign-based corporations. A secondary, but still important goal, should be to avoid creating a tax advantage for corporate investments abroad versus domestic investments. To avoid double taxation of corporate overseas profits, our tax rules provide a tax credit for taxes paid to foreign governments on foreign earnings.

But our system has a key defect. It allows corporations to indefinitely "defer" reporting on their tax returns profits earned, or ostensibly earned, by their foreign subsidiaries. This means that corporations can avoid paying U.S. taxes, and often *any* taxes, on profits that they can persuade the IRS are "foreign." To compound this problem, the rules allow corporations to reduce their U.S. taxable income by some of their costs of earning foreign profits. The Treasury Department estimates that its short list of offshore corporate tax subsidies will cost the government $50 billion in fiscal 2011 alone. Many analysts believe that the real cost is much higher when offshore subsidies not on Treasury's list are taken into account.

(1) Offshore profit shifting
Companies with valuable intellectual property, such as high-tech companies, drug companies and the like, often are able to use complicated tax schemes to move, for tax purposes, what are actually profits earned in the United States to offshore tax havens where those profits go untaxed. Meanwhile, these companies often can deduct some of the cost of earning these so-called "foreign" profits to reduce their remaining U.S. taxable income.

There are many parts to these complicated tax shelters, including mispricing of intracompany transactions to shift deductions into the United States and revenues outside the United States. But the key to making these schemes work is the fact that U.S. corporations do not have to report the profits of their foreign subsidiaries on their U.S. tax returns. Ending this "deferral" privilege would eliminate most of this kind of tax sheltering activity.

(2) Incentives to move jobs out of the United States
In some cases, our tax system encourages companies to shift actual investment and jobs away from the United States. Of course, there are many reasons why American companies may want to do business outside of the United States. There may be opportunities to sell products or to obtain cheap labor, for example. But our tax code can magnify those advantages by making it more profitable, after taxes, to create jobs in low-tax countries. This violates what should be the second goal of our international corporate tax system: to avoid favoring foreign investment over U.S. investment.

Of course, corporate lobbyists are not lacking in arguments about why it's somehow a good idea to tilt the tax playing field in favor of foreign investment. And, of course, they don't phrase their arguments that way, preferring instead to claim that foreign investment is actually good for U.S. jobs. But our experience with the notable shift in jobs away from the United States over the past decades strongly indicates that these claims don't hold water. We have written about this topic in depth in reports on our website (www.ctj.org), but here is just one prominent example:

- In 2004, Congress enacted the "American Jobs Creation Act," which added more than $200 billion in new corporate tax subsidies over 10 years. It was a bill that the General Electric Company helped write and in which GE gained billions of dollars in new subsidies, particularly for its offshore activities. GE promised, of course, that these new subsidies would be good for our economy and U.S. jobs. But six years later, GE had cut its American workforce by 32,000 jobs, a 19 percent drop, while increasing its foreign jobs by 8.5 percent. In 2004, 54 percent of GE employees were in the United States. By 2010, that had dropped to only 46 percent.

Of course, corporate lobbyists will relentlessly tell Congress that businesses need tax subsidies from the government in order to be successful. They promise more jobs if they get the subsidies, and threaten economic harm if they are denied them. A central claim in the lobbyists' arsenal of falsehoods is the assertion that their clients need still more tax subsidies to compete because U.S. corporate taxes are much higher than foreign corporate taxes.

To evaluate this claim, we recently took a look at the corporations in our 2001-03 study cited earlier. Of the 275 companies in that study, 106 reported significant foreign profits. Here's what we found about their effective tax rates:

- Three-quarters of the 106 corporations paid higher foreign tax rates on their foreign profits than they paid to the United States in federal and state income taxes on the U.S. profits.
- On average for all 106 corporations, the effective foreign tax rate on their foreign profits was 29.3 percent. That was more than a third higher than the 21.3 percent U.S. federal and state rate they paid on their U.S. profits.[3]

Effective tax rates:
US federal & state tax rates on U.S. income vs. foreign income taxes on foreign income for 106 U.S. companies with significant foreign profits

	2001-03 total ($-billion)		
	Profit	**Tax**	**Rate**
US fed & state	$ 562.6	$ 121.0	21.5%
Foreign	304.7	89.3	29.3%
Foreign / US			**136%**

We have not yet compiled comprehensive recent data on U.S. versus foreign effective tax rates, although we doubt that things have changed very much since the early 2000s. We can, however, point to a few recent examples:

- Over the 2006-10 period, General Electric's U.S. federal tax rate on the $26.3 billion in pretax U.S. profits it reported to its shareholders was a negative 15.8 percent (GE enjoyed a net of $4.2 in tax rebates from Uncle Sam). In contrast, GE's foreign tax rate on its $67.7 billion in reported foreign profits was 19.6 percent.

[3] The profits referred to here are the U.S. and foreign pretax profits that companies report to their shareholders. These profit figures are often quite different from the geographic profit allocations that companies report to the IRS, because of tax schemes that shift what should be taxable U.S. profits to offshore tax havens. At least in 2001-03, corporations generally seemed to be more accurate in reporting to their shareholders than to the IRS.

- In 2009, ExxonMobil says it paid a 49.2 percent effective foreign tax rate on its foreign profits. But on its U.S. profits, it paid no federal income tax at all, but instead got a rebate of $0.8 billion.

We can also point out that a 2007 study by the Bush Treasury Department also concluded that the effective U.S. corporate tax rate is lower than the average corporate effective tax rate imposed by our major competitors.[4]

3. Tax fairness

Since the mid-1990s, expanded business subsidies have sharply reduced taxes on capital income, so that such income is now taxed at far lower rates than workers pay on their wages. That's unfair in and of itself. In addition, because capital income is so concentrated on high-income people, the tax subsidies for capital income also undermine the progressivity of our tax system.

Subsidies that reduce federal income taxes on C corporations:
If one looks at the tax subsidies for C corporations on Treasury's official list for fiscal 2011 and compares that to what corporate income tax payments would be without the subsidies, one finds that in the current fiscal year, tax subsidies are expected to reduce corporate income taxes by a staggering 44 percent. But that's not the full story, because some corporate tax subsidies are not included on Treasury's list. As I noted earlier, we're working on a new comprehensive study of the taxes paid or not paid by America's biggest and most profitable companies, and our preliminary results so far suggest that corporate tax subsidies are now larger than corporate taxes paid.

Subsidies that reduce federal income taxes on C corporation shareholders (individuals):
Corporate profits are not only largely untaxed at the corporate level, they're also barely taxed at the personal level.

- Two-thirds of stock dividends paid to individuals, directly or into retirement plans or charitable coffers, are effectively taxed at a zero rate or less, and stock dividends that are reported on personal income tax returns are generally subject to a top tax rate 20 points below the regular rates.

- Most capital gains on corporate stock are never realized and thus are never subject to income tax, and even when such gains are realized, they are subject to a top tax rate 20 points below the regular rates.

- According to the IRS, the 400 individuals with the highest adjusted gross income reported on their tax returns now pay only 14 or 15 percent of their reported income in federal income taxes, mainly because of the low tax rate on realized capital gains (some of which "capital gains" are probably disguised wages). But when you think for a minute, you know that even that paltry 14 percent rate is a far higher rate than these extraordinarily well-off people actually pay, since a large portion of capital gains are never cashed in, and thus go untaxed.

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[4]U.S. Department of the Treasury, "Treasury Conference on Business Taxation and Global Competitiveness: Background Paper," July 23, 2007.

- It's worth noting that about 70 percent of the tax savings from the low tax rates on the small portion of capital gains and stock dividends that is subject to personal income tax goes to the best-off one percent.

The bottom line is this: When one adds up the federal income taxes paid by corporations and their shareholders, it is clear that there is no "double tax," as some corporate lobbyists and economists claim. In fact, there is not even a single tax.

In contrast, most wages are subject to both personal income tax and payroll tax. And this "double tax" adds up to a much higher effective rate on wages than the rate imposed on capital income.

This disparity between the relatively heavy taxation of wages and the light taxation of capital income is a key reason why combined federal, state and local taxes of all kinds are now virtually flat across all income groups from the middle of the income scale to the best-off one percent.[5]

Conclusion

Curbing the many ways we now subsidize businesses through the tax code is long overdue. [6] President Reagan's 1986 Tax Reform Act, along with lessons learned thereafter, can provide an excellent template for action.

On the corporate side, we need to start with a serious reform of our international tax system. Getting rid of "deferral" is the key to eliminating artificial offshore profit shifting and ending tax incentives for companies to invest abroad instead of here in the United States. Once we clean up our international tax mess, then we are likely to find it far more attractive to crack down on unaffordable and unwarranted domestic business tax subsidies as well.

With regard to business subsidies in the personal income tax, we would start by going after tax subsidies for capital gains and stock dividends, and go on from there.

More details on our reform proposals can be found on our website (www.ctj.org).

Of course, there are many non-business subsidies in the tax code. A large proportion of them, however, are means-tested in one way or another, which makes many of them praiseworthy or at least inoffensive in terms of equity. On the other hand, there's no doubt that there are personal tax subsidies that are unwarranted or far less desirable than continuation of other spending priorities.[7]

That said, we firmly believe that business subsidies are the biggest problem in the tax code today. They are distributionally harmful, which means they create even greater inequality. They should

[5] CTJ, "All Americans Pay Taxes" (April 2010).

[6] Of course, the time may not yet be ripe to do so. We may be wise to wait until the many current members of Congress who believe that eliminating virtually any subsidy administered by the IRS entails an unacceptable "tax increase" are either persuaded otherwise or move on to other careers.

[7] It would be remiss not to mention that requiring the IRS to administer so many tax-based spending programs outside its field of expertise surely interferes with the IRS's main mission: to collect taxes as fairly and as simply as possible.

have little economic appeal to anyone who believes that business investment decisions are usually best left to market forces. And curbing corporate subsidies is one of the few kinds of spending cut that enjoys wide public support.

So, as you take on the delicate task of reducing long-term budget deficits without endangering the fragile economic recovery, we urge you to make elimination or reduction of business tax subsidies your highest priority. Doing so can slash the deficit while retaining essential programs, improve economic efficiency, add jobs and make America a more equitable society.

Citizens for Tax Justice
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202-299-1066 • ww.ctj.org

Chairman CONRAD. Thank you, Mr. McIntyre.

Next, we will hear from Mr. Hodge, the President of the Tax Foundation. Welcome. Good to have you before the committee. Please proceed with your testimony.

STATEMENT OF SCOTT HODGE, PRESIDENT, TAX FOUNDATION

Mr. HODGE. Thank you, Mr. Chairman and members of the committee. The immutable principles of economically sound tax policy tell us that taxes should be neutral to economic decisionmaking, they should be simple, transparent, stable, and they should promote economic growth. In other words, an ideal tax system should only do one thing and do it well, and that is just raise a sufficient amount of money for the government activities while doing the least amount of harm to the economy, and I think everyone on this committee will agree that the U.S. tax system is far from that ideal.

Over the past two decades, we have asked the tax code to direct all manner of social and economic behavior, such as buying hybrid vehicles, turning corn into gasoline, encouraging people to save more for retirement, purchase health care, buy a home, replace the windows in that home, adopt children, put them in day care, take care of grandma, buy bonds, spend more on research, purchase school supplies, go to college, invest in historic buildings, and on and on and on. In too many respects, the IRS has become a substitute for every other cabinet agency, from Energy to Education to HHS and HUD.

And thanks to the generosity of the credits and deductions in the tax code, a record 52 million taxpayers, or 36 percent of all filers, pay no income taxes at all and are now off the tax rolls. In other words, they have no skin in the game. And indeed, many of these people now look to the IRS as a source of income, thanks to more than $100 billion worth of refundable tax credits paid out to people who have no income tax liability at all.

You know, the OECD reports that the U.S. has the most progressive income tax system of any industrialized country. Indeed, the top 1 percent of U.S. taxpayers now pays a greater share of the income tax burden than the bottom 90 percent combined.

But the entire Federal fiscal system is progressive, not just the tax code. Tax Foundation economists have estimated that the majority of American families now receive more in government spending benefits than they pay in taxes. And overall, the Federal fiscal system, between taxes and spending, combine to redistribute more than $824 billion from the top 40 percent of families to the bottom 60 percent.

Unfortunately, many companies and industries, as Bob has mentioned, are now looking to the IRS as a source of income, too. In fact, a recent case, one-third of the profits of a major appliance company came from the Energy Production Credits, and I doubt that when Members of Congress enacted that program that they thought that it would be to this appliance company what the EITC is to poor people, an income subsidy.

And today, the biggest crises facing working families and the economy are health care, housing, and local government finances. And ironically, these are the areas in which the government and the tax code are most involved. So the cure to what ails these industries is that we wean them off the tax code, not give them more subsidies.

The tax preference for employer-provided health insurance has undermined in health care the market forces that deliver quality goods and services to everything from bread to computers. Housing suffers a similar problem because of the plethora of tax and spending subsidies intended to promote home ownership. One study determined that the MID is an ineffective policy to promote home ownership and to improve social welfare. And it should be noted——

Chairman CONRAD. Can I just stop you on that?

Mr. HODGE. Yes.

Chairman CONRAD. You were referencing there the Mortgage Interest Deduction?

Mr. HODGE. I apologize for using the acronym.

Chairman CONRAD. Yes. You know, any time, because we have people watching this——

Mr. HODGE. Geek-speak.

Chairman CONRAD. Yes. So I know in the Washington community and Congress, everybody knows what that is, but if you will use the words so that people listening know what it means, as well.

Mr. HODGE. My apologies. It should be no surprise that State and local debt has soared from $1.5 trillion in 2000 to $2.4 trillion today because local governments can pass off some of that cost to Uncle Sam through State and local tax deductions and subsidized municipal bonds.

And we have, because, I think, in part, the rising local taxes, more and more Americans are finding themselves trapped by the AMT.

But Washington can actually do more for the American people by doing less. The solution lies in fundamental tax reform, which means lowering tax rates while eliminating many of the preferences in the tax code. And a good starting point could be the Zero Plan by Erskine Bowles and Alan Simpson. And it is certainly not a perfect plan, but it does demonstrate that Americans could enjoy lower tax rates and the government could raise as much money if some, if not all, of the tax expenditures were eliminated.

That said, with $1.5 trillion deficits, it is tempting to look at closing loopholes as a honey pot for deficit reduction, but I believe that would be a mistake. The primary goal of fundamental tax reform should not be raising more money for the government. It should be to improve the nation's long-term economic growth and lift the living standards of every American.

Economists at the OECD in Paris, the Organization for Economic Cooperation and Development, have determined that high corporate and high personal income tax rates are the most harmful taxes for long-term economic growth. Unfortunately, of course, as many of you know, the U.S. has one of the highest corporate tax rates in the industrialized world, and as I mentioned, we have one of the most progressive personal income tax systems in the industrialized world.

Fundamental tax reform can restore the nation's competitiveness and put us on a growth path for the future. And not only will this improve the living standards of all Americans, but it will improve the nation's fiscal health, as well, and that is a win-win for everyone.

Thank you very much, Mr. Chairman. I welcome any questions that you may have.

[The prepared statement of Mr. Hodge follows:]

Prepared Statement of

Scott Hodge
President
Tax Foundation

Hearing on

Distribution and Efficiency of Spending in the Tax Code

Before the U.S. Senate Budget Committee

March 9, 2011

TAX FOUNDATION

National Press Building
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Washington, DC [illegible]
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Distribution and Efficiency of Spending in the Tax Code

By Scott A. Hodge
President, Tax Foundation

Hearing on Distribution and Efficiency of Spending
in the Tax Code
Before the U.S. Senate Budget Committee

March 9, 2011

Mr. Chairman and members of the Committee:

I am Scott Hodge, president of the Tax Foundation. Thank you for the opportunity to speak to you today regarding the distributional and economic issues surrounding tax expenditures in the federal budget.

Founded in 1937, the Tax Foundation is the nation's oldest organization dedicated to promoting economically sound tax policy at the federal, state, and local levels of government. We are a non-partisan 501(c)(3) organization.

For nearly 75 years, the Tax Foundation's research has been guided by the immutable principles of economically sound tax policy that were first outlined by Adam Smith: Taxes should be neutral to economic decision making; they should be simple, transparent, and stable; and they should promote economic growth.

In other words, the ideal tax system should do only one thing: raise a sufficient amount of revenues to fund government activities with the least amount of harm to the economy. As Jean Baptiste Colbert famously wrote, "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing."

By all accounts, the U.S. is far from that ideal. According to the National Taxpayer Advocate, tax complexity is the number one issue facing taxpayers and the IRS today. The main cause of that complexity has been the proliferation of credits, deductions, and preferences built into the tax code.

Introduction

Over the past two decades, lawmakers have increasingly asked the tax code to direct all manner of social and economic objectives, such as encouraging people to: buy hybrid vehicles, turn corn into gasoline, save more for retirement, purchase health insurance, buy a home, replace the home's windows, adopt children, put them in daycare, take care of Grandma, buy bonds, spend more on research, purchase school supplies, go to college, invest in historic buildings, and the list goes on.

In too many respects, the IRS has become an extension of, or rather a substitute for, every other cabinet agency, from Energy and Education to HHS and HUD. But perhaps the most troubling development in recent years is that the efforts of lawmakers to use the tax code to help low- and middle-income taxpayers have knocked millions of taxpayers off the tax rolls and turned the IRS into an extension of the welfare state.

Today, a record number of Americans—52 million, or 36 percent of all filers—have no direct connection with the basic cost of government because they pay no income taxes. If we add this group to the people who have some income but don't file a tax return, the ranks of American households outside the income tax system rise to 48 percent.[1]

Indeed, many of these 52 million tax filers now look to the IRS as a source of income thanks to the more than $100 billion in refundable tax credits paid to people who have no income tax liability.

As a result of removing millions of people from the bottom of the tax rolls, we have dramatically reduced the number of people with "skin in the game." Indeed, the top 1 percent of taxpayers now pays a greater share of the income tax burden than the bottom 90 percent combined.

Sadly, individuals are not the only taxpayers looking to the IRS as a source of income. The proliferation of tax credits aimed at promoting technologies such as renewable energy and fuel-efficient products has addicted many companies and industries to IRS handouts. In a recent case, one-third of the profits of a major appliance company were attributable to energy producrion credits.

Ironically, but perhaps not surprisingly, the sectors suffering the biggest financial crises today—health care, housing, and state and local governments—all receive the most subsidies through the tax code. The cure for what ails these industries is to be weaned off the tax code, not given more subsidies through such things as the First Time Homebuyer's Credit, Premium Assistance credits, or more tax-free bonds.

Washington can actually do more for the American people by doing less. The solution lies in fundamental tax reform. Indeed, as the plan authored by Erskine Bowles and Alan Simpson (co-chairmen of President Obama's National Commission on Fiscal Responsibility and Reform), demonstrated, Americans could enjoy much lower tax rates, and the government could raise the same amount of revenue if most—if not all—tax expenditures were eliminated.

That said, the primary goal of fundamental tax reform should not be raising more money for government. The primary goal should be improving the nation's long-term economic growth and lifting living standards.

Economists at the OECD have determined that high corporate and personal income tax rates are the most harmful taxes for long-term economic growth. Unfortunately, the U.S. has one of the highest corporate income taxes among industrialized nations and one of the most progressive personal income tax systems.

Cutting these rates while broadening the tax base would greatly improve the nation's prospects for long-term GDP growth. The benefits of higher economic growth will accrue to taxpayers and Uncle Sam alike.

What Are Tax Expenditures?

According to the Joint Committee on Taxation, "tax expenditures include any reductions in income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers."[2] These special preferences are called tax expenditures because some people consider them the equivalent of direct spending through the tax code.

However, aside from the refundable cash outlay portion of some credits, tax expenditures are really not the same as direct spending. Instead, they are an attempt to achieve certain public policy goals by inducing or incenting taxpayers with the prospect of a lower tax bill. Essentially, lawmakers are trying to get taxpayers to achieve these policy objectives by using their own money, not "the government's."

To be sure, many people improperly view the forgone revenue from tax expenditures as "the government's money." By this view, what the tax code allows taxpayers to keep through tax preferences has thus been "spent" in the same manner as a government program.

But there is a very real moral and functional difference between the government taking $1,000 from a taxpayer and giving it to the Department of Energy for switch grass research, and a tax preference which allows that taxpayer to keep $1,000 of his own money because he purchased new windows for his home. The tax credit may be poor tax policy, but the transaction is clearly one that the taxpayer chose of his own accord. The government did not actively take his money and give it to Home Depot for the new windows.

How Many Tax Expenditures Are There?

While estimates of tax expenditures vary, there is no doubt that their numbers have grown in recent years. Table 1 in the Appendix to this report illustrates the growth in the number of tax expenditures according to a recent analysis by economists at the OECD. In 2002, the OECD identified 135 separate tax preferences in the U.S. tax code. By 2010, the number had increased to 164, a jump of 21 percent.

The biggest growth in tax expenditures was in the area of industry-specific provisions, where the number jumped from 35 to 54 between 2004 and 2008. The majority of these new industry-specific provisions were targeted to businesses involved in renewable energy and energy efficiency.

Which Are the Largest Categories of Tax Expenditures?

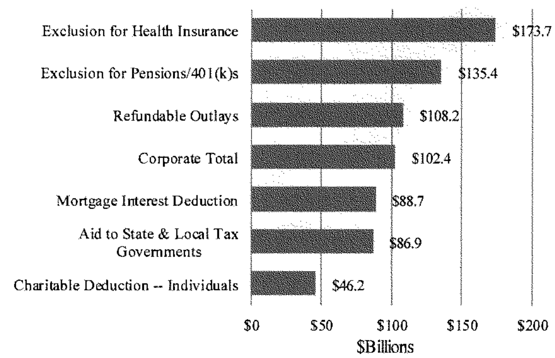
According to the President's FY 2011 budget documents, corporate and individual tax expenditures will total more than $1 trillion this year. The vast majority of these tax preferences, roughly $900 billion, operate through the individual side of the tax code.

Both the Joint Committee on Taxation and the Treasury caution against viewing the estimated cost of tax expenditures as the amount that could be raised if the preferences were eliminated. Eliminating a preference causes numerous behavioral and substitution effects that are not captured in these budgetary estimates. Thus, eliminating a provision could raise substantially less new revenue than the budgetary cost associated with it.

With that cautionary note in mind, Figure 1 shows the composition of the largest categories of tax expenditures in FY 2011. By far the largest of these, at $174 billion, is the tax exclusion for employer-provided health insurance. The next largest category, at $135 billion, is for the collection of tax exclusions for pensions, 401(k)s, Individual Retirement Accounts, and Keogh plans.

For the sake of comparability, we've included the actual outlay cost of the refundable portion of tax credits even though they are not included in the overall cost of traditional tax expenditures. However, as we will discuss later, they are among the fastest-growing tax preferences and now comprise the third-largest category of preferences in the tax code with an actual cost of $108 billion in 2011.

Figure 1: Major Categories of Tax Expenditures FY 2011



The amount of corporate "loopholes" is actually much less than what is commonly thought. Overall, the roughly 80 separate corporate tax preferences have a combined budgetary cost of roughly $102 billion in FY 2011, only slightly larger than the cost of the mortgage interest deduction alone.

As Figure 1 shows, the mortgage interest deduction confers roughly $89 billion in benefits to homeowners and the housing industry each year. State and local governments receive about $87 billion in benefits through the combined effects of the deduction for state and local taxes and through tax-exempt bonds. Lastly, charities benefit from about $46 billion in budgetary resources each year.

Tax Expenditures and Distributional Issues

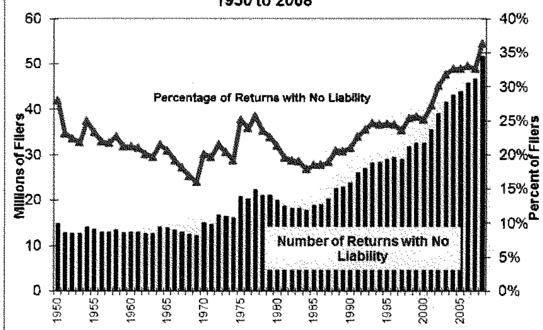
One of the dominant issues in any discussion of tax expenditures is who benefits from them. Because the value of a tax deduction depends upon the taxpayer's marginal tax rate, many of the largest and best known tax preferences, such as the mortgage interest deduction, do tend to benefit upper-income taxpayers. However, over the past 20 years or so, lawmakers have increasingly turned to using tax credits to benefit low- and middle-income taxpayers. This has had the unintended consequence of removing millions of taxpayers from the tax rolls altogether.

Setting aside for the moment the question of the true economic incidence of tax expenditures (i.e. who ultimately benefits from them), the major individual tax expenditures are largely claimed on the returns of upper-income taxpayers. For example, according to the Joint Committee on Taxation, 64 percent of the benefits of the mortgage interest deduction flow to taxpayers earning over $100,000, while 81 percent of the benefits of the deduction for state and local taxes (income, property, and sales) went to the same group.[3] Many rightfully argue that these provisions effectively subsidize high-tax communities at the expense of low-tax communities or subsidize homeowners at the expense of renters.

Similarly, JCT found that 80 percent of the benefits of the charitable deduction went to taxpayers earning over $100,000. To be sure, Americans earning under $100,000 give billions each year to charity, but because they are not among the roughly one-third of taxpayers who itemize on their tax returns, the tax code does not reward them for their generosity.

The Growth of the Nonpaying Population

Figure 2: Number and Percentage of "Nonpayers": 1950 to 2008

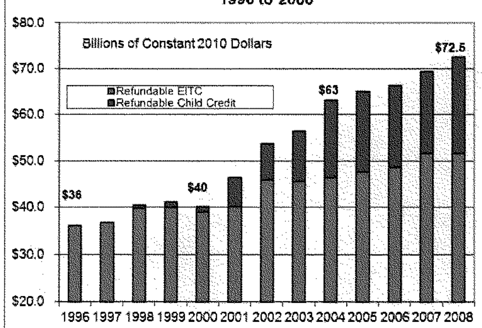


Source: Tax Foundation Calculations based on IRS Data

While the tax code's benefits to high-income taxpayers are well documented, less attention has been given to the growth in tax benefits targeted to low- and middle-income taxpayers. Since the early 1990s, lawmakers have increasingly used the tax code instead of government spending programs to help low-income and middle-class taxpayers. In terms of tax revenue, the most significant of these socially targeted credits was the $500 per-child tax credit enacted in 1997. The 2001 and 2003 tax bills doubled the value of the credit to $1,000 and added a refundable component.

Most tax credits can only reduce the amount a taxpayer owes to zero, but the EITC and the child tax credit are also refundable, meaning that taxpayers are eligible to receive a check even if they have paid no income tax during the year. Those tax returns have become, in effect, a claim form for a subsidy delivered through the tax system in much the same way that a traditional government program sends out a welfare check or a farm support check.

Figure 3: Growth in Refundable Tax Credits from 1996 to 2008



Source: IRS Preliminary Data Tables 1996-2008

In 2008, according to the most recent IRS data available, 25 million tax filers received $51.6 billion in EITC benefits. Of this amount, $50.5 billion was refundable in excess of their income tax liability. Also in 2008, some 25.3 million filers received $30.7 billion in child tax credit benefits, with more than 18 million of these filers getting $20.5 billion in refundable checks. Many families are eligible for both the EITC and the child credit. These are not refunds of overpaid tax; they are payments to people who have already gotten back everything that was withheld from their paychecks during the year.

Figure 2 shows the fluctuation in the number and percentage of nonpayers since 1950 and how that has soared over the past decade.[4] The percentage of tax returns with no liability was fairly low in the 1960s and again in the early 1980s. The recent growth in the number of nonpayers was accelerated by two major tax changes enacted during the 1990s, followed by the Bush tax cuts in 2001 and 2003, and then the Economic Stimulus Act of 2008, which included a tax rebate of $300 per person, $600 per couple.

In 2008, these tax rebates boosted the number of nonpayers to nearly 52 million, or roughly 36 percent of all tax filers. Moreover, the rebates boosted the maximum income for nonpayers to more than $56,700. In the absence of the rebates, the threshold would have been roughly $44,500.

When the final IRS data is tallied for tax years 2009 and 2010, it is likely that the number of nonpayers could approach 40 percent due to President Obama's making-work-pay credit, first-time homebuyer credit, and American Opportunity tax credit. As a rule of thumb, we can now expect that the typical family of four earning up to $50,000 will owe no income taxes.[5]

Refundable Credits Soar

Since it was enacted in 1913, the income tax code has contained provisions—such as the standard deduction, personal exemption, and dependent exemption—that exempted low-income workers from tax or greatly reduced their income tax burden. But starting with the earned income tax credit (EITC), and then the child tax credit, the IRS was required to send a "refund" check to taxpayers even though they had no income tax liability.

As Figure 3 shows, the amount of refundable checks sent by the IRS to nonpayers has doubled in real terms between 1996 and 2008, growing from $36 billion to over $72 billion. These credits are so generous, that the Joint Committee on taxation estimates that in 2009, they exceeded the employee share of payroll taxes for 23 million tax filers and exceeded the employer's share of payroll taxes for 15.5 million filers.[6]

In recent years, more and more tax provisions are resulting in a cash outlay from the IRS. As Table 1 shows, in 2011 there are 13 tax provisions that will result in $108 billion in outlays. In five years, after the Premium Assistance Credit takes effect in 2014, tax outlays will top $117 billion.

Table 1: Outlay Components of Tax Credits in 2011 and 2016

Tax Provision	Outlay Component 2011 ($Billions)	Outlay Component 2016 ($Billions)
Earned Income Tax Credit	$54.96	$44.91
Child Tax Credit	24.17	24.17
Making Work Pay	20.49	0
Health Coverage Tax Credit	0.15	0.15
Adoption Credit	0.41	0
Build America Bonds	2.59	2.45
Premium Assistance Tax Credit	0	43.84
Small Business Credit	0.18	0.32
Energy Production Grants	4.2	0.62
Credit for holding clean renewable energy bonds	0.02	0.03
Qualified energy conservation bonds	0.05	0.06
Recovery Zone Bonds	0.12	0.13
Credit for holders of zone academy bonds	0.02	0.03
Qualified school construction bonds	0.85	1.02
Total =	**$108.21**	**$117.73**

Tax Expenditures and Progressivity

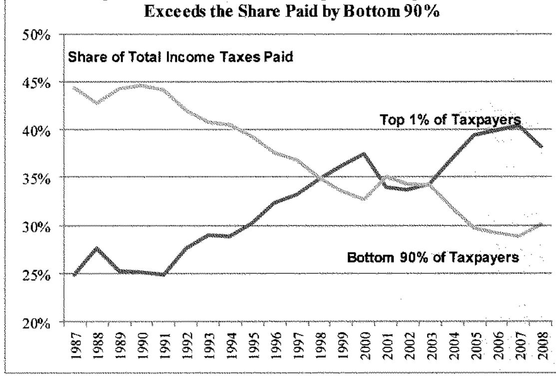
There is a common belief that because so many tax expenditures benefit upper-income taxpayers, the "rich" are not paying their fair share of taxes. Nothing could be further from the truth.

Indeed, because of the expansion of tax benefits aimed at low- and middle-income households, the OECD finds that the U.S. has the most progressive income tax system of any industrialized country. What that means is that the top 10 percent of U.S. taxpayers pay a larger share of the income tax burden than do the wealthiest decile in any other industrialized country, including traditionally "high-tax" countries such as France, Italy, and Sweden.[7]

Meanwhile, because of the generosity of such preferences as the EITC and child credit, low-income Americans have the lowest income tax burden of any OECD nation. Indeed, the study reports that while most countries rely more on cash transfers than taxes to redistribute income, the U.S. stands out as "achieving greater redistribution through the tax system than through cash transfers."[8]

The share of the income tax burden borne by America's wealthiest taxpayers has been growing steadily for more than two decades. Figure 4 compares the share of income taxes paid by the top 1 percent of taxpayers to the share paid by the bottom 90 percent of taxpayers.

Figure 4: Tax Burden ofthe Top 1% ofTaxpayers Now Exceeds the Share Paid by Bottom 90%



The chart shows that, as of 2008, the top 1 percent of taxpayers paid 38 percent of all income taxes, while the bottom 90 percent of taxpayers paid just 30 percent of the income tax burden. By any measure, this is the sign of a very progressive tax system.

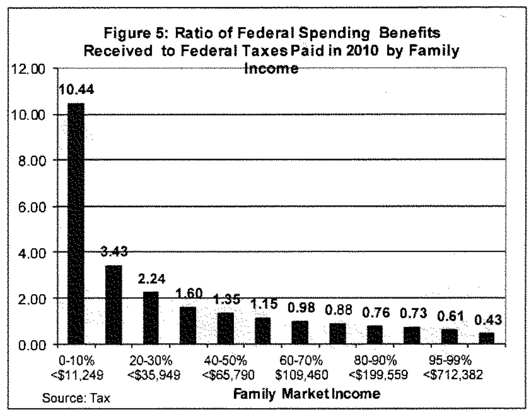
Measuring the Distribution of Both Taxes and Spending

While the topic of this hearing is the distribution and efficiency of tax expenditures, it is a mistake to focus solely on the distributional effects of tax policy without considering the distributional effects of spending. After all, federal spending is intended to achieve various policy objectives and benefit different groups of Americans in different ways. Thus, it is important to look at the progressivity of the entire fiscal system, not just the tax side.

In an important 2009 study, in order to gain a better understanding of the overall amount of redistribution that occurs through both tax and spending policies, Tax Foundation economists measured how much families at various income levels paid in taxes versus how much they received in spending benefits. The results of this analysis show that federal tax and spending policies are very heavily tilted to the poor and middle-class, even before considering the Obama administration's major policy initiatives such as health care reform. For 2010, the Tax Foundation report found that the bottom 60 percent of American families received more in government spending than they paid in taxes.

Not surprisingly, as Figure 5 shows, government spent $10.44 on the lowest-income families for every dollar they paid in taxes. Remarkably, families in the middle-income group received $1.15 for every dollar they paid in taxes.

By contrast, the top 40 percent of families paid more in taxes as a group than they received in government spending benefits. The highest-income families received 43 cents in government spending for every dollar they pay in taxes, even though they are assumed in this study to disproportionately benefit from public goods such as national defense.



Overall, federal tax and spending policies combined to redistribute more than $824 billion from the top 40 percent of families to the bottom 60 percent of families in 2010. In other words, the entire federal fiscal system is very progressive and redistributive.

Tax Expenditures Are the Cause of Today's Financial Crises

Today, the biggest financial crises facing working families and the economy are health care, housing, and state and local government finances. Ironically, these are the areas in which government is already the most involved.

For example, the tax preference for employer-provided health insurance creates a classic third-party payer problem in which patient-consumers are disconnected from the cost of service. The cost of health care is soaring because we have an unlimited demand for health care since someone else is paying the bills. The market forces that deliver quality goods at low prices for everything from toasters to automobiles have been disrupted in the health care system because it is tax preferred. The recent health care reform legislation will make this problem worse, not better.

Housing suffers a similar problem because of the plethora of tax and spending subsidies intended to promote home ownership. Professor Dennis J. Ventry, Jr. of the UC Davis School of Law, calls the mortgage interest deduction (MID) the "accidental deduction," because the authors of the original tax code never intended the deduction for personal interest expenses to subsidize home ownership.[9]

Economists find that the MID gets capitalized into the price of homes and may amplify price volatility,[10] which offsets whatever effect it has on promoting home ownership. The actual economic benefits of those capitalized costs tend to flow to the home builders and realtors, who have naturally been the most vocal opponents of eliminating the MID. One study determined that the MID is "an ineffective policy to promote homeownership and improve social welfare."[11]

While the lion's share of the blame for the current housing crisis properly rests with government-sponsored enterprises Fannie Mae and Freddie Mac, the MID certainly played a role in encouraging some families to purchase homes that they really could not have afforded otherwise. Canada does not have a mortgage interest deduction, yet its rate of homeownership is equal to that in the U.S. Even the *Washington Post* has editorialized that it is time to "[t]rim the excessive tax subsidy for real estate."[12]

The deduction for state and local taxes and the tax subsidies for municipal bonds allow local governments to raise taxes and pass as much as one-third of those costs to Uncle Sam. This is especially true for high-cost, high-tax suburban communities. Ironically, the state and local tax deduction is the primary reason more and more taxpayers in these high-tax urban areas—largely in so-called Blue States—are being ensnared in the Alternative Minimum Tax. The AMT is not an issue for taxpayers in lower-tax states and communities.

One study found that the state and local tax deduction leads to higher local tax revenues "by increasing the rate of local property taxation." Specifically, the authors found "that if deductibility were eliminated, the mean property tax rate in our sample of 82 communities would fall by 0.00715 ($7.15 per thousand dollars of assessed property), or 21.1 percent of the mean tax rate."[13]

In the same way that the MID encourages some families to purchase larger, more expensive homes than they otherwise could afford, federal tax subsidies for state and local activities may encourage some governments to buy more government than their taxpayers could otherwise afford. In recent years, state and local debt has grown significantly as a share of GDP according to Steven Malanga, a fellow with the Manhattan Institute. He estimates that:

> Over the last decade, through good times and bad, total state and local debt has soared from $1.5 trillion in 2000 to $2.4 trillion (in current dollars). When that debt is added to other growing obligations that governments are racking up, using techniques like not paying their bills on time, state and local liabilities have increased from 15 percent of GDP in 2000 to an estimated 22 percent this year. In 1980, they were 12 percent.[14]

It is very likely that these governments would not have borrowed as much as they did were it not for the fact that tax-free municipal honds allow them to pass some of that cost off to the federal government.

Dependent Corporate Interests

History shows that lawmakers need to be very cautious about trying to use targeted tax preferences to promote specific industries or technologies because these preferences can create a dependent class of industries in the same way that refundable tax programs such as the EITC and child credit can create a dependent class of families.

The recent tax policies aimed at promoting renewable energy sources and more efficient appliances provide two good examples. Many recent news reports have documented the fragility of the wind and solar power industry without federal tax subsidies. During last December's debate over the extension of the energy investment credit, the CEO of the American Wind Energy Association warned that without the tax credit the prospects for the industry would be "flatline or down."[15]

The *Washington Post* reports that the wind industry "has had its production tax credits lapse three times—in 1999, 2001 and 2003. According to the American Wind Energy Association, new installed wind capacity declined 93, 73 and 77 percent, respectively."[16] In other words, without the tax subsidy, there is no investment.

According to a recent *Bloomberg* story, the tax incentives for the production of energy-efficient appliances have also resulted in very unintended consequences:

> Whirlpool Corp. will claim $300 million this year in U.S. tax credits for making energy-efficient appliances, collecting almost four times the government's estimate for what all companies would receive from the tax incentive.
>
> The credit will generate about one-third of Whirlpool's earnings this year, according to the company's projections.
>
> Company filings show that as of Dec. 31, 2010, Whirlpool had $555 million in stockpiled business credits and $2 billion in tax losses. Both can typically be used to offset up to 20 years of future income and taxes.[17]

When Congress created the tax credit in 2005 to encourage the production of energy-efficient appliances, it seems unlikely that lawmakers envisioned that it could someday comprise one-third of a company's profits. For Whirlpool, the energy credit is an income subsidy in the same manner as the EITC subsidizes the income of a poor family.

