

**CONCURRENT RESOLUTION ON THE  
BUDGET FISCAL YEAR 2013**

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**HEARINGS**

BEFORE THE

**COMMITTEE ON THE BUDGET  
UNITED STATES SENATE**

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

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**January 26, 2012—THE OUTLOOK FOR THE U.S. AND GLOBAL  
ECONOMY**

**February 1, 2012—THE OUTLOOK FOR THE EUROZONE**

**February 2, 2012—THE BUDGET AND ECONOMIC OUTLOOK: FISCAL  
YEARS 2012-2022**

**February 7, 2012—THE OUTLOOK FOR U.S. MONETARY AND FISCAL  
POLICY**

**February 9, 2012—ASSESSING INEQUALITY, MOBILITY, AND  
OPPORTUNITY**

**February 14, 2012—THE PRESIDENT'S FISCAL YEAR 2013 BUDGET  
PROPOSAL**

**February 15, 2012—THE PRESIDENT'S FISCAL YEAR 2013 BUDGET  
REQUEST FOR THE U. S. DEPARTMENT OF TRANSPORTATION**

**February 16, 2012—THE PRESIDENT'S FISCAL YEAR 2013 BUDGET AND  
REVENUE PROPOSALS**

**February 28, 2012—THE PRESIDENT'S FISCAL YEAR 2013 BUDGET  
REQUEST FOR THE U.S. DEPARTMENT OF DEFENSE**

**February 29, 2012—PUTTING HEALTH CARE SPENDING ON A  
SUSTAINABLE PATH**

**March 1, 2012—TAX REFORM TO ENCOURAGE GROWTH, REDUCE THE  
DEFICIT, AND PROMOTE FAIRNESS**

**March 6, 2013—PERSPECTIVES ON THE PRESIDENT'S FISCAL YEAR  
2013 BUDGET REQUEST FOR THE U.S. DEPARTMENT OF DEFENSE**

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# THE OUTLOOK FOR THE U.S. AND GLOBAL ECONOMY

THURSDAY, JANUARY 26, 2012

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, Nelson, Cardin, Whitehouse, Warner, Merkley, 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 Committee will come to order. I want to welcome everyone to the Senate Budget Committee.

I want to start with a bit of the business of the Committee because I know people are asking what is our intention with respect to going to a markup, and I want to make clear to everyone that I intend to go to a markup in the Committee, and I want to do it sooner rather than later. The unknown for us is when we will get CBO's re-estimate, and we do not have an answer on that. They sometime ago talked to us about March 9th as a time they might have a re-estimate. Since that time, they have indicated that might slip, so we just have to wait and see.

But I will be talking to all the members of the Committee, and I am going to start that consultation immediately. We will start consultations next week with respect to members of the Committee and will certainly be talking to Senator Sessions about timing, and hopefully we will know in the near term what CBO's schedule is with respect to a re-estimate. I wanted to start with that.

I also want to—

Senator SESSIONS. Thank you. I appreciate that. I know that the Chairman deeply cares about these issues, and I think that process will be good for America. Thank you.

Chairman CONRAD. I do, too. Look, we may have some disagreements on some part of what has happened heretofore, and I will talk a little about some of that as well. We also have places where we agree, and I think it is good for us as a body and good for the country to have the fullest possible debate.

You know, last year in some ways we got overtaken by a separate process because very early on a negotiation began at a higher level than ours, and that had an effect on what we did. I do want

to say that when I hear discussions that we do not have a budget, I do not agree with that. I just think that is wrong, because when we did the Budget Control Act in August, that provided a budget for this year and next. And the Budget Control Act was not the normal way of doing a budget. I would be the first one to say that. But in many ways, it is a stronger document than a typical budget resolution, because a typical budget resolution never goes to the President for signature. It is purely a congressional document. The Budget Control Act is actually a law passed overwhelmingly in the Senate 74–26, and not only does it have the force of law, it also set discretionary spending caps for 10 years instead of the 1 year that you normally have in a budget resolution. And it provided enforcement mechanisms, including a 2-year deeming resolution, which improves the enforcement of budget points of order, something that I insisted on in the Budget Control Act. And, finally, it created a reconciliation-like Super Committee to address entitlement and tax reforms, and it backed that process up with a \$1.2 trillion sequester. So it is certainly different than a typical budget resolution, but we do have the critical elements of a budget in place.