Ironically, the stockpiling of tax credits can turn some companies into opponents of corporate tax reform. That is because these credits are booked as "assets" on the company's balance sheet and have a value linked to the corporate tax rate of 35 percent. Should the corporate tax rate be lowered, to say 25 percent, then the value of those assets will fall by about one-third, which directly impacts the book value of the company. Since no CEO wants that, they have an incentive to lobby on behalf of higher corporate tax rates.

Tax Reform Is the Solution

In its 2010 Annual Report to Congress, the National Taxpayer Advocate identified tax complexity as the most serious problem facing taxpayers and the IRS, and urged lawmakers to simplify the system.[18]

Simply complying with the tax code costs taxpayers an estimated $163 billion each year. About 62 percent of all taxpayers use tax return preparers, but the percentage climbs to about 73 percent for those claiming the EITC.[19] Moreover, the complexity of EITC eligibility is a contributing factor to the estimated $10 billion to $12 billion in erroneous overpayments out of nearly $44 billion of total EITC claims in 2006.[20]

According to a recent Tax Foundation study, the "deadweight" costs, or excess burden, of the current individual income tax is not inconsequential, amounting to roughly 11 to 15 percent of total income tax revenues. This means that in the course of raising roughly $1 trillion in revenue through the individual income tax, an additional burden of $110 to $150 billion is imposed on taxpayers and the economy.[21]

New revenues should not be the primary goal of reform. To be sure, with the deficit now topping $1.5 trillion, many lawmakers may look at eliminating tax "loopholes" and simplifying the tax code as an opportunity to raise more revenues. This should not be the primary goal of tax reform. The primary goal should be to promote long-term economic growth and better living standards for the American people. If the byproduct of increased economic growth is more tax revenues, then that is a win-win.

Clearly, eliminating "loopholes" and other distortionary tax provisions can wring some of the deadweight losses out of the economy. But the key to promoting long-term growth is cutting top tax rates. A recent study by economists at the OECD found that corporate income taxes are the most harmful tax for long-term economic growth and that high personal income taxes were found to be the second-most harmful for long-term growth.

Not only does the U.S. have the most progressive income tax system among OECD nations, it also has the second-highest corporate income tax rate in the OECD. These high taxes on corporate and personal income are jeopardizing the country's long-term prospects for growth. Cutting both personal and corporate income tax rates while eliminating tax expenditures would result in both improved GDP growth and a more efficient tax system.

According to OECD economists, cutting the top personal tax rate can "raise productivity in industries with potentially high rates of enterprise creation."[22] In other words, lower marginal rates can increase entrepreneurship and risk taking. Moreover, they find that "lowering statutory corporate tax rates can lead to particularly large productivity gains in firms that are dynamic and profitable, i.e. those that can make the largest contribution to GDP growth."

There are any number of plans that would greatly simplify the tax code, including the flat tax, Rep. Paul Ryan's "Roadmap," the FairTax, and the Bradford X-tax. A good illustration of how far tax rates can be lowered by eliminating some or all of the tax expenditures in the code is the "Zero Plan" drafted by the chairmen of President Obama's National Commission on Fiscal Responsibility and Reform, Erskine Bowles and Alan Simpson.[23]

As the table from the Bowles/Simpson report shows, below, eliminating all tax expenditures could lower the top corporate tax rate from 35 percent to 26 percent and the top individual rate from 35 percent to 23 percent. This would also allow the lowest tax rate to be reduced from 10 percent to 8 percent. [24]

COMPREHENSIVE TAX REFORM DRAFT

Option 1: The Zero Plan

	Bottom Rate	Middle Rate	Top Rate	Corp. Rate
Current Rates for 2010	10% 15%	25% 28%	33% 35%	35%
Scheduled Rates for 2011	15%	28% 31%	36% 39.6%	35%
Eliminate all Tax Expenditures*	8%	14%	23%	26%
Keep Child Tax Credit + EITC*	9%	15%	24%	26%
Keep Child Tax Credit + EITC; Reform Mortgage, Health, and Retirement Benefits at 80% of Current Level and Switch to Territorial System*	12%	20%	27%	27%
Keep Child Tax Credit, EITC, and Current Mortgage, Health and Retirement Benefits and Switch to Territorial System*	13%	21%	28%	28%

Rates based on very rough static estimates. No behavioral effects are assumed. Magnitude of tax expenditures estimated broadly.

*Note: All options set aside $80 billion for deficit reduction and treat capital gains and dividends as ordinary income

24

With these optimal rates in mind, the plan shows lawmakers and taxpayers the cost of putting various credits and deductions back into the tax base. The more tax preferences you put back into the code, the higher the rates have to be to raise the same amount of revenues.

For example, keeping the child tax credit and the EITC would boost the bottom individual rate from 8 percent to 9 percent and the top rate from 23 to 24 percent. Every rate would have to go up another 3 percentage points should lawmakers want to keep the child credit and EITC while slightly scaling back the MID, health exclusion, and retirement benefits. The rates would have to go up another percentage point if all of these major provisions were kept unchanged in the current tax code.

While these are difficult trade-offs to be sure, the goal of the process is to wring as much inefficiency out of the tax system as possible while rewarding taxpayers with lower rates and a simpler, less complicated tax code.

Cautions and Caveats

Not every tax expenditure listed by either the JCT or the Treasury should be put on the chopping block. Some measures listed as tax expenditures under the current tax code would be the norm under an ideal tax system.

For example, bonus depreciation and other accelerated depreciation measures are currently listed as tax preferences. Most economists would argue that the ideal tax system would allow for full expensing of business investment, so bonus depreciation should be seen as closer to the ideal than as a tax preference.

Similarly, the preferential rates for capital gains and dividend income are currently seen as tax expenditures. But an ideal tax system would not double-tax corporate income as is currently the case with capital gains and dividends. The flat tax, for example, would not tax capital gains or dividend income since that income is already taxed once at the corporate level.

The current system also treats the deferral of tax on profits earned abroad as a tax expenditure. These profits have already been taxed by the host country where they were earned and should not be taxed a second time when they are brought home to the U.S. Ideally, America should be moving toward a territorial system of taxation of foreign profits, as have the majority of our major trading partners. The United Kingdom and Japan are the two most recent competitors to move toward such a system.

The Research and Development tax credit is a trickier issue. On the one hand, a neutral tax system would not preference specific business activities such as research and development over other investments. However, many economists believe that in the absence of such a preference, the free market would under-invest in R&D and the economy would suffer. Moreover, most of our major economic competitors have generous incentives for R&D, so to eliminate this incentive from our system may be likened to unilateral disarmament.

Conclusion

The U.S. tax system is in desperate need of simplification and reform. The relentless growth of credits and deductions over the past 20 years has made the IRS a super-agency, engaged in policies as unrelated as delivering welfare benefits to subsidizing the manufacture of energy efficient refrigerators. I would argue that were we starting from scratch, these would not be the functions we would want a tax collection agency to perform.

While tax cuts will always curry more favor with voters than new spending programs, Washington needs to call a truce to using the tax code for social or economic goals. The consequence of trying to micromanage the economy as well as individual citizens' behavior through the tax code is a narrow tax base and unnecessarily high tax rates. These high rates are endangering America's global competitiveness and undermining the nation's long-term economic growth.

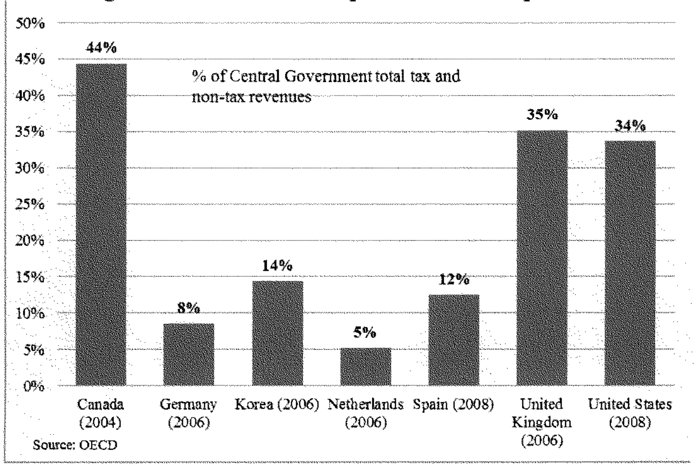
Fundamental tax reform can restore the nation's competitiveness and put us on a growth path for the future. Not only will this improve living standards in America, but it will improve the nation's fiscal health. That is a win-win for everyone.

Thank you very much. I would welcome any questions you may have.

Appendix 1: How Do U.S. Tax Expenditures Compare to Other Nations?

Compared to other industrialized nations, the U.S. is well above average in terms of the percentage of budgetary resources going toward tax expenditures. As Figure 2 below shows, tax expenditures in the U.S. equal roughly 34 percent of total government tax and non-tax receipts. By contrast, tax expenditures in Germany, Korea, the Netherlands, and Spain, total less than 15 percent of government receipts. On the other end of the spectrum, Canadian tax expenditures equal 44 percent of government receipts, while in the U.K., tax expenditures equal 35 percent of receipts.

Figure 2: International Comparisons of Tax Expenditues



Source: OECD

Appendix Table 1: Tax Expenditures in OEDC Countries

Tax Expenditures in OECD Countries - OECD © 2009 - ISBN 9789264076891
Source: http://dx.doi.org/10.1787/747140815638
Version 1 - Last updated: 10-Nov-2009

Number of tax expenditures in the United States % of GDP

	With reclassifications by author								
	2002 †	2003	2004	2005	2006	2007	2008	2009‡	2010‡
Purpose of Tax Expenditure, Income Tax*									
General Tax Relief	0	0	0	0	0	0	0	0	0
Low-Income Non-Work Related	11	11	11	11	11	11	11	11	11
Retirement	11	11	11	10	10	10	10	10	10
Work Related	10	9	9	9	9	9	10	10	10
Education	14	15	15	16	16	16	16	16	16
Health	8	8	8	8	8	9	9	9	9
Housing	8	8	9	9	9	9	11	11	11
General Business Incentives	16	16	16	17	18	18	18	18	18
R&D	2	2	2	2	2	2	2	2	2
Specific Industry Relief	34	35	35	43	50	52	54	54	54
Intergovernmental Relations	3	3	3	3	3	3	3	3	3
Charity	4	4	4	4	4	4	5	5	5
Other	3	3	3	3	4	4	4	4	4
Total	124	125	126	135	144	147	153	153	153
CAPITAL INCOME TAXATION									
Accelerated Depreciation	2	2	2	2	2	2	2	2	2
Interest	1	1	1	1	1	1	1	1	1
Dividends	1	1	1	1	1	1	1	1	1
Capital Gains	3	3	3	3	3	3	3	3	3
Subtotal	7	7	7	7	7	7	7	7	7
Total	131	132	133	142	151	154	160	160	160
Make Work Pay Provisions	4	4	4	4	4	4	4	4	4
Total	135	136	137	146	155	158	164	164	164
Non-Income Tax Related	0	0	0	0	0	0	0	0	0
Grand Total	135	136	137	146	155	158	164	164	164
Structural Items	1	1	1	1	1	1	1	1	1
Income Tax Expenditures by Type*									
Credits	28	28	28	31	35	36	38	38	38
Deductions, Exemptions, and Exclusions	80	81	82	88	91	92	96	96	96
Deferrals	22	22	22	22	24	25	25	25	25
Reduced Rates	5	5	5	5	5	5	5	5	5

† In fiscal years: fiscal year 2006 is from October 1st 2005 to September 30th 2006.
‡ Projection.
* Classification of tax expenditures by purpose and by type is to some degree arbitrary.

Sources: Budget of the U.S. Government, Fiscal Years 2009 and 2010, Analytical Perspectives, Chapter 19, Table 19-1

Appendix Table 2: Nonpayers by State in 2008

State	Total Filers	Filers with a Tax Liability	Filers with No Tax Liability	Percentage of Filers with No Liability	Rank (Most to Least)
US Total	143,490,468	95,520,933	51,045,911	36%	
Mississippi	1,254,942	719,916	567,195	45%	1
Georgia	4,255,054	2,598,415	1,753,675	41%	2
Arkansas	1,223,637	755,772	498,682	41%	3
New Mexico	923,431	573,865	372,148	40%	4
Alabama	2,076,195	1,288,134	833,877	40%	5
South Carolina	2,047,201	1,273,969	818,631	40%	6
Louisiana	1,983,957	1,250,519	780,097	39%	7
Texas	10,792,258	6,822,725	4,226,513	39%	8
Florida	8,875,483	5,645,900	3,468,156	39%	9
Idaho	666,723	423,714	258,528	39%	10
Tennessee	2,842,898	1,814,965	1,100,304	39%	11
North Carolina	4,180,091	2,664,444	1,607,594	38%	12
Utah	1,145,303	730,938	432,744	38%	13
Arizona	2,714,182	1,756,481	1,010,982	37%	14
Kentucky	1,869,439	1,218,223	694,890	37%	15
California	16,478,215	10,809,941	6,083,777	37%	16
Oklahoma	1,605,411	1,051,298	591,878	37%	17
Montana	477,153	314,174	174,568	37%	18
Indiana	3,019,320	1,992,138	1,083,040	36%	19
Michigan	4,626,365	3,059,154	1,659,010	36%	20
Missouri	2,739,220	1,832,981	963,611	35%	21
West Virginia	785,966	527,282	275,876	35%	22
New York	9,203,531	6,233,030	3,223,814	35%	23
Oregon	1,753,860	1,182,640	608,311	35%	24
Nevada	1,272,433	854,584	441,251	35%	25
Illinois	6,112,426	4,128,709	2,100,258	34%	26
South Dakota	389,575	266,064	131,608	34%	27
Kansas	1,328,944	905,922	446,675	34%	28
Nebraska	857,622	591,594	282,150	33%	29
Maine	633,674	443,576	206,378	33%	30
Vermont	320,162	224,748	103,669	32%	31
Hawaii	656,452	459,268	211,696	32%	32
Pennsylvania	6,130,055	4,264,743	1,975,694	32%	33
Ohio	5,562,764	3,876,376	1,789,893	32%	34
Wisconsin	2,767,859	1,940,996	873,884	32%	35
Colorado	2,340,854	1,654,661	731,210	31%	36
Iowa	1,415,088	1,000,188	441,887	31%	37
Rhode Island	510,709	361,016	159,378	31%	38
Delaware	425,490	303,666	129,186	30%	39
New Jersey	4,304,848	3,077,401	1,301,727	30%	40
Virginia	3,727,792	2,674,714	1,120,668	30%	41
Minnesota	2,569,679	1,850,504	764,698	30%	42

Washington	3,185,705	2,302,518	939,240	29%	43
Maryland	2,776,026	2,012,029	811,278	29%	44
North Dakota	322,761	235,533	92,955	29%	45
Wyoming	274,041	201,684	77,085	28%	46
New Hampshire	668,971	497,127	184,299	28%	47
Connecticut	1,742,470	1,296,183	474,410	27%	48
Massachusetts	3,197,925	2,387,861	866,220	27%	49
Alaska	359,709	290,564	74,876	21%	50
District of Columbia	302,531	223,339	84,641	28%	

* Source: Tax Foundation calculations based on IRS data.
Adjustments were made to account for EITC recipients in the nonpayer estimate.

Notes

1. Roberton Williams, "Why Nearly Half of Americans Pay No Federal Income Tax," *Tax Notes*, June 7, 2010, p. 1149.

2 "Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates," Joint Committee on Taxation, February 28, 2011, p. 2.

3. "Estimates of Federal Tax Expenditures for Fiscal Years 2010—2014," Joint Committee on Taxation, U.S. Government Printing Office, December 15, 2010, p. 55-56.

4. Individual Income Tax Returns, Tax Year 2008 Preliminary Data: Selected Income and Tax Items, by Size of Adjusted Gross Income. Internal Revenue Service. http://www.irs.gov/pub/irs-soi/08in01pl.xls. These preliminary data represent estimates of income and tax items based on a sample of individual income tax returns filed between January and late September of a given processing year. These returns are then weighted to represent a full year of taxpayer reporting. In general, some of the returns processed during the remainder of the year may have somewhat different characteristics compared to these earlier ones. Therefore, these preliminary data are best utilized by comparisons made to the preliminary estimates from the prior year. When available, the estimates from the Complete Year Data should be used in place of the preliminary data.

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20. Ibid. p. xix.

21. Robert C. Carroll, "The Excess Burden of Taxes and the Economic Cost of High Tax Rates," Tax Foundation *Special Report* No. 170, August 14, 2009.

22. "Tax Policy Reform and Economic Growth," *OECD Tax Policy Studies*. No. 20., OECD Publishing, 2010, p. 24.

23. This example is for illustrative purposes only. The Zero Plan did set aside $80 billion per year for deficit reduction and treat capital gains and dividends as ordinary income. The Tax Foundation does not support these aspects of the plan.

24. National Commission on Fiscal Responsibility and Reform. "Co-Chair's Report," November 11, 2010. http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/CoChair_Draft.pdf

ABOUT THE TAX FOUNDATION

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., the Foundation's economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability. The Tax Foundation seeks to make information about government finance more understandable, such as with the annual calculation of "Tax Freedom Day," the day of the year when taxpayers have earned enough to pay for the nation's tax burden and begin earning for themselves.

Chairman CONRAD. Yes. Very good testimony, all three. Thank you very much. You made a real contribution to the committee. I appreciate your taking the time to be here and share your thoughts with the committee.

I would like to go to something that has been a pet peeve of mine for many years. I used to be a tax administrator. I used to be Chairman of the Multi-State Tax Commission. And one of the things that jumped out at me in those years was the rise of offshore tax havens and the, what I think is the extraordinary ripoff that is occurring to average taxpayers and, frankly, to other businesses that do not avail themselves of the opportunity to use these offshore tax havens.

Many times, I have shown the picture of Ugland House down in the Cayman Islands that claims to be the home to 18,000 companies, a little five-story building, and all of them claim to be doing business out of little Ugland House down in the Cayman Islands. I would say it is the most efficient building in the world to be the home of 18,000 companies. Of course, there is no business being conducted out of there. The only thing that is being conducted is monkey business, because what they are doing is they are avoiding taxes in the United States and other jurisdictions.

The estimate by the Subcommittee on Investigations is we are losing $100 billion a year to offshore tax havens. If anybody doubts that this is a big problem, I would invite you to go Google "offshore tax havens." See what you get. I think you will be amazed at what you get. I certainly was.

No. 2, abusive tax shelters. We now have the spectacle in this country of some companies buying European sewer systems and writing them off on their U.S. books to reduce their tax obligation here, not because they are in the sewer business. It would be legitimate if they are in the sewer business. But these are companies that are simply looking for a tax cover and buying European sewer systems, deducting them on their books for U.S. tax purposes, leasing them back to the European cities that built them in the first place.

And it does not only apply to European sewer systems. They are doing the same thing with European transit systems. They have even gone so far as to buy European city halls and then deduct them on their books for U.S. tax purposes, lease them back to the European cities that built them in the first place. I mean, really, how can anybody justify this? That, the Subcommittee on Investigations, say is costing us $50 billion a year.

Mr. Greenstein, have you looked into the abuses of offshore tax havens, abuse of tax shelters, and if so, what have you found?

Mr. GREENSTEIN. I think this is probably more an issue for Bob McIntyre. We have not looked at offshore tax havens ourselves, but I think he has probably done a lot of that.

Chairman CONRAD. Mr. McIntyre?

Mr. MCINTYRE. Well, I think you put your finger on probably the most serious problem in our tax code today and our subsidy system today, on the corporate side in particular, because there are individual issues of hiding income and there are corporate issues of artificially shifting profits, and I think the second is your major focus there.

The reason that happens, that we let it happen, is two. First, we have this extraordinarily complicated system of how companies allocate their expenses and their revenues. They have to pretend when they are dealing with their wholly owned subsidiaries offshore that they are dealing with an unrelated third party and they just make stuff up and the IRS cannot police it.

Chairman CONRAD. Let me just——

Mr. MCINTYRE. But that problem, by the way, would be trivial, absolutely trivial. This arm's length of pretending you are negotiating with yourself would be a trivial and almost nonexistent problem were it not for the fact that if they can shift that profit to the Cayman Islands or wherever, then the tax that ought to be paid on the income is indefinitely deferred. If we got rid of that deferral, then it would not do them any good to move it to the Cayman Islands and the problem would be solved.

Now, there are some people in the Congress, I know many business lobbyists, I am sure, who are calling for Congress to make this problem worse by saying that not only can you defer what you shift to the Cayman Islands, you can be exempt forever on it. It is called the territorial system, or as one of my assistants called it, a territorialism system, because it would make—it is like a terroristic attack on the Internal Revenue Code.

So as you go on on this, and it will come up for you in the Finance Committee, there is going to be a lot of talk. What should we do with our current system? Should we try to do what John Kennedy wanted to do back in the early 1960s and get rid of deferral, or should we go to what the Europeans have done, which is go to this territorial system which has turned out to be a disaster for them and would be a disaster for us and would make your building down in the Cayman Islands have to add a very large annex.

Chairman CONRAD. Let me ask you this question. Have you done any analysis on how big the revenue hemorrhage is from offshore tax havens?

Mr. MCINTYRE. Well, on the corporate side, the Treasury Department has been doing a somewhat better job of putting a number out. A lot of the estimates have been bootstrapped. You know, some reporter will ask me how much, and I say, I do not know, $70 billion. Then somebody reads that and says, well, I am going to raise you.

But Treasury has made a serious effort. They peg it right now at about $50 billion, but I think they are leaving something out. So the numbers you gave, could it be 75, could it be 100 a year, I think it could. But they are at least getting it up there, because—and if you look in their latest tax expenditure book, you will see it, and that is a big piece of that $365 billion in corporate subsidies.

Chairman CONRAD. Let me just say, when I was a tax commissioner, I one time found a company that was doing business in the United States and I found out through involvement with the IRS, this company just kept—they had a series of transactions within the United States between wholly owned subsidiaries here showing no profits at any point in the United States. They got to the Cayman Islands. They showed $20 million in profit with one employee working half-time. I always said that was the most efficient guy in the world, to produce $20 million in profit half-time. And, you know, the Cayman Islands gave them the opportunity to defer it indefinitely.

So, you know, this is the kind of thing that is really going on in the real world and it is, I think, patently unfair to people who have all of their income exposed to taxation at whatever level of income, to have some who are avoiding everything that they owe through these kinds of tax dodges.

My time has expired. Senator Sessions.

Senator SESSIONS. Well, it is very complex. I am aware of a businessman who sold a profitable asset in another country and his comment to me was, well, I will tell you, the United States Treasury is going to receive a lot less money because this is a foreign company and they probably will not even incorporate in their country. They will probably incorporate in the Islands and not going to have any income. But the income tax he was paying was a significant factor in his decision to cease to sell the business.

I guess, Mr. Hodge, we have had a good bit of talk about the corporate tax rate, simplification, and the rest of the world is going to the territorial system. None of them are going back from it, I do not think, Mr. McIntyre. They must be reasonably happy with it. And we are ending up with the highest rate in the world. When Japan reduces theirs, I believe we will be the highest developed corporate tax rate in the world. And within that structure, as the Commission said and the Chairman has noted, we have great disparities between health care—industry is paying 5 percent, the trucking company is paying 30 percent, and it is a hodgepodge—no pun intended—of a tax situation.

Is there any way we could—what are the principles here that we ought to consider as we seek to do something about the difficult challenge of corporate tax rates that is making the United States less competitive, costing jobs in America. There is no doubt about that.

Mr. HODGE. Well, Senator, I think we first have to understand that the United States has a Neiman Marcus corporate income tax system where the rest of the world is moving toward Walmart tax prices. We have everyday high taxes every day while the rest of the world has everyday low taxes every day. Every other country on earth looks like a tax haven compared to the United States. As you mentioned, the United States has a combined corporate tax rate of nearly 40 percent. Only Japan has a higher rate. And in 3 weeks, they are about to lower their rate to below 35 percent, which will make the U.S. the highest in the nation.

But we cannot also forget that Canada has already cut their corporate tax rate again as of January 1, from 18 percent to 16.5 percent at the Federal level, and they are on their way to reduce their rate to 15 percent in a few years. The U.K. in 3 weeks, as of April 1, will reduce their corporate rate from 28 percent to 27 percent on a long-term path to reduce their overall corporate rate to 24 percent. And they, along with Japan, were the two most recent countries to move to a territorial system and for very different reasons.

Japan did it because Japanese companies were not repatriating profits from largely U.S. income back to Japan because their tax rate was so high and they had a worldwide system. So they had to move to more of an exemption-based system to encourage those companies to repatriate those profits back to Japan, which has been in about a 20-year recession.

Great Britain moved toward a territorial system because it was losing companies to other countries who were redomiciling in Ireland or Switzerland or the Netherlands, and so they had to move toward a territorial system in order to prevent those companies or discourage companies from leaving the country. And so they have had to make corrective actions to make themselves more competitive in a global environment.

Let us not forget, when we talk about companies that are——

Senator SESSIONS. I would just say, in this time when jobs are just a critical factor for us, what would you say to a working individual in the country who thinks that corporations ought to pay more, that they are having a hard time getting by. They read about corporate assets, their wealth they are sitting on and not spending. How do you explain in simple language your view that tax increases can be damaging?

Mr. HODGE. Well, first of all, understand that every multinational company in the United States has IRS agents permanently staffed in their offices auditing their books. Imagine if you had to give up your guest bedroom to an IRS agent and they were constantly looking over your shoulder——

Senator SESSIONS. One company said, I had to provide free coffee. I am still irritable about that.

[Laughter.]

Mr. HODGE. But to get to your point, what the economic research is telling us is that the real economic burden of the corporate tax is now falling more and more on workers and labor, and that is because in a global environment where capital is very mobile but workers are not, the real economic burden of the corporate tax falls on workers through lower wages and productivity. And so if we want to encourage higher wage growth, higher productivity, we need to cut that corporate income tax and those benefits will eventually fall onto workers or benefit workers.

And I think that if we really care about the long-term living standards of Americans and workers, we need to cut our corporate tax to be more competitive and to reduce the incentives for other countries——

Senator SESSIONS. And that will create jobs——

Mr. HODGE. It will create jobs——

Senator SESSIONS [continuing]. Make the companies healthier and be able to probably drive up wage rates——

Mr. HODGE. Exactly.

Senator SESSIONS [continuing]. Which I would like to see happen. Well, so on the Canadian border, and a company is deciding where to locate a plant, would this corporate tax rate induce them—I am sure that is Canada's goal, to induce corporations to expand in Canada rather than expand in the United States. Is that realistic?

Mr. HODGE. The Canadian government has an explicit policy, and it is on their website if you go there, that they want to become—they want to have the lowest corporate tax of all of the G–7 nations, the major G–7 nations, and to make themselves as competitive as possible and as attractive as possible, not only to U.S. companies, but to all inbound investment.

So I think that there—we often look at Ireland as being sort of the model for low corporate taxes, but we ought to be most concerned about Canada. As they are driving to be more and more competitive, it is going to become a much more attractive place for U.S. businesses to grow and expand and we risk falling behind the longer we delay doing something about our high corporate tax.

Senator SESSIONS. And the haven problem is exacerbated by higher rates, would you agree?

Mr. HODGE. Absolutely. I think, and as the Chairman understands, being former Revenue Director, when you have States such as South Dakota and Wyoming or Nevada that do not have personal and corporate income taxes, those look like pretty attractive places for high net worth individuals or businesses to expand and grow. So tax competition is real, not only in the States, but also globally, and the more we understand that we need to bring down our tax rates to be more competitive, the shorter time we will risk falling behind.

Senator SESSIONS. Well, we face a lot of challenges. We do have a revenue shortfall and we cannot tax ourselves out of competitive world markets.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman. I appreciate you having this hearing.

As I think both the Chairman and the Ranking Member are aware, it has been calculated that we spend, as Americans, about six billion hours every year in tax compliance. So clearly——

Senator SESSIONS. Does that include looking for lost documents?

Senator WHITEHOUSE. Six billion hours. Think what you could build and design and invent and create with six billion hours of human economic activity.

Anyway, one of the things that interests me is to sort of look back and try to put some historical perspective on where we are right now. And if you go back to 1935, there was essentially parity between what individuals in America contributed in the revenues of the country and what corporations contributed in the revenues of the country. It was one-to-one.

And then in 1948, we broke through to two-to-one, with individuals contributing two dollars to the revenue of the country for every one dollar that corporations contributed. In 1971, we broke through three-to-one, three individual dollars to our national revenues for every one dollar that corporations contributed. In 1981, we broke through four-to-one. And in 2009, we hit close to a high-water mark at six-to-one, six dollars out of America's individual pockets into our revenues for every one dollar that corporations contributed to our national revenues.

I understand the competitive advantage from lower corporate tax rates, but are we condemned to a race to the bottom in which corporations end up paying essentially no share of our national revenues and the entire burden is on individuals? That is a big change from a history during which America was a pretty strong power and that has lasted 75 years.

Mr. McIntyre?

Mr. MCINTYRE. Well, you are absolutely right that the race to the bottom is what is going on in the world today, and if it is going to be stopped, it is going to take some leadership from the United States.

The other countries are not happy about it either. They are losing revenues that they could use to pay for the public programs that they are cutting instead that would help their economies a lot more. But we have been the instigator of this for a long time. They blame us for the race. And if we were to lower our corporate rate, they will just lower theirs more. It is one of those things that we have to get together, just like the States need to do, get together to stop profits moving into the low-tax States. And you worked on that for years, Senator Conrad.

But, yet, it is absolutely a critical problem, and the answer is not to give up, which I think is Scott's advice, but rather to take the steps that we need to do to get with our trading partners and work out a way that we can all collect some money from the owners of capital.

Senator WHITEHOUSE. Mr. Greenstein, I was struck by the Chairman's remarks about the top 400. I have seen that as well, and I did a comparison between the rate that the top 400 paid, on an average $344 million each in annual income, with what that would connect to in Rhode Island. And the Bureau of Labor Statistics says that a hospital orderly on average makes about $29,100, and at that point they are paying about 16.7 percent. That is about where the crossover is as you climb the ordinary income wage scale if you a single person.

So you have this sort of peculiar effect of the hospital orderly, you know, pushing his cart down the halls of a Rhode Island hospital at 2 in the morning paying the same share in total Federal tax, combining the income with payroll taxes, as the person who is making more than a third of a billion dollars a year, and that just does not seem right. The Chairman's Park Avenue example, you know, similar effect.

If you take a look at H.R. 1, clearly there are going to be substantial burdens for people, and we often hear how we all have to share in this. For the hypothetical person making more than a third of a billion dollars in income and paying that 16.7 percent tax rate, how does H.R. 1 affect their lives compared to, say, a family that needs Head Start to take care of the kids because both parents are working in the morning or a family that has kids in public school? What is in there that would change anything for that person?

Mr. GREENSTEIN. Well, I think there are fundamental things the Government does that benefit people at all income levels from making sure that the food supply is safe or funding research into diseases that affect you wherever you are on the income scale.

Senator WHITEHOUSE. But those would apply equally to all people, in theory.

Mr. GREENSTEIN. Yes.

Senator WHITEHOUSE. Those are common goods.

Mr. GREENSTEIN. Those are common goods.

Senator WHITEHOUSE. Is there anything that does not qualify as a common good that would apply to the person making $344 million in a year?

Mr. GREENSTEIN. Well, as a general rule, if we are looking at various sorts of services, spending, subsidies, for lower-income people they primarily come—not exclusively—on the spending side of the ledger, and for higher-income people they primarily come through tax expenditures on the tax side of the ledger. And the example I gave——

Senator WHITEHOUSE. H.R. 1 does not do anything in that regard, does it?

Mr. GREENSTEIN. Well, H.R. 1 by virtue of just focusing on nonsecurity discretionary programs necessarily has a larger adverse impact on people lower on the income scale.

Senator WHITEHOUSE. The last quick question as my time runs out. Mr. Hodge, I just want to clarify one thing. I doubt you meant to suggest that there was a defense for tax dodges in the Cayman Islands that allow people to defer all taxation on their income indefinitely if they have been able to hide it there successfully by justifying the rate—justifying that by virtue of the corporate tax rate we have here. If we cut the corporate tax rate in half, you still cannot beat deferring taxes indefinitely by hiding them down in the Cayman Islands, can you? I mean, that is a real race to the bottom if we have to compete with the Cayman Islands and the tax dodge itself as our corporate tax baseline.

Mr. HODGE. Well, the basic point is that—I am not going to defend tax dodges, obviously. But the fact is that the United States' high corporate tax rate is anticompetitive, and the rest of the world looks extremely competitive by comparison. It looks like a tax haven, because the average OECD rate is around 26 percent while the U.S. rate is nearly 40 percent. And so that——

Senator WHITEHOUSE. Nominal rate.

Mr. HODGE. Nominal rate and the effective rates. There are also great disparities between the U.S. effective rate and the effective rates of the rest of the world as well.

Chairman CONRAD. I thank the Senator.

Senator THUNE.

Senator THUNE. Thank you, Mr. Chairman.

Mr. Hodge, you rightly pointed out that the goal of our Tax Code is not to raise ever-increasing amounts of revenue but instead to spur economic growth. With that in mind, what do you think is the most important pro-growth tax reform that we could undertake here?

Mr. HODGE. Well, following the guide and the research of economists as the OECD who have looked at the relationship between different types of taxes——

Senator SESSIONS. OECD, would you explain that?

Mr. HODGE. Excuse me, sir. The Organization for Economic Cooperation and Development, and their job is to look at how Government policies affect long-term economic growth, and when they look at the relationship between different types of taxes and growth, as I mentioned, they find that the corporate income tax is the most harmful tax for long-term economic growth followed by high personal income taxes, and then consumption and property taxes are found to be least harmful.

So I would address first our high corporate and personal income tax systems and try to bring down the rates, and while doing so we can certainly broaden the base by eliminating many of the provisions that are currently in the Code. But by doing so we will not only make ourselves more competitive, but I think that we will super charge the economy, get us back going again, and that will be good for everyone in terms of higher wages and living standards, which ought to be the primary objective of any tax reform.

Senator THUNE. You had mentioned that a typical family of four earning $50,000 now does not pay any taxes. Historically, what has been that break-even point? Do you know what that sort of historical average would be?

Mr. HODGE. It has been climbing over time. There was a time where perhaps it was around, you know, $20,000, $25,000 a year, and over time, as we have included such things as the earned income tax credit, the child credit, and then making those refundable—meaning even if you did not have an income tax liability you would still get a refund check—the income threshold for those not paying income taxes has grown, as you mentioned, now to around $50,000 a year.

Senator THUNE. You had mentioned in your testimony, I think, that 36 percent of the people in the country now do not pay taxes. There was some reporting here awhile back that it was like 47 percent. Are you including payroll and income?

Mr. HODGE. No. The 36 percent refers only to people who file an income tax return, and then there is a great group of Americans who earn some income but not enough to break the threshold of actually filing a tax return.

When you add those two groups together, that comes out to close to 47 percent of all American households are essentially outside the income tax system.

Senator THUNE. What would be the distributional impact of a VAT tax, in your opinion?

Mr. HODGE. By and large, economists believe that the value-added tax is regressive, much like sales taxes. It tends to disproportionately harm low-income people over high-income people.

Senator THUNE. Could you discuss further the exclusion of the employer-provided health insurance and its effect on labor markets and health care costs? Because that is something that was debated during health care. There was a limitation, although a small, modest one, placed on so-called Cadillac plans. Do you believe that changes made in the health care bill are going to be effective in addressing these problems of distortions in the labor market and health care costs, increased health care costs?

Mr. HODGE. The tax exemption for employer-provided health care really creates what we call a third-party payer problem, and that is, the real consumer or patient is disconnected from the real transaction. The real people paying the bills, the real ones that doctors pay attention to, are the employers and the insurance companies, not the patient. But the patient wants as much health care as possible because they are not paying the bills. So it breaks up the market system and creates an imbalance there. And so the closer we can get to really putting consumers and patients in the driver's seat, I think the better off we will be. Moving toward things like health savings accounts is an important step. I do not think that the health care reform bill that recently passed is going to solve this problem. In fact, it could exacerbate it by creating a larger third-party payer problem, and people will just simply demand more and more health care because they are simply not paying enough of the cost.

Senator THUNE. In his opening statement, the Chairman pointed out the discrepancy between the top 400 and someone at the lower-income level might be paying as a percentage less of their income. And one of the suggestions or explanations for that was that they had unearned income that was taxable at lower rates, capital gains and dividend rates. I am just curious, though, what your thoughts are on the impact of raising those rates. One of the reasons, I think, that the rates have been lower is that we have tried to encourage investment that is considered to be a pro- growth type policy to not tax investment, cap gains, and dividends at the ordinary income rates.

So what would that do just in terms of economic growth, in your opinion?

Mr. HODGE. Well, first of all, a lot of these individuals get some of their income through tax-free municipal bonds, and so essentially the Federal Government is subsidizing that to some degree, and so I think we ought to be concerned about that.

But to get to your point, we do tend to forget that capital gains and dividends are really a second layer of taxation on corporate income. And when the OECD looks at the rates on dividend income, the U.S. has one of the highest combined rates on dividend income among industrialized nations. I think we are fourth of the 30 major industrialized countries in terms of our combined corporate and personal tax rates on dividend income.

So I think that the more we can reduce that second layer of tax or reduce those dividend rates, I think that we will have more economic growth and we will have a better economy overall.

Senator THUNE. All right. Thank you.

Mr. Chairman, just, as a final closing point, I would like to see the rates on everybody come down and broaden the base. You talked a lot about tax expenditures, which I happen to agree. I think we have way too many preferences in the Tax Code today and lots of distortions as a result of that. But rather than raising rates to the higher level, I would like to see the rate that, you know, the lower-income person is paying come down. Let us get everybody down to where we are lowering rates and hopefully broadening the base. So thank you. Thank you, Mr. Chairman.

Chairman CONRAD. That was really the approach of the Fiscal Commission: broaden the base, bring down rates.

Senator SANDERS.

Senator SANDERS. Mr. Chairman, thank you very much for assembling this excellent panel. You know, sometimes we wish we could have 2 days just to go over this stuff. This is very, very important stuff. It is a little bit complicated, and we have some different perspectives—not only perspectives but different facts coming out.

For example, I would say to Mr. Hodge, my understanding is that a 2007 study by the Bush Treasury Department concluded that the effective—not nominal—U.S. corporate tax rate is lower than the average corporate effective tax rate imposed by our major competitors.

But, Mr. Chairman, I think most of us understand that we have a serious deficit problem, that we also have major problems in our economy, that we want a fair tax system, and we want a tax system that enables us to improve the standard of living of ordinary Americans.

Mr. McIntyre made the point that I would reiterate, that each and every year large and profitable corporations all over this country are able to avoid paying billions of dollars in Federal income taxes through loopholes in the Tax Code and generous tax breaks. In my view, this is simply unacceptable when we have a $14 trillion national debt.

According to an August 2008 GAO report, two out of every three corporations in the United States paid no Federal income taxes between 1998 and 2005. Amazingly, these corporations had a combined $2.5 trillion in sales but paid no income taxes to the IRS. That is according to the GAO.

Further, as Mr. McIntyre mentioned in his statement, a report from Citizens for Tax Justice on corporate tax abuses, what I found astonishing, is that 82 Fortune 500 companies in America paid "zero or less in Federal income taxes in at least 1 year from 2001 to 2003." And when you have record-breaking deficits and a huge national debt, I find that just inexplicable.

Mr. Chairman, let me also mention that—and you made the points—I am sorry. Mr. Sessions made the point that the top 20 percent pay 70 percent of all Federal taxes. That is what Mr. Sessions said. But that has to be put within the context of the fact that the top 20 percent earned 52 percent of all income more than the bottom 80 percent.

So one of the realities when you talk about who is paying taxes, you have to also remember that median family income has gone down. Most of the new jobs that are being created are, unfortunately, low-wage jobs, and you cannot get blood from a stone.

So I think all of our panelists have talked about the fact that millions of Americans are paying nothing in income taxes. That is true. You know why? Because they do not have any money to pay. If you are making $25,000 a year and you have a few kids and you have a house and you have a car, you have to get some health insurance, you maybe have some child care, there is no money to pay income taxes.

Now, Mr. Hodge mentioned the OECD, the Organization for Economic Cooperation and Development. I will get to you, Mr. Hodge. I do not want to leave you out. But, Mr. Greenstein or Mr. McIntyre, of all of the countries in the OECD, is there any that does not provide health care to all of their people as a right of citizenship?

Mr. MCINTYRE. They all do.

Senator SANDERS. They all do.

Mr. MCINTYRE. And they give it to them for free.

Senator SANDERS. Oh, my word.

Mr. MCINTYRE. And yet those people, despite the fact that they could spend every day of their lives in the doctor's office should they so choose do not.

Senator SANDERS. I do not want to get into health care right now, but the point is when we talk about OECD nations, let us look at the whole picture. The United States has 50 million people without any health insurance. We are the only country in the industrialized world that does not provide health care to all people.

To send a kid to Harvard University today costs what, would you guess? Fifty, sixty thousand a year? How much does it cost to send to the best universities in Europe? Mr. Greenstein, Mr. McIntyre, Mr. Hodge, do you have any guess on that? Not much. In fact, I think in Germany tuition there is probably free. Not a magical thing. That government there believes it is important to invest in education for the well-being of their country. We charge very high prices, and a lot of our kids cannot afford to go to college or they come out deeply in debt. When we talk about OECD countries, how do we compare, Mr. Greenstein and Mr. McIntyre, in terms of child care? I have a daughter in Burlington having a hard time paying for child care. What do you think? Do the governments in Europe do a little bit better job? Of course they do.

Mr. GREENSTEIN. Yes.

Senator SANDERS. All right, et cetera, et cetera. So, Mr. Chairman, my first point is you have to look at the entire picture.

In terms of income inequality, Mr. Hodge, which major country on Earth has the most unequal distribution of income and wealth?

Mr. HODGE. According to the latest OECD countries, the United States was, I think, fourth on the list.

Senator SANDERS. Compared to what? What countries were ahead of us? Major countries.

Mr. HODGE. On the list, I think it was Portugal, Turkey, and Italy or something.

Senator SANDERS. Mexico, I suspect.

Mr. HODGE. Mexico.

Senator SANDERS. Turkey. Well, there it is. We have a more progressive distribution of income than Turkey does. But of any major countries on Earth, what would be the answer? Major economy.

Mr. HODGE. Well, I think I just answered that——

Senator SANDERS. The United States of America, right.

Mr. HODGE. We also have the highest overall average per capita income, ironically.

Senator SANDERS. Average.

Mr. HODGE. Yes.

Senator SANDERS. Meaning that if you have somebody who is making a billion dollars and somebody who is broke, average income is half a billion a year. We understand that. But you are also—I do not want to get into the average. We have dealt with the average issue here a whole lot. It does not mean a whole lot when the median family income of the average American has gone down by $2,500 in the last 10 years.

My point, Mr. Chairman, is this is a fascinating discussion, and we need a lot more of this. Clearly we want tax policies which generate good-paying jobs. We want to deal with the huge trade deficit of some $500 billion a year where company after company is shutting down here and going to China. I would argue that taxes are not the only factor. I think wages, the incentives offered by the Chinese Government are also important.

But my main point is that when we talk about who is paying taxes in this country, we also have to talk about the kinds of incomes that our people are experiencing. And the sad reality is that for millions and millions of Americans, their real incomes are going down. So it should not be shocking that they pay less in taxes.

I would also add, when Senator Sessions talked about the top 20 percent pay 70 percent of all Federal taxes, while that is true, if you add to that, Senator Sessions, State taxes and you add local taxes, which are, by and large, regressive—right? A billionaire and a working person fill up a gallon—fill up their gas tank in a car, right? So if you are making $25,000 a year, that is a heavier burden on you than if you have a whole lot of money. Property taxes, by and large, are regressive. So when you add the Federal income tax and State taxes and local taxes, you probably end up with a situation where, for millions of people, working people, their effective total tax rate is a hell of a lot higher than it is for some of the richest people in this country.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator JOHNSON.

Senator JOHNSON. Thank you, Chairman. Thank you for appearing.

I would like to start out with Mr. McIntyre. I really like looking at the reality of the situation. Who in effect pays the corporate income tax? When corporations view the tax as a cost, just like in my business I view resin prices as a cost, who in effect pays that corporate tax?

Mr. MCINTYRE. The shareholders, in my view.

Senator JOHNSON. You do not think it is the consumers of the product?

Mr. MCINTYRE. Absolutely not.

Senator JOHNSON. Mr. Hodge, what would you say——

Mr. MCINTYRE. I can prove that to you, if you want. There are many, many companies in this country that argue for replacing the corporate income tax with a tax on consumers. It would seem to me a waste of time if it was already a tax on consumers. So why wouldn't—I cannot understand why they would make the effort.

Senator JOHNSON. Mr. Hodge, I would like your thoughts on that.

Mr. HODGE. Economists are pretty well agreed that there are three parties that pay the corporate income tax. It is either consumers through higher prices, shareholders through lower share returns and lower share prices, and workers through lower wages. But what we are finding in a global economy is that workers are paying the lion's share of the corporate income tax through lower wages and productivity. And so we need to really understand this in a global context where capital is extremely mobile but workers are not, that it is workers that are bearing that lion's share of the corporate tax.

Senator JOHNSON. You know, oftentimes when I listen to these discussions, it is like we have an option not to compete. The U.S.

as a country has to compete for global capital, correct? We do not have that option. We have to compete. So how do we compete when the CEO from Intel says in his decisionmaking factor, in order to produce—or build a semiconductor plant, it costs $4 billion in Asia and $5 billion in the U.S., and he largely attributes that to the tax regimen. I am sure regulations play a part in that.

If you are a corporation manager, let us say, from a different country, if you are looking at investment decisions, why would you spend an extra billion to invest in the U.S.?

Mr. MCINTYRE. Well, there is no doubt that some companies have advantages in low wages or that they provide other benefits that make it cheaper to do things abroad, and there is not too much we can do about that.

My point is that we probably should not be paying our companies to go there. So if there is a tax advantage in China—I will take your word for it—we could solve that problem by getting rid of deferral so that the Chinese profits would be taxed at the same rate as if those profits were earned in the United States. So, yes, if that is a problem, my solution solves it.

Senator JOHNSON. Mr. Hodge?

Mr. HODGE. The corporate tax rate in China is 25 percent, which is just slightly below the average of the major industrialized countries. It is 15 percentage points lower than the Federal corporate tax rate. So, by definition, it is a much more competitive place, a cheaper, at least from a tax perspective, place to do business. And by ending deferral, as Bob has suggested, you would instantly make U.S. companies less competitive while doing business there and give a distinct advantage to German firms, Swiss firms, French firms, all the other firms that are doing business there. We want U.S. companies to do business in China. We want them to succeed in the global marketplace. And by hamstringing them by eliminating deferral or keeping the U.S. tax rate where it is, we are making the U.S. less competitive, we are making U.S. companies less competitive, and ultimately we are making U.S. workers less competitive. And that is a recipe for slow economic growth.

Senator JOHNSON. Isn't it also true that when a U.S. company invests overseas, that also provides an awful lot of jobs in the U.S. supplying and servicing those overseas operations?

Mr. HODGE. Yes, the research of Matt Slaughter from Dartmouth University has shown that it is what they call in the military the "tooth-to-tail ratio," and that is, you need a certain number of people back home to service those people who are on the front lines. And it is that way in corporate America, too. So if we are doing business in China, we need researchers and designers and computer experts and financial people and all these people back here who do a lot of the brain work to support that work that is going on overseas. And so as we are growing abroad, U.S. companies are also growing domestically, and Mr. Slaughter has shown that pretty convincingly in his economic research.

Senator JOHNSON. Overall, the U.S. economy has never really generated much more than about 18.8 percent of GDP in terms of revenue. Professor Hauser calls that "Hauser's Law." I would like you to speak to that basic fact. As much as we would like to believe we could raise 21 percent of GDP in revenue by a different tax regimen, how realistic is that to actually occur?

Mr. MCINTYRE. Well, we have done it before. In fact, the only time we have ever balanced the budget in the last 50 years is when we did it.

Senator JOHNSON. In the 2012 budget, President Obama's budget, there are only 3 years where we actually collect revenue greater than 20 percent of GDP.

Mr. MCINTYRE. Right. I am saying the last time we balanced the budget was in the Clinton administration when revenues went up to almost 21 percent of the GDP. Back in the 1960s, we balanced the budget briefly when it was about 20 percent of the GDP. All the other years in between those balanced budgets in Clinton and Johnson—a different Johnson—were places where we had lower revenues and unbalanced budgets.

Senator JOHNSON. But don't you acknowledge the fact that taxpayers simply cannot reorganize their affairs quickly enough when you increase tax rates? It just takes a little while. You are able to snare a higher percentage of GDP when you increase taxes, but eventually that benefit falls off.

Mr. MCINTYRE. No, I do not think that is true. I think what happened—and it is very clear what happened to the corporate income tax—is that Members of Congress are either cajoled or threatened by the corporate lobbyists to give them back their loopholes, and then every once in a while, we have to clean up the Tax Code again. It used to be on a 15-year cycle. We missed out on the 2001 one due to a difficult election decision, but we are overdue to clean it up again. Yes, it is kind of like the Medicare rules with the doctors. If you do not change them often enough, they will understand them.

Senator JOHNSON. Well, first, I am totally supportive of slim-lining this Tax Code. It is absurd, 70,000 pages——

Mr. MCINTYRE. Yes, and I am not talking about raising tax rates, you know. I am talking about probably cutting tax rates a bit to make it more palatable. But all these subsidies we have in the Code, don't we believe in free markets at all anymore? And, gee willikers, the companies come in with the same story, and you guys fall for it every time. The 2004 American Jobs Creation Act, they came in and said look what is going to happen when you give us this thing. General Electric said give us all this stuff—they wrote half the bill—and we will create jobs in the United States. What did they do? Since then, 32,000 fewer jobs at GE in America, and jobs are up overseas.

So, yes, I mean, you can fall for it or not, but——

Senator JOHNSON. You have no argument with me on the special tax rates.

Mr. MCINTYRE. Good. I appreciate that, Senator. We are friends now.

Chairman CONRAD. I would like to go back to one thing I heard, that 47 percent of the people in this country pay no taxes. I do not think that is an accurate statement. They may not pay income taxes, but they pay payroll taxes. In fact, I think two-thirds of the people in this country pay more in payroll taxes than they pay in income taxes. But I would just like the panel to respond to that.

Mr. GREENSTEIN. Well, actually the 47-percent figure is incorrect for the percentage of people that do not pay income taxes as well. It was a correct figure for 2009 and 2010 for two reasons. We were in a deep recession, and a lot of people lost their jobs and did not have income. And Congress passed a temporary making-work-pay tax credit that took more people off of the income tax roll. So, for starters, we want to look at the underlying figure without the make-work-pay tax credit and without 9 or 10 percent unemployment.

So the figure before the recession was 37 percent. However, that is just income tax. When you take into account payroll tax and to a minor degree excise tax, the best estimates are that about 10 percent of families do not pay any Federal tax; about 90 percent do. But that is a 1-year figure. Income is very volatile. People lose their jobs, they gain their jobs.

If you said over a 5- or a 10-year period what percentage of people do not pay any tax year after year after year, any Federal tax, it would be very, very tiny.

The other thing that—you know, we have a figure from CBO that if we take the bottom quintile, the whole bottom 20 percent of Americans, for 2007—the last year we have—yes, their income tax was negative because of things like the earned income credit, but their total average Federal tax rates was 4 percent. They paid 4 percent of their total income in Federal taxes of one sort or another, even though the income alone was negative.

I guess the last point I would make on this is that you made a conscious and I think the right decision here in Congress on a bipartisan basis over the years that if you wanted to make sure that parents working full time did not raise their children in poverty, you could have not had an earned income credit or had a much smaller credit and had a dramatically higher minimum wage. Now, business would have complained mightily about the job and employment effects of having a much higher minimum wage. So you ended up doing somewhat less on the minimum wage and putting place a robust earned income credit, and my recollection—I remember in 1989 or 1990 there was a debate over how much to raise the minimum wage, and the single biggest EITC expansion bill introduced that year was by Mr. Armey, now active with the Tea Party, because he felt it would be bad for business to raise the minimum wage a lot and that the alternative was to do a very large increase in the earned income credit.

So we really need to take all these factors into account. But the idea that nearly half of Americans have no skin in the game is really not borne out by the facts.

Chairman CONRAD. Isn't it true that the vast majority of people in the country pay more in payroll tax than they pay in income tax?

Mr. GREENSTEIN. Yes, they do, and also nearly everyone pays State and local taxes because a very large share of State taxation is the sales tax. And regardless of how low your income is, you pay that. So most people at the bottom, Federal and State together, they pay tax liability, often a fairly significant amount, because in many States—and Bob McIntyre's group has done the key work on this—in many States the percentage of income you pay in tax at the State and local level is higher for people in the bottom quintile than people in the top quintile because of the regressivity of sales taxes.

Chairman CONRAD. Mr. Hodge, were you seeking recognition?

Mr. HODGE. Yes, Mr. Chairman. In my written testimony, I point out a Joint Committee on Taxation report looking at refundable credits against—and how that not only eliminates people's income tax burden but also how much it erases of their payroll tax burden. And for 2009, these refundable credits exceeded the employee's share of payroll taxes for 23 million tax filers and exceeded the employer's share of payroll taxes for 15.5 million filers.

So in addition to erasing their personal income tax burden, these refundable credits have become so generous they are now erasing their payroll tax burden as well. But we often forget we are just looking at the tax side of things, and we have to look into what also is being given to these people in various Government benefits. And when we look at both sides of the equation, we find that low-income people get as much as $10 in Government benefits overall for every dollar that they pay in taxes. And so we have to look at both sides of the equation, not just the tax side.

Chairman CONRAD. OK. I want to just in my remaining time go off the subject of this hearing because Mr. Greenstein is here. We had Mr. Bowles and Mr. Simpson here yesterday. I wanted to just have a moment to talk about Social Security with you, Mr. Greenstein. In the Bowles-Simpson Commission, as we looked at Social Security, we saw that in 2037 Social Security faces a 22-percent cut, or thereabouts. It depends on a lot of factors. But in 2037, there is an across-the-board cut because Social Security cannot make all the payments that are scheduled.

And so the question is: What does one do about that? The Commission concluded that it is important to address that sooner rather than later, made a series of changes, and one of the things that was done was to try to have a set-aside for people who need to retire early because they are in hard physical labor positions.

On restring solvency, there were a series of other steps taken, going to chained CPI, which economists tell us is a more accurate measure of inflation; changing the bend points; and also raising the income level which Social Security taxes apply to because the traditional 90 percent of income being subjected to Social Security has fallen away.

There is a technical problem with what the Commission reported, which I have been repeatedly assured will be fixed—it has not yet been fixed—so that the lowest quintile would be protected. As it turns out, because of a technical flaw in what the Commission did, the lowest quintile have not been fully protected, but it is clearly the intention that they be.

What would be your assessment of the Social Security provisions?

Mr. GREENSTEIN. I do think there are some serious problems with the Social Security provisions in the Bowles-Simpson plan. I fully agree with sooner rather than later and the chained CPI applied to everything, tax code, other benefit programs.

Chairman CONRAD. Which the Commission did.

Mr. GREENSTEIN. But the problem, for starters, the problem at the bottom really is not just a technical problem. So the Commission did—it intended, no question, fully intended to protect people in the bottom quintile through a hardship exemption. But now that the actuaries have looked at it more closely, only 20 percent of people with very low lifetime earnings would qualify for the hardship exemption.

There is not an easy technical fix. If you redesign the hardship exemption to make sure you get all or nearly all of the bottom quintile, it is hard to do it without sweeping in large numbers of people in higher quintiles, as well, and costing a lot of money.

I am also concerned about the next——

Chairman CONRAD. Can I stop you just on that? So is it your view that there is not a way to protect that lower quintile?

Mr. GREENSTEIN. There is a—here is where I am heading. I see two problems, and they sound like they are in conflict. They did not do an adequate job for the bottom or the next-to-the-bottom, you know, elderly widows at $15,000 a year. Under the plan, they both have higher Medicare copays and lower Social Security benefits.

The second problem is while I fully agree that we should be hitting people at the top more than the bottom, I worry about how far Bowles-Simpson went. Today, the higher earner pays 5.6 times as much in payroll tax over a career, gets 2.5 times as large a benefit. Under Bowles-Simpson, ultimately, you pay eight times as much in payroll tax and maybe get less than twice as much benefit.

To me, the bottom line is it is very hard to solve all these problems if you have two-thirds of the solvency coming on the benefits side. I think Rivlin-Domenici, which is about 50–50, really—you know, you can quibble with it, but it largely addresses these problems. Changes could be made to ease the problem on the bottom quintile. It is going to be very hard to fully solve it unless there are some larger changes in the mix.

Chairman CONRAD. Can I just ask, outside of this, for your recommendations on what we would do——

Mr. GREENSTEIN. Yes.

Chairman CONRAD [continuing]. In your view, to fix, that at least is partially a technical issue, not intended effect, and in a larger view, what you think needs to be done.

Mr. GREENSTEIN. I would be happy to do it, and without going into details now, I would note that I think in order to do this in a cost efficient way, one needs to bring the SSI program, which is highly targeted on the bottom, into the mix. There is more one can do in a cost effective way if we look at Social Security and SSI——

Chairman CONRAD. Well, I would very much—you know, we are at a critical moment here, and as soon as you could provide recommendations—I should have called you before this, but I think as we haveten into it, we have understood better, and frankly, the thought piece that you put out, I think it was last week——

Mr. GREENSTEIN. Yes.

Chairman CONRAD [continuing]. That I saw, helped us understand better that there are problems here and we certainly want to address them.

Senator Portman.

Senator PORTMAN. Thank you, Mr. Chairman, and I really appreciate the panel being here. I have so many questions and so little time, but I just have to touch on a couple of things quickly.

One is on the issue of tax reform and as it relates to the EITC. I came in when you were discussing some of the history of this and the fact that some people view this as an alternative to minimum wage. My point on the EITC is really a very simple one, which is there are better ways to do it. If you look at what the IRS is asked to do today, it is really kind of the opposite of what the IRS is good at. I mean, they are asked to find out how much income we all have and question whether we are showing all of our income, and then for EITC, it is the opposite.

And it is also, frankly, not their expertise to be able to deal with these kinds of issues, which are better sometimes dealt with by social service agencies, and the IRS is not the most gentle organization sometimes. So I think it is tough for them to do it and that is why you see 23 to 28 percent improper payments, according to the IRS Inspector General. You know, that is $11 to $13 billion a year in improper payments.

One way to deal with it, obviously, is to use the payroll tax system. Offset payroll taxes. Now, as Mr. Hodge has said, because our system is increasingly progressive, it is difficult to cover everybody with payroll tax, but most people would be covered and then you would not have the IRS asking people, again, to do something that the IRS is not good at and you would not have the IRS in a position, again, more like social service agencies would be, looking at people's incomes at that level.

So I think it is a call for reform, and part of the tax reform ought to include looking at EITC. These kinds of improper payments in the context of our budget crisis just cannot continue, just as we have talked about today.

I would say, Bob, to your point on Social Security, it is a whole different environment on that, too. I mean, I understand what you are saying on looking at the benefit side versus more taxes, but we are looking at a very different scenario than we were in 1983 and certainly than we were even 5 years ago.

On tax reform generally, I would love to get the views of the panelists. I know there are some differences of opinion that I heard expressed earlier. But let me quote Bob Greenstein before the Fiscal Commission. "With sensible base broadening, we can reduce the inequities and inefficiencies in the corporate income tax, lower the top corporate rate, boost competitiveness, and raise somewhat more revenue."

Mr. McIntyre today says, "We want corporations to do things that are not economical in the tax code. It distorts markets." I agree with him. I agree with you.

Mr. Hodge, of course, has talked about the fact that our corporate rate is not competitive, and we may wish that the world were different, but the world is increasingly competitive and other countries have lowered their rates precisely because they want jobs in their economies and it is working.

So I guess I would just throw out to the group, do we at least have a consensus here, although differences in terms of how to do it, that we do need, at a minimum, to lower the rate, reduce the number of preferences, and therefore have a more competitive tax system on the individual and the corporate side? I throw it out. Bob?

Mr. MCINTYRE. Well, I think we should reduce the rate a little just so we can get some political support from the high-tax companies to pass it. But if we get back into the race to the bottom with Europe rather than moving to a system where we protect jobs in the United States by getting rid of deferral, this will not stop. It started a number of years ago and it is a problem for everyone in the world and we need to stand up and say to the other countries, let us talk about this. It is not working for us. Get a system where we can get some tax on income from capital, and we are not getting it now and that is bad for the fairness of our society.

Senator PORTMAN. Well, it would surprise a lot of folks to hear we are not getting any. It is not a race just with Europe, as you know. It is a race with Asia, certainly Canada, as Mr. Hodge has pointed out. They are all very aggressive on this notion of taxing capital or capital taxes. There is pretty much a consensus among economists, most of that cost is borne by labor and a lot of it is passed along to us as consumers, obviously. So it is a different sort of tax.

But, Bob, go ahead. Sorry.

Mr. GREENSTEIN. The concept of broadening the base and lowering rates has very broad support, but I think there are a couple of key things that have to go with it. No. 1, given our fiscal situation, unlike 1986, it cannot be revenue neutral——

Mr. MCINTYRE. It was not revenue neutral in 1986, Bob. It raised corporate taxes by one-third.

Mr. GREENSTEIN. No, no, I am talking about——

Senator PORTMAN. Overall.

Mr. GREENSTEIN [continuing]. Corporate and individual combined, overall. It cannot be revenue neutral.

Second, on the individual as opposed to the corporate side, 1986 lowered rates, but it eliminated lower rates for capital gains and dividends. I think one should not be talking about lowering top rates in the income tax unless one is going to tax capital gains and dividends as ordinary income.

Last key point, I just want to say quickly on the Earned Income Credit, the research literature is now overwhelming on the degree to which the credit has been successful in promoting work, reducing welfare. It has very low administrative costs. I do not think doing it through the social service side would be anywhere near as——

Senator PORTMAN. Well, remember, I talked about offsetting payroll taxes, because most of these people have payroll tax liability——

Mr. GREENSTEIN. If you offset it through payroll tax——

Senator PORTMAN [continuing]. And you would avoid a lot of the improper payments through that.

Mr. GREENSTEIN. Let me suggest an alternative route. If you try to offset it through the payroll tax and you want to do as much to promote work and reduce poverty at the bottom, you will have to spend a lot more money, because in the payroll tax, you do not know families' total income. You do not know who is a one-earner family or a two-earner family.

I think the alternative route is, No. 1, to simplify the EITC, which has more pages of instructions than the Alternative Minimum Tax. And No. 2, gets to the question of IRS enforcement. We are now getting to the point where we have more data bases that could be used to, both in the EITC and the general code, find more questionable claims and followup on them. The problem is that we have not invested enough money in either updating IRS computer systems or, frankly, in enough IRS staff. So when the IRS looks, they can do more EITC examinations and save, I forget, four dollars for every dollar they spend. But if they use that money on small business or corporate noncompliance, the ROI is higher.

Senator PORTMAN. Yes. Listen, I——

Mr. GREENSTEIN. They just do not have enough resources to do it.

Senator PORTMAN. I agree with you on the data base, of course, and simplification, you are absolutely right on the EITC. But my point is, this is all about reform, and Mr. Hodge, do you have any comments on reform quickly? I have just got 1 second left, literally.

Mr. HODGE. Well, very quickly, the National Taxpayer Advocate says that while 63 percent of Americans pay someone else to do their taxes, for EITC recipients, it is around 75 percent. I think it is a shame that poor people have to pay an expert in order to be able to get the EITC benefit.

But more broadly, I think we need fundamental tax reform across the board to remain competitive and to—it sort of sounds like shouting into wind to say that, well, we can only lower our rates a little bit, but we are not going to go as far as the Europeans or the Asians. The world is changing and we have to change with it, and if we do not, we are going to continue to fall further and further behind in this very, very competitive global economy.

Senator PORTMAN. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. I want to thank all three of your organizations. We have worked with you on these issues for quite some time.

And I want to start by talking to you a little bit about the urgency of all of this. My concern is that if a fire is not put together for significant bipartisan comprehensive tax reform, in all probability, the lame duck session of Congress in 2012 will look much like the lame duck session of Congress in 2010. There will be a debate once again about how damaging it would be to raise taxes on middle-class folks, something I happen to agree with and I think all of you do. And once again, people will go into this kind of automatic kind of pilot routine where you say, let us just extend this extraordinarily broken system for a while longer, something that is not creating jobs, is just riddled with all of these loopholes and exemptions and the Swiss cheese nature of the system. And, of course, by that time, we will probably have a bunch more loopholes.

So I would like to get a sense from all of you about your judgment, whether you agree with me that it is urgent that Congress move. I think it is urgent just from the jobs standpoint. As all of you know, I just saw a debate between Bob McIntyre and Bob Greenstein, two Bobs I admire very much. The one thing that is not in dispute about 1986 is in the 2-years after that bill was signed, our country created 6.3 million non-farm jobs, according to the Bureau of Labor Statistics. That is enormous in its implications, and boy, it sure looks good compared to 2001 and 2008, when we created three million new jobs. In 2 years after tax reform was enacted, we created 6.3 million new jobs.

So your judgment, before I get into some of the details, that this is really urgent, both from the standpoint of job creation, most important, and second, so we are not staring down the road here in the lame duck session of 2012 at repeating exactly what I think all three of your organizations are against. So this is just a question about whether this is urgent. Mr. Greenstein?

Mr. GREENSTEIN. Let me first say, Bob McIntyre are in agreement, not disagreement. He was saying 1986 raised revenue on the corporate side and I was saying it was neutral overall. I think we are——

Mr. MCINTYRE. Right. It was just a dangling antecedent, not a disagreement.

Mr. GREENSTEIN. So do I think this is urgent? Yes, but. What I think would be a step, unfortunately would not be the wise thing to do, and you and I may have a disagreement on this, I worry that if we do tax reform, comprehensive tax reform in a way that is deficit neutral, that that will be a long-term negative because it will make it almost impossible to get a comprehensive deficit reduction agreement. The low-hanging fruit on the tax expenditure side will be gone, and in the absence of having revenues on the table, we will not get a big agreement.

Senator WYDEN. Fair, fair——

Mr. GREENSTEIN. However, I do think it would be urgent to do comprehensive changes that give us long-term deficit reduction, do not take effect on the deficit reduction side until the economy is back, and include as part of them tax reform that both makes the system more competitive and raises significant revenue at the same time.

Senator WYDEN. Well, fair enough. As you know, Mr. Greenstein, there are definitions about revenue neutrality. The legislation I had with Senator Gregg, the Joint Tax Commission said it was more than revenue neutral and all the analyses that were done said it would produce revenue because of the extra benefits from job creation.

I just think, having read a lot of the excellent work you have done, you share my view that not repeating in the lame duck session of 2012 what we had in 2010——

Mr. GREENSTEIN. That is correct.

Senator WYDEN. Thank you.

Mr. McIntyre, same point, not repeating the lame duck drill of 2010.

Mr. MCINTYRE. Oh, well I hate lame ducks, but you asked the question whether it is urgent to do tax reform as soon as possible. I would worry about that, because I cannot imagine a bill that could pass the House of Representatives that you and I would not hate. If you can persuade me that you can persuade them, then my urgency level goes way up. But right now, it is not there.

Senator WYDEN. Fair enough. Chairman Tiberi, who has done some very good work on this, put out a statement with me early on that could have been written by you because it talked about the benefits of 1986. So I tell you, I think there are a lot of Democrats and Republicans, who if we can just coalesce here fairly quickly and not write this thing off for another couple of years, which is what concerns me, I think a lot of what thoughtful people like our witnesses have been doing is still quite, quite doable, and take a look at Chairman Tiberi's statement about 1986. And he, of course, is the Chairman of a Ways and Means subcommittee who is very involved with the House leadership, and that was an extremely encouraging statement.

Let us ask for your colleague from the Tax Foundation, Mr. Hodge, who we have worked with, too, how important it is to move on this.

Mr. HODGE. It is critically important, Senator, to move as quickly as possible. Uncertainty in the tax code is one of the enemies of economic growth, and we have great uncertainty in the tax code through all of these temporary measures, short-term, 2-year or 1-year, or in some cases with certain things, like the R&D tax credit, companies never know whether they can use it up until December 31. That is an enemy of economic growth, and the quicker we can move to fundamental long-term tax reform that broadens the base and brings down rates and adds certainty to the tax system, I think the better off we are going to be, and more importantly, the better off the economy will be over the long term.

We are losing ground globally, as I have mentioned repeatedly, and I worry that the longer we wait to solve this problem and be more competitive, the more we are going to lose basically jobs and growth to other, more competitive countries.

Senator WYDEN. Mr. Chairman, I had one other area, deferral, that I wanted to get into, but it takes a little time.

Chairman CONRAD. No, take some extra time, because I think it is very important we do get into it. You and Senator Gregg had, I think, a very, very important proposal and dealt with that issue and I think we should take the time, because we are not going to have another opportunity.

Senator WYDEN. Thank you, Mr. Chairman.

Let me start with you, Mr. McIntyre, and kind of walk it through in terms of how somebody in a supermarket sees it. If you go and see somebody in a supermarket and talk about what you are doing on the Senate Finance Committee on which I serve, the first thing they say is, take away those tax breaks for those guys shipping the jobs overseas. That is outrageous. I want red, white, and blue jobs.

And then, of course, you go to the companies and the companies say, yes, you know, we want jobs in the United States, too, but our tax rates are higher than just about anybody in the Western industrialized world. You have heard their position, as well. And they will make the case that they have to have tax deferral in order to have jobs in the United States because of the relationship between jobs offshore and jobs here.

So what I have said is, let us see if we can find our way out of this and say that we are going to roll back in a substantial way some of these breaks that are going overseas—there is deferral and there are foreign credits—by dramatically lowering the rate for people who manufacture and do business in the United States. I call them red, white, and blue jobs, and when I bring it up with American businesses and I bring it up with labor folks, who, as we know, have not exactly seen eye to eye on it, conceptually, they think that this is something that they can proceed with.

What is your take in terms of how we work our way through this question that starts in the supermarket or the coffee shop when our citizens are understandably furious about tax laws rewarding doing business overseas, and at the same time being competitive in a tough global market? What is your sense about how we might—because it was a lot of your creativity that brought people together in 1986—what might unlock an agreement in the future on this issue, starting with the person in the supermarket all the way to American business that has been concerned about competitiveness and how you might bring a new consensus together.

Mr. MCINTYRE. Well, I mean, what is important to understand is that your proposal to get rid of deferral and tax worldwide income of corporations addresses the problem of subsidizing foreign investment, because wherever you move your money, whether you artificially shift it to the Cayman Islands or you really build a factory in China, you will still be subject to U.S. tax, and if you pay taxes to a foreign country, of course, we will not tax you twice. That addresses that problem.

The companies' retort is that, well, yes, but you want us to go to China. Now, I do not understand why we want them to go to China very well. They have this argument that for every 10,000 jobs they create in China, 300 are created in the United States to manage the business in China. But I would much prefer to have the whole 10,000 here, personally. And so their idea that they have to be competitive with the Germany company in China, eh, trivial at most, although that is what they make as the argument.

So if we are talking to the person in the supermarket who wants to know why we are paying companies to go offshore, I would say, well, yes, Ron Wyden is going to solve that. Now, he has another thing he wants to do, too. He thinks that we should have a lower rate if you do business here in the United States, and he and I have an argument about that, because I think it is more important for American business to get the benefit of the public services that they need, the roads and the schools and everything else. That will make them more competitive with the rest of the world by doing business here in the United States and giving them a few points off their corporate rate.

And you say, well, Mr. McIntyre, why do you not just tax the poor people to pay for these things for the businesses and give the businesses lower taxes? And I say, well, that makes things unfair, plus, I do not think the public would tolerate it. So this is the discussion you and I have had a lot.

But the No. 1 thing that I admire so much about your plan is you take away the incentive to move things offshore, which just automatically says, now you have more of an incentive to do it here. And so if you want to provide a little bit bigger one on top of that, OK, but remember, that comes at a price.

Senator WYDEN. I want to hear from Mr. Greenstein and Mr. Hodge, and again, just before I leave you, colleagues, when you look back at the history of how it came together in 1986, Bob McIntyre did as much as anybody to, in effect, thread that needle, and we are going to be calling on you often. And this is, as I have talked about with both colleagues, this is an inexact science.

Mr. Greenstein, you wanted to add something. We are talking about how we can find a way in a bipartisan fashion- -I mean, part of what the companies have said with respect to deferral, I think, is just understandable, because, oh, somebody is talking about making an abrupt change in a major economic policy that relates to competitiveness and I have said I am interested in working in a bipartisan way with good people like here and Chairman Tiberi and others so we can have transition rules, which Mr. McIntyre knows a lot about and would allow us to start making our way to a new system. But in terms of the principles of how we would wrestle with the corporate rate and deferral and going forward in a bipartisan way, your thoughts, Mr. Greenstein.

Mr. GREENSTEIN. I have not studied your specific proposal here to the degree that Bob McIntyre has. His comments make a lot of sense to me.

The point I wanted to add was to contrast your proposal with something that I think would be very unwise and might soon come before you, which is the idea to, in the absence of reform, simply allow a big repatriation at a 5-percent rate. You know, we tried that in 2004. It did not create the number of jobs it was supposed to. But the more important point is that when it was done in 2004, it was said, this is one time only. And if we do it again now, it will create a sense, I think, among companies that they should actually shift more investment and jobs overseas because all they have to do is wait until the next recession or whatever and they will get another holiday where they can bring everything back at only a 5-percent rate.

So I think, unlike what you are trying to do, I think if you simply do a repatriation, in the long run, you are actually going to lose jobs. You are going to have exactly the opposite incentive to what you are trying to have.

Senator WYDEN. One of the opportunities, again, for common ground for this table to ponder is that I think that there may be an opportunity to look at repatriation if it was part of tax reform. In other words, if it was part of a tax reform proposal that adhered—and I saw the little skirmish we had on 1986, but 1986 was progressive. It got rid of preferences and it held rates down, something I think all three of you have in common, and I think if repatriation is discussed, as I have heard Senators and House members talk about it in the context of tax reform, we may be able to get some more common ground.

Mr. Hodge, and I am just very appreciative of you, Chairman Conrad. I just think this is a big issue that does not get talked about much. Mr. Hodge, your way out of this conundrum involving international tax policy and the person who is our constituent in the supermarket.

Mr. HODGE. Well, Senator, I agree with your plan to lower the rate. I think reducing the rate to at least 24 percent is the absolute way to go. Preferably, I would like to see the Federal rate be around 20 percent so that when you add back the average of State rates, we are at about 25 percent overall, which would equal us to China and roughly the OECD average.

But I disagree with remaining with the worldwide system and I would prefer to move toward a territorial-type system. That is the trend among our major competitors. The United Kingdom and Japan were the two latest countries to move toward more or less of a territorial-type system. And to remain with a worldwide system would simply hamstring American companies as they are trying to compete in an incredibly competitive global marketplace.

I do not think that we want to concede China or Asia or Europe or any of these other emerging markets to our foreign competitors, and I think to remain with this worldwide system would absolutely do that. I think if somebody is going to make tractors in China, I want it to be Caterpillar. I want it to be John Deere. I do not want it to be a Germany company or a Swiss company or someone else. I want U.S. companies to be as competitive as possible in this global economy.

And the benefit principle of taxation says that taxes should at least be linked to the benefits, and U.S. companies are paying taxes on those profits earned abroad. They are paying them to the host country where those profits were earned. And I think it is unfortunate the U.S. system penalizes U.S. companies for trying to bring those profits back and reinvest in the United States. And that is why I would like to see a permanent territorial system so there is no penalty for reinvesting, not one of these one-off. I agree that that was bad tax policy. And any of these holidays tend to produce unintended results. Permanence is the way to go.

Senator WYDEN. My Chairman has his gavel in his hand. Let me just kind of close with what our challenge is, and I would welcome your ideas, the three of you.

Senator Gregg and I spent an enormous amount of time debating just this, and I will keep my public posture as being open to this and a variety of other things you will hear. Mr. McIntyre made very good intellectual arguments against it. What I have to tell you is we are going to need some proposals quickly on how people at this table might come together behind it, because issues like transfer pricing, which are sure to be compounded by anything in this area, have to be addressed in order to go forward.

So I am open. A lot of Senators on both sides are interested in this. The Commission was interested in it. But we are going to have to have, quickly, some very creative kind of work done by people like the three of you in order to give this a pulse and I am going to stay open.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you so much. It was very important we have this discussion because we really are at critical moments of decisionmaking.

With that in mind, I would ask both Mr. McIntyre and Mr. Hodge if you could provide to me and this committee a summary of the arguments that you believe are most important to keep in mind on the question of territorial versus worldwide. It would be very important that we get that because we are at a critical moment in discussions and it would be very helpful to have the information that you have and the knowledge that you have brought to bear as this decision is made. So could you do that?

Mr. HODGE. Sure, absolutely.

Chairman CONRAD. All right. Senator Portman would like an additional moment, as well.

Senator PORTMAN. Well, just to follow on with the Chairman's request, this is a critical time because I think when you look at the economic growth possibilities as part of looking at our fiscal situation, tax reform is high on the list and it happens to be bipartisan. It is something the President is talking about, we are talking about on our side of the aisle, and we need to move and move quickly, in my view. We cannot wait another 18 months or 2 years, and because the election is coming up, it needs to move particularly quickly.