Now, I would be the first to say I would like to see it different than what was adopted in the Budget Control Act. I am sure each of us would have done it differently if we had the power to do it.

Today's hearing I want to focus on now focuses on the outlook for the U.S. and global economy. We have three excellent witnesses: Dr. Alan Blinder, former Vice Chairman of the Federal Reserve, now professor of economics and public affairs at Princeton University; Dr. Joel Prakken, the chairman of Macroeconomic Advisers, one of the most respected macroeconomic firms in the country; and Dr. Ike Brannon, the director of economic policy at the American Action Forum. Welcome to all of you. Thank you for being here. We appreciate very much your spending time with us.

## Economic Crisis of 2008-2009

- Worst recession since Great Depression
- Economy contracts 8.9% in 4<sup>th</sup> quarter of 2008
- 800,000 jobs lost in January 2009 alone, unemployment surging
- Housing market crisis ripples through economy – homebuilding and sales plummet, record foreclosures
- Financial market crisis threatens global economic collapse – lending frozen

I would like to briefly review the economic situation confronting the country. It is important to remember the economic crisis that we have come through. In 2008 and 2009, we experienced the worst recession since the Great Depression. The economy contracted almost 9 percent in the fourth quarter of 2008. That is really stunning—a 9-percent contraction in the fourth quarter of 2008. We lost 800,000 private sector jobs in January of 2009 alone. The housing market crisis was rippling through the economy with home building and home sales plummeting and record foreclosures, and we faced a financial market crisis that threatened to set off a global economic collapse. Credit markets were largely frozen.

Now, we have come a long way since then. The Federal response to the crisis, including actions taken by the Federal Reserve, the Bush administration, the Obama administration, and Congress, successfully pulled us back from the brink. It is clear that our economic situation would be much worse now if we had not had that Federal response. In fact, one of our witnesses today, Dr. Blinder, along with economist Mark Zandi, who is a former adviser to the McCain Presidential campaign, completed a study in 2010 that measured the impact of Federal actions on shoring up the economy. Their conclusion was as follows:

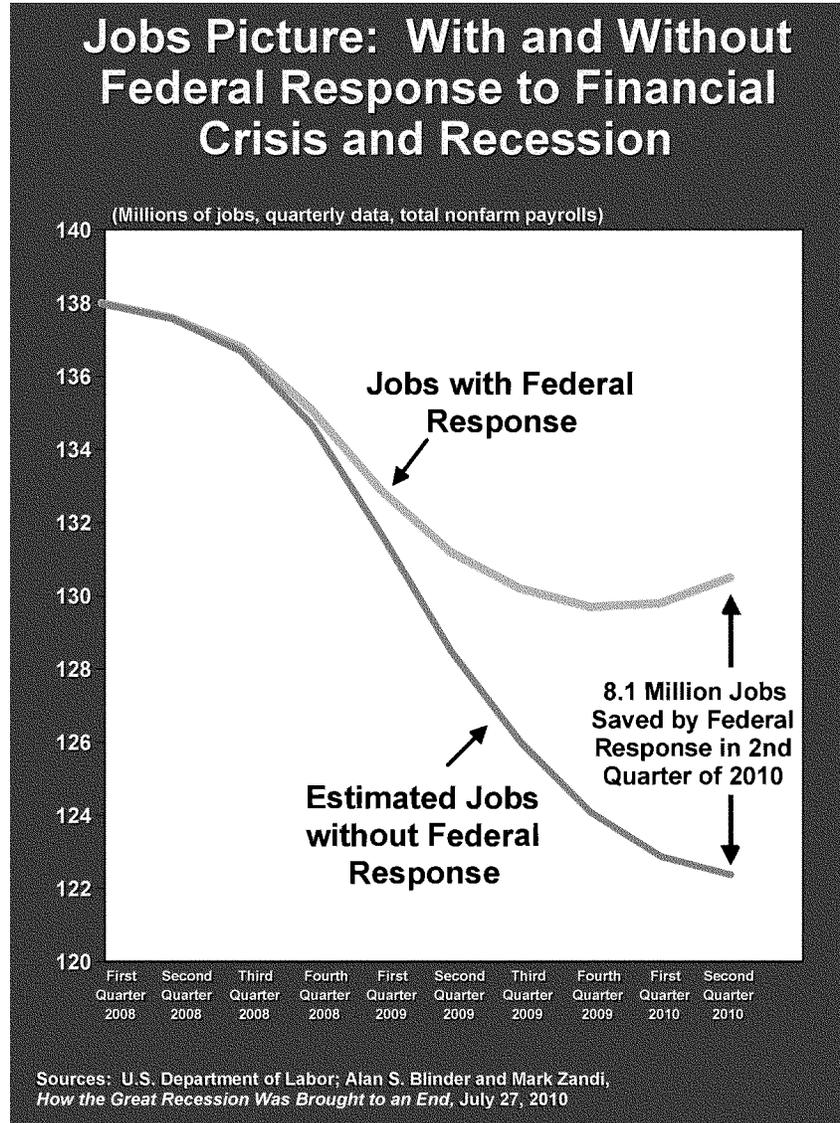
## Economists Blinder and Zandi on Federal Government Response to Financial Crisis and Recession