I have a very different point of view, Mr. McIntyre, on what we ought to be encouraging U.S. companies to do, so our policy proposals may not be that different, because I am strongly supportive of what my colleague is talking about in terms of lowering the corporate rate, and Ron Wyden has done terrific work on this, because it solves a lot of those problems.

But let me just give you a quick example, because we did this analysis in Ohio. There is a study recently done by an economist at Kenyon showing 17,000 jobs would be lost in Ohio just by extrapolating from some of the national data on deferral. So if you would eliminate deferral, you would lose jobs in Ohio.

In the case of my hometown of Cincinnati, Proctor and Gamble Company, as you know, is a global company. They do a lot of business overseas. They do not export Tide, they make Tide elsewhere. You cannot export it and be competitive. Forty percent of the jobs in Cincinnati, and they are the largest private sector employer in our area, so over 5,000 jobs are there because of their international sales. So it is not just a couple hundred jobs for a couple thousand because they do all their research in Mason, Ohio, and they do their back office accounting and legal and marketing and so on. It is a U.S. company. We want them to stay in the United States.

Their incentive right now, not speaking for them but speaking for international companies generally, if you are to keep the relatively high corporate rate relative to other countries and keep this notion in place that we should not allow them to defer prior to them bringing their profits back, would make it advantageous for them either not to be a U.S. company, first, and we have seen some companies make that decision.

I remember when Daimler Chrysler testified before the Ways and Means Committee and told us why it was Daimler Chrysler and not Chrysler Daimler, but also, it obviously incentivizes them to sell their foreign subsidiaries and to allow those companies to be purchased by companies from other countries that have better tax advantages. They can pay a premium, the Italians, the Germans, the Japanese, the Chinese. That is what is going on in the real world right now.

So I would say we need to be very careful. Ninety-five percent of the consumers live outside of our borders. We want to access those consumers. We want to create jobs here in America by accessing those consumers. If we do not, our standard of living will go down in this country. We will lose employment. And if we keep the corporate rate relatively high, and even 25 percent is relatively high if these other countries, as Japan, continue to lower their rates, and if we are the only country of our major competitors that has a territorial, or a worldwide tax system rather than a territorial system.

So we, I think, are right on the edge here. If the rate is low enough, some of this can be looked at. But if it is not low enough, then we will continue to lose jobs here in this country. So I wanted to get that on the record and again appreciate all three of you today. I have enjoyed working with you in the past and look forward to your help on trying to come up with a bipartisan approach to tax reform that does create jobs and opportunity. Thank you.

Chairman CONRAD. Thank you, and I would like to turn to one other matter just quickly, because this really is a critical time, and that is the question of consumption tax as an increased part of the tax base of the United States.

Virtually every expert from every philosophical background who came before the Commission, the tax group of the Commission—Congressman Camp and I were given the responsibility to lead the discussion in that area—told us we should have more of a hybrid system, that consumption should be more of a part of the tax base of the United States, that it should be done progressively, which is challenging, but there are ideas for how you do that. Professor Graetz, as many of you know, has a proposal to take 100 million people off the income tax rolls and have a consumption tax. The man has some ideas for how it be made progressive. Others who came before the Commission from a more progressive viewpoint had other ideas for how it could be made progressive.

What are your thoughts with respect to having a system that has a consumption tax component as part of the base?

Mr. MCINTYRE. Well, we already have one, of course. The States have sales taxes, which these days run around almost 7 percent. So we have consumption tax as part of our mix. It is, in some ways, unfortunate because those taxes are so regressive, and every plan I have ever seen to try to deal with that regressivity is a failure because it is so hard to do.

Mike Graetz's plan—he does not take 100 million people off the tax rolls. He just has 100 million people filing for tax rebates against their consumption tax. But they have to file their same income tax return they do now, pretty much.

But anyway, no, I think people say, well, you know—I do not understand. Let us suppose that we are talking about a value-added tax, and some people say that would be a great idea, and I say, I look at them and I say, why? If you want to make the income tax less progressive, you could do it if that is your goal, to have a more regressive tax system. But why would you set up a new bureaucracy that estimates say would have to double the size of the IRS to collect this tax just to get a more regressive system?

Now, they may have other arguments besides the fact that they may want more regressivity, but the ones I have heard do not hold water. So I am strongly and probably irrevocably opposed to adding a Federal consumption tax.

Chairman CONRAD. All right.

Mr. GREENSTEIN. Well, on this one, it may be the only thing we have discussed today I am in a different place than Bob McIntyre. I think over the coming decades, we are going to have no alternative but to get revenue to a somewhat higher share of GDP, given the aging of the population, increases in health care costs, and whatever other international challenges we may face. And whether it would be my preference or not, I do not see politically that happening on the income tax side alone.

I think we will need a supplementary consumption tax. Were we able to do it, my first choice would not be a VAT but a carbon tax because of the growing concerns of the impact not only on well-being, but on the world economy of global warming. But I am not sure that a carbon tax is not even politically more difficult than a value-added tax. Interestingly, the last conversation I had on this with Michael Graetz, I think Michael privately probably would prefer a carbon tax, as well.

Now, having said that, particularly for a VAT, there are two huge challenges. One you noted, progressivity/regressivity, easier on paper to make it progressive than in the real world. You can offset the adverse effect on the bottom. As you may know, we helped design a provision that would have done that in the cap and trade bill that passed the House, and we were working with Senators Kerry, Graham, and Lieberman when they were moving forward on an energy-type bill before it collapsed. But the farther you want to go up the income scale into the middle class with the kind of mechanism we developed, it gets harder.

The other big challenge, particularly for a VAT, is—and it is really complicated—is figuring out how to design it so it does not interfere with State and local tax collection, and the local is actually harder, because a lot of localities have sales taxes than the State.

One last point. I am not sure, you will have to ask Michael, but I think in my last conversation with him on this, he had me actually do a session for this VAT group that he has on how to offset the impacts on the bottom in December. I thought by the end of it, he was kind of convinced that his idea of taking 100,000 people off and having no income tax, that he was moving away from that, and there were two problems with that.

Michael fully agrees that we need to make people whole with regard to the Earned Income Credit and the Child Credit and the like, but neither he nor anybody else has really figured out a good way to do that that works in the real world in the absence of any income tax at all.

The second is health care. Whether you favor the Affordable Care Act, as I do, or you favor the kinds of approaches that Republicans offered when George Bush was President, in both cases, they rely on marketplaces where people get subsidies—people who are low and modest income get subsidies to make coverage affordable and the subsidies are delivered as tax credits through the tax system. And the people that get the subsidies are all in the income group that under the Graetz plan no longer files a tax return. And when I mentioned this to Michael, he said, oh, that is a really good point. I designed my plan before we went in that direction in health care.

Chairman CONRAD. All right. Mr. Hodge, any comment?

Mr. HODGE. Very quickly, Mr. Chairman. I once had a very senior British tax official tell me that if you want a perfect tool for funding big government, the value-added tax is the perfect tool. It is hidden from view and you can always dial up the rate if you want more revenues, and that is exactly what the British government has done recently to solve their problems.

I do not believe that we need an imperfect tax on top of a tax system that we already have. The value-added tax has many of the same problems in Europe and elsewhere that we see with sales taxes here in the United States. They have various carve-outs for groceries and medicines and children's clothing and other things and that creates as many problems as you have seen at the State level.

I do believe we can move toward more of a consumption base by moving toward what you might call the traditional flat tax, as advocated by Professors Hall and Rabushka at Stanford or Steve Forbes or even a plan like what Congressman Paul Ryan has put forward, where you have a flat tax for individuals, a flat tax for corporations, you do not tax savings on the individual side, you allow full expensing at the corporate side, and you essentially have more of a consumption base, but you do it within kind of an existing system as we have, rather than adding something on top of what we already have. I would prefer that.

Chairman CONRAD. Let me just say, my reaction to that is what you do is you would either raise a lot less revenue- -every flat tax proposal I have seen does—or you would dramatically make more regressive the tax system, because our system now is progressive. If you have a flat tax that generates the same amount of revenue, it is a mathematical certainty that people at the top pay less and people at the bottom are going to pay more.

Let me just thank you. We have really gone well past what we intended and what we had asked you to prepare for. I deeply appreciate the contributions you have made. This is a very timely hearing and important to the work of the committee and the work of other groups who are having discussions right now. I thank you all.

The committee will be adjourned.

[Whereupon, at 12:18 p.m., the committee was adjourned.]

Questions for the Record
from Senator Begich
for Mr. Greenstein
Budget Distribution and Efficiency of Spending in the Tax Code
3/9/2011
Senate Budget Committee

1) Mr. Greenstein, I think we can all acknowledge everyone has a different opinion on how best to reform the tax code. Ultimately the question of reform will require which tax expenditures to eliminate and which to keep. What would u recommend as a metric to measure which tax expenditures are worth keeping?

2) Does tax reform make it easier or harder to tackle the deficit? Obviously, tax reform that is revenue-neutral does nothing to help the deficit, but revenue-raising could be joined with certain tax reforms that benefit individuals or corporations who currently don't get a lot of loopholes or who just want a simpler system. The result could be revenue-positive even though some people or corporations benefit from it. That's what happened in the 1986 tax reform, which raised taxes on corporations overall, but some corporations still supported it because they had no loopholes and they benefited from the reduced rates. Can that happen again today?

Robert Greenstein's Answers to Senator Begich's questions for the record:

1) I believe three metrics are particularly useful: economic efficiency, equity, and deficit reduction. As the Congress turns to tax reform in the context of long-term deficit reduction, tax expenditures that are "upside down" stand out as an area in need of reform.

   These tax expenditures are designed to promote activities that provide benefits not just to the specific taxpayer but to communities and society generally. For example, incentives for retirement savings, if successful, boost national savings and help fund productive investment.

   The value of many of these tax expenditures, which tend to come in the form of deductions or exclusions from taxable income, is tied to a taxpayer's marginal rate. This means that high income households receive a larger tax incentive or subsidy, even they often would have taken the desired action (e.g., putting aside some income for retirement) with *or without* the tax incentive and are likely to be people on whom the incentive has only a small effect.

   Consider how the tax code affects two differently-situated households with respect to their decisions to purchase a new home. An affluent investment banker who lives in a large house, has a $1 million mortgage, and pays $40,000 in mortgage interest each year will receive a housing subsidy of $14,000 annually. In other words, the banker pays 65 cents of every dollar of mortgage interest, with taxpayers, in effect, picking up the remaining 35 cents. A typical middle class family, by contrast — say a welder or a nurse making $60,000 a year — might pay $10,000 a year in mortgage interest on their more modest homes. They would receive housing subsidies worth just 15 percent of their $10,000 interest payments, or $1,500 annually.

   There is no reason to believe that the banker requires a larger subsidy to be enticed to become a homeowner — if anything, one would expect the opposite to be true. Further, it is doubtful that society benefits more from the banker's owning a home than from the nurse or welder doing so. For these reasons, the design of this tax subsidy is economically inefficient. (It also scores low on equity grounds.)

   The tax code includes many similarly structured provisions that are quite costly. Guided by the metrics of efficiency, equity, and budget any savings, many tax expenditures are ripe for reform.

2) The United States is on an unsustainable fiscal path. It is essential, therefore, that any tax reform contribute significantly to deficit reduction. Addressing our long-term fiscal imbalances will require difficult changes in federal programs, but our budget math cannot be solved on the spending side alone.

   This is a widely shared view. Bipartisan majorities on each of the major recent deficit reduction panels — the Bowles-Simpson commission, the Rivlin-Domenici commission, and a panel convened by the National Academy of Sciences — agreed that a balanced approach consisting of both program and tax reforms, each of which contribute to deficit reduction, will be required to restore long-term fiscal balance. This has been done before: the last big bipartisan deficit-reduction agreement signed into law — the 1990 budget agreement reached by President George

H.W. Bush and Congressional leaders of both parties — was a balanced mix of program reductions and new tax revenues.

This means that while the 1986 Tax Reform Act represented sound tax policy, its bottom line of revenue-neutrality is not one we should seek to replicate now. By broadening the tax base, tax reform will remove many deficit-reduction targets from the tax code, likely making it harder to secure revenue contributions to deficit reduction in the future. It thus is essential that tax reform done now make a significant deficit-reduction contribution. Given our fiscal situation, we cannot afford to do otherwise.

Questions for the Record
from Senator Begich
for Mr. McIntyre
Budget Distribution and Efficiency of Spending in the Tax Code
3/9/2011
Senate Budget Committee

1) Mr. McIntyre, Do you recommend eliminating the tax cut contained in last year's tax extension package for individuals making a $1 million or more per year.

2) Mr. McIntyre, Given the high levels of unemployment that continue to challenge our economy, what type of tax incentives should we provide employers who hire low-income workers?

3) Looking down the road, the U.S. will face significant changes in its workforce as large numbers of boomers retire. What shifts should we make in the tax code to better prepare a future generation of workers?

4) The top one percent increased their wealth and income by 275% since 1980, while the income and wealth of the bottom 90% stagnated. Isn't it time the wealthy shared in the sacrifices needed to restore fiscal balance? In other words, shouldn't part of our focus on fighting the deficit occur by raising revenue from the wealthiest Americans?

5) Many people have argued that repatriating money that companies have kept overseas would create jobs because of the infusion of money into our economy. But I would like to know if you have any thoughts about increased tax revenue that might come from the repatriated money being introduced into the economy? I know that's counterintuitive because most of the time when we talk about repatriating we are talking about giving up revenue. Do you have any estimates on increased tax revenue we may see from repatriated money once it's back in the economy?

Questions for the Record
By Senator Sheldon Whitehouse
Distribution and Efficiency of Spending in the Tax Code
March 9, 2011
Senate Budget Committee

For Mr. McIntyre:
In your testimony, you recommend eliminating income tax "deferral" – the ability of corporations to move their operations overseas and delay paying U.S. taxes. The ability to defer income can encourage U.S. firms to send factories and jobs abroad. I've introduced legislation to end deferral for manufacturers that produce goods offshore to sell to U.S. customers. My bill – the Offshoring Prevention Act (S. 45) – would generate $19.5 billion in revenue over ten years by eliminating this particularly odious use of deferral. In your testimony, you discuss ways in which our corporate tax system misallocates capital and jobs. Would my bill help to remedy this? What would be the effects of my bill on U.S. jobs and the allocation of capital here?

For Mr. Hodge:
In your testimony you state, "the U.S. has the most progressive income tax system of any industrialized nation." To support this claim, you cite an OECD statistic that the top 10% of U.S. taxpayers pay a larger share of tax receipts than the other countries – 45% in 2008 according to your source. Is it not relevant that the top 10% of U.S. taxpayers earned a greater share of national income than in most countries – 42% in 2007 according to CBO? According to these figures, the top 10% of U.S. income earners pays only a slightly larger share of income taxes than its share of income. Would it not be more reasonable to evaluate the progressivity of a tax system based on tax receipts by adjusting for the underlying allocation of income?

Your OECD source also states that, "[t]he United States is the country with the highest inequality level and poverty rate across the OECD, Mexico and Turkey excepted. Since 2000, income inequality has increased rapidly, continuing a long-term trend that goes back to the 1970s. If the U.S. has the "most progressive income tax system of any industrialized nation," what accounts for the fact that it has the highest inequality level and poverty rate?

Answers from Robert S. McIntyre, director of Citizens for Tax Justice, to written questions from Senators in connection with the March 9, 2011 Senate Budget Committee hearing on tax subsidies

Question from Senator Whitehouse:

In your testimony, you recommend eliminating income tax "deferral" — the ability of corporations to move their operations overseas and delay paying U.S. taxes. The ability to defer income can encourage U.S. firms to send factories and jobs abroad. I've introduced legislation to end deferral for manufacturers that produce goods offshore to sell to U.S. customers. My bill — the Offshoring Prevention Act (S. 45) — would generate $19.5 billion in revenue over ten years by eliminating this particularly odious use of deferral. In your testimony, you discuss ways in which our corporate tax system misallocates capital and jobs. Would my bill help to remedy this? What would be the effects of my bill on U.S. jobs and the allocation of capital here?

We have endorsed versions of your bill introduced by Sen. Byron Dorgan in previous sessions of Congress, and we continue to support this reform. Although it would certainly be a significant improvement, however, it is only a part of the bigger reform we think is needed: full repeal of "deferral."

Questions from Senator Begich:

1) Mr. McIntyre, Do you recommend eliminating the tax cut contained in last year's tax extension package for individuals making a $1 million or more per year.

Yes, but we would go much further, and let most, if not all of the Bush tax cuts to expire as scheduled under current law. Over ten years and counting interest, that would save about $4 trillion — equal to the total amount of deficit reduction proposed by the President's deficit commission.

2) Mr. McIntyre, Given the high levels of unemployment that continue to challenge our economy, what type of tax incentives should we provide employers who hire low-income workers?

We do not support business tax incentives, which we think are an ineffective way to encourage useful behavior. In particular, tax subsidies for hiring low-income workers have been enacted in the past, but were found to be ineffective, and essentially rewarded behavior that would have occurred anyway. We think that the best way to boost employment during a recession is to boost consumer demand with the sorts of measures that were included in the American Recovery and Reinvestment Act of 2009.

3) Looking down the road, the U.S. will face significant changes in its workforce as large numbers of boomers retire. What shifts should we make in the tax code to better prepare a future generation of workers?

We need a tax code that raises sufficient revenues so that we can afford to fund the investments in education, infrastructure and other programs to better prepare a future generation of workers.

4) The top one percent increased their wealth and income by 275% since 1980, while the income and wealth of the bottom 90% stagnated. Isn't it time the wealthy shared in the sacrifices needed to restore fiscal balance? In other words, shouldn't part of our focus on fighting the deficit occur by raising revenue from the wealthiest Americans?

As my testimony indicates, we believe that curbing or eliminating business subsidies administered by the IRS, subsidies that primarily benefit the wealthiest Americans, should be Congress's highest priority in deficit reduction. Doing so can slash the deficit while retaining essential programs, improve economic efficiency, add jobs and make America a more equitable society.

5) Many people have argued that repatriating money that companies have kept overseas would create jobs because of the infusion of money into our economy. But I would like to know if you have any thoughts about increased tax revenue that might come from the repatriated money being introduced into the economy? I know that's counterintuitive because most of the time when we talk about repatriating we are talking about giving up revenue. Do you have any estimates on increased tax revenue we may see from repatriated money once it's back in the economy?

We do not believe that another amnesty for repatriating profits artificially shifted offshore would be a good idea. Since these companies already have access to their offshore profits through borrowing, we do not believe it would lead to any significant "infusion of money into our economy." As is well known, the mistake of the 2004 repatriation did not add to U.S. jobs. Repeating it would reward corporate tax dodgers for their bad behavior and encourage them to continue their tax sheltering ways in the expectation that they would again be rewarded with additional "repatriation holidays" in the future.

Response of Scott Hodge
To questions for the record
By Senator Sheldon Whitehouse
Distribution and Efficiency of Spending in the Tax Code
March 9, 2011
Senate Budget Committee.

Thank you Senator. As I read it, you are looking for answers to two basic questions: (1) If the richest 10% of taxpayers earn the most of any OECD country, doesn't it make sense that they bear the largest tax burden of any country and (2), If the U.S. has the most progressive income tax system of any OECD nation, what accounts for the fact that we have one of the highest incidences of inequality of any OECD nation?

The answer to the first question can, in part, be found in the OECD table I reference in my testimony [see attached]. This table shows the share of taxes paid by the richest 10 percent of households, the share of all market income earned by that group, and the ratio of what that 10 percent of households pays in taxes versus what they earn as a share of the nation's income.

The first column shows that the top 10 percent of households in the U.S. pays 45.1 percent of all income taxes (both personal income and payroll taxes combine) in the country. Italy is the only other country in which the top 10 percent of households pays more than 40 percent of the income tax burden (42.2%). Meanwhile, the average tax burden for the top decile of households in OECD countries is 31.6 percent.

By contrast, column #2 shows that the richest decile in America earned 33.5 percent of the market income in the country in 2005 – the year in which this snapshot was taken, but little has changed since then. But, other countries do have a greater or similar concentration of income as does the U.S. For example, the OECD table shows that the wealthiest decile of households in Italy and Poland earn a greater share of their country's market income than do our "rich" – 35.8 percent and 33.9 percent respectively – while the share of income earned by the top decile of households in the U.K. is about on par with those in the U.S. at 32.3 percent.

To your question, the table does adjust for the underlying allocation of income by showing the ratio of income taxes paid to the share of income earned by the top decile in each country. The ratio for U.S. households is 1.35, far greater than the ratio of taxes to income in any other country. Even in the three countries with a comparable distribution of income, the ratio of taxes to income was less, 1.18 in Italy, 0.84 in Poland, and 1.20 in the U.K.

Interestingly, countries with top personal income tax rates that are higher than in the U.S., such as Germany, France, or Sweden, have ratios that are closer to 1 to 1. Meaning, the share of the tax burden paid by the richest decile in those countries is roughly equal to their share of the nation's income. By contrast, we prefer to have the wealthiest households in this country pay a share of the tax burden that is one-third greater than their share of the nation's income.

To your second question, how can the U.S. have so much inequality with such a progressive tax system? There are two possible answers: (1) We have inequality despite such a progressive income tax system; or, (2) There is a limit to how much a tax system can reduce inequality.

That said, the OECD does find that the U.S. tax system is among those that achieve the largest reductions in income inequality. Indeed, while most countries redistribute twice as much through direct spending as they do through the tax system, "the United States stands out for achieving greater redistribution through the tax system than through cash transfers."[1] This is because of the generosity of the refundable portions of the EITC and the child tax credit.

The bottom line is that the tax system cannot counteract most of the forces that are contributing to the actual or perceived causes of inequality in America – nor should we wish it to. These factors include: The growing share of dual-income working couples; the increasing economic returns to higher education; and the growth in entrepreneurship (and the rise in flow-through business entities such as S-corps).

In 1959, the year I was born and when Leave it to Beaver was the hit show on TV, we did have less inequality in America. However, the top tax rate was 91%, the majority of families were single-earner (Ward worked while June stayed home), most people had only a high-school education, and most people worked a blue collar job for a big company.

I don't think making the tax code even more progressive tax system will take us back to such an America, nor would most Americans want to go back.

[1] "Growing Unequal? Income Distribution and Poverty in OECD Countries," Organization for Economic Cooperation and Development, 2008. p. 112.

Table 4.5. Alternative measures of progressivity of taxes in selected OECD countries, mid-2000s

	B. Percentage share of richest decile		
	1. Share of taxes of richest decile	2. Share of market income of richest decile	3. Ratio of shares for richest decile (1/2)
Australia	36.8	28.6	1.29
Austria	28.5	26.1	1.10
Belgium	25.4	27.1	0.94
Canada	35.8	29.3	1.22
Czech Republic	34.3	29.4	1.17
Denmark	26.2	25.7	1.02
Finland	32.3	26.9	1.20
France	28.0	25.5	1.10
Germany	31.2	29.2	1.07
Iceland	21.6	24.0	0.90
Ireland	39.1	30.9	1.26
Italy	42.2	35.8	1.18
Japan	28.5	28.1	1.01
Korea	27.4	23.4	1.17
Luxembourg	30.3	26.4	1.15
Netherlands	35.2	27.5	1.28
New Zealand	35.9	30.3	1.19
Norway	27.4	28.9	0.95
Poland	28.3	33.9	0.84
Slovak Republic	32.0	28.0	1.14
Sweden	26.7	26.6	1.00
Switzerland	20.9	23.5	0.89
United Kingdom	38.6	32.3	1.20
United States	45.1	33.5	1.35
OECD-24	31.6	28.4	1.11

Source: Computations based on OECD income distribution questionnaire.
http://dx.doi.org/10.1787/422013187855

THE PRESIDENT'S FISCAL YEAR 2012 DEFENSE AND INTERNATIONAL AFFAIRS BUDGET

THURSDAY, MARCH 10, 2011

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

The Committee met, pursuant to notice, at 10:01 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Wyden, Cardin, Warner, Begich, Sessions, and Thune.

Staff present: Mary Ann Naylor, Majority Staff Director; and Marcus Peacock, 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 today. Today's hearing will examine the President's budget request for defense and international affairs. Our witnesses today are the Deputy Secretary of Defense Bill Lynn and Deputy Secretary of State Tom Nides. We appreciate them being here and look forward to their testimony.

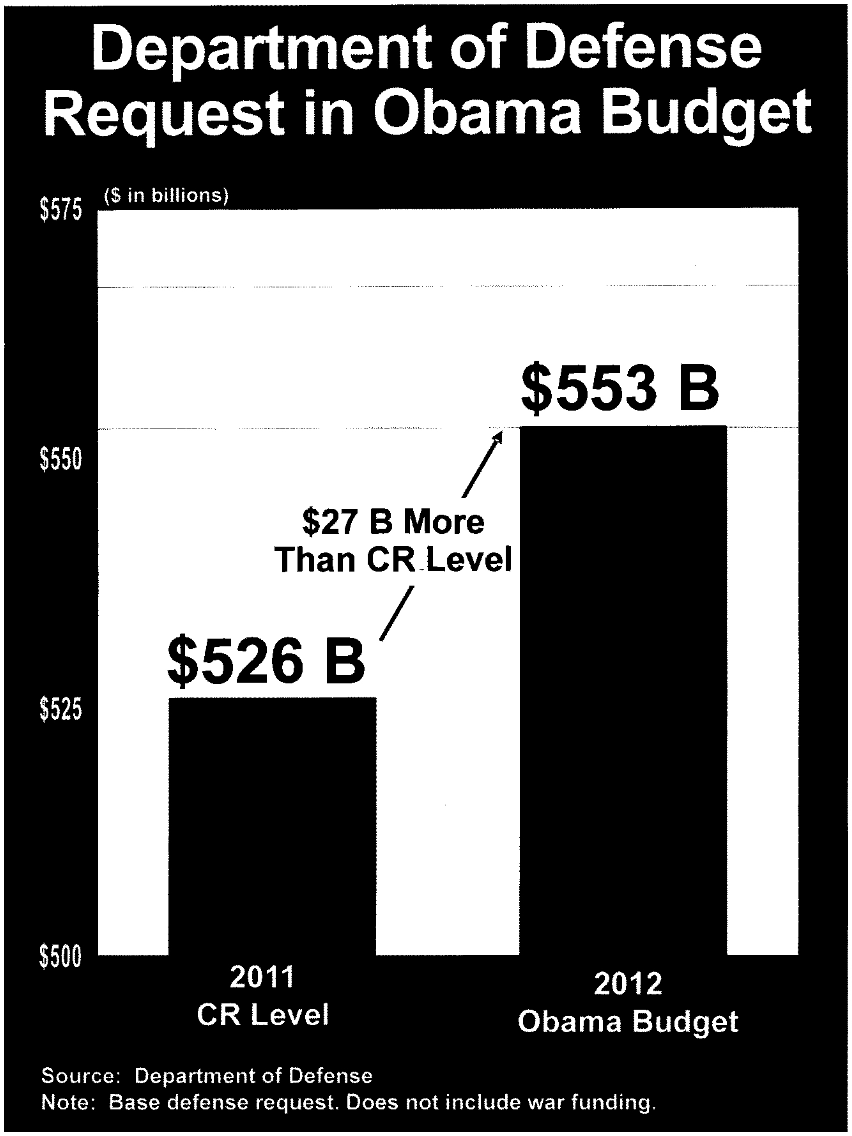
For a number of years, many people have stressed that our national security relies not just on the Defense Department but also on the State Department through its diplomatic missions. So I am glad this hearing will provide a chance to look at our national security with both agencies represented.

Our country is at a critical juncture. We are borrowing about 40 cents of every dollar that we spend. Deficits have exceed $1 trillion for 3 years in a row. Federal debt is soaring. The long-term outlook is even more sobering. We are clearly on an unsustainable course.

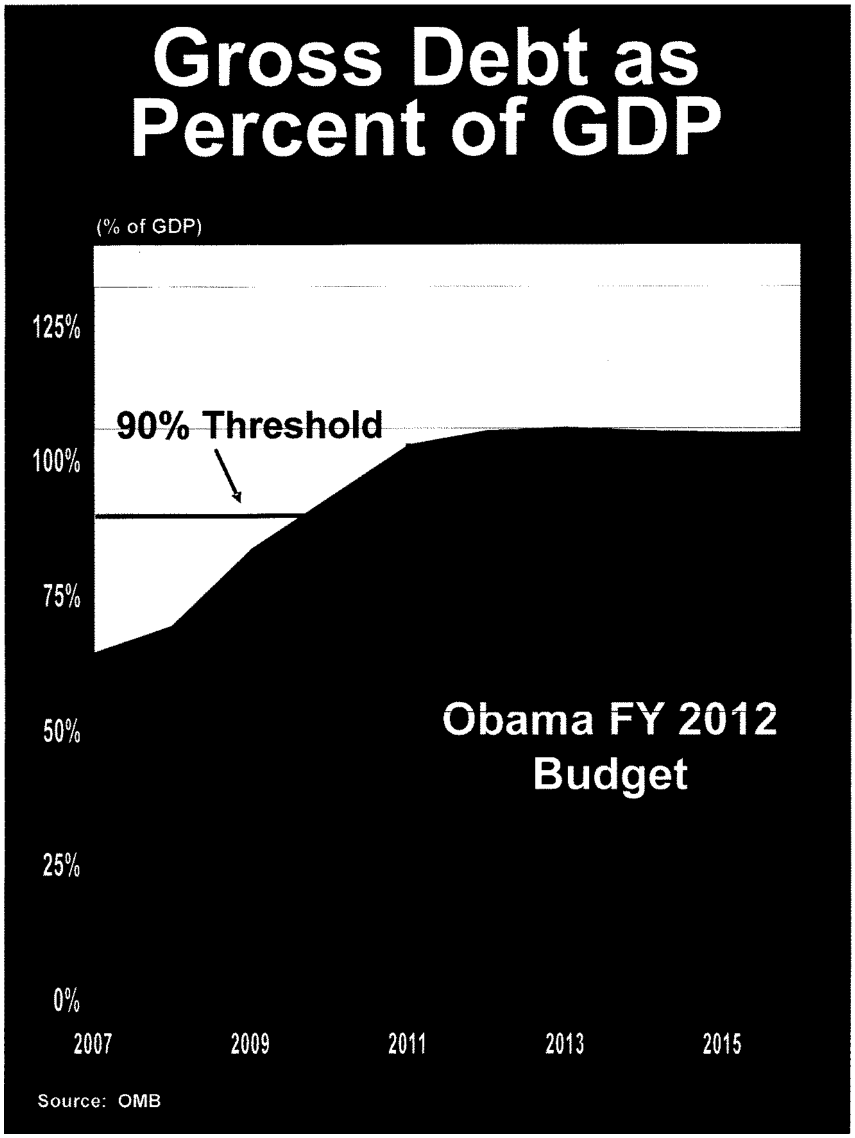
Our budget situation is not just a fiscal and economic threat. It is also a threat to our national security. We simply will not be able to remain a global superpower if we fail to stop the explosion of Federal debt. And I would note the story this morning that the PIMCO Total Return Fund has indicated they have dumped all U.S. debt.

Now, let me repeat that. The PIMCO Total Return Fund has made public today they have dumped all U.S. debt.

Here is what Admiral Mullen said about the debt threat: "Our national debt is our biggest national security threat." That is coming from the Chairman of the Joint Chiefs of Staff.

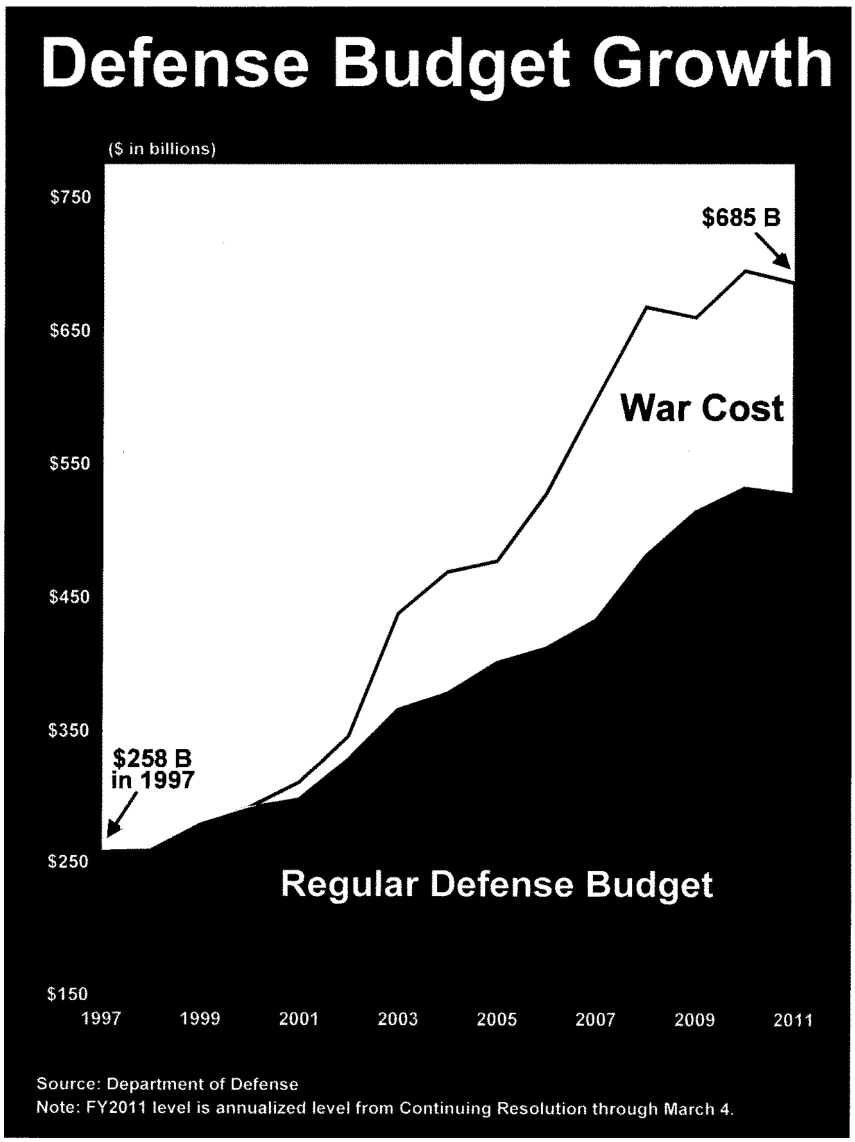


This year, for the first time since World War II, gross Federal debt will exceed 100 percent of GDP, well above the 90-percent threshold that many economists regard as the danger zone. That has to be a wake-up call for all of us.

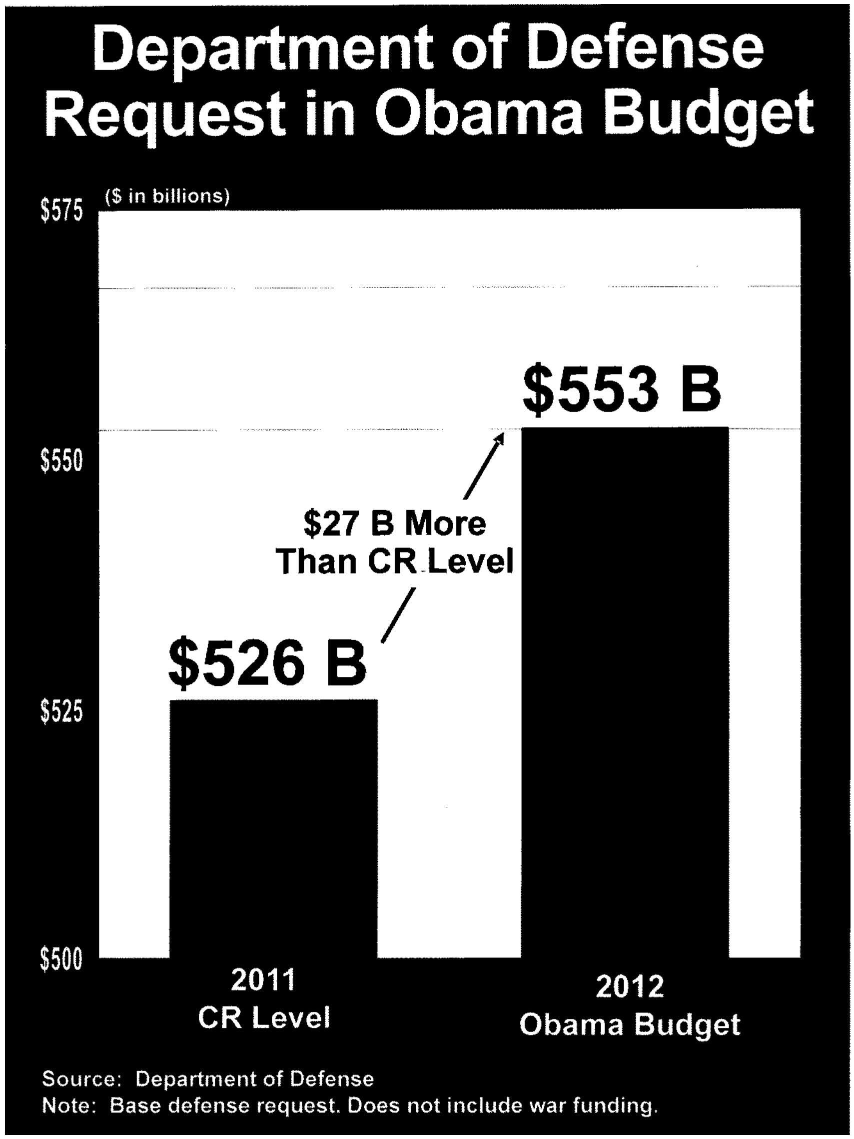


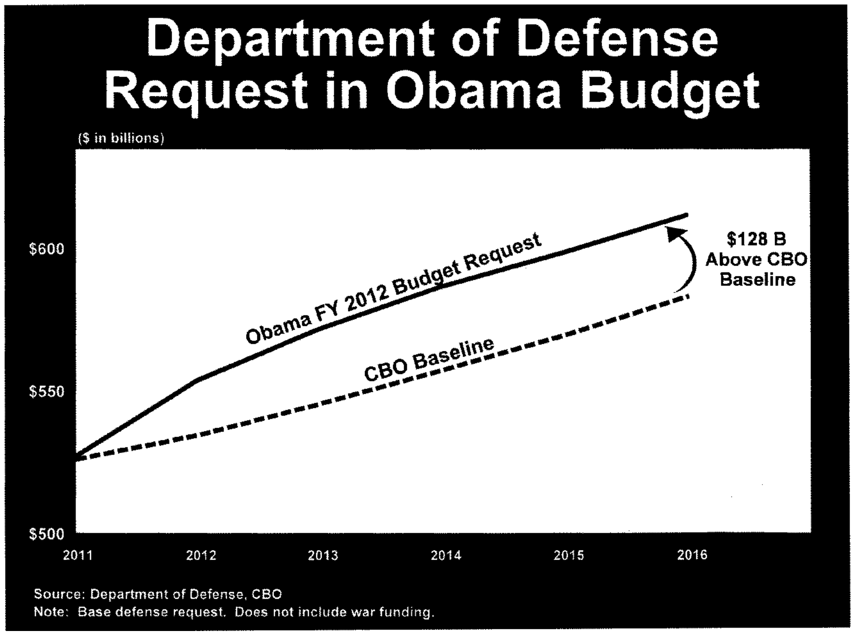
I have always been a strong supporter of defense spending because I believe providing for the national defense is the Government's single most important responsibility. And make no mistake, Congress will continue to provide our troops what they need for their mission and to keep them safe. But given the fiscal crisis, every area of the budget is going to have to come under scrutiny, is going to have to find savings, including defense. That was the conclusion of every bipartisan Commission that has examined the long-term fiscal imbalances, including the President's own Fiscal Commission and the Domenici-Rivlin group that we will hear from next week.

The examples of inefficiencies in the Defense Department that have come to light are particularly troubling. We need to root out wasteful spending everywhere we find it, including defense. The reality is that defense spending has grown dramatically in recent years and has contributed to the climb in deficits. In 1997, we spent $258 billion on the Department of Defense. This year, when we include war costs, we will spend about $685 billion on the Department. To put that in a historical perspective, this will be the fifth year in a row we will be spending more on defense than we did at the height of the Korean War in real terms.

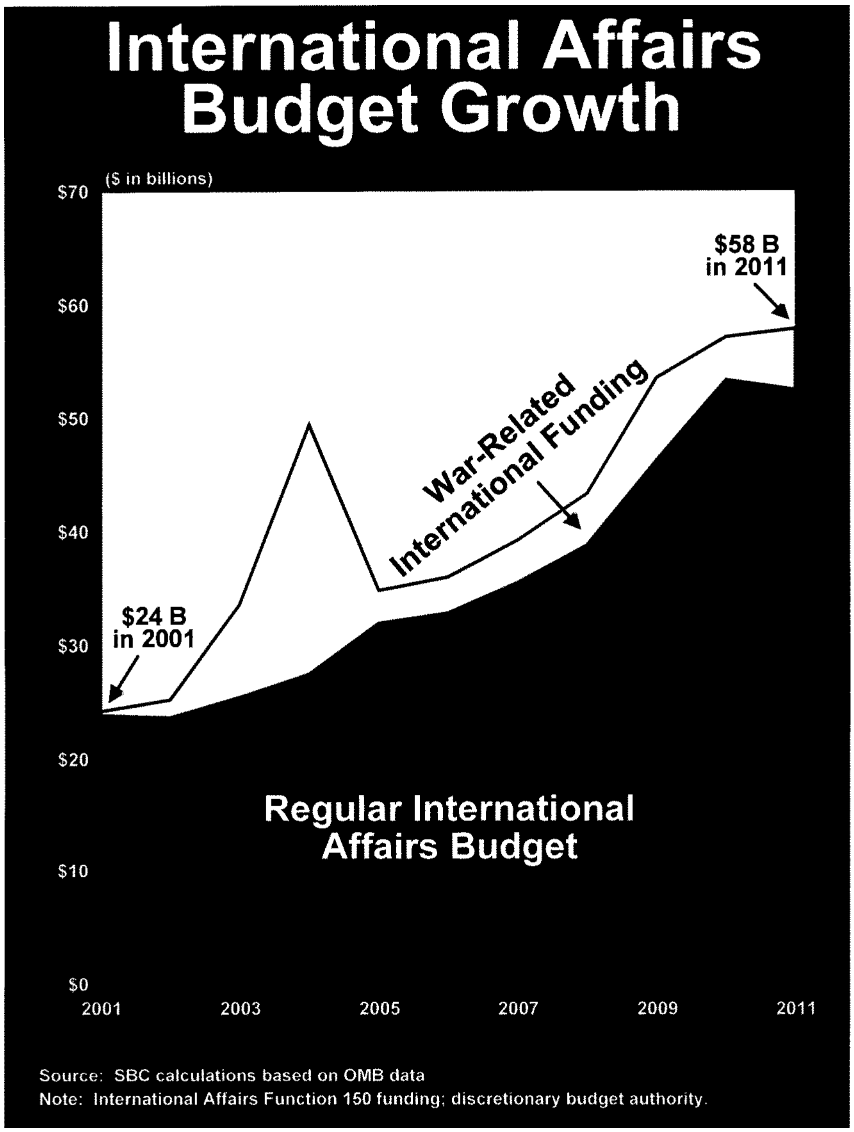


The President's budget proposes to continue to increase the defense budget. In 2012, the administration requests $553 billion for the regular defense budget, representing a $27 billion increase over the 2011 continuing resolution level. The administration has said its defense request would save $78 billion over 5 years by implementing savings proposed by the Secretary of Defense, Mr. Gates. While I welcome those savings proposals, that estimate compares the President's current budget request with the President's request last year, which was never implemented or agreed to. Compared to CBO's baseline for defense spending, the administration's current request actually represents a $128 billion increase over the 5 years. That is over the baseline, $128 billion.


Department of Defense
Request in Obama Budget
($ in billions)
$575
$550
$525
$500
$553 B
$27 B More
Than CR Level
$526 B
2011
CR Level
2012
Obama Budget
Source: Department of Defense
Note: Base defense request. Does not include war funding.

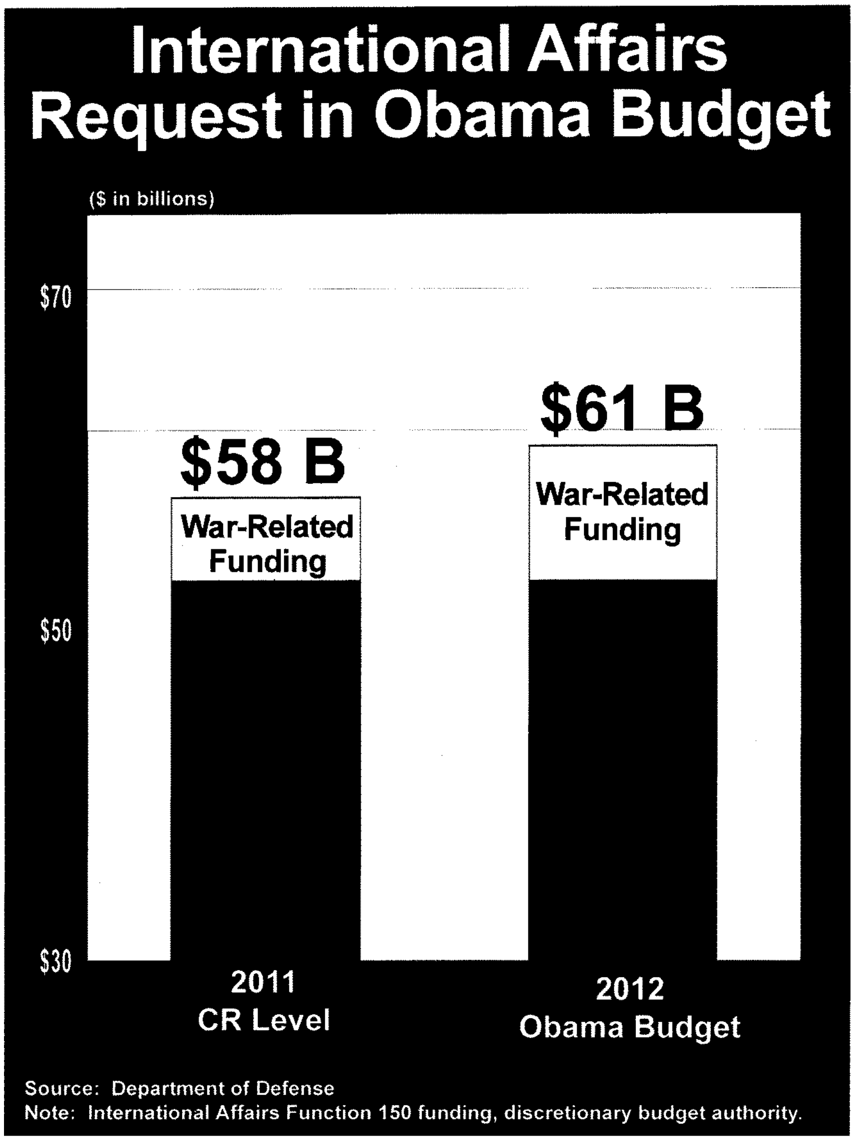

Department of Defense
Request in Obama Budget
($ in billions)
$600
$550
$500
2011
2012
2013
2014
2015
2016
Obama FY 2012 Budget Request
CBO Baseline
$128 B
Above CBO
Baseline
Source: Department of Defense, CBO
Note: Base defense request. Does not include war funding.

This chart shows a similar rise in our international affairs funding, although on a considerably smaller scale. In 2001, we spent $24 billion on international affairs; in 2004, we saw a notable spike in war-related international affairs funding from Iraq reconstruction. This year, we are spending a total of $58 billion on international affairs when war-related funding is factored in.

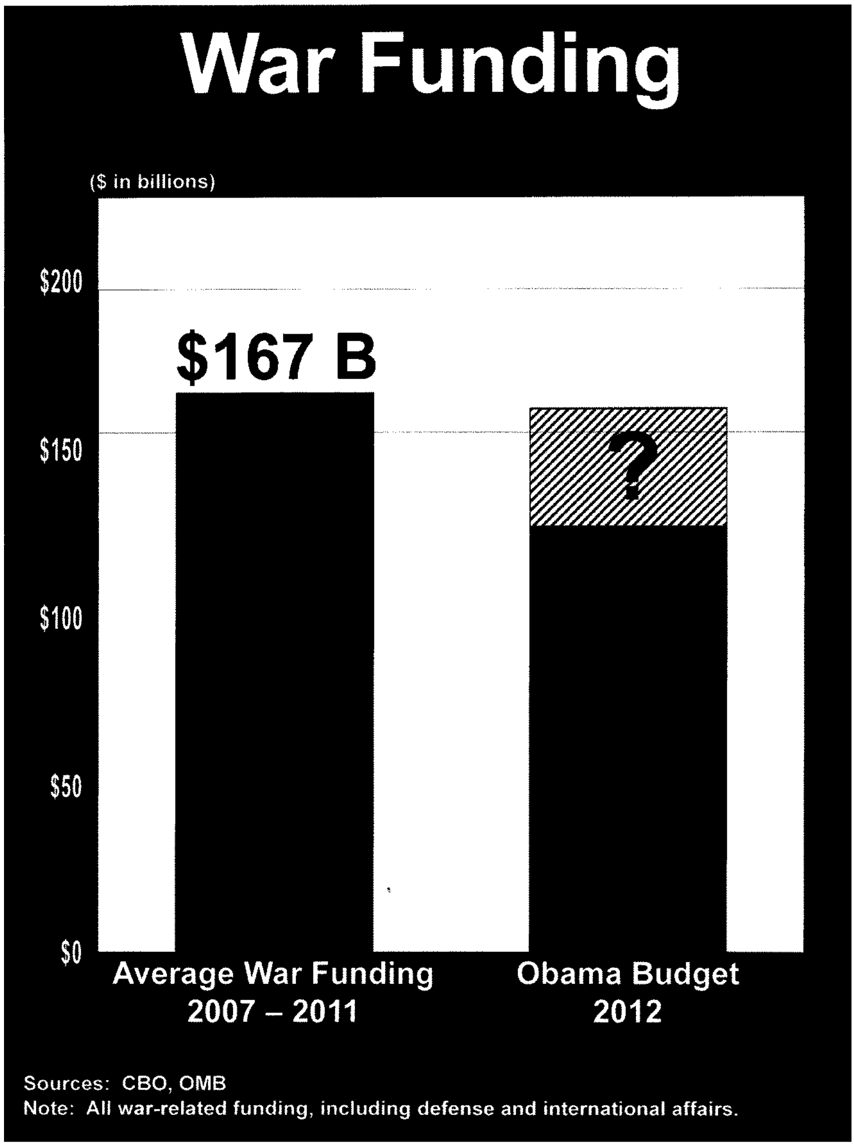


For 2012, the administration proposes to keep the base international affairs budget at $53 billion, the same level as in the 2011 continuing resolution. However, when war-related international affairs funding is added in, the administration is requesting a total of $61 billion for international affairs, representing a $3 billion increase over the total for 2011. I would be the first to acknowledge that is modest.

The requested increase in international affairs war-related funding is explained in part by the transition in Iraq where the State Department is scheduled to take over responsibility for U.S. operations there.



For overall war funding, including both defense and international affairs, the administration is requesting $127 billion in 2012. That is $40 billion less than the average war funding provided from 2007 through 2011. In those previous years, this administration and the previous administration made two or three war funding requests each year. Although I give this administration substantial credit for being much more accurate and realistic with its initial request each year, I do hope our witnesses will be able to comment on whether this $127 billion war funding request will be it for the year or whether we should anticipate another request later on.



Again, I want to emphasize we will provide our troops with whatever they need to complete their missions and to be safe. But the days of an open checkbook here are ending for everyone. I want to make that very clear. This Committee—I think I can speak for both sides—recognizes the debt threat hanging over this country. It must be addressed. There is not an option. And, again, I would go back to the story this morning—the PIMCO Total Return Fund advising us they have dumped all U.S. Government debt. If that is not a wake-up call for where we are headed, I do not know what would be.

With that, we will turn to Senator Sessions for his opening remarks. Senator Sessions.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Mr. Chairman, and I want to welcome our guests. They represent two of the great historic Departments of the U.S. Government, and we value your insight and your testimony.

The Chairman of the Joint Chiefs of Staff, Admiral Mullen, spoke the plain truth when he declared that our national debt was our greatest long-term national security threat. I believe that Secretary Clinton has said the same thing, that it represents the greatest threat to American security.

The DOD's annual budget compared to the projected growth of the Nation's interest payment on our surging debt turns out to be in the years to come less spent on defense than we spend on interest on our debt. Right now we are spending about 3 times as much on defense as we spend on interest. It just shows, I think, the perspective that we are facing.

Mr. Chairman, I share with you the urgency that we have with regard to spending. I do not believe there is an opportunity for us to delay any longer. Moody's told the Government in December that if things do not change, they could downgrade our debt in less than 2 years. Alan Greenspan said in January that, in his view, there is a 50–50 chance, a little better than 50–50 chance, but not much better, that we would have a debt crisis in 2 to 3 years. This is the former Federal Reserve Chairman. And Mr. Geithner told this Committee last week that he agreed with the Rogoff study showing that debt at the levels we are now, 90-plus percent of GDP, pulls down economic growth and puts us in danger of a crisis. He volunteered that. And he agreed with the Rogoff studies.

Then we have Mr. Simpson, Alan Simpson, and Mr. Bowles, who chaired the Debt Commission, appointed by President Obama, and they said to us the day before yesterday that a debt crisis could actually happen. In fact, Mr. Bowles suggested 2 years. He said it could be a little sooner, it could be a little later. And Mr. Simpson said in his view it would be a year or less.

So I suggest that the message is clear. We need to do some things now, and the Defense Department cannot be absolved from those challenges.

I so much admire and love the men and women who serve our country. We have the finest military, Mr. Lynn, the world has ever known, the finest I believe this Nation has ever fielded in terms of being trained, being disciplined, being courageous, willing to go into combat, and also being equipped and trained on how to use their equipment, and the coordination among the branches and services is at a level never before achieved, and it is critical, Mr. Chairman, as we ask the Defense Department to constrain spending, that we do so in a way that does not damage what we have been blessed to have created over the last number of years.

When the cold war ended, we had too much reduction in forces. Army divisions were cut from 18 to 10. The 600-ship navy went to 300. The Air Force fighter wing equivalent fell by half. We ended up with a high proportion of muscle and fat, I am afraid, during that situation. So we will have to watch it. We have to be careful.

I am concerned about some of the surging increases requested by the State Department. We are going to have to look at that carefully. I also, frankly, am concerned that the role we are calling on the State Department to fill in Iraq may be beyond the capabilities of any State Department to fulfill, and I worry about that both as to cost and to the capability of achieving that mission.

So, Mr. Chairman, thank you for the hearing. This represents a huge, substantial portion of the discretionary budget. We have to ask our Defense Department to do more with less. But at the same time, we want to do it in a way that does not call for bad decisionmaking. Driving up the cost of procurement per item, that would be unnecessary. We need to do it in the right way.

Thank you for your leadership.

Chairman CONRAD. Thank you, and thank you for your partnership, Senator. I think we have had a series of hearings here that have been very important. My staff tells me we have now done more hearings on this budget cycle than have been done in previous budget cycles for a very long time. And I think we have done a pretty good job of outlining for those who are paying attention the dimensions of the problem, the challenge that we confront, the need to take action now. And we have had a chance to hear from the President's Fiscal Commission. Next week we will hear from the other bipartisan Commission, the Domenici-Rivlin Commission. And then we will go to work on the budget resolution, and I hope to be able to work closely with you on that because, frankly, I do not think there is time to waste.

Reading this story about PIMCO making the decision to dump all of their U.S. Government debt, this is a long article from Bloomberg this morning, five pages, six pages. Anybody that reads this, pretty sobering stuff in here about people—Jim Rogers of Rogers Holdings deciding to short U.S. Government debt because of the debt overhang in this country. You know, it is what we have been talking about for a number of years on this Committee, that no one can predict when this day comes. The one thing we can say with certainty is we are moving very rapidly toward the fiscal cliff. We do not know when we will get there, if we get there this year or next year or the year thereafter. What we know with certainty is when we are adding $1 trillion of debt every year, gross debt every year, we are putting this country in an extremely vulnerable position. It cannot continue.

With that, Mr. Lynn, Mr. Nides, thank you for being here. Who would like to go first? Tom, if you would like to go first.

Let me just say that Mr. Nides, of course, helped run Morgan Stanley before being convinced to come into the Government. We very much appreciate the sacrifice that you have made, the personal sacrifice that you have made and that your family has made to serve the Nation at this difficult time. Welcome to the Budget Committee.

STATEMENT OF THE HONORABLE THOMAS R. NIDES, DEPUTY SECRETARY OF STATE FOR MANAGEMENT AND RESOURCES, U.S. DEPARTMENT OF STATE

Mr. NIDES. Thank you very much, Chairman Conrad and Ranking Member Sessions. I began my career on Capitol Hill as Assistant to Majority Whip Tony Coelho and then to Speaker Tom Foley, so I very much appreciate the pressure you all are under to justify every dollar that is spent.

Today I want to explain how with just 1 percent of the Federal budget, the State Department and USAID prevents conflicts abroad, promotes prosperity at home, and, most importantly, protects the American people. From countering extremism in Yemen to serving alongside our troops in Iraq and Afghanistan, to train Mexico's police force to help ensure our southern border, we do every day—what we do is for our national security.

I appreciate you inviting me to speak alongside Deputy Secretary of Defense Bill Lynn. The fact that we are presenting our budgets together is a very important first. It speaks to the sense of shared mission that begins with the President, the Secretary of Defense, and the Secretary of State, and extends all the way to the civilians and troops working shoulder to shoulder in Iraq, Afghanistan, and Pakistan. Cooperation between State and the Department of Defense has never been better.

Today I want to walk you through the investments that allow us to combine diplomacy, development, and defense to advance our national security.

This year, for the first time, our request is divided into two parts. The first part is our core budget, our foreign assistance and operations in just about every Nation in the world. Our 2012 request is $47 billion, essentially flat from the 2010 levels.

The second part is our extraordinary temporary war costs in Iraq, Afghanistan, and Pakistan. This year, for the first time, the President's budget presents our war funding in the same way it funds the Pentagon's—in a separate account called the Overseas Contingency Operation Account, or OCO for short. This more transparent approach distinguishes between the temporary war costs and our enduring budget and reflects a shared effort on the ground. The State Department and USAID's share of the President's OCO account of $126 billion in 2012 is $8.7 billion, which I will come back to in a moment.

Let me start with our core 2012 budget request of $47 billion. It represents a 1-percent increase over the comparable levels in 2010, less than the rate of inflation. And make no mistake, even without the extraordinary war costs, the core budget should be considered part of the U.S. Government's national security budget. It stabilizes conflict zones and reduces the threat of nuclear weapons; it restores old alliances; it supports democratic transitions; it counters extremism; it opens global markets; and it protects American citizens abroad. And where we are not actively working with the military today, State and USAID are deploying diplomats and development specialists so that the Department of Defense does not have to deploy our troops tomorrow.

We are investing in four principal areas:

First, we devote $11 billion of our $47 billion core budget to prevent conflict and support fragile states. For example, this budget supports humanitarian and security assistance for the likes of Yemen, crisis diplomacy in Sudan, and rebuilding Haiti.

Second, we invest $7.4 billion of our $47 billion core budget to support key allies and partners. This includes over $3 billion for Israel and strong support for our partners on every continent. It also includes military-to-military partnerships in 130 countries across the world, administered by State and implemented by DOD.

Third, we invest $14.6 billion of our core budget to advance human security. We have targeted drivers of future conflict: disease, hunger, and climate change. Our largest single investment is $8.7 billion in global health programs, including the continued support for PEPFAR, the program to treat and prevent HIV and AIDS started under George W. Bush.

We are also investing $1 billion in food security, $650 million to address climate change, and over $4 billion in emergency humanitarian assistance for victims of war, survivors of natural disasters, and refugees, like the hundreds of thousands who have fled Libya in the last few weeks.

Fourth, we invest $14 billion to strengthen and sustain our presence across the world. This is an investment of a remarkable group of public servants, and it delivers significant returns to the American people. Our political officers build relationships and promote democracy. Our economic officers fight every day for American companies and jobs. Our development officers spread opportunity and stabilize societies, while our public diplomacy officers tell our story across the world. And our consular officers help average Americans every day.

Finally, we have our temporary extraordinary war costs in the front-line states. I am glad to have Deputy Secretary Lynn here with me because when you consider our two OCO requests together, you come away with a much clearer picture. The Pentagon is saving $45 billion this year on its overall OCO request from the 2010 levels, largely due to the transition from military to civilian leadership in Iraq.

Chairman CONRAD. Tom, if I can just stop you on that point, because we have people listening and sometimes we use terms here that are not familiar to the viewing audience. If you would describe what OCO stands for, because it is going to be continually referenced during this hearing, I think it would help who might be listening. If you could describe what OCO stands for.

Mr. NIDES. Certainly, sir. OCO is basically an ability for us to be able to show the costs of our war funding, which is defined as temporary and extraordinary. As you know certainly from the State Department and somewhat from DOD, much of our war funding in Afghanistan, Iraq, and Pakistan has been funded by supplementals. And so this year in 2012, we want to have a fuller picture of what we believe we need to fund the front-line states. So we are separating our core budget from our war costs budget for you all to be able to understand exactly what we define as temporary and extraordinary.

Chairman CONRAD. And OCO stands for Overseas Contingency Operations.

Mr. NIDES. Yes, sir.

Chairman CONRAD. So when people hear this reference, OCO, that stands for Overseas Contingency Operations. It relates to war funding and conflict funding globally.

Mr. NIDES. Yes, sir. So as I was saying, as the Pentagon is saving $45 billion this year on its overall OCO request for 2010, largely due to the transition from military to civilian leadership in Iraq, ours—that being the State Department—is increasing by $4 billion. And as Secretary Clinton likes to say, every business owner she knows would gladly invest $4 to save $41.

In Afghanistan and Pakistan, alongside our military offensive, we are engaged in a major civilian effort to strengthen our partners, undercut the Taliban, and take on al Qaeda. We are also working to deepen our partnership with the Pakistani people and empower the governments who act on our shared interest in taking on violent extremists. Our OCO request for Afghanistan and Pakistan is $3.5 billion.

A few weeks ago I visited Iraq, and as soldiers pass on the responsibility to civilians, the State Department is ready to lead. But we need the support and the resources to do the job. We have lost too many lives and spent too much money not to see this through. The Iraq portion of our OCO request for State and USAID totals $5.2 billion.

Finally, sir, I would like to address our funding for the rest of 2011. The 16-percent cut for State and USAID that passed the House last month would put our missions severely at risk. In the front-line states, our efforts would be hollowed out. In the Middle East, we would be forced to scale back exactly at the wrong moment. And, finally, we would turn our backs on millions of HIV/AIDS patients, mothers, and children.

The American people are right to be concerned about our national debt, and so are we. But they still expect us to make smart investments in the future. And when a crisis erupts—and they always do—they expect us to be ready. This is a moment when America needs to lean forward and not pull back. I look forward to working with you to do what is necessary to keep America safe, strong, and competitive in a changing and dangerous world.

Thank you.

[The prepared statement of Mr. Nides follows:]

TESTIMONY AS PREPARED
DEPUTY SECRETARY OF STATE THOMAS R. NIDES
SENATE BUDGET COMMITTEE
THURSDAY MARCH 10, 2011

Thank you very much, Chairman Conrad and Senator Sessions. I began my career on Capitol Hill as an aide to House Majority Whip Tony Coelho and then to Speaker Tom Foley. I appreciate the pressure you are under to justify every dollar that is spent.

Today I want to explain how—with just one percent of the federal budget—the State Department and USAID prevent conflict abroad; promote prosperity at home; and, most importantly, protect the American people. From countering extremism in Yemen to serving alongside our troops in Iraq and Afghanistan to training Mexico's police force to help secure our southern border, what we do is critical to our national security.

I appreciate your inviting me to speak alongside Deputy Secretary of Defense Bill Lynn. The fact that we are presenting our budgets together is an important first. It speaks to a sense of shared mission that begins with the President, the Secretary of Defense and the Secretary of State—and extends all the way to the civilians and troops working shoulder to shoulder in Iraq, Afghanistan, and Pakistan. This is a relationship defined by deep mutual respect. And I am proud to say that cooperation between State and the Department of Defense has never been better.

As Secretary Clinton said last week, "the most effective and cost-effective way to advance our security across the world" is to use "the combined assets of diplomacy, development and defense to protect our interests and advance our values."

We partner closely not just in the frontline states, but wherever our security is at stake. In Egypt, close ties between our militaries have been crucial to our diplomacy and to Egypt's transition. In Libya, an integrated strategy—diplomacy, humanitarian efforts and defense—is unfolding in real time. The entire region is changing, and a strong, strategic and fully-integrated American response will be vital.

Today I want to walk through the key investments in a budget that allows us to use all the tools in our national security arsenal to advance our security across the world.

This year, for the first time, our request is divided into two parts.

The first part is our core budget—our foreign assistance and operations in just about every nation in the world. Our core budget request for 2012 is $47 billion, essentially flat from 2010 levels.

The second part is our extraordinary, temporary contingency costs in Iraq, Afghanistan, and Pakistan. For the first time, the President's budget presents our war funding the same way it presents the Pentagon's—in a separate request called Overseas Contingency Operations, or "OCO" for short. Instead of continuing to cover war expenses through supplemental appropriations, this is a more transparent approach. It reflects our shared efforts on the ground. And it distinguishes between temporary, exceptional contingency costs and our core, enduring budget. The State Department and USAID's share of the President's $126 billion OCO request for 2012 is $8.7 billion.

Our core 2012 request is $47 billion, which supports our diplomatic and development experts in almost every country in the world. It represents a 1% increase over comparable 2010 levels, which is less than the rate of inflation. Even without the extraordinary contingency costs, the core budget should be considered part of the US government's national security budget. It stabilizes conflict zones. It reduces the threat of nuclear weapons. It restores old alliances. It supports democratic transitions. It counters extremism. It opens global markets. And it protects American citizens abroad. And where we are not actively working with the military today, State and USAID are deploying diplomats and development specialists so that the Department of Defense does not have to deploy our troops tomorrow.

We are investing in four principal areas:

First, we devote $11.1 billion of our $47 billion core budget to prevent conflict, foster economic security and support fragile states. We are supporting development, humanitarian and security assistance to Yemen to stabilize the country and deny Al Qaeda a safe haven. And we are pursuing those same goals in Somalia. This budget supports crisis diplomacy in Sudan and rebuilding in Haiti. And it proposes a new Global Security Contingency Fund that would pool resources and expertise with the Defense Department to respond quickly as new challenges and opportunities emerge. In a fast-changing world, we are working to tear down the bureaucratic walls and jurisdictional obstacles that prevent government from being as efficient as it can be.

Second, we invest $7.4 billion of the $47 billion core budget to support key allies and partners. This includes over $3 billion for Israel and strong support for the West Bank, Jordan and partners on every continent. It also includes military-to-military partnerships in over 130 countries across the world—overseen by the State Department and implemented by DoD. As Secretary Clinton said last week, when crises came, we had already developed close ties with a generation of Egyptian and Tunisian military officers who showed restraint during their countries' transitions.

Third, we invest $14 billion of our core budget to advance human security. We have targeted disease, hunger and climate change. These challenges not only threaten the security of individuals—they are the drivers of future conflict.

Our largest single investment is $8.7 billion in global health programs. This includes treatment and prevention of HIV/AIDS through continued support for the PEPFAR program started under George W. Bush. We are fighting malaria and tuberculosis and saving the lives of mothers and children.

We are investing $1.1 billion in food security, another cornerstone of global stability, and $650 million to address climate change. These are two whole-of-government efforts against serious and growing threats that, if fully funded, will contribute to a more secure and stable world for years to come.

This budget also reflects over $4 billion in humanitarian assistance for victims of war, the survivors of natural disasters, refugees and migrants like the tens of thousands who have fled Libya in recent days.

Fourth and finally, we invest $14 billion of our $47 billion core budget to strengthen and sustain our diplomatic and development presence. We fly the flag at Embassies and consulates in 164 countries and maintain diplomatic relations with another 22.

Our political officers build relationships, solve problems and promote democracy. Our economic officers open markets and fight every day for American companies and jobs. They are determined to use diplomacy as a force for economic renewal at home. Our development officers spread opportunity and stabilize societies, while our public diplomacy officers tell our story to the world. Our consular officers have evacuated 2,600 people from Egypt and Libya. Last year, they also issued 14 million passports, assisted in 11,000 inter-country adoptions and even helped return 485 abducted children to their parents. This budget also funds protection for our diplomats and development workers and provides them with modern, secure Embassies and consulates.

Finally, there is the portion of our budget that covers the temporary, extraordinary war costs in the frontline states. I am also pleased to be testifying alongside the Deputy Secretary of Defense because considering our two OCO requests together paints a much clearer picture. The Pentagon is saving $45 billion on its overall worldwide OCO request from 2010 levels, largely due to the transition from a military to civilian-led mission in Iraq. Ours are rising by less than $4 billion. As Secretary Clinton likes to say, "every business owner I know would gladly invest $4 to save $45."

In Afghanistan and Pakistan, alongside our military offensive, we are engaged in a major civilian effort to strengthen our partners, undercut the Taliban and take on Al Qaeda. Our civilian and military surges set the stage for a diplomatic surge: an intensified push in support of an Afghan process to split the Taliban from al-Qaeda and reconcile Afghans who renounce violence and accept the Afghan constitution.

We also offer assistance to Pakistan, a nuclear-armed nation with influence and interests in Afghanistan. We are working to deepen our partnership with the Pakistani people. And we are finding creative ways, in a difficult environment, to empower their government to act on our shared interest in taking on Al Qaeda.

The State Department and Department of Defense have designed the Pakistan Counterinsurgency Capability Fund (PCCF) to build Pakistan's capacity to secure its borders and deny safe haven to al-Qaeda and other violent extremists. It leverages the strengths and increases the flexibility of State and DoD to address Pakistan's counterinsurgency requirements as they emerge and keep their forces in the fight. It's an example of our commitment to integrate defense and diplomacy into a single shared effort to pursue our national security goals.

The Afghanistan and Pakistan portion of our OCO request for State and USAID totals $3.5 billion.

A few weeks ago, I visited Iraq. I saw the courage of the men and women serving there. And I also saw a true whole-of-government effort underway as soldiers pass on responsibilities to civilians. We have a window of opportunity to help Iraq emerge as a stable democracy and a strategic partner. These funds let us work throughout the country to defuse crises and find long-term solutions. Our budget includes programs to train Iraqi police and assist Iraqi security forces. Both of these programs were previously led by the Pentagon. The Department of State is ready to take the lead, but we need the support and resources to do the job. We have lost too many lives and spent too much not to see this through.

The Iraq portion of our OCO request for State and USAID totals $5.2 billion.

Finally, I also want to address our funding for the rest of 2011.

The 16% cut for State and USAID that passed the House last month would put our mission severely at risk. In the frontline states, our efforts would be hollowed out with troops still on the ground. In the Middle East, we would have to scale back our presence and our influence at exactly the wrong moment. We would lose consular officers who act as our first line of defense against terrorists and economic officers who are helping our companies compete. We would turn our backs on millions of HIV/AIDS patients, mothers and children.

The American people are right to be concerned about our national debt. So are we. But they still expect us to make smart investments in our future. And when crises erupt—and they always do—they expect us to be ready.

Our 2011 and 2012 budgets represent our assessment of the funding we need to use civilian power to advance our national security—not more, not less. This is a moment when America needs to lean forward, not pull back. I look forward to working with you to do what is necessary to keep America safe, strong and competitive in a changing and dangerous world.

Chairman CONRAD. Thank you, Mr. Nides.

Now we will go to Deputy Secretary Lynn. Let me just indicate that Secretary Lynn enjoys credibility on both sides of the aisle here because he has a reputation as a very strong manager and somebody who has been dedicated to public service for a long time and somebody that we respect.

Welcome, and please proceed with your testimony. And before you do that, I should also indicate this hearing, which is for the first time a joint appearance by Defense Department and State Department, was actually requested of us by the Secretary of Defense, Mr. Gates, and the Secretary of State, Ms. Clinton. They made this request of us, and we have accommodated that request because they felt it was important given how their operations are closely linked.

Secretary Lynn.

STATEMENT OF THE HONORABLE WILLIAM J. LYNN, III, DEPUTY SECRETARY OF DEFENSE, U.S. DEPARTMENT OF DEFENSE

Mr. LYNN. Thank you. Thank you very much, Mr. Chairman. If it pleases the Committee, I would like to have my full written statement included in the record, and what I would like to do is just summarize the main points for you.

Chairman CONRAD. That will be done.

Mr. LYNN. As you indicated and as Secretary Nides indicated, this is, I think, the first time or at least the first time in recent memory that the two Departments have been before this Committee together, and it does represent, as you said, the desire of Secretary Gates and Secretary Clinton to represent the strong partnership that they have established and the two Departments have established to jointly address our national security challenges. It is really two sides of the same coin. We at the Department of Defense strongly believe that a full and robust funding of our foreign policy operations is a very effective means of meeting our national security and that, indeed, if we promote stability and responsible governance as crises are brewing, we will be able to avoid later in the crisis deployment of armed forces, of U.S. military forces. And so we fully want to support that partnership. We believe that the mix of competencies between the State Department, the Department of Defense, as well as USAID is what is needed to address the kinds of security crises, the kinds of instabilities, the kinds of regional conflicts that spark up around the world and to do those at the earliest possible point.

We think that the budgets that we are putting forward today, both the State Department and Defense Department budgets for fiscal year 2012, well represents that partnership. In Afghanistan, State, DOD, and USAID are working together on counternarcotics programs, on the training of Afghanistan law enforcement. We have proposed with congressional concurrence an Afghan infrastructure program that will meld the DOD responsibilities for counterinsurgency and the AID and State responsibilities for development in a way that is, I think, more integrated than in the past, integrated with both the long-term development plans in Afghanistan as well as the more immediate needs of the military campaign plans.

At the same time, we are working together with the State Department to ensure the joint delivery of security assistance wherever U.S. interests are at stake. We have developed over the past several years some joint authorities, some dual key cooperative authorities, such as the Pakistan Counterinsurgency Capability Fund, the Section 1206 authority to train and equip partner nations in the counterterrorism fight. Similarly, this year we are requesting funding for an Office of Security Cooperation in Iraq. This would be a remaining DOD presence as we transition to a State Department lead in Iraq. We think there is still some need for a DOD presence in terms of security assistance. We think that is yet another key joint mission.

In Mexico, we have jointly addressed surveillance, interdiction, air and maritime operations and planning through a variety of initiatives.

We continue to work together to train partner militaries in over 100 countries through programs such as the International Military Education and Training program, as well as the newly proposed Global Peace Operations Initiative.

For fiscal year 2012, we are also requesting a new and I think path-breaking program which would involve pooled funding where State and DOD would both contribute to a fund in which we would seek to anticipate security issues, whether they are in Africa or Latin America or Asia, and to jointly target assistance for development funding, for economic assistance, and for security assistance in an integrated way in an effort to anticipate brewing crises and reduce them before they get started.

I also want to endorse what you and Secretary Nides were talking about that the State Department is proposing, that its funding for the conflicts that we are in, particularly Afghanistan and Pakistan, be funded through the Overseas Contingency Operations fund, to identify those funds which are essentially the marginal costs above the base budget of addressing those contingencies, that that is appropriately done in a separate fund that Congress can consider fully and transparently in that manner.

As the partnership between State and DOD indicates, concepts of security assistance are changing. We at DOD view the security assistance activity as a vital instrument that can prevent or attenuate instabilities that might otherwise draw the United States into armed conflicts. If properly applied in a timely manner, security assistance is likely to be more decisive and less costly than direct military intervention after a problem has become a crisis.

Our cooperation with the State Department is, therefore, an important component of our national defense, and so I would urge, as Secretary Gates has, that you fully fund the State Department request.

With regard to our request for fiscal year 2012, we are seeking a total of $671 billion. That is divided between a base budget of approximately $553 billion and an OCO, or Overseas Contingency Operations, budget of nearly $118 billion. In our judgment, this budget is both reasonable in that it meets our national security needs and prudent in that it supports the administration's plan to hold down the deficit. The proposed budget will take care of our people. It will continue to rebalance the U.S. defense posture. It will provide deployed forces with what they need to carry out their very important missions, and it continues the reform agenda that Secretary Gates has been embarked on for the past 2 years in terms of streamlining our business operations.

As we built this budget, the military departments found approximately $100 billion in savings from business operations and lower-priority programs. They reinvested that $100 billion into higher-priority programs: intelligence surveillance and reconnaissance, unmanned aerial vehicles, cyber defense, and other programs.

At the same time, outside the military departments, the Secretary and his staff were able to identify an additional $78 billion in defense-wide efficiencies. That money was reduced from the Department's top line over 5 years to support the administration's efforts to reduce the deficit.

Finally, Mr. Chairman, I would close my opening remarks by mentioning the unfinished business that confronts both the executive and the legislative branch. We are still operating 5 months into the fiscal year under a continuing resolution. If Congress is unable to enact an appropriations bill for DOD, DOD would presumably have to continue to operate under a CR, continuing resolution, for the entire year. This would have three very negative effects on the Department's operations.

First, it would not provide in our view enough money to meet all of our national security needs. It would represent a $23 billion reduction from the request the President made for fiscal year 2011.

Second, a year-long CR would leave the dollars that we do have in the wrong places. For example, it would not provide enough funding in the personnel accounts to support the military pay raises that have been approved, and it would not provide enough funding in the operations accounts, in the medical accounts to meet medical inflation.

Third, a year-long CR would not provide us with sufficient management flexibility to address the needs of the Department. We would not be able to start new weapons, we would not be able to increase production of existing weapons systems, and we would be unable to start new military construction projects. We are already dealing with those problems 5 months now into the year. If the CR continues for the full year, those problems will get far more severe.

So, Mr. Chairman, it is our hope that working with the Committee and the Congress we will be able to find a way to get approved and signed a full year appropriations bill for the Department of Defense.

Mr. Chairman, that concludes my prepared remarks, and Secretary Nides and I, I am sure, would be happy to take your questions.

[The prepared statement of Mr. Lynn follows:]

Statement

of

William J. Lynn, III
Deputy Secretary of Defense

before the

Senate Budget Committee

March 10, 2011

Embargoed Until Released

By the Senate Budget Committee

Mr. Chairman and members of the Committee, thank you for this opportunity to discuss the budget proposal for the Department of Defense for Fiscal Year 2012.

It is a privilege for me to testify this morning along with the Deputy Secretary of State. Our testimony this morning demonstrates the strong and growing partnership between our two Departments, which is rooted in the belief that adequately funding foreign policy operations is crucial to the national security mission of the Armed Forces.

Partnership with Department of State

The ability of the United States to promote stability and responsible governance in other nations is critical to our security. The foreign aid, diplomatic engagement, and security assistance we provide to our partners and allies helps to combat irregular threats and to head off brewing crises before they explode into conflicts that require costly intervention. Providing the full range of assistance to other nations requires a mix of competencies that extend beyond a single department or agency. The Department of State, Department of Defense, and USAID have each cultivated specific expertise. Only by partnering closely together are we able to advance U.S. security goals most effectively. This close collaboration is already occurring and will increase under our FY 2012 budget request.

Carefully coordinated assistance is especially critical in the crises we currently face. In Afghanistan, State, DoD, and USAID are already collaborating on many fronts, particularly with regard to counter-narcotics, border management, and the support and training of Afghan law enforcement organizations.

The Ike Skelton National Defense Authorization Act for FY 2011 provides an important new tool, the Afghanistan Infrastructure Program. Under this program the Departments of State and Defense work together to improve the infrastructure in Afghanistan in ways that support the needs of our military campaign plans while also recognizing long-term development of Afghan society.

In addition to our growing budgetary and operational coordination in overseas contingency operations, we are also working to enhance our joint delivery of security sector assistance. Over the past several years, spanning two Administrations, a number of cooperative, "dual-key" authorities have also been created, most notably the Pakistan Counterinsurgency Capability Fund and the "1206 authority" to train and equip the military forces of partner nations. Last year, the largest of the 1206 coalition programs was for Georgia, which has committed to deploy an infantry battalion to conduct counterinsurgency operations with our own U.S. Marines in Helmand Province, Afghanistan.

We are also requesting $524 million in this year's budget for a key component of our joint mission in Iraq -- the Office of Security Cooperation – Iraq (OSC-I), which will assist in executing foreign military sales and supporting military-to-military efforts to advise, train, and assist Iraq's security forces. OSC-I is funded by both DoD and State. To provide timely assistance and help with a timely transition to a civilian-led mission in Iraq, we need to begin funding OSC-I initiatives this fiscal year, and we need to receive full funding in FY 2012. DoD also needs legislative authority to stand up the OSC-I, and we ask Congress to provide this authority in the appropriation bill for this fiscal year.

Although our "dual key" initiatives and joint programs in Iraq, Afghanistan, and Pakistan are top Department of State and Defense priorities, we are also working together in other parts of the world where U.S. interests are at stake. Our support of Mexico's fight against transnational criminal organizations is notable in this regard. DoD supports the State-led Merida Initiative to improve Mexico's capabilities in surveillance, interdiction, air and maritime operations, and planning. We are significantly increasing DoD training, equipping, information sharing, and exchanges of expertise, especially as they relate to safeguarding human rights as the military supports law enforcement activities. The Defense Department also executes the International Military Education and Training (IMET) program that is funded by the Department of State. In FY 2010 alone, IMET provided professional training to more than 7,000 foreign military students from over 130 countries.

The Global Peace Operations Initiative (GPOI), which helps train, equip, and build countries' capabilities to support peacekeeping missions, is another productive collaboration between our two departments. GPOI is funded in the Department of State's peacekeeping account; policy and funding decisions are made jointly by State and DoD. Since it was initiated in 2004, GPOI has helped facilitate the deployment of more than 110,000 personnel from 31 countries to 19 operations around the world, and to support 28 national and regional peacekeeping training centers. To cite only one example, through GPOI we recently trained and equipped a Thai detachment that will fill a vital peacekeeping role in Darfur.

For FY 2012, the State and Defense Departments have proposed an important new tool, the Global Security Contingency Fund, also known as the "pooled fund." This fund would allow us to provide assistance for security forces and institutions and rule of law and stabilization programs in key nations. One of the unique aspects of this proposal is that it would allow us to provide targeted assistance within the budget cycle whenever we have a strategic opportunity or see a threat emerge. This fund is based on a new model of interagency coordination, one that emphasizes the links between defense, diplomacy, and development, and enables our departments -- in close consultation with Congress -- to respond jointly and effectively to a broad range of transnational challenges. Initial funding of $50 million has been requested for the State Department together with authority for State or Defense to provide additional funds. I ask your support for this proposal.

As our increasing partnership with the Department of State illustrates, our whole concept of security assistance is changing. DoD views this activity as a vital instrument that can prevent or attenuate instabilities that might otherwise draw the United States into new conflicts. Security assistance can over the long term reshape the threat environment we face, allowing us to address regional instabilities before they become problems that could require armed interventions. With many of the future challenges, security assistance properly applied in a timely manner is likely to be more decisive and less costly than direct military intervention after a problem has become a crisis.

For all these reasons our cooperation with the State Department is an important component of our national defense. Virtually every complex foreign policy issue requires coordinated interagency analysis and response. While budgets are only part of our interagency cooperation, they are also an important statement of our national priorities. In Iraq, Afghanistan, Pakistan, and so many other places around the globe, the Department of Defense needs a strong, robustly funded State Department as our partner.

Overseas contingency operations are among the most complex missions our government will undertake. I believe a new budgeting approach being proposed by the State Department will significantly enhance clarity and accountability for these contingency operations. In FY 2012, for the first time, State identifies its wartime funding requirements as Overseas Contingency Operations (OCO) funds – just as Defense has been doing for several years. We believe this approach promotes transparency by clearly identifying the portions of the State Department budget that are directly associated with wartime efforts. We strongly support State's use of an OCO budget.

More broadly, the President's budget requests for FY 2012 and 2011 recognize the importance of this partnership for national security by exempting both the Departments of State and Defense and related agencies from the five-year discretionary spending freeze that will affect other, non-security agencies. The President recognizes that providing for the common defense is a fundamental constitutional obligation. In the interest of maintaining our national security, I urge the Committee to support the full budget requests made by the Department of State and the Department of Defense, which will enable our two departments to continue and to expand our work together.

Budget Proposal for FY 2012

Turning now to FY 2012: Our budget request was submitted to Congress last month. The Department is asking for about $671 billion of discretionary budget authority to support our mission next year — including $553.1 billion to fund base defense programs and $117.8 billion to support Overseas Contingency Operations, primarily in Afghanistan and Iraq. Compared with funding for FY 2011, this proposal will result in a decline in the total defense spending of between $15 billion (if DoD remains under a year-long CR throughout FY 2011) and $37 billion (if DoD received the funding for FY 2011 requested by the President).

In our judgment, this budget is prudent, in that it meets national security needs, and responsible, in that it supports the Administration's plan to hold down deficits. Our request is built around several broad themes:

- The proposed budget takes care of our people. That is our top priority, since the all-volunteer force is America's greatest security asset. We propose a military pay raise of 1.6 percent. We are also asking for $8.3 billion for family support programs, a sum that fully supports the President's Military Families Initiative. For military healthcare, we are asking for $52.5 billion, including $677 million for research and support for traumatic brain injury and psychological health care, and more than $400 million to continue medical research on behalf of wounded, ill, and injured Service Members.

- The proposed budget also continues to rebalance the U.S. defense posture to provide the capabilities needed to fight current wars while also building capability for potential future conflicts. To support current war efforts, we plan substantial investment ($4.8 billion) in intelligence, surveillance, and reconnaissance capabilities, including various unmanned aircraft, which are in high demand by Combatant Commanders. We are also proposing to invest $10.6 billion in rotary wing aircraft. In addition we are requesting increased funding for key cyber activities as well as substantial funding for chemical and biological defenses and security assistance programs that build up the capabilities of our allies.

- To prepare our forces for potential future conflicts, our budget proposal for FY 2012 invests in advanced capabilities such as the Joint Strike Fighter (JSF) program. We will instill discipline in this major program by imposing a two-year "probation" period for the STOVL (Short Take Off and Vertical Landing) variant while we seek to resolve design issues. Meanwhile, we plan to buy additional F/A-18 aircraft as an operational and competitive hedge. We also plan an aggressive shipbuilding program of 11 ships in FY 2012 and 56 over the next five years. We are investing in a family of long-range strike options, including a new long-range bomber program and $900 million for the KC-X tanker program. We have a new family of armored vehicles in the works. And we are requesting $10.7 billion for ballistic missile defenses.

- The proposed budget provides our deployed forces with everything they need to carry out their mission. It includes expenditures for reset of damaged and destroyed equipment, for purchases of force protection equipment, for high priority infrastructure projects in Afghanistan that support counterinsurgency objectives, for the Commander's Emergency Response Program (CERP)—a valuable tool in theater—and for funding to establish the Office of Security Cooperation in Iraq.

In addition to supporting these broad objectives, our proposed budget continues the Secretary's reform agenda. Reforms began in FY 2010 and 2011, with a focus on the restructuring and termination of a number of weapons programs. Some programs, such as the F-22 and the C-17, were cancelled because we had already acquired enough of the capabilities they provide. Other programs, like the VH-71 Presidential helicopter, were terminated because of cost overruns or development problems, or because they would have provided what Secretary Gates has termed "exquisite" capabilities that are not central to our current security challenges.

Secretary Gates has continued his reform agenda in FY2012-16 by streamlining business operations. Guided by his Efficiencies Initiative, the Services have identified $100 billion in savings and reinvested those savings into high-priority programs that strengthen warfighting capability. These savings will be realized through better business practices, by reorganizations, and by terminating or restructuring weapons programs. Examples of proposed changes include the elimination of unneeded task forces, combining of air operations centers, consolidation of e-mail servers, and cutting back on lower-priority tasks associated with facilities sustainment and construction. The Services also propose terminating programs such as the Non-Line of Sight Launch System and the Marine Expeditionary Fighting Vehicle (EFV).

The Services also continue to seek improvements in the way they acquire weapons. The Air Force, for example, has proposed a new approach to buying two satellite programs. We call it EASE, the Evolutionary Acquisition for Space Efficiency program. EASE features block buys of satellites, which will help to preserve stability for the manufacturer and curb our own tendency to make expensive design changes. It also includes stable research funding and fixed-price contracts. Overall we believe that EASE will significantly reduce costs. For these two satellite programs to be fully funded, EASE requires the use of advance appropriations in the Air Force procurement accounts, and we request the Committee's support for these advance appropriations.

In addition to the $100 billion in savings by the Services, our budget identifies $78 billion in further defense-wide efficiencies in FY 2012 through 2016. These efficiencies allow the defense topline to be reduced in support of the Administration's deficit-reduction efforts, beginning with a $13 billion reduction in FY 2012.

This topline reduction was largely achieved through changes in the portion of our budget less directly related to warfighting capability. We are proposing revisions in military health care, alterations in the economic assumptions that underlie the budget, and defense-wide personnel changes, including a freeze on most civilian pay and personnel levels through FY 2013 and a reduction in the number of contractors who augment government staffs.

DoD medical costs have shot up from $19 billion in FY 2001 to $52.5 billion in FY 2012. Our objective is to slow the growth in these costs, while continuing to provide high-quality military health care for the troops and their families. For FY 2012, we propose changes in pharmacy co-pays designed to increase the use of generic drugs and mail-order delivery. We are also proposing a modest increase in TRICARE enrollment fees for working-age retirees—the first such increase since the mid 1990s—and indexing of those fees to a medical deflator. And we intend to phase out subsidies for a number of non-military hospitals where the Department pays higher claims rates. Enactment of some of these military health care proposals requires changes in the Department's mandatory spending, which have been submitted in the budget and we ask you to support.

The FY 2012 budget also proposes a conditions-based decrease in the permanent end strength of the Army and Marine Corps starting in FY 2015. In one of his first acts upon becoming Secretary of Defense four years ago, and in the midst of our engagements in Iraq and Afghanistan, Secretary Gates increased permanent end strength for the Army by 65,000 and 27,000 for the Marines. By 2012 we will have completed the military mission in Iraq and by FY 2014 we will have largely shifted the security mission in Afghanistan from allied to Afghan forces. As a result, we believe that, in FY 2015 and 2016, we can reduce active duty end strength by 27,000 within the Army and by 15,000 to 20,000 in the Marine Corps with minimal risk. If our assumptions about Iraq and Afghanistan prove incorrect or global conditions change for the worse, there will be ample time to adjust the size and schedule of this change, or reverse it altogether.

Mr. Chairman, we believe that the budget levels proposed in the FY 2012 Defense request represent the funding required to carry out our national security mission properly. This budget also makes tough choices – terminating lower-priority programs, streamlining others, and disestablishing unneeded organizations – to ensure that every defense dollar is spent wisely.

Need for an FY 2011 Appropriations Bill

Even as we start the debate over the FY 2012 budget, there is unfinished business that concerns us greatly. The Department still needs an appropriation for FY 2011. As members of this Committee are aware, the Department of Defense has been operating under a Continuing Resolution (CR) for more than five months.

If the current CR continues throughout the year, it will cause further harm for three reasons. First, a year-long CR would reduce the Department's funding by $23 billion compared with the request, leaving us with inadequate funding to carry out our national security commitments properly. Second, a year-long CR would leave the funding that we do get in the wrong places. Because we would be required to execute at FY 2010 levels, we would not, for example, have adequate dollars to pay for the increased costs associated with the military pay raise and the growth in military health care costs. In the wartime portion of our budget, there would be too much funding for MRAP vehicles, for which the buy was finished in FY 2010, but not enough for the Afghanistan National Security Forces, where costs are increasing. To correct these mismatches, we would be forced into extensive reprogramming actions that would result in further delays and shortfalls. The third problem associated with a year-long CR is lack of flexibility. A year-long CR would prohibit us from starting new weapons and major construction programs or increasing production rates of existing ones. This would affect dozens of acquisition programs and hundreds of construction projects. A year-long Continuing Resolution would leave inadequate funding and management flexibility to meet warfighter needs.

Adverse effects from operating under a CR are already occurring. The Army and Marine Corps have temporarily stopped hiring civilian employees, which means key support billets are going unfilled. The Navy has reduced advance notice of moves for military personnel, an action that puts added strain on military families. Investment activities are also being harmed. The Army recently was forced to issue a stop work order on a contract for the Stryker weapons programs, delaying needed improvements. The Navy has been unable to issue a contract for the second Virginia-class submarine and is struggling to avoid a work stoppage at the shipyard. Together the Services have 75 major military construction projects on hold, delaying needed improvements to everything from maintenance hangars to barracks.

Problems like these will increase substantially in number and severity if the CR continues for the rest of the fiscal year. We will be forced to cut back on maintenance for weapons and on exercises for non-deployed units, both of which will directly harm readiness. Facilities sustainment will likely be cut sharply. We will experience more and more cutbacks and work stoppages in our acquisition programs.

Finally, there will be harmful management consequences associated with a year-long CR, many of them difficult to notice from inside the Beltway. Program managers will delay contracting actions out of necessity, only to be required to act hastily at a later time in an effort to catch up. In the face of uncertainty, other managers will resort to short-term contracts that add cost to taxpayers and instability to the industrial base.

In short, a year-long CR will damage national security. It presents the Department – and the nation – with what Secretary Gates has aptly described as "a crisis at our doorstep." We strongly urge Congress to enact a Defense appropriation bill for FY 2011 and to provide funding for the government as a whole.

Mr. Chairman, we look forward to working with this Committee and the Congress as you consider our request. It is our hope that Congress will support our FY 2012 request and enact an appropriations bill for FY 2011 as soon as possible. This concludes my prepared remarks. I welcome the Committee's questions.

Mr. LYNN. Mr. Chairman, that concludes my prepared remarks and Secretary Nides and I, I am sure, will be happy to take your questions.

Chairman CONRAD. We appreciate that. Thank you both for your testimony. Let me start by saying, I have supported, in my 24 years on this Committee, every penny that has been requested by every President for our national defense and our national security. For 24 years, I have supported every penny requested.

But I have to say to you, we are going to have to change course. It is as clear as anything can be to me. We have the Chairman of the Joint Chiefs saying, as I indicated in my opening statement, the biggest threat to our national security is our national debt. I believe that to be the case.

I served on the President's Fiscal Commission, 18 of us did. Eleven of the 18 agreed to a plan that would reduce both defense and non-defense discretionary spending over the next decade by $1.7 trillion. We did so not because it was attractive to do or politically popular to do, but because we saw a fundamental threat to the economic and national security interests of the United States if we failed to act.

We also called for an additional trillion dollars of revenue over that period by reforming the Tax Code, broadening the base, actually reducing tax rates to help America be more competitive so we could generate more jobs. And those savings on spending, and we also save money, some $600 billion in so-called mandatory accounts over that period, and because of those savings through spending cuts and additional revenue, we saved hundreds of billions of dollars in interest, for a total package of some $4 trillion.

And defense was not exempt. Defense was asked to shoulder its fair share of savings. I was delighted to see Secretary Gates propose a package of reductions of some $78 billion in the defense budget, but he took those savings and put them elsewhere in the defense budget. So that is not a change in overall spending.

I just want to share with you things I heard during the Commission considerations of the defense budget going forward. Testimony before the Commission by some of the top defense analysts in the country were that 51 percent of all Federal employees are at the Department of Defense. 51 percent of all Federal employees are at the Department of Defense. And that does not count contractors.

When we asked the contractors—we asked the analysts, How many contractors does the department have, they said, We cannot tell you. I pressed the analysts and asked them, Well, can you give us a range? Yes, we can give you a range, 1 to 9 million. That was the range provided the Commission, 1 to 9 million contractors. That is a pretty big range.

When we asked the General Accounting Office for an auditable record of the Department of Defense, they told us the books are not auditable. You know, we have a big problem here and I have concluded, we simply cannot stay this course. And it is not just the Defense Department, it is every part of government operations.

We are going to run a deficit this year of $1.5 trillion. I mean, that is a number so stunning, if 5 years ago anybody would have told me we were going to ever run a deficit in this country of $1.5 trillion in 1 year, I would have thought, it is not possible. But it is not just this year. We are going to add to the gross debt of this country every year for the next 10 years over a trillion dollars.

We have a gross debt now of 100 percent of our gross domestic product. At the end of this year, we are going to have a gross debt of 100 percent of our GDP. We have just had a study that was done by Carmen Reinhart at the University of Maryland, Ken Rogoff at Harvard, studied 200 years of fiscal crises in 44 countries. Their conclusion: When you have a gross debt of more than 90 percent of GDP, your future economic growth is sharply reduced. That was the testimony before the Commission.

When gross debt is 90 percent of your gross domestic product, your future economic growth is sharply reduced. Our gross debt, at the end of this year, will not be 90 percent. It will be 100 percent.

So I just say to you, and my question would be, Secretary Lynn, can't the Defense Department come up with savings that are net savings? Not just savings that are redirected so that the overall spending remains the same? Aren't there savings that you can find there?

Mr. LYNN. Yes, and I think we have. Let me first say, I agree with you and your citation of Admiral Mullen that we should indeed treat the deficit problem, the national debt, as a national security problem and we need to address it with that type of urgency.

I think, though, as we look at defense reductions, as every department, you need to approach it in a balanced way. We need to ensure that we retain what Senator Sessions talked about, is that we have the best trained, best equipped, best led military that the world has ever seen and we do not want to lose that by taking precipitous or unwise cuts.

In that context, I think we can learn from prior draw downs, ones that may not have gone as well as we would have hoped. When we take reductions, we need to take them in a balanced way. We need to take them not just in one account, but we need to take them across all accounts. We need to reduce force structure, investment and operations in a seamless way so as not to unbalance and hollow out the force.

We need to take tough decisions early. We have tried to do that with some of the weapons' decisions in the past couple of budgets, not always popular, but I think important decisions that we need to take. And we need to be sure that we do not over-reach, that we do not cut into the true bone of that high quality military that we have.

Now, with that as a preamble, let me go to your specific numbers question, Mr. Chairman. The savings that we were able to identify as we built this budget were actually $178 billion. You are correct, we reinvested $100 billion of that $178 billion. $78 billion was removed from the top line, and it was done in a way, I think, that reflects the lessons that I just said.

It was done in a balanced way in that there are force reductions, but we tried to do it in a prudent way in that those force reductions do not occur until 2015 and 2016 when we hope we will have completed the draw-down in Iraq and that we will have been able to transfer the bulk of the security function in Afghanistan to indigenous forces.

That will then allow us to get to the kind of reductions that you are talking about. But I think we have to step through this in the process that I have just described.

Chairman CONRAD. Let me just say, I think I have great respect for you, Mr. Lynn. I do not know if we have ever met except in passing, but I have read about you and I know the kind of record you have brought to this position. So I want to say, I have great respect for you.

But, you know, words, I think, that we use in this town can be very misleading. When we talk about there being $78 billion in savings here on a net basis, you know, it is from an inflated baseline that comes off of years where the budget was just going straight up.

So, if one looks at the year over year spending levels in this budget, every year the spending goes up. It goes up. It goes up. It goes up. And honestly, as the Chairman of this Committee, I am talking to colleagues and there are so many people who are giving the speeches they gave 20 years ago. The world has changed.

I salute the Secretary for saying, Hey, we have to take money out of the baseline plan. I am just saying to you, Then to take a big chunk of it and put it right back in, it is not going to work. It might work this year. It might work next year. These budgets, all of them in all of the Federal Government, this is not going to work.

Our spending, as a share of the national income, is the highest it has been in 60 years. Our income, as a share of the national economy, is the lowest it has been in 60 years. So the reality is going to come crushing in on us here. It is going to come crushing in on us. Those who are financing this debt, half of it now abroad, much of it from the Chinese, if you read the reactions today of this announcement that Pimco has dumped U.S. debt, I just urge you, read what the Chinese are saying.

Former Chinese Finance Minister saying, They have to re-evaluate whether they are going to continue buying U.S. debt. I will tell you, we are on a crash—we are on a collision course for a financial crash. It is as clear as it can be. And doing things the way we have been doing them is not going to cut it.

Senator Sessions.

Senator SESSIONS. I think that is a bipartisan consensus, gentlemen, and it is very scary. The reality is upon us and it is critical that we take some steps to show that we get it and we are putting the country on the right path. I would just note that I have to be critical of this Administration, both of which you are a part.

The Education Secretary was in here the week before last, last week, and testified in favor of an 11 percent increase next year in his budget. And the Energy Secretary was here, testified in favor of a 9.5 percent increase. And the Transportation Secretary was here and proposed a 62 percent increase. And the Defense Department, if we do real numbers based on what the CR is and where you want to go next to, is a 5 percent increase. That puts you in better company, Mr. Lynn, a little bit.

Mr. LYNN. It is pretty reasonable.

Senator SESSIONS. Well, it may sound that way, but it is not in light of the debt we have and the crisis that is happening in the country. I think we are in a bubble in Washington. I think people are talking about investments. I think they are talking about business as usual. We are in denial about the reality of the threat. I am just saying, I agree with Senator Conrad, change is upon us and we are going to have to make it. I do not think our institutions have yet grasped that.

Some in the Congress have not yet grasped it. The ones who just ran for election did. They talked to the American people who, I think, get it. The State Department is proposing a 10.5 percent increase in the State Department total increase in spending.

So these are not acceptable increases, I do not believe, and I do not think they are going to be approved, so we have to work on it. I agree with our Chairman, that language is important. I mean, I love the Defense Department. I know how big it is and how hard it is to move this monumental ship of defense, but DoD has portrayed the 2012 request that you made, not as an increase, but as a $13 billion cut from last year's projection of $566 billion.

So one of the things we have to do in Washington is we have to get our language straight. We have to abandon this idea that somebody's projection increases are the fact and that a reduction of increase is a cut in spending. We have to talk about, what is our current level, the CR level, and how much up you plan to go from that.

As I calculate it, Mr. Lynn, you are talking about going from this year a 5 percent increase over the CR level, which would be a real increase, but not—I think that would be an accurate way of saying it based on my articulation of an accurate way of saying it. Would you agree? Is that where you say you are, about 5 percent?

Mr. LYNN. I think that would be an accurate reflection of the base budget. Of course, it does not include OCO budget which represents a $40 billion reduction.

Senator SESSIONS. You are talking about $158 billion on the war funding to $118 billion, a saving of $40 billion, which is very significant.

Mr. LYNN. And that will actually get you a net reduction. I cannot do the math in my head, but it would be a few percent net reduction.

Senator SESSIONS. Well, but we are not going to go down that road either, because that is the military conflict and one of the things we hope to achieve by this rapid draw-down—I hope it is not too rapid—is a financial savings and that to be separate. We are looking at the base defense budget. So I know you have done some things.

But let's talk about, when you focus on procurement and reductions there, you have stretched out, as I see it, the Joint Strike Fighter. You call that a restructuring, but basically it just moves the requirement from this 5-year window out further. Does that have an increased cost for a copy if our contractor now is making few planes in his assembly line, is less? Are there any kind of cost increases that occur from that in addition to the fact you d not get the planes as soon as you would like them?

Mr. LYNN. There is a modest—I think it is in the 1 or 2 percent range—increase in the unit cost from that move, but we thought it was prudent. As you are well-aware, Senator, we have had challenges with this program and we thought it was prudent to slow that production line down until we were further along in the development; that we thought that that was, frankly, the best use of the taxpayer dollars.

You are correct. There is some modest unit costs, but they are, as I say, relatively modest like 1 or 2 percent.

Senator SESSIONS. But in general, when you take a procurement plan and you stretch it out, it tends to drive up costs as well as delaying you obtaining the system.

Mr. LYNN. It does do that. However, if you buy the planes too early and then the development is not complete and then you have to go back and retrofit the planes with the fixes that you develop later in the development process, that is actually even more expensive.

Senator SESSIONS. I got you. I think that may well be justified in this case. I am just raising the point that as you make tough choices about trying to save money, sometimes your savings can actually drive up costs, and we need to be careful we do not unnecessarily do that.

With regard to the State Department, Mr. Nides, over the last 10 years, the State Department has more than doubled. It has gone up about 7.7 percent annually. The rule of 7, your money doubles in 10 years. And the budget for the State Department from 1908 to 1910, I guess that period of time, is a 33 percent increase.

So what I want to say is, that is an unsustainable rate. That is over 10 percent, 11 percent rate, I guess it is on—well, actually, those 2 years. 1909 and 1910 is a 33 percent increase, so that is about a 16 percent increase each year. So I have to tell you, we do not have—we cannot sustain that. My time is up and I will let you comment on it and we will just say one more thing.

I am very worried that the State Department, by its nature, is going to be in a situation where it is asking its State Department personnel to go in dangerous areas of Iraq and Afghanistan that the military goes every day. They salute and they go and they take the risk, as they have sworn to do.

But our State Department people have not taken the same kind of oath and do not see themselves as combat personnel. I am really worried as to whether or not we will be able to handle this massive challenge you seem to be undertaking in Iraq. But basically, on your budget, I will give you a chance to respond to my comments.

Mr. NIDES. Well, thank you, Senator, and I agree with Secretary Lynn. We all are quite concerned and certainly very much focused on making sure each dime we can justify, and certainly understand the focus that taxpayers have on how we are spending our money.

I should say, in our 2012 request, as I think you noted, our base budget, which is base budget over 10, is basically flat from base to base. The growth in our 2012 budget is principally and solely in the OCO account, which is principally the transition, which I will get into in a minute—for military——

Senator SESSIONS. It is a 3.6 percent increase on the regular budget, which is above the inflation rate.

Mr. NIDES. Yes, I——

Senator SESSIONS. It is not flat, to my way of thinking.

Mr. NIDES. Well, our budget of—again, this is from where—the State Department/USAID's perspective and the way we look at our budget, our budget is $47 billion for our base budget in the 2012 request, versus basically that same number was in 2010. There is a $6.7 billion OCO request, which then adds to the total number of our request for the budget.

So between our OCO request and our base budget, we felt that, at least from our base budget perspective, there was a substantial justification for the moneys that we were spending since, obviously, we were basically flat from the 2012 to 2010. Obviously, the OCO account, as I spoke about earlier, as you have seen the OCO account being reduced by DoD, ours has gone up $4 billion and theirs has come down $45 billion.

But again, I think it is, from our perspective, we are trying to be, and I think Secretary Clinton has spoken not only to the appropriating committees, but to the public, a very clear understanding of how we are focused on every dollar that we are spending for this department.

As it relates to Iraq, if you would like me to comment on that?

Senator SESSIONS. According to the numbers I have, the regular budget is up 3.6. If you break it down to State operations, that is 2.9; foreign operations, 4.0; war is about a double increase. Total budget authority goes up 10.5 percent.

Mr. NIDES. Senator, I would be more than happy——

Senator SESSIONS. It is not flat. I do not believe it is flat.

Mr. NIDES. The 150 account, which includes outside of the State and USAID, and that is the only account I am speaking to, the 150 account is up 3 percent, the 150 account. But state operations are base budget, and I would be more than happy to come back to your Committee and walk through the numbers. Our base budget of $47 billion for state and USAID, which we include a variety of items in that, the base of that is flat, but the increase—and you are right—the increase is our OCO account for 2012.

Chairman CONRAD. Let me just thank the Senator for his questions and we will go now to Senator Wyden.

Senator WYDEN. Thank you very much, Mr. Chairman. I want to thank two very dedicated and long-time public servants, Secretary Nides and Secretary Lynn, and we welcome you both.

I want to start with Libya. And last week, Secretary Lynn, Secretary Gates said, and I am pretty much quoting directly here, "We have to think frankly about the military in another country in the Middle East." That was Secretary Gates. Now, I am of the view that part of the frank thinking is considering the financial cost to American taxpayers, especially in light of the trillion dollars plus that has been spent in Iraq and Afghanistan.

So my first question is, can you provide me with an estimate of the costs weekly, per day, to taxpayers of establishing a no-fly zone in Libya?

Mr. LYNN. I cannot at this hearing. I could provide something for the record, but it would depend on what the dimensions of that no-fly zone were.

Senator WYDEN. Well, walk us through the various options that I know the Department would be looking at. For example, the Center for Strategic and Budget Assessments went through three scenarios that seemed to be getting a wide amount of debate. They called them the full and the limited and the standoff approach. So walk us through the analysis that you have done to date of the various options.

Mr. LYNN. That, Senator, that analysis is still ongoing and I am not in a position to provide that yet to the Committee, but I would be happy to come back at an appropriate time and in an appropriate forum and do that.

Senator WYDEN. You feel you need to do it in a classified manner?

Mr. LYNN. Yes. Yes, I do.

Senator WYDEN. Well, I am on the Intelligence Committee as well. When could you have that at the Committee to the Chair, Senator Feinstein, Ranking Minority Member, Senator Chambliss, and myself? When could I have that in the Intelligence Committee in a classified way?

Mr. LYNN. I am going to have to come back to you because we are in the middle of the planning and I am not sure when the planning will be completed and when the President will want to share what—that planning with the Congress. But whenever that is ready, we would be prepared to do that.

Senator WYDEN. Would it be possible? I mean, as you know, there is a statute that says Intelligence Committee members have to be kept informed. Would it be possible to have, within the next 72 hours, what you have to date, at the Intelligence Committee?

Mr. LYNN. Again, I have to defer and come back to you with a specific response on both timing and content.

Senator WYDEN. I will ask Secretary Gates this same question.

Part of what I am concerned about is that we are looking at a double standard with respect to inefficiency. As Chairman Conrad correctly pointed out, the Department cannot get its arms around the number of contractors it has; and yet, we are cracking down on contractors in other parts of government.

What I want to do is look at a number of the issues that concern me the most, and I want to start with what seems to be the continuation of a number of cold war-era programs and facilities that no longer deal with the most important threats.

I mean, it is puzzling, for example, that the Pentagon needs five nuclear aircraft carriers to fight the Soviet Union, but it needs 11 to fight current threats, mostly insurgents and terrorists. And those 11 carriers cost more than $16 billion a year to operate. As the Chairman noted, there is also the question of bases. I am particularly concerned about bases in Europe that were built to deter an invasion by the Soviet Union. I think the Europeans ought to do more to defend themselves in the future.

So my question here is, why has the Department rejected so many of the Commission's recommendations for defense cuts?

Mr. LYNN. Well, let me come back to the two specific ones you raised, Senator. With regard to aircraft carriers, the analysis that you are looking at for war-fighting with the Soviet Union is a surge capability and a discreet engagement with the Soviet Union; and indeed, that, as you know, has disappeared.

The requirement for 11 carriers is not based on that same kind of analysis. What it is based on is what kind of engagement around the world for crises such as Libya, what kind of carriers do you want to have on station and available? That requires a multiplier.

In other words, to keep two or three carriers forward, you need 11 carriers. So the judgment there is that we do need those two or three carriers forward to deal with crises such as Libya, to deal with potential problems in the Gulf, in the Persian Gulf, in the

Middle East, to deal with Asian challenges. So the analysis has to do with that rotational base as opposed to a war-fighting analysis, which I think you have correctly characterized, is not clearly part of today's world.

With regard to bases in Europe, that happens to be timely. It is not just bases, but forces in Europe. Secretary Gates is meeting, as we speak, with his colleagues at NATO talking about what kinds of reductions in U.S. forces we might be able to take as a consequence of the changing environment.

And it is not just reductions. We think that in terms of large ground units, we can take reductions in terms of some naval units, in terms of missile defense, in terms of some other units. There may indeed be enhanced capabilities that might be needed to meet the new challenges that the alliance faces, and we should have, coming out of his ministerial that the Secretary is at, some new plans that we would be happy to share with you.

Senator WYDEN. What is your response to my concern that there is going to be a double standard with respect to measuring inefficiency? I mean, to taxpayers, waste is waste wherever it takes place across the Government.

The Chairman issued a very powerful statement in his opening statement, who has consistently supported defense, that when the Department cannot get its arms around the number of contractors, and we are trying to crack down on contractors elsewhere. I am trying to crack down on contractors in the intelligence sector. Why shouldn't we ask the Department of Defense to make a crackdown on contractors within its own agency?

Mr. LYNN. You should. The—two things there.

Senator WYDEN. Well, wait. Well, you prepare—because my time is out. Will you prepare a specific response to what the Chairman has said with respect to why we shouldn't, in this Committee, cut the number of contractors? We are going to have a budget resolution pretty quickly, and I am going to propose that we make reductions in those kinds of areas, and I would much prefer to do it in concert working with you than trying to go forward myself. So can you get a plan to us with respect to cutting the number of contractors so we do not have this double standard?

Mr. LYNN. We have indeed proposed such a plan, particularly for the contractors that I think you may be focused on, which are basically augmentees to headquarters' functions. We have a 10 percent per year plan over the next 3 years that we will share with you. I know we are over time, but the underlying premise to your question is correct. Our data on contractors is inadequate and we need to remedy that and we are taking steps to do that.

Senator WYDEN. I would like to work with you on it. If I cannot work with you so we can come up with an agreed upon plan to cut the number of contractors, I am going to work with colleagues here on both sides of the aisle to do it. I would much prefer to do it with you. Thank you, Mr. Chairman.

Chairman CONRAD. I just want to followup and rivet this point. You know, everybody has to be in on the solution to this debt matter. Everybody has to be in. And if we do not do this, it is going to be imposed upon us.

I was just sharing with Senator Sessions some of the reaction to PIMCO Total Return dumping all U.S. Government debt. And one of the reactions was in an interview with Mr. Gross, who says, "We have not lost faith in the U.S. Government. America is still strong and the economy is growing, and we have, you know, perhaps $30 to $40 billion worth of U.S. Treasury bills, but those are shorter maturity obligations." The Treasuries from the Total Return Fund, they dumped them all as of the end of February.

And in an interview, he was asked, "Well, where should you invest?" Here is what he said: "You should probably go outside the United States. I mean, the emerging markets, the developing countries are improving credit. They have better balance sheets than the United States. You have Brazil, for instance, has half the debt relative to GDP that the United States does—as does Mexico."

You know, you think about this, I think Senator Thune, who grew up in South Dakota, I grew up in North Dakota. Had anybody said that Mexico when I was growing up was a safer place to invest because they have half the debt relative to GDP the United States has, it would have been such a stunning concept, nobody could haveten their head around it. Now here we are. It is the reality. Brazil and Mexico have half the debt to GDP that we do, and I will bet you we are giving them money. I will bet you if I asked my staff to go find for me what we are doing with Brazil and Mexico, I bet we are giving them money.

Senator Thune.

Senator THUNE. Thank you, Mr. Chairman.

Secretary Lynn, Secretary Nides, thanks for appearing before us today. As a follow-on to the Chairman's observations, you know, the Chairman of the Joint Chiefs, Admiral Mike Mullen, said a few months back that the greatest threat to America's national security is our national debt. And Secretary of State Hillary Clinton called the expected $1.3 trillion U.S. deficit, I quote, "a message of weakness internationally," and went on to say that "...it poses a national security threat in two ways: it undermines our capacity to act in our own interests, and it does constrain us where constraint may be undesirable."

I am just curious about your response to those observations and whether or not you share the view that—you know, when you talk about the threats that we face around the world today—and they are many: potentially nuclear Iran, instability in the Middle East, nuclear North Korea, China, lots of potential threats out there to pinpoint the national debt as being the biggest among those, if that is a view that you share and just sort of your general observations in response to what both the Chairman of the Joint Chiefs has said as well as what Secretary Clinton said.

Mr. LYNN. Senator Thune, I certainly agree with both Admiral Mullen and Secretary Clinton that the national debt, the fiscal crisis we face is a true national security problem. And as we discussed a bit earlier with the Chairman, I think that DOD does need to be part of the solution to that fiscal crisis. And Secretary Gates has tried to take a strong step in that direction by developing $178 billion worth of savings: $100 billion of that was reinvested in capabilities; $78 billion was removed from the defense top line and put toward that deficit reduction.

We have tried, though, to do this in a responsible way. We need to take reductions in a balanced way, and that ultimately means if you are going to reduce the top line, you really need to reduce the underlying force structure. If you reduce the top line without reducing the force structure, what you will do is hollow out the forces by not giving them adequate training, adequate equipment. And we have seen that movie. We do not want to repeat that, so we want a balanced reduction.

Our feeling was that given the fights that were in—Iraq as we are phasing down, Afghanistan we hope to phase down but not yet—we think it would be prudent to have those reductions starting in 2015 but not earlier. And so that is what we have laid in to the budget proposal that we have presented to the Committee and the Congress, so that the budget does go down. The reductions get us to a flat budget by 2015. They do that, though, with those force reductions in that timing, and that reflects the conditions we see internationally.

Senator THUNE. Anything to add to that, Secretary Nides.

Mr. NIDES. As someone who has spent a great deal of his career in the finance world, I certainly share both your and Senator Conrad's concern about this debt, and I certainly am very concerned about the issues as it relates to the bond market and the reaction to the debt, which is certainly an enormous problem for all of us.

As we sit at the State Department—and I know you would be surprised for me to say this—we actually look at our budget as an ability to avoid conflict, to avoid the cost of my colleague on the left putting boots on the ground. There is a misperception that the State Department and foreign assistance is 10, 15, 25 percent of our national budget, our Federal budget. It is 1 percent of the Federal budget—1 percent of the Federal budget—and I think even within that 1 percent, Secretary Clinton has been very clear that every dollar that we are spending on conflict resolution and what we are spending in Afghanistan and Pakistan and Iraq or food security or health has to be justified. And that is why, as I spoke with Senator Sessions, we have attempted to be very conservative in our base budget, and the only increase that you are seeing in 2012 is those costs in what we refer to as "the war costs" or "extraordinary/temporary costs." But I, too, agree very much about the issues around the debt and the importance of resolving it, obviously at least reducing it as soon as humanly possible.

Senator THUNE. Let me touch on a current issue, and it bears on this discussion because, Secretary Lynn, as you know, many of our key European allies are seeking to substantially cut their military budgets. For example, the U.K. has de-commissioned its aircraft carrier, retired its fixed-wing air component because, according to the U.K.'s Strategic Defense and Security Review, "There are few circumstances we can envisage where the ability to deploy air power from the sea will be essential."

Now, ironically, the U.K. is telling the world that a no-fly zone must be established above Libya and is working to draft a U.N. resolution to do so. Obviously, establishing a no-fly zone for Libya will at least partly require the ability to deploy fixed-wing air power from the sea.

It seems that our European friends are seeking to cut their military budgets while at the same time pushing us to intervene in world hot spots where only the United States has the ability to project power. And so my question is: What effect do these military cuts by our European allies have in placing even more of a burden on our defense budget?

Mr. LYNN. We have been watching very closely what our allies, particularly NATO, have been doing with their defense budgets. Some of the reductions do concern us. We have worked particularly closely, though, with the British, and we have tried to work with them to ensure that as they adjust their budgets, it is done in the way that best protects our collective security.

They are facing in many ways the same fiscal challenges that we are, and so we recognize what is driving this. It is driving us as well. But as I indicated to you earlier, I think we need to take reductions that are prudent and wise, although we do need to address the debt problems, as they do they.

Senator THUNE. Can I just followup on that? From what I have seen, the cost of establishing a no-fly zone over northern and southern Iraq during the 1990s was over $1 billion a year, and we flew about 34,000 sorties a year. Do you have any notion of how much it would cost to establish a no-fly zone over Libya on an annual basis?

Mr. LYNN. I do not because we do not yet know what the dimensions of that no-fly zone would be and how it would compare to the Iraqi operations. It would be really premature for me to try and estimate the cost.

Senator THUNE. My time has expired, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Thune. I thank you for really excellent questions.

Mr. Secretary, both the Ranking Member and I have talked about the use of language here. And in your response to Senator Thune, you used language, again, that somebody listening that does not know how baselines work around here, how budgets are inflated over time, might conclude that somehow the spending is going down. And I would just like to ask you for the record, the base budget for 2011 for defense is $526 billion under the CR. Is that correct?

Mr. LYNN. The fiscal year 2010 budget would be $526 billion if you do a nominal extension. That is correct.

Chairman CONRAD. OK. So for 2012, what is the request without war costs?

Mr. LYNN. The request without war costs is $553 billion.

Chairman CONRAD. And for the next year?

Mr. LYNN. I would have to look that up, but—$571 billion.

Chairman CONRAD. OK. And for the next year? 586 is the number I have, for the next year 598. And the 553—so the point I am making every year, people need to understand the spending is going up, and we are talking about somehow it is going down. And for fiscal year 2012, the $553 billion does not include the war costs. With the war costs what would the budget be?

Mr. LYNN. About $671 billion, which I think is actually, just to continue your line, I think that is down about 3 percent from fiscal year 2011. So when you do the net with the war costs coming down over $40 billion, the next of the base budget plus the war costs will come down from fiscal year 2011 to fiscal year 2012.

Chairman CONRAD. Can you assure this Committee that there will not be an additional request for funds in 2012 for war costs?

Mr. LYNN. I cannot do that. It is possible, but as you noted at the beginning, we have tried to be conservative with our estimates of what those war costs would be to prevent exactly that.

Chairman CONRAD. Well, I would just say the history that we have, not in this administration but previous administrations, is they were nowhere close in estimating. They would come to this Committee and tell us that they were going to be $50 billion, and then it would be $120 billion. I understand that you have changed course here. You are trying to give us a more accurate reflection, which we appreciate. But the point I am making here is the language we use I think kind of misleads us. I am not accusing you of intentionally misleading anyone. You are using the language that is used with respect to a baseline. The actual dollars are going up every year.

Senator CARDIN.

Senator CARDIN. Thank you, Mr. Chairman. Let me thank both Secretary Nides and Secretary Lynn for your service to our country and for you being here.

I agree with the Chairman that our current deficits are not sustainable, and they are huge national security issue that needs to be dealt with on a bipartisan basis by having a credible plan to deal with the deficit. We are not going to be able to do it on the discretionary budget side.

We have already agreed that we are going to have at least a freeze on discretionary domestic spending, and we have also agreed that we are going to be reducing our defense spending.

I might say on defense spending—and I am sorry, Chairman, we do not have charts, but if you look at America versus the rest of the industrial developed nations of the world and how much we devote toward national defense issues, we are shouldering a larger burden than our allies. And at one point we have to recognize that and do something about it because it is not fair to the American economy. And I am one who will always support the necessary budgets for the defense of the people of this Nation. But we are shouldering an unusual burden, and it is part of the problem that we have today trying to figure out a sustainable budget for our growth and for dealing with the deficit.

Entitlement spending needs to be contained. I think we took a major step in that direction last year by the Affordable Care Act, by investing in technology and prevention and managing people's diseases and setting up clinics rather than the use of emergency rooms. I think we are going to bring down Medicare and Medicaid spending and health care spending in this country. We need to do more. There are more entitlement programs. And we have talked about revenues. We just had several hearings in the Finance Committee dealing with looking at tax reform so that we can equate our revenues with our necessary spending.

Which brings me back to the issue at hand. We are not going to balance the budget on 12 percent of the budget, on 12 cents out of every dollar, and that is the discretionary domestic spending, which our international development assistance happens to fall under. I happen to think that less than 1 percent of our budget being spent on international development assistance is a very modest amount of money. As you point out, both of you point out, these types of expenditures are critically important for U.S. objectives internationally and developing capacities in other countries to provide more stable regimes, putting less stress on the future needs of our military and developing the type of stability that is important to the United States, including markets that will buy U.S. products. All that I think is very true.

And I must tell you, I find the share of the pie that is devoted toward international development assistance to be a little bit too modest, and I think we should be making greater strides. Having said that, we need to have accountability in every dollar that is spent.

So I want to know what you are doing to make sure that the dollars that are being appropriated by Congress are spent for their intended purpose. And what are you doing to make sure that we are not financing corruption among different regimes? We are very concerned that dollars that we appropriate may very well be ending up in foreign bank accounts of deposed leaders. So what assurances can you give us that you are monitoring the moneys that are being spent so that we get value for the dollars that we are appropriating?

Mr. NIDES. Would you like me to take the question first? Thank you very much, Senator. I want to emphasize—and you pointed out the 1 percent of the Federal budget again. I want to emphasize that 1 percent is all of the costs for the State Department and USAID. That includes all of our embassies across the world, all of our foreign service officers, civil service officers, our locally engaged, all of our foreign aid, all of what we do to fight hunger, all we do to fight AIDS and HIV, and all the things that we are doing to help us in those individual crisis countries. So as the American people—and you and I have spoken about this. The American people hear about how much money is spent on foreign aid, and obviously the views of it is 15 or 20 percent. It is 1 percent, and it includes all of what we are doing around the world.

No. 2, to answer your question specifically, the Secretary announced for the first time the QDDR. Actually we borrowed the idea from DOD. The QDDR was our attempt to do exactly what you are looking at. How do we look at ourselves faster, better, smarter? How do we find the efficiencies? How do we look at every dollar that we are spending, be it on global health, be it on how we organize, how our staff is paid, how we as an organization operate? And in our attempt to try to very much focus on what you are getting at, as it relates to our issues around how dollars are sent, we have a very strong IG within the State Department. We work very closely with them all over the world, particularly in areas we are spending a lot of development dollars. So we are as an organization inherently committed because we know the focus that you have on the money spent and we know how rare those dollars are.

Senator CARDIN. In order to have successful efforts for increasing capacity of other countries, there needs to be a priority on gender equality. There is a direct relationship between how women are treated in countries as to their economic growth and potential. The Millennium Challenge Corporation has integrated gender equality into their basic core missions.

What are you doing in the State Department or Defense to make sure that in our efforts to help other countries on their development assistance, priority is placed on gender equity, equality?

Mr. NIDES. I will quickly answer the question, and then I will turn to my colleague. As you probably know, there is probably not much more that the Secretary cares more about than this issue. You may have seen her on the cover of the recent news magazine talking specifically on this topic. It is inherent in everything we do, with the way we organize and how we focus, how we put programs together, beyond global health, what we are doing for women and girls and what we do across the world. But this is something that certainly is part of our core, and I assure you that Secretary Gates feels the same way, but it is a part of our foundation because we believe that conflicts end at the beginning of what we do on gender and what we do specifically about women and girls.

Senator CARDIN. Secretary Lynn?

Mr. LYNN. Secretary Nides is correct. Secretary Gates shares the importance and the attention that is needed for gender equality. It goes to the more general question that we started the hearing with, that we are trying to create a much strong partnership between State and Defense so that we are working together with State and Defense on common goals like gender equality and that the overall impact for our national security is that we should be able to anticipate and respond to brewing crises, with development and security and diplomatic assistance, before we have any need for any kind of armed intervention. And we are trying to work a strong partnership toward those ends.

Senator CARDIN. Thank you very much.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator Begich.

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

Secretary Lynn, let me followup on what Senator Cardin just started with this conversation in regards to where we have to balance the budget and deal with the costs of the Federal Government.

Do you agree with his statement that it has to be spread among all agencies and discretionary cannot take the load that it is taking? Do you agree with that statement?

Mr. LYNN. Absolutely.

Senator BEGICH. OK. I know Senator Wyden asked this question, and I want to expand on it—he was here earlier—in regards to the overseas stationing and the bases and the construction budgets. I have only been here 2 years, but one of the things we put in the defense authorization bill—and I know it is in process. You have indicated, I think, that it is Secretary Gates' hands or a start process of reviewing our stations overseas, and there will be a report coming soon. Can you define—and this is what I have learned in my hearings. What does "soon" mean? Define "soon" when that report will come, that we will see some report that tells us our overseas base operations, what we need to do to create more efficiency, scale back, or reassign.

Mr. LYNN. I am not sure which report you are referring to, Senator, but in the earlier discussion what I was referring to is that there are ongoing consultations with our NATO allies about what the future force structure in Europe ought to look like, and we will have the results of that later this spring.

Senator BEGICH. OK. In expansion of that, I am pretty sure—and I will confirm this with my staff and maybe your staff—that is, I think an authorization bill, we also wanted the Defense Department to look at the overall overseas operations; in other words, not just Europe but where we have bases. And, you know, is it the right model for the wars that we are engaged in today and the security that we are engaged in today? And how can we examine that and see if there are opportunities for savings there? We will pull that language. We will share it with you. It makes me nervous because it is 2-year-old language, but I will work with your office, because we have to look at the whole picture. As you are looking at NATO allies, we have operations worldwide, and we have to re-examine what is the right approach. And, honestly, we cannot afford what we are doing. It does not matter if it is in education or defense, or you pick the subject matter. Based the President's own conversations, we cannot afford to be on the track we are on financially for this country because at the end of the day we will hit a brick wall, and there will be nothing available for us to operate. So I will get your staff that language.

Mr. LYNN. Terrific.

Senator BEGICH. Let me ask you also, I know GAO has done a report that identified issues that are overlap or duplication. There are about 30-some of these issues. About 10 relate directly to DOD.

One, have you started to review that report, those responses of that GAO report?

Two, do you anticipate giving a response to this Committee and/or to Armed Services or what your actions will be? And I only say this based on history that I read in 2005 when this effort was approached in a more narrow focus. The military started, then they stopped. They did not do anything.

Mr. LYNN. Started what? I am sorry.

Senator BEGICH. It was a review of efficiencies. I think it was the medical command, if I remember right, unification of the medical command, and it just kind of—they started but they never went any further even though GAO had reported in 2005, I think it was, that there were some inefficiencies, opportunities. So what I am worried about—because now we have another report that talks about ten other areas that are potential. What is going to be—I should preface this with saying I think one of the things I have learned here after 2 years, we do not do a good enough job in oversight, to be very frank with you. And so having this meeting, my intention would be your response to continue to badger you in this Committee and the Armed Services Committee to know what we are doing, because what I find is I keep reading report after report of stuff that has been done by GAO, and then kind of just brushed aside, and new administration, new Congress, new people, out of sight, out of mind. So my objective is to kind of keep my shopping list and keep pounding.

So have you see that report, the latest one? And what are your intentions with it?

Mr. LYNN. I have seen the report. Let me say two things, one broad, one a little narrower.

First, the Secretary developed even before this GAO report his Efficiencies Initiative and developed, as we have discussed in the rating agencies, $178 billion worth of savings. These are business efficiencies, consolidation of headquarters, elimination of lower-priority programs, reduced use of contractors, reduced civilian hiring, a whole variety of measures.

We plan to continue that effort. That was not a one-time deal to your point. We are looking for all inputs to the next phase of that effort. We are certainly going to look at that GAO report you mentioned, and in response to the specific question on the issue of how should we organize our medical operations, we are going to look at the issue of should we have a defense health agency, should we have a unified military command, should we continue and try and improve the process that we have now. We will look at all of those options.

Senator BEGICH. What is your timetable for doing that?

Mr. LYNN. We are looking at—we just started that review, so I do not have a precise timetable, but I think the next iteration of this broader efficiencies effort would be we would have something to submit with the fiscal year 2013 budget.

Senator BEGICH. Which I appreciate because I know the GAO report had between $280 and $400 million, give or take. You know, in this world we live in, a few million here and a few million there. But it is significant. And so I appreciate your willingness to take a look at that.

My time is almost up, but I want to followup on one that is—actually the conversation started in the Armed Services Committee when I was over there. I think it was earlier this week or last week. I have kind of lost track of time here a little bit. But it is on the MEADS air and missile defense system, and I just want you to help me understand the proof of concept and how this works, because for a guy who does not deal with those terms, I see we spend almost $1 billion, but then wisely the military says, you know, this is not working out, this program is running—you know, it is delayed. It is not cost-effective. The list goes on and on. You made a good decision to cancel it.

The problem is we are going to have to pay $800 million, give or take a few there, in regards to the proof-of-concept requirement. How does that—I guess, you know, as a former mayor, when I had people doing software development for me, for our technology and so forth, the risk was on them. We gave them the idea. Their job was to give us a bid with cost ranges, and then if they could not fulfill that and I canceled the contract, I did not pay one dime. That was their risk.

One, how do we do this? And do we do this in every contract? Or I should not say "every." In other contracts?

Mr. LYNN. Well, it depends on the program. We have a variety of different contracting mechanisms. With this program, the

MEADS program, this is complicated not only by contracting mechanisms, but it is an international program. We have two major international partners, the Germans and the Italians. So we cannot take unilateral decisions. This has to be a joint decision.

We have, as you correctly cited, decided that we are not going to pursue production of this program. Partly it is a narrow need. It can be met by other programs. Partly, as you said, the costs have grown and the schedule has slipped.

We have to make that decision, though, in consultation and collaboration with our allies, and what we have decided to do is to finish the development phase, which takes over the next 2 years, and then if they choose—they may choose to go forward with production. That is their decision. We will be pulling out at that point.

You might say, Why not pull out now?

Senator BEGICH. Right.

Mr. LYNN. Which I think was the thrust of your question. The nature of the way the contract was signed many, many years ago is that if one of the three nations pulls out, they pay all of the termination costs. If we pay all of the termination—you can question that, but that is the way it is.

Senator BEGICH. Right.

Mr. LYNN. Decided long ago. If we pay all of the termination costs, we will pay essentially the same amount and get nothing. That did not seem to be the wise choice. We decided we will pay that amount and get the technology that is developed, which can be used in other systems. But that is the central reason for that.

Senator BEGICH. Thank you very much.

Mr. Chairman, I know my time is out. I just have one question for the record, if I could, and that is, in general——

Chairman CONRAD. Senator, we are doing well, so if you want to take a little additional time, you can do it.

Senator BEGICH. OK. Thank you very much, Mr. Chairman.

I guess on this one, can you prepare—and I know you probably cannot do it right now, obviously, but what other—because I would consider that a financial risk to the Federal Treasury when we have contracts that have these out clauses that cost us money to get out of a development. Are there other contracts like this that if that can be estimated, what kind of these risk costs could be for us if we get out of contracts? I mean, at this point I know the Defense Department operates uniquely in their own way, but, honestly, I got to tell you, I am always surprised—you know, the F–35 was another example. I think when I first came here 2 years ago, it was, I do not know, $60 million a copy or whatever it was. I forget what it is now, 120, 130, whatever. But it almost seems like when we work with these defense contractors—who actually, we were shown yesterday, paid 1.6 percent taxes, the lowest of all corporate entities in this country, but put that aside for a second. We are their biggest customer. How is it that, you know, we lay out the parameters, but I see on and on again we always have these costs that we have to pay the contractor to get out of the contracts that we have, and the reality is, without our contracts, they would not be in business? I mean, we are their platinum customers. When they take this technology and we allow them to sell it to other countries, our allies—I mean, I am struggling with this.

I know there is some long explanation for the military infrastructure, but I just do not get it because—you know, I can talk about the personnel system when you are trying to change the system on payroll, you spend half a billion dollars. Cancel the contract because it did not work like you had anticipated? I mean, if I was in the city as a mayor, we would sue the contractor and get our money back because they had sold us a bill of goods, because they came in and gave us a razzmatazz in the RFP process and it did not really work. I mean, I do not—I do not understand. Or the satellite system where we spent, I do not know, $4 or $5 billion and it really did not work out as well as we expected.

How do we get a handle on these contractors that know they win either way? Because they do come back and contract with us later, because there is such a limited group. So they know they have us because there are only so many we do business with. If they fail to perform, we pay them anyway—not all of it, obviously, but they build it into the margins. They are smart business people. That is why they are very profitable and they pay very little in taxes to the United States. How do we get at that? I mean, it is billions. I am shocked, just in the 2 years that I am here, how many contracts we have canceled and we are just, like, what is half a billion here, what is 5 billion here, and now today it is another $800 million.

Mr. LYNN. Well, there are a couple of things there, Senator. One is whenever you take the tough decisions to eliminate a system—and I think we have taken quite a number—you are losing your sunk costs. And the judgment there is that even though you are losing that sunk cost, the marginal cost going forward is not worth the value or benefit to the Government of paying even the additional marginal costs. And we have made that—but you have to acknowledge there is going to be some cost to that prior decision probably not recapturable.

To your broader question of can we do something about how we contract, we are trying. In particular, we have focused on using fixed-price contracts, which I think is more what you are expecting as mayor and whatever. But we have tried that in the past, and it has been worked poorly at times, and you have to be careful about where you used fixed price.

Senator BEGICH. Sure, I agree.

Mr. LYNN. If you are using fixed-price contracts where you a developing cutting-edge technology, that is probably not going to work.

Senator BEGICH. I agree.

Mr. LYNN. Where you have mature technology, where you have an established contract, where you have an established production base, we think you can pursue a fixed-price development contract. Now, frankly, the Government is probably going to pay a little bit additional on that contract up front because you are asking the contractor now to take more risk. The benefit to the Government is that is the limit of the Government's risk. At this point now the risk migrates to the contractor, and they have every incentive to deliver the contract on that amount of money.

So we have tried—the large example that has been in the papers recently that you will know about this is the tanker contract.

Senator BEGICH. Right.

Mr. LYNN. In the prior iterations, the development contract was cost-plus. We felt that that met exactly the criteria I just laid out. It is well-understood technology. Our requirements are stable, and we had two companies that, frankly, had very mature production bases. We were able in that case, therefore, to go to a fixed-price contract as well as not to exceed contracts for the production. We ended up with a very, very strong competition, and the result of that is, frankly, versus the 2008 competition, the American taxpayers saved billions.

Senator BEGICH. Thank you, Mr. Chairman, for allowing me. Can I get for the record—because I know I used a number, but I do not know if it—you know, it is what I keep hearing is the amount that our buyout is or our termination costs in the MEADS contract. Can you put that——

Mr. LYNN. We will get that to you for the record.

Senator BEGICH. And do all contracts that we negotiate have subject to appropriation?

Mr. LYNN. Yes, I believe so.

Senator BEGICH. OK. Honestly, I would just say we are not going to appropriate to MEADS, so what happens?

Mr. LYNN. Well, there is already—I will get it for the record. I believe we have already had enough appropriations. The way we would work is there has already been enough money appropriated to cover the termination liability. Otherwise——

Senator BEGICH. Right, but I guess for the legal department here is the question: If we clawed back and said you do not get that money, we are not appropriating that money for the purpose that you have described, the contract then terminates. I am not a lawyer, but I would be curious what the law department thinks within your ag.

Mr. LYNN. We will get that.

Senator BEGICH. It is just a different way to skin the cat.

Senator BEGICH. I will leave it at that. Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

I thank both the witnesses. I appreciate very much your appearance here today, Secretary Nides, Secretary Lynn. I would ask you to take the message back—and I think you have probably heard it loud and clear here. There are more cuts coming. I mean, you can write it down. It is going to happen.

No. 2, those cuts will be more draconian if there is not a comprehensive long-term deal that involves tax reform and the entitlement programs. That is as clear to me as it can be. And I visit with colleagues on these issues every day. The votes are not there to sustain spending at these levels. There are more cuts coming—the cuts will be much more draconian—to all of discretionary spending if there is not a comprehensive long-term deal that involves tax reform and the entitlements. And it does not matter whether I am here as Chairman or not. As you know, I have announced I am not running again. But it is going to happen. It is just as sure as we all sit here. And it may happen much sooner than anyone anticipates if we get more news like the news today that PIMCO dumps all their U.S. Government debt.

I have been here 24 years. I do not know of anything that is more clear to me than the cuts that will be imposed on your agencies could be draconian and could come much quicker than anybody anticipates if there is not a more comprehensive long-term deal that involves tax reform and the entitlements. I know that with certainty, so I would ask you to share it.

Thank you very much, and we stand adjourned.

Mr. LYNN. Thank you very much, Mr. Chairman.

Mr. NIDES. Thank you.

[Whereupon, at 11:47 a.m., the Committee was adjourned.]

Questions for the Record Submitted to
Deputy Secretary of State Thomas R. Nides by
Senator Patty Murray (#1)
Senate Budget Committee
March 10, 2011

Question:

What would be the impact on assistance programs in the areas of global health, humanitarian and development assistance, and the management and operations of USAID if Congress were to adopt the funding levels proposed in H.R. 1?

Answer:

H.R. 1 would have a devastating impact on assistance programs in the areas of global health, humanitarian, and development assistance, and the management and operations of USAID. For example, H.R. 1 would:

- Reduce critical global health programs, jeopardizing the progress we are making in saving the lives of millions and building a better and more secure world for children and their families.
    - **Malaria**: 5 million children and family members will be denied treatment or preventative interventions for malaria.
    - **Tuberculosis (TB):** 43,000 children and family members with tuberculosis will be denied treatment, of whom 12,000 will likely die.

- **Neglected and Tropical Diseases (NTD)**: More than 16 million persons will be denied treatment for debilitating conditions such as blinding trachoma and onchocerciasis.
- **Maternal and child health (MCH):** 3,500 mothers will die and more than 40,000 children under five years of age – of whom 16,000 are newborns – will perish in the absence of highly effective child survival interventions.
- **Nutrition:** More than 500,000 undernourished children will be deprived of highly effective nutrition interventions, putting them at risk for stunting and death.

- Severely limit our ability to maintain required levels of assistance for ongoing disasters and respond to large emergencies at a time when the United States is responding to three new, urgent humanitarian crises in Japan, Libya/Tunisia, and Cote D'Ivoire/Liberia.
- Force USAID to cease providing food aid to 15 million people receiving life-saving assistance.
- Reduce Development Assistance by 40 percent from the President's FY 2011 Request, which could lead to a severe reduction in, or even the elimination of, funding for the Feed the Future (FtF) and/or the Global Climate Change (GCC) Initiatives.

- With world food prices at their highest since the 2008 crisis, and the volatility that food prices recently helped spark in the Middle East, it is more important than ever that the US engage to help countries achieve long-term food security and avert short-term food crises. A substantial reduction to FtF would leave at least 1 million people—largely women, children, and small farmers—extremely vulnerable to rising food prices and natural disasters, at risk of chronic hunger, and in potential need of humanitarian assistance.
    - Alternatively, if the Development Assistance reduction was absorbed by the initiatives, FtF would be virtually eliminated leaving 4 million people at risk of chronic hunger.
- Severe reductions in Global Climate Change would jeopardize our ability to meet our Copenhagen/Cancun commitments; curtail aid that helps countries mitigate the destabilizing impacts of climate change; and damage efforts to expand the markets and reach of U.S. clean energy technologies.

- **Microfinance:** Microfinance institutions in nearly 30 countries around the world will be forced to significantly scale back operations or shut their doors, resulting in nearly 600,000 fewer clients, mostly women, accessing financial services to sustain their businesses and contribute to the economic livelihoods of their families and communities.

- **Water:** 700,000 persons will be deprived access to clean drinking water and sanitation.
- **Education:** Out of the approximately 64 million children benefitting from USG education assistance worldwide, over 19 million will lose access to schooling opportunities. 10 million girls will be deprived access to basic education, causing further social and financial marginalization.

- Destroy the bipartisan effort to revitalize USAID as the world's premier development agency. The reduction would reverse this progress and have the following effects:
  - Halt hiring of all Foreign Service Officers (FSOs) under the Development Leadership Initiative.
  - Jeopardize the functioning of USAID's Compliance and Oversight of Partner Performance (COPP) division which manages the suspension and debarment of firms and individuals seeking to defraud the taxpayer, making vulnerable billions in current and future obligations.

- Inhibit USAID's ability to more aggressively combat waste, fraud, and abuse in our programming.
- Hamper contracting oversight efforts: During the past decade, the Agency has been required to oversee up to $18 billion in funds per fiscal year with a reduced workforce of contracting officers, putting tens of billions of dollars at risk for fraud, waste, and abuse.
- Reduce our ability to more quickly shift from cost-reimbursement to fixed-price contracting, which will force the Agency to continue with riskier and more costly contract mechanisms.
- End support for USAID's Implementation and Procurement Reform Initiative, and its goal of implementing more USAID assistance through local NGOs, businesses and other local entities, and U.S. small businesses, thereby hastening our exit strategy for assistance to developing countries and lowering our unit costs.
- Curtail USAID's ability to provide safe and secure space for hundreds of Foreign Service Officers overseas, which will limit the Agency's ability to deploy officers to critical posts.

Questions for the Record Submitted to
Deputy Secretary of State Thomas R. Nides by
Senator Patty Murray (#2)
Senate Budget Committee
March 10, 2011

Question:

Would there be an impact on U.S. based non-governmental organizations or universities who receive USAID funding? Can you give some examples?

Answer:

The reductions under H.R. 1 would severely impact USAID's development, humanitarian and health programs. These are the very programs which are largely carried out by nongovernmental organizations including universities. Therefore, many of these organizations would be impacted by these proposed cuts. For example, if the cuts to humanitarian assistance in H.R. 1 are enacted, nongovernmental organizations such as Catholic Relief Services, CARE, World Vision, etc. could be affected.

Questions for the Record Submitted to
Deputy Secretary Thomas Nides by
Senator Patty Murray (#3)
Senate Budget Committee
March 10, 2011

Question:

How would elimination of USIP affect ongoing programs where State, USAID and USIP are collaborating?

Answer:

As the Quadrennial Diplomacy and Development Review (QDDR) highlights, internal violent conflict and weak or failed governance in many countries have become a central security challenge for the United States. The United States Institute of Peace (USIP) works alongside the Department of State, USAID, and Department of Defense to respond to these challenges, providing analysis and programmatic responses to help prevent, manage, and resolve conflicts around the world. With a reputation for impartiality and effectiveness, the Institute fills an important niche that complements official U.S. Government efforts to address these important issues.

The elimination of USIP would undermine our national security by removing a national institution that plays an important role in crisis and conflict prevention and resolution and the promotion of sustainable, responsible, and effective governance in fragile states. Losing this institution as a part of civilian toolkit would be harmful to national security and development missions in Afghanistan, Pakistan, Iraq, Sudan, and Colombia, and other peacebuilding efforts around the world.

Questions for the Record Submitted to
Deputy Secretary of State Thomas Nides by
Senator Ron Wyden (#1a)
Senate Budget Committee
March 10, 2011

Congress has enacted tough sanctions to give the Administration the tools necessary to stop Iran from developing nuclear weapons. However, I am concerned about the lack of sanctions on companies that continue to invest in Iran's energy sector in violation of the U.S. law.

Question:

Does the State Department have a plan to fully implement existing sanctions that target Iran's energy sector? Will the State Department meet the 180-day deadline – on March 29th – to complete investigations and make determinations regarding investment in Iran's energy sector?

Answer:

The State Department has been robustly implementing the Iran Sanctions Act, as amended by the Comprehensive Iran Sanctions, Accountability, and Divestment Act (CISADA). Secretary Clinton used the Act's provisions when she sanctioned Swiss-based, Iranian-owned firm Naftiran Intertrade Company (NICO), a major investor in a number of oil and gas development projects in Iran and a partner with a number of international firms in projects outside Iran. NICO was responsible for securing much of Iran's foreign investment as well as its refined petroleum supplies, and sanctioning this firm has had a chilling effect on its activities.

In addition, we utilized the Special Rule provision in CISADA to secure the withdrawal of five major international oil companies from Iran. We also used the law as a tool for warning foreign companies and governments of the consequences of engaging in potentially sanctionable activity in Iran's energy sector. In part due to the U.S. government's coordinated and comprehensive efforts, major oil companies such as Total, Statoil, Royal Dutch Shell, ENI, INPEX, and Repsol have committed not to undertake any new activities in Iran. Other large companies such as Vitol, Glencore, and Trafigura, as well as ThyssenKrupp, Siemens, Toyota, Kia Motors, and Linde have also opted to end business with Iran, even in cases where investment is in areas not directly covered by sanctions. Moreover, many have decided not to compete for opportunities in Iran to avoid U.S. scrutiny.

Regarding the investigations announced by Deputy Secretary Steinberg on September 30, 2010, the Secretary has already made decisions on a number of these cases, and that information has been provided to the Congress. We will promptly inform Congress of any other decisions that are taken with respect to these ongoing investigations.

We continuously monitor companies for new or ongoing potentially sanctionable activity, and are currently collecting information on several cases. We expect to inform the Congress of the decisions on these cases in the very near future.

Finally, we remain heavily engaged in outreach to build support for and compliance with CISADA's provisions. We have raised Iran sanctions issues at the highest levels during trips to the UAE, Iraq, China, Sweden, Germany, South Korea, France, UK, Azerbaijan, India and many others since the Act was passed and came into effect. We successfully worked with our partners in the P5+1 and the Security Council to put in place tough new, multilateral sanctions on Iran through Security Council Resolution 1929. In addition to UNSCR 1929, we have worked with other members of the International Community to impose their own additional sanctions on Iran. The European Union, Japan, South Korea, Canada, Norway, Australia, and Switzerland have all imposed tough new sanctions, which complement our sanctions under the ISA and CISADA.

Questions for the Record Submitted to
Deputy Secretary of State Thomas Nides by
Senator Ron Wyden (#1b)
Senate Budget Committee
March 10, 2011

The Iran sanctions law requires companies seeking U.S. government contracts to certify that they do not conduct certain prohibited activities in Iran's energy sector.

Question:

What is the Department of Defense doing to ensure contractors comply with this provision? Is the Defense Department conducting reviews of current activities of contractors that have previously conducted prohibited business in Iran, such as Honeywell Corporation, to ensure they are complying with the sanctions law?

Answer:

We refer you to the Department of Defense on this matter.

**Questions for the Record Submitted to
Deputy Secretary of State Thomas Nides by
Senator Ron Wyden (#2)
Senate Budget Committee
March 10, 2011**

Question:

A few days ago I wrote to Secretary Clinton to commend her on her speech about how it is in America's national economic and security interest to promote a global, open Internet. I specifically encouraged her to take advantage of her meetings with the Prime Minister of Australia this week to enlist her help in making the promotion of an open Internet a clear priority of the Asia Pacific Economic Council.

Because the Internet is increasingly the means by which commerce is conducted and societies organize, it is in our economic interest to ensure that foreign regimes aren't blocking or filtering content for political or commercial protectionist reasons.

- How is the Department of State going to coordinate with the United States Trade Representative and the Department of Commerce to commit to a framework that ensures an open Internet?

Answer:

The Administration has been addressing a range of economic concerns, including an open Internet, with our global trading partners. We have, for instance, stressed the importance we place on balanced trade ties in our bilateral fora, such as the U.S.-China Strategic and Economic Dialogue (S&ED), and in multilateral settings such as the G20 and the Organization for Economic Cooperation and Development (OECD). State Department has led US government efforts to unite the human rights and economic issues of Internet Freedom in our bilateral and multilateral diplomacy to demonstrate that blocking Internet content has both a moral and a financial cost.

The State Department has coordinated with the Office of the U.S. Trade Representative (USTR), the Department of Commerce, and the White House in the submission of Draft Principles for Internet Policy-Making to the OECD in order to promote the Internet economy and maintain an open and innovative Internet environment. We also play an active role in the Trade Policy Staff Committee, an interagency body chaired by USTR, where we review together all aspects of global trade issues, including open Internet access for commerce. It is important to emphasize that we will continue to press our foreign trading partners to meet their international obligations to protect the intellectual property rights of American companies and entrepreneurs. This is a critical tenet of the Internet economy.

We know that interagency cooperation is key to successfully meeting Administration objectives, particularly in the fast-moving environment of the Internet. We will continue to work together to develop sound principles for an open Internet and to stress to our economic partners the imperative and economic benefits of an open Internet.

Questions for the Record Submitted to
Deputy Secretary of State Thomas Nides by
Senator John Thune (#3)
Subcommittee on State and Foreign Operations
Senate Committee on Appropriations
March 10, 2011

Question:

Joint Effort to Respond to Unforeseen Events

As we've seen recent events unfold in the Middle East, it's apparent that our government cannot predict every crisis nor are we fully capable of understanding the cascading effects of one turbulent event. I understand the Departments of Defense and State are working together to create a pilot program that will allow both Departments to jointly deploy to crisis events like we're seeing in the Middle East. Can you describe this program more in-depth and how you intend to fund this program in FY2012 and in the future?

Answer:

There are two different programs in the State Department FY2012 budget submission that your question touches upon.

The Secretaries of State and Defense have proposed a new tool called the Global Security Contingency Fund (GSCF) which would allow DoD and State to pool resources and expertise to provide assistance to security forces and the government agencies responsible for those forces as well as justice sector and stabilization assistance. We believe this proposal advances U.S. national security interests in four main ways: (1) it provides us with the agility needed to address today's complex strategic environment; (2) it serves as a new business model, emphasizing collaboration and the interconnected nature of defense, diplomacy, and development; (3) it enables our departments to respond jointly and effectively to a broad scope of transnational challenges; and (4) it leverages the resources and expertise of other departments and agencies.

We envision specific uses of the GSCF will vary depending on the emergent threat, opportunity, and operating environment. Current events in the Middle East suggest increased flexibility and agility in U.S. government responses within the budget cycle will certainly be necessary to respond to rapidly changing circumstances in regions critical to U.S. interests.

Your question may also refer to the requested Civilian Stabilization Operations (CSO) account, which supports the Civilian Response Corps (CRC) and the Office of the Coordinator for Reconstruction and Stabilization (S/CRS). The CRC is an expeditionary interagency U.S. government response capability that deploys civilian expertise to assess, plan, prevent, mitigate, and respond to conflict. It is a mainstream program that has been authorized and funded since October 2008. In addition, although CSI supports close coordination with the military, the

CRC is comprised of experts from nine civilian agencies of the U.S. government and by definition cannot include members of the uniformed services.

The State Department strongly supports full funding for both the GSCF and the CSO as they address different needs for preventing and responding to conflict and other security challenges and opportunities. GSCF provides assistance funding, which can be used for a variety of activities, to strengthen a country's ability to prevent or respond to security and rule of law challenges or opportunities, while CSO provides operational funding to deploy the CRC to prevent and respond to conflict.

CHARRTS No.: SB-01-001
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Murray
Witness: DEPSECDEF Lynn
Question: #1

Retiring NASA Space Shuttles

Question: Mr. Secretary, the President's FY 2012 budget for the U.S. Air Force' contains $14 million to pay for preparation and delivery of NASA Space Shuttle Atlantis to the National Museum of the Air Force (Operation and Maintenance, Air Operations, Servicewide Activities).

Has NASA selected the National Museum of the United States Air Force in Dayton, Ohio as the site for one of the retiring space orbiters?

Answer: No, NASA has not yet announced the plan for retiring space orbiters.

CHARRTS No.: SB-01-002
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Murray
Witness: DEPSECDEF Lynn
Question: #2

Retiring NASA Space Shuttles

Question: Mr. Secretary, the President's FY 2012 budget for the U.S. Air Force contains $14 million to pay for preparation and delivery of NASA Space Shuttle Atlantis to the National Museum of the Air Force (Operation and Maintenance, Air Operations, Servicewide Activities).

Has the Museum entered into any preliminary discussions or agreements with NASA on this subject?

Answer: No, the National Museum of the United States Air Force did not entered into any preliminary discussions or agreements with NASA on this subject. As with other interested aviation museums, the National Museum of the United States Air Force has engaged NASA to obtain information on their selection process and timeline, as well as background information for NASA's expectations and requirements for acceptance of a Space Shuttle.

CHARRTS No.: SB-01-003
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Murray
Witness: DEPSECDEF Lynn
Question: #3

Retiring NASA Space Shuttles

Question: Mr. Secretary, the President's FY 2012 budget for the U.S. Air Force' contains $14 million to pay for preparation and delivery of NASA Space Shuttle Atlantis to the National Museum of the Air Force (Operation and Maintenance, Air Operations, Servicewide Activities).

If not, is it premature for the Air Force to be allocating funds for this activity?

Answer: Due to the Department of Defense budget process, any substantial known requirement for Fiscal Year 2012 must be included to prevent an unplanned execution year bill. NASA is scheduled to retire shuttles in Fiscal Year 2011 and deliver them to the recipients by the end of Fiscal Year 2012. So, if the Air Force receives a shuttle, the cost to prepare and transport it would be a Fiscal year 2012 expense.

CHARRTS No.: SB-01-004
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Murray
Witness: DEPSECDEF Lynn
Question: #4

Retiring NASA Space Shuttles

Question: Mr. Secretary, the President's FY 2012 budget for the U.S. Air Force contains $14 million to pay for preparation and delivery of NASA Space Shuttle Atlantis to the National Museum of the Air Force (Operation and Maintenance, Air Operations, Servicewide Activities).

The budget states that the Air Force has 'requested an interagency transfer of the Space Shuttle Atlantis to the National Museum of the United States Air Force.' Was this a formal request and when was it submitted? Can you define what is meant by an interagency transfer? What, if any, is the significance of the Space Shuttle Atlantis to the Air Force?

Answer: A formal request was signed by the Secretary of the Air Force to NASA on March 18, 2009. An interagency transfer is a common term used to describe how a U.S. Government agency or Department can obtain excess property directly from other Federal agencies and the process is regulated by the Federal Management Regulation (FMR), Title 41 of the Code of Federal Regulations section 102-36.145.

The Space Shuttle Atlantis is particularly significant to the Air Force having flown more Department of Defense-dedicated missions than any other orbiter. Atlantis launched on its first space flight on October 3, 1985 in support of a Department of Defense project. Ten space shuttle missions were wholly dedicated to DoD projects. While Defense payloads have flown on many additional missions, Atlantis flew half of these dedicated missions and the majority (4 of 7) of the Department's classified missions. To date, 38 astronauts with Air Force, Air Force Reserve, or Air National Guard affiliations have flown aboard Atlantis.

CHARRTS No.: SB-01-005
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Murray
Witness: DEPSECDEF Lynn
Question: #5

Retiring NASA Space Shuttles

Question: Mr. Secretary, the President's FY 2012 budget for the U.S. Air Force contains $14 million to pay for preparation and delivery of NASA Space Shuttle Atlantis to the National Museum of the Air Force (Operation and Maintenance, Air Operations, Servicewide Activities).

What does the $14 million cost in the budget represent? NASA documents reveal the costs to prepare and deliver a shuttle to be much higher. Has NASA provided the Air Force with a separate cost estimate?

Answer: In the Fiscal Year 2012 President's Budget request, the Air Force requested $14 million for preparation and delivery of an orbiter for the National Museum of the United States Air Force. The current estimate assumes a portion of the preparation work will be done by the Air Force. NASA did not make a decision about whether to provide a shuttle to the Air Force. If NASA selects the Air Force to receive a shuttle, the Air Force, with the approval of Congress, anticipates providing the necessary resources to prepare and transport it to the National Museum of the United States Air Force. NASA did not provide the Air Force a separate or a detailed cost breakdown.

CHARRTS No.: SB-01-006
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Murray
Witness: DEPSECDEF Lynn
Question: #6

Retiring NASA Space Shuttles

Question: Mr. Secretary, the President's FY 2012 budget for the U.S. Air Force contains $14 million to pay for preparation and delivery of NASA Space Shuttle Atlantis to the National Museum of the Air Force (Operation and Maintenance, Air Operations, Servicewide Activities).

I understand that there are a number of non-government museums across the country that are qualified to display a NASA shuttle and are hoping to secure one. How does the Air Force answer the charge that including Federal funds in the FY 2012 budget for this purpose gives the National Air Force Museum an unfair advantage in the NASA selection process? Would you characterize this allocation as a Presidential earmark?

Answer: As a Federal entity, the National Museum of the Air Force (NMUSAF) depends on the budget process. It is precluded by law and regulation from soliciting private funds; therefore, it must seek the support of Congress. This is not an unfair advantage, nor a Presidential earmark. Rather, the NMUSAF is following the normal budget processes available to it in order to meet the mission requirement to preserve, maintain, and make available possible portions of our Nation's heritage to the widest public audience. A Space Shuttle Orbiter is an important part of the Air Force's history and heritage and as such, it is appropriate for the Secretary of the Air Force to request a Space Shuttle for display and to seek budget support.

CHARRTS No.: SB-01-008
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Murray
Witness: DEPSECDEF Lynn
Question: #8

TRICARE

Question: Mr. Secretary, The US Family Health Plan designed by Congress in 1996 provides the full TRICARE Prime benefit for military beneficiaries in 16 states and the District of Columbia for over 115,000 beneficiaries. In Washington State, over 11,500 of my constituents are enrolled in USFHP through Pacific Medical Centers. These beneficiaries tell me they are very satisfied with this health care option. Pacific Medical Centers employs a medical home model of care to provide prevention and wellness programs as well as effective disease and care management programs designed to care for beneficiaries' health care needs over their lifespan. This is one of the major reasons the enrollees are so satisfied with the program.

The FY 12 President's Budget Request includes a proposed legislative provision that future enrollees in US Family Health Plan would not remain in the plan upon reaching age 65. I am concerned that this proposal would push the cost from the Department of Defense to Medicare and increase the out-of-pocket cost for the retiree as they would be obligated to pay for TRICARE for Life and Medicare Part B instead of USFHP.

Public Law 104"201 Sec 726(b) mandates the Government cannot pay more for the care of a US Family Health Plan enrollee than it would if that beneficiary were receiving care from other government programs.

Is the destabilization of this program consistent with the DQD's stated priorities of improved health management and taking care of people?

Answer: The Department believes these changes responsibly manage DoD's health care finances, while continuing to promote models of care which improve population health and enhance the patient experience. Only approximately 30,000 of the 115,000 patients enrolled in the USFHP are in medical home practices. All 9.6 million TRICARE patients enjoy preventive care benefits at no cost shares, regardless of the program in which they are enrolled. The current cost for a USFHP enrollee aged 45-65 ranges from $6,600 to $10,000 while the cost for a comparable patient under TRICARE Prime is $4,202. I encourage further implementation of medical home within USFHP as a method to help achieve better care at a lower cost.

The Department's proposal makes only a modest change to the USFHP method of payment. Current enrollees are excluded from the change, further limiting the impact on the model of care. Future enrollees would shift to Medicare Part B and TRICARE for Life payment upon reaching age 65. This proposal does not prevent the USFHP from collecting from both Medicare and

TRICARE and retaining these patients for health care. Since 90 percent of USFHP enrollees are already covered under Medicare, the changes to them would be modest as well.

Since we estimate that less than 3 percent of USFHP enrollees would shift to the new funding mechanism over the next five years, the USFHP would have time to adopt their program. The Administration estimates that the proposal will save the government $279 million over the next decade and reduces the Department's contribution to the Medicare Eligible Retiree Health Care Fund by over $3 billion over the next 5 years.

CHARRTS No.: SB-01-009
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Murray
Witness: DEPSECDEF Lynn
Question: #9

TRICARE

Question: Mr. Secretary, The US Family Health Plan designed by Congress in 1996 provides the full TRICARE Prime benefit for military beneficiaries in 16 states and the District of Columbia for over 115,000 beneficiaries. In Washington State, over 11,500 of my constituents are enrolled in USFHP through Pacific Medical Centers. These beneficiaries tell me they are very satisfied with this health care option. Pacific Medical Centers employs a medical home model of care to provide prevention and wellness programs as well as effective disease and care management programs designed to care for beneficiaries' health care needs over their lifespan. This is one of the major reasons the enrollees are so satisfied with the program.

The FY 12 President's Budget Request includes a proposed legislative provision that future enrollees in US Family Health Plan would not remain in the plan upon reaching age 65. I am concerned that this proposal would push the cost from the Department of Defense to Medicare and increase the out-of-pocket cost for the retiree as they would be obligated to pay for TRICARE for Life and Medicare Part B instead of USFHP.

Public Law 104"20I Sec 726(b) mandates the Government cannot pay more for the care of a USFamily Health Plan enrollee than it would if that beneficiary were receiving care from other government programs.

Mr. Secretary, in the past I have opposed any increase in TRICARE enrollment fees. While I recognize the impact of providing health care for the military, their dependents and retirees is a rapidly increasing budget item, I continue to be concerned about the financial impact to the individuals affected. Working-age retirees that may be unemployed or underemployed could struggle to make their premiums and may forego health insurance if their fixed pension does not cover their cost of living. Please explain what "medical deflator" those fees would be indexed too and how they would impact the rise in premiums.

Answer: A final decision on the exact medical index has not been made. The Department engaged various stakeholders as to the appropriateness of a variety of indices. The goal is to choose an index that is transparent, externally derived, relevant to the retired population, and easy to understand, and reflects growth in health care costs.

With respect to the general TRICARE fee increases, DoD was careful to recommend modest changes. The increase in TRICARE premiums would be $5 per month and the first such increase since 1995. Military pensions have risen considerably over that time period and the increase should not be an undue hardship on these beneficiaries. Furthermore, DoD is recommending that these increases not apply to medically retired beneficiaries or their survivors. The changes in pharmacy co-pays that are recommended are also modest and include a reduction in the co-pay for generics obtained through the mail order option.

With regard to those currently enrolled in USFHP, they would be grandfathered and would see no change in their coverage. For those who choose to enroll in USFHP in the future, they would be transitioned to TRICARE for Life (TFL) upon reaching age 65, consistent with other TRICARE Prime enrollees. TFL has no additional premium although there is a requirement to purchase Medicare Part B. Approximately 90 percent of current USFHP enrollees over the age of 65 are enrolled in Medicare Part B.

CHARRTS No.: SB-01-010
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Murray
Witness: DEPSECDEF Lynn
Question: #10

MyCAA

Question: Mr. Secretary, the MyCAA career advancement account program is a great benefit for our servicemembers' spouses. However, the program experienced some significant difficulties in 2010 including a temporary stoppage and the October announcement reinstating the program for a limited group of spouses. This program should be expanded to include all military spouses as originally planned. In this difficult economic climate and with the stress placed on military families faced with repeated deployments, having portable careers that provide meaningful work is key to helping manage some of the stresses faced by repeat moves and increasing financial demands. The temporary stoppage caused financial hardship to a number of military families already in the MyCAA system.

How much would it cost to expand the program to all spouses going forward?

Answer: The Department estimates that it would cost approximately $374 million above the current fiscal year budgeted $66 million if expanded to the original program. The Department estimates that it would cost approximately $440 million annually to return to the original program. The potential total liability is estimated to be $4 billion if all military spouses used the program to its fullest benefits. This is a rough estimate based on the short program history with limited data and with the significant changes from the initial start of this program to the current program.

The original program was open to approximately 750,000 military spouses (double the number of spouses currently eligible) with a $6,000 benefit cap and allowed all degree types. The current program has a $4,000 benefit cap and is designed to assist spouses of junior personnel (E1-E5, W1-W2, O1-O2) pursuing an associate's degree, or a license or credential leading to a portable career.

The MyCAA program is part of the more expansive Spouse Education and Career Opportunities (SECO) program that offers services to all military spouses at no cost. Services include career exploration and discovery to include skill, interest and aptitude inventories; education, training and licensing requirements; career readiness such as resume preparation and interview techniques; and career connections to identify federal and private employment opportunities to include the Military Spouse Employment Partnership.

CHARRTS No.: SB-01-011
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Murray
Witness: DEPSECDEF Lynn
Question: #11

MyCAA

Question: Mr. Secretary, the MyCAA career advancement account program is a great benefit for our servicemembers' spouses. However, the program experienced some significant difficulties in 2010 including a temporary stoppage and the October announcement reinstating the program for a limited group of spouses. This program should be expanded to include all military spouses as originally planned. In this difficult economic climate and with the stress placed on military families faced with repeated deployments, having portable careers that provide meaningful work is key to helping manage some of the stresses faced by repeat moves and increasing financial demands. The temporary stoppage caused financial hardship to a number of military families already in the MyCAA system.

How much of an increase is that over prior year funding and can you detail the breakout of the total amount?

Answer: The Department estimates that it would cost approximately $374 million above the current fiscal year budgeted $66 million if expanded to the original program. The total estimated cost of $440 million for the extended program is a rough estimate based on the short program history with limited data and with the significant changes from the initial start of this program to the current program. The total potential liability based on every eligible spouse taking advantage of this program at $6 thousand per spouse could be as high as $4 billion.

CHARRTS No.: SB-01-012
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Warner
Witness: DEPSECDEF Lynn
Question: #12

National Security Implications of the United States' Deficit and Debt

Question: The United States currently has a budget deficit of $1.3 trillion and a national debt of more than $14 trillion, much of which is owned by the Chinese government.

Is the United States' fiscal situation becoming a national security problem? If so, to what extent will the U.S.' mounting debt and budget shortfalls constrain our freedom of action overseas and affect our military policy choices in the future?

Answer: To the extent that reducing the deficit were to prevent the United States from properly resourcing the military and other instruments of national power (diplomacy, development, intelligence), the national debt poses a potential threat to the ability to carry out the national security strategy. If future defense budgets are reduced significantly, there is a risk of hollowing out military forces, constraining today's operations and the development of future capabilities, and failing to support adequately our men and women in uniform.

The world remains dangerous and unpredictable, and our global commitments are significant. The Department can be more efficient, but DoD cannot afford to put off investments in future capabilities or undermine critical relationships. The Department must continue efforts to make our forces and capabilities more strong, agile, and versatile. Broad and comprehensive investments in science and technology and in research and development are of increasing importance to preparing for future challenges. Short-sighted cuts to reduce our defense budget now may lead to costlier responses and more tragic consequences later.

Like the rest of the federal government, the Defense Department is prepared to tighten its belt, but there is little that is discretionary about the security we provide to the United States. Cuts can only go so far without hollowing the force. DoD's efficiencies effort reallocated $100 billion across the Military Departments to top priority areas, and the Department identified an additional $78 billion in savings over the next five years. The cumulative effect of these efforts and our new investments allow the Department to protect the military's combat power, despite a flattening defense budget.

CHARRTS No.: SB-01-013
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Warner
Witness: DEPSECDEF Lynn
Question: #13

GAO Report on Reducing Duplication in Government Programs

Question: The GAO in March 2011 released a report on reducing duplication and cutting costs in government programs. Within the Defense Department, the report highlighted 7 areas of duplication and another 6 categories where the Defense Department can save taxpayers' money. In one notable example, the report found that by realigning the Defense Department's military medical command and consolidating common functions, projected savings could be achieved of between $281 million to $460 million annually.

(a) Do you agree with GAO's conclusions and the resulting taxpayer savings that could be generated, primarily by avoiding duplication? If so, how do you plan to implement the report s recommendations and how long will it take to do so?

(b) In addition to those areas mentioned in the GAO report, are there other places within the Defense Department where costs can be cut or overlap can be reduced? If so, where, and how much cost savings can be achieved?

Answer: There is always a potential for cost savings associated with avoiding duplication. In the case of military healthcare, potential savings must be carefully weighed against the risk of reduced military readiness or degraded care to service members and their families. There is no current plan to create a unified military medical command.

In 2006, a working group chartered under the Under Secretary of Defense for Personnel and Readiness (USD (P&R)) and the Chairman, Joint Chiefs of Staff, prepared recommendations and possible courses of action for a unified medical command. The USD (P&R) and the Assistant Secretary of Defense for Health Affairs (ASD (HA)) advanced an alternative framework and, after due consideration I approved a framework for Achieving More Jointness and Unity of Command on November 27, 2006. Over the past four years, the framework was partially implemented. A formal review of the results of the implementation is now being conducted by the GAO and is expected to be complete in late 2011. There is no current plan to create a unified military medical command.

With respect to the potential savings from a unified medical command, the figures cited by the GAO are from a 2006 study by the Center for Naval Analyses (CNA). The CNA study recognizes that there could be numerous configurations of a consolidated military medical command. This makes it difficult to prepare an accurate estimate of costs or savings. The study further suggests that a significant portion of the savings due to reorganization would come from a reduction in medical manpower: military, civilian, and contractors.

Significantly, the Department's FY2012 budget request includes an assumed reduction in nearly 800 contractors in the TRICARE Management Activity (TMA). In addition, we point out that Congress has prevented the Department from pursuing conversions of hundreds of military medical billets to civilian positions. In many, if not most, cases, a civilian incumbent would be less costly than a uniformed service member.

The CNA report also acknowledges, but does not include in its estimated savings, that implementing a unified medical command would require a "long and potentially costly transition period." The report, however, does not include an estimate of these costs.

Aside from the unified medical command, the Department continues to aggressively pursue reductions in redundant or overlapping functions. In all, the Department's FY 2012 budget request includes a proposed $78 billion reduction in the defense budget topline over the next five years.

CHARRTS No.: SB-01-014
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Warner
Witness: DEPSECDEF Lynn
Question: #14

Relocation of United States African Command (AFRICOM)

Question: The GAO report also recommends the Defense Department assess the costs and benefits of its overseas military presence. The United States is spending billions of dollars to maintain overseas installations in places like Germany, which currently hosts 2,000 personnel at the United States African Command (AFRICOM).Question: Given that the Defense Department is still looking for a permanent home for AFRICOM, could significant cost savings be achieved by relocating this facility to the Hampton Roads area in Virginia? The decision to close the United States Joint Forces Command (JFCOM) has created excess capacity in Norfolk-skilled and cleared personnel, secure facilities, IT, and other host infrastructure-which could be leveraged to enable AFRICOM to become operational without additional cost to the taxpayer.

Answer: Please refer to the Department's latest correspondence on this matter from Assistant Secretary Alexander Vershbow to Senator Lindsey Graham.

CHARRTS No.: SB-01-015
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Warner
Witness: DEPSECDEF Lynn
Question: #15

Arlington National Cemetery

Question: As you are aware, the Northern Virginia Technology Council (NVTC) spent 5 months studying the business processes at Arlington Cemetery and produced a comprehensive report offering specific solutions to fix many of the cemetery's problems.

(a) Will the United States Army seek a supplemental appropriation in FY 2011 funding to put in place the short-term, "off the shelf' fixes recommended in the NVTC report? If so, how much supplemental funding will the Army request?

(b) The United States Army National Cemeteries Program requested $45.8 million for FY 2012. Is this funding sufficient to implement NVTC's recommended long-term infrastructure improvements that will be required to transform Arlington National Cemetery?

Answer: The Northern Virginia Technology Council made five main recommendations involving chain of custody, case management, culture, process automation, and program management. These recommendations are consistent with efforts already underway for gravesite accountability, digital maps, architecture modernization, the Department of the Army Inspector General (DAIG) remediation, historic records automation, hiring actions, and master plan development. These efforts are estimated to cost $17.5M in FY 2011.

Due to the fact that we are operating under continuing resolutions and that the spending level for the Army National Cemeteries Program has not been set for FY 2011, it is unknown whether the FY 2011 funding will be sufficient. The FY 2012 budget request for the Army National Cemeteries Program was based on the best available information and will need to be re-assessed once FY 2011 funding is determined.

CHARRTS No.: SB-01-016
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The Presindent's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Begich
Witness: DEPSECDEF Lynn
Question: #16

GAO Report

Question: GAO identified several other initiatives the Department of Defense could take to reduce redundancies and achieve cost savings and increased performance. For instance, GAO identified 31 entities within DOD where duplication and overlap of work occurs responding to warfighter urgent needs. GAO also identified several entities within DOD whose work most likely overlaps on counter-IED efforts. Streamlining efforts across the Department not only saves money, it will allow DOD to manage its resources better and respond to our warfighter quicker. Right now, for every major issue DOD encounters it seems a new task force or organization is created to respond. Realistically, the ability already exists within DOD to address many of the problems encountered without creating entirely new organizations that often times are meant to be temporary but become permanent.

a. Are you aware of the other recommendations in the report?

b. Joint Forces Command and the Business Transformation Agency are visible and prominent organizations. I commend the Department for taking the initiative to consolidate the functions of those organizations, but did the Department take a serious internal look at all the entities and organizations during the efficiencies initiative?

c. How many entities and agencies exist within DOD?

d. How many people are employed in the surrounding area for the Department and military services, including employees in Crystal City? How much does Crystal City space cost the Department each year?

Answer:

a. DoD is aware of the 17 recommendations in the March 2011 GAO report.

b. The Secretary directed the entire Department to "take a hard and unsparing look at how the department is staffed, organized and operated." As a result, the entire Department found about $154B in savings over the Future Years Defense Program (FYDP). While these results were admirable, the Secretary remains committed to inculcate a "culture of savings" within the Department at all levels. Clearly more work remains in both ensuring that these savings are realized and finding additional efficiencies.

c. Currently, the Department of Defense is composed of the Office of the Secretary of Defense, the Joint Chiefs of Staff, the Joint Staff, the Office of the Inspector General of the Department of Defense, 10 Combatant Commands, 3 Military Departments, 18 Defense Agencies, 10 DoD Field Activities, and such other offices, agencies, activities, organizations, and commands established or designated by law, or by the President or by the Secretary of Defense, in accordance with sections 111, 113, and 192 of title 10, United States Code.

d. There are approximately 13,700 DoD personnel in Crystal City. The FY11 projected space cost for Crystal City is $162.3M. Going forward, these costs will likely not be the same from one year to the next due to scheduled BRAC closures of some buildings, Anti-Terrorism/Force Protection (AT/FP) right sizing of existing buildings to house non-BRAC, and the additions of new buildings for future space requirements. These changes apply to the entire National Capitol Region (NCR) inventory.

CHARRTS No.: SB-01-017
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Begich
Witness: DEPSECDEF Lynn
Question: #17

GAO Report

Question: GAO also concluded the Department of Defense could save $281 to $460 million annually by creating a Joint Medical Command. GAO also noted the Department has been unable to move forward with a Joint Medical Command because of cultural differences among the services.

a. Has the Department of Defense recently assessed cost savings associated with a Joint Medical Command? Why or why not?

b. Are the GAO's projected cost savings of this initiative accurate?

c. If there is a cost savings, why isn't the Department moving forward with a Joint Medical Command?

d. In a fiscally constrained environment it is imperative the Department of Defense make every effort to reduce wasteful spending. Especially when eliminating redundancies may serve our military members betters. How committed is the Department to ensuring cultural barriers don't continue to prevent achieving cost savings and increasing productivity?

Answer: The Department has not recently assessed cost savings associated with a Joint Medical Command. In the case of military healthcare, potential savings have to be carefully weighed against the risk of reduced military readiness or degraded care to service members and their families.

In 2006, a work group chartered under the Under Secretary of Defense for Personnel and Readiness (USD (P&R)) and the Chairman, Joint Chiefs of Staff, prepared recommendations and possible courses of action for a unified medical command. The USD (P&R) and the Assistant Secretary of Defense for Health Affairs (ASD (HA)) advanced an alternative framework and, after due consideration the I approved a framework for Achieving More Jointness and Unity of Command on November 27, 2006. Over the past four years, the framework was partially implemented. A formal review of the results of the implementation is now being conducted by the GAO and is expected to be complete in late 2011. There is no current plan to create a unified military medical command.

With respect to the potential savings from a unified medical command, the figures cited by the GAO are from a 2006 study by the Center for Naval Analyses (CNA). The CNA study recognizes that there could be numerous configurations of a consolidated military medical command. This makes it difficult to prepare an accurate estimate of costs or savings. The study further suggests that a significant portion of the savings due to reorganization would come from a reduction in medical manpower; military, civilian, and contractors.

Significantly, the Department's FY 2012 budget request includes an assumed reduction in nearly 800 contractors in the TRICARE Management Activity (TMA). In addition, the Department points out that Congress prevented the Department from pursuing conversions of hundreds of military medical billets to civilian positions. In many, if not most, cases, a civilian incumbent would be less costly than a uniformed service member.

The CNA report also acknowledges, but does not include in its estimated savings, that implementing a unified medical command would require a "long and potentially costly transition period." The report, however, does not include an estimate of these costs.

The Department is committed to ensuring that no barriers—cultural or otherwise—prevent the achievement of cost savings and increased productivity. Aside from the unified medical command, the Department continues to aggressively pursue reductions in redundant or overlapping functions. In the spring of 2010, in recognition of the fiscal pressures the country is facing, the Department launched a comprehensive effort to reduce its overhead expenditures. In all, the Department's FY 2012 budget request includes a proposed $78 billion reduction in the defense budget topline over the next five years.

CHARRTS No.: SB-01-018
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Begich
Witness: DEPSECDEF Lynn
Question: #18

GAO Report

Question: For the record, please submit a formal response to GAO's report outlining the Department of Defense's action it will take on GAO's recommendations and any internal cost data regarding the recommendations.

Answer: The GAO's recommendations are consistent with the Secretary's guidance and generally aligned with the Department's ongoing initiatives. The DoD actively considered all of these proposals and, in many cases, has similar efforts underway. Note that many of these initiatives (electronic health records, for example) are large projects that will take time and require congressional support to complete. I look forward to working with you on these as they develop.

CHARRTS No.: SB-01-019
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Begich
Witness: DEPSECDEF Lynn
Question: #19

Efficiency Initiatives

Question: Some of the efficiencies are tangible savings, like the civilian hiring and pay freeze. However, many of the efficiencies savings outlined have yet to be realized. For instance, the end strength decreases are projected to save money, yet they are contingent upon a number of factors and may not actually be realized. Additionally, military construction project savings were really just delayed to future years. Please identify the tangible savings from the efficiency initiatives. How will DOD monitor efficiency efforts to ensure cost savings are realized?

Answer: The Secretary challenged the Military Departments and Special Operations Command with an efficiency goal of at least $100B in savings that these organizations could retain and shift to higher priority programs. These efficiencies came from reorganizations ($25.1B), better business practices ($45.5B), program reductions and terminations ($21.5B), and reduced lower priority programs ($8.2B).

The Military Departments and Special Operations Command are able to provide additional details such as those found in the Department of Defense Efficiency Initiatives FY12 Budget Estimates Justification Book which was provided to Senate staff.

The Department will monitor the efficiency efforts through the normal budgeting and programming process.

CHARRTS No.: SB-01-020
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Begich
Witness: DEPSECDEF Lynn
Question: #20

Efficiency Initiatives

Question: How are the efficiency initiatives impacted by a year-long continuing resolution?

Answer: The continuing resolution negatively affects the Department's ability to effectively conduct business in a number of critical ways, not least of which may be risks associated with operational demands, the inability to implement new programs, and uncertainty regarding budget levels. Some efficiency initiatives may suffer delay as a result, but the Department remains committed to full implementation as quickly and rationally as possible.

CHARRTS No.: SB-01-021
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Begich
Witness: DEPSECDEF Lynn
Question: #21

MEADS

Question: I applaud the Department of Defense's decision to not proceed to procurement of the MEADS air and missile defense system. As noted in the DOD Memo, the program is substantially over budget and behind schedule; and it would take an extra \$974M to \$1.16B just to complete the Design and Development (D&D). But I understand approximately \$804M will still be spent to implement a "proof of concept" effort. I am concerned that this would mean spending hundreds of millions of limited dollars on a system that we will not procure.

Please elaborate on the decision to implement a proof of concept effort - I want to make sure I understand why we are investing almost \$1 billion on a system we are not going to procure and what the way ahead is.

Answer: The Department believes implementation of a "proof of concept" D&D program, within the funding limits agreed in the MEADS D&D Memorandum of Understanding (MOU), is the best option for the United States and its partners, Italy and Germany. Funding MEADS up to the existing MOU cost ceiling by providing the remaining U.S. commitment of \$804 million allows the Department to harvest technology from its investment. With this investment, the MEADS program completes those prototypes that already passed critical design review. In many cases, component parts were ordered or delivered for these major end items, such as the radars. The program would complete limited system integration and demonstrate capability via ground and flight tests of these prototype systems. This allows documentation of the tested design, the ability to assess the capabilities of the major system elements, and the development of data packages for these elements. This decision ensures the DoD: will fulfill its obligations under the MOU; will avoid a situation where the DoD may be viewed as reneging on its international obligations; will avoid requiring the DoD to pay termination costs we do not believe would be any less than the cost of completing the "proof of concept" effort under the MOU; and, importantly, will facilitate the maturation of key technologies useful to the DoD in the other programs and to its MOU partners, Italy and Germany, in any follow-on effort.

Even if the MEADS program was terminated, which would require the consent of the German and Italian Ministries of Defense, it would effectively force the DoD and its German and Italian partners to devote significant funds to cover contractor termination costs – funds that could otherwise be used to bring MEADS development to a useful level of maturity. It is our firm belief: harvesting key technologies developed under MEADS for use in other DoD programs; capturing the engineering, design, and test documentation for the "proof of concept" effort; and supporting our allies in their air defense capability development efforts are worthy of the continued funding for the remainder of the D&D effort.

CHARRTS No.: SB-01-022
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Thune
Witness: DEPSECDEF Lynn
Question: #22

Defense Cuts in Europe and Effect on U.S.

Question: Many of our key European allies are seeking to substantially cut their military budgets. For example, the United Kingdom has decommissioned its aircraft carrier and retired its fixed-wing air component because, according to the UK's Strategic Defense and Security Review "there are few circumstances we can envisage where the ability to deploy airpower from the sea will be essential." Ironically, now the UK is telling the world that a no-fly zone must be established above Libya, and is working to draft a UN resolution to do so. Obviously, establishing a no-fly zone for Libya will at least partly require the ability to deploy fixed-wing airpower from the sea.

It seems that our European friends are seeking to cut their military budgets while at the same time pushing us to intervene in world hotspots where only the United States has the ability to project power. While defense budgets in Europe and the United States are facing constraint and decline, defense budgets in Asian and Middle Eastern countries are expanding dramatically.

What kind of effect is this global redistribution of military power likely to have over the long term?

Answer: I share your concern about allies' reduced defense budgets. The Department continues to engage in frank discussions with all of its partners regarding the challenges associated with declining defense expenditures. Such discussions must be based on a shared understanding of security threats. NATO Secretary General Rasmussen, in a February 2011 conference in Brussels, echoed these sentiments when he said: "Europe simply cannot afford to get out of the security business.... It has to revitalise its role as the United States' prime security partner and adjust to the new global security environment."

In our view, although these are challenging economic times and many countries have significant fiscal challenges, Allies will need to find ways to spend limited funds more wisely through pooling, specialization, and multinational procurement. Although not a panacea, these practices should be a step in the right direction.

Notwithstanding the shortfall in investment, however, allies demonstrated an unparalleled level of commitment to the mission in Afghanistan with a current contribution of more than 35,000 personnel and sustained support for almost a decade. In Libya, our European partners are showing a willingness and capability to assume leadership of military operations. These are clear indications that our allies have the will and the resolve to share burdens and responsibilities to see these missions through to a successful conclusion.

CHARRTS No.: SB-01-023
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Thune
Witness: DEPSECDEF Lynn
Question: #23

Budget Reductions and Plan to Flatten DoD's Base Budget

Question: The 2011 National Military Strategy (NMS) of the United States of America highlighted the dangers associated with a nuclear armed Iran and North Korea. It also highlighted China's continued military modernization efforts and China's expansion interests beyond Asia.

In an unpredictable world with threats like those mentioned in the NMS, how does the FY2012 budget request and the four-year budget plan address an uncertain world that may require the U.S. to respond to future contingency operations, such as establishing a no-fly zone?

And, is this budget plan based on a stable world where the U.S. is not at war or responding to crises?

Answer: The FY 2012 budget and the outyear plans addresses an uncertain world by funding the military capabilities that national security leadership believes are required to protect and advance U.S. interests around the globe. This funding supports what leadership assesses to be the right mix of air, ground, and naval forces to respond to a full spectrum of contingencies. It balances support for ongoing operations and preparing for an uncertain future.

No, this budget plan is not based on a stable world where the United States is not at war or responding to crises. It is based on a continued fight against terrorism, engagement in Afghanistan, and protecting America in an unstable and uncertain world.

CHARRTS No.: SB-01-024
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Thune
Witness: DEPSECDEF Lynn
Question: #24

Joint Effort to Respond to Unforeseen Events

Question: As we've seen recent events unfold in the Middle East, it's apparent that our government cannot predict every crisis nor are we fully capable of understanding the cascading effects of one turbulent event. I understand the Departments of Defense and State are working together to create a pilot program that will allow both Departments to jointly deploy to crisis events like we're seeing in the Middle East.

Can you describe this program more in-depth and how you intend to fund this program in FY2012 and in the future?

Answer: The Secretaries of State and Defense have proposed a new authority, which would be called the Global Security Contingency Fund (GSCF), and which would allow the Department of State and Department of Defense to pool resources and expertise to provide assistance to security forces and the government agencies responsible for those forces, as well as to provide assistance to the justice sector and for stabilization. The three-year pilot program will enable the United States Government to utilize interagency expertise to respond to emergent challenges and opportunities through joint program formulation, approval, and, in some cases, implementation.

I envision that specific uses of the GSCF will vary depending on the emergent threat or opportunity, and the operating environment. Current events in the Middle East suggest that increased agility in government response within the budget cycle is necessary to respond to rapidly changing events on the ground.

Our departments propose to start modestly, with a $50 million appropriation to the Department of State. The proposed legislation also will allow either the Department of State or the Department of Defense to transfer additional funds from existing appropriations into the GSCF, up to a combined total of $500 million in appropriations and transfers. The intent of the fund is not to spend $500 million on an annual basis, but to have adequate resources available to respond rapidly to emergent challenges or opportunities within a given fiscal year, in the event that such resources are necessary. Actual expenditures in a given year depend on the requirements. I believe this approach is a responsible way to balance the need for additional agility with a funding structure that encourages rigor in programming decisions due to the need to transfer funds from other sources.

CHARRTS No.: SB-01-025
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Thune
Witness: DEPSECDEF Lynn
Question: #25

Rising Healthcare Costs and the effect on DoD

Question: I'm aware that Secretary Gates has voiced great concern about the escalating military health care costs and the financial impact on DoD. According to DoD estimates, health care costs are projected to increase from $50 billion in FY2011 to $65 billion in FY2015.Because of these escalating health care costs, I understand that DoD has implemented several cost cutting measures, such as increasing TRICARE Prime enrollment fees and increasing pharmacy co-payment fees. Can you explain in more detail what these new fees are and how much they will cost? And, how did DoD establish a fee that would achieve cost savings over the long term-what was your methodology?

Answer: Yes, the Department of Defense (DoD) is proposing to adjust fees in two ways: TRICARE Prime enrollment fees and pharmacy co-pays. TRICARE Prime enrollment fees have not been adjusted since the program's inception in 1995, when it was set at $460/year for a retired family. The first proposal would only modestly increase Prime enrollment fees for military retirees and family members -- $2.50 per individual retired beneficiary/month or $5 per retired family/month. Beginning in 2013, these retiree enrollment fees would be indexed to health care inflation. This would avoid the current situation with the enrollment fees having no relationship to rising health care costs. Medically retired Service members and survivors would be exempt from these increases. The Department of Defense estimates that this proposal would save $31 million in FY 2012 and $434 million over 5 years.

The second proposal would increase incentives for beneficiaries to choose the most effective outlets for prescriptions. This proposal would eliminate co-pays for generic drugs through mail order (from the current $3/prescription). Furthermore, it would increase co-pays for drugs purchased through retail pharmacies to $5 for generics, $12 for brand name drugs and $25 for Tier 3 (non-formulary) drugs (from $3/$9/$22 respectively). Prescriptions obtained from military facilities would remain free. Mail order co-pays for brand name drugs would remain $9 while for Tier 3 drugs, the co-pay would increase to $25 from the current $22. With these adjustments the incentives would be for the beneficiary to utilize military facilities and/or mail order and to choose generics over brands. Our estimate is that this proposal would save DoD $95 million in FY 2012 and nearly $2.6 billion over 5 years.

CHARRTS No.: SB-01-026
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Thune
Witness: DEPSECDEF Lynn
Question: #26

Building Organic Capability within DoD

Question: According to the Commission on Wartime Contracting in Iraq and Afghanistan, DoD often lacks sufficient core expertise and will then rely heavily on embedded contractors, sometimes in high-risk areas, to perform mission-critical support. Furthermore, the Commission recommended that DoD conduct an assessment to determine the organic resources needed to preserve a core level of capability.In light of the Commission's recommendations, what steps have you taken or plan to take to start growing an organic capability?

Answer: The Civilian Expeditionary Workforce (CEW) represents one DoD initiative designed to build organic capability within the Department. The goal is to establish and maintain the DoD CEW as a force multiplier to leverage the Department's capability to respond to threats to our national security and to provide a more agile and ready force.

Currently, CEW relies on Capability-Based Volunteer (CBV) to support DoD mission requirements, predominantly in the U.S. Central Command Area of Responsibility. Over the next two years, an appropriately sized subset of civilian workforce positions will be identified and will be organized, trained, and equipped in a manner that facilitates the use of their capabilities for operational requirements. This workforce shall be ready to deploy in support of combat operations by the military; contingencies; emergency operations; humanitarian missions; disaster relief; restoration of order; drug interdiction; and stability operations of the Department of Defense. The Department's policy is to rely on a mix of capable military members and DoD civilian employees to meet DoD global national security mission requirements.

DoD civilian employees are an integral part of the Total Force. They serve in a variety of positions, provide essential capabilities and, where appropriate for civilians to do so, support mission requirements of the Department.

CHARRTS No.: SB-01-027
Senate Budget Committee
Hearing Date: March 10, 2011
Subject: The President's Fiscal Year 2012 Defense and International Affairs Budget
Member: Senator Warner
Witness: DEPSECDEF Lynn
Question: #27

GAO Report

Question: A recent GAO report concluded "DOD should assess the costs and benefits of oversees military presence options before committing to costly personnel realignments and constructions plans." According to GAO, this could save the Department billions of dollars. I am concerned about DOD's continued investment overseas. There has been no real strategic look at U.S. presence, and force structure changes, like the recent end strength decrease announcement, continue to delay decisions like the one regarding whether or not an Army Brigade will stay in Europe.

Answer: I disagree with the statement that "there has been no real strategic look at U.S. presence." Since taking office the Obama Administration has conducted extensive strategic reviews, including analyses of the U.S. presence abroad. Additionally, the Department of Defense completed its 2009 Quadrennial Defense Review, and its budget requests and force structure recommendations reflect that strategic review. Our decisions on Army and Marine Corps end strength, and bringing home an Army brigade from Europe, support our strategic assessments and our judgment on how best to allocate our constrained resources.

Questions for the Record from Senator Bill Nelson for Dr. Till von Wachter
"Challenges for the U.S. Economic Recovery," Senate Budget Committee
Thursday, February 3, 2011

Questions:

Florida's economy largely relies on stability in the housing market. The Treasury Department and the Department of Housing and Urban Development are expected to release a plan for reforming Fanne Mae and Freddie Mac sometime this month. Do you believe the housing sector would be significantly encumbered by a quick withdrawl of Gannie and Freddie from the secondary mortgage market? How would structure Fannie Mae and Freddie Mac given the past distortion of risk within the mortgage industry?

Response:

Senator, I do not have specific recommendations in response to your question, as they fall outside my area of expertise.

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