"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."

— Alan S. Blinder and Mark Zandi  
*How the Great Recession Was Brought to an End*  
July 27, 2010

"We find that its effect on real GDP, jobs, and inflation are huge and probably averted what could have been called '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."



This 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 had 8 million fewer jobs in the second quarter of 2010 if we had not had the Federal response. Now, I understand Dr. Blinder will present estimates for the number of jobs saved in 2011 as well, which I look forward to hearing.

Although the recovery has recently shown signs of strengthening, it has been a long and difficult road back. Now, that is not unexpected. Economists have found that following recessions caused by or accompanied by a severe financial crisis, recoveries tend to be shallower and take much longer. Here is what two leading econo-

mists, Dr. Carmen Reinhart and Dr. Vincent Reinhart, found in their research, and I quote:

**Following Severe Financial Crises,  
Economic Recoveries Are Shallower  
and Take Much Longer**

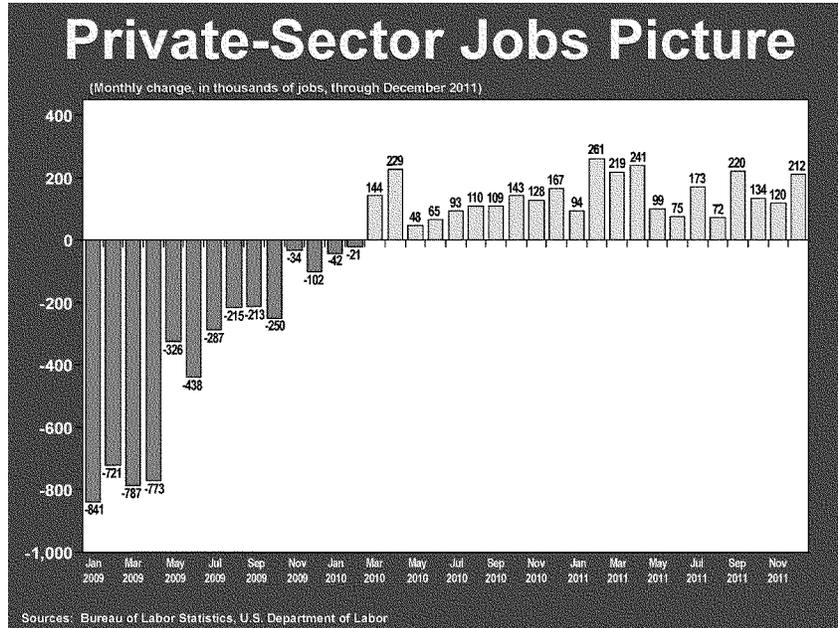
“Real per capita GDP growth rates are significantly lower during the decade following severe financial crises.... In the ten-year window following severe financial crises, unemployment rates are significantly higher than in the decade that preceded the crisis....

“[T]he decade of relative prosperity prior to the fall was importantly fueled by an expansion in credit and rising leverage that spans about 10 years; it is followed by a lengthy period of retrenchment that most often only begins after the crisis and lasts almost as long as the credit surge.”

— Dr. Carmen M. Reinhart, Peter G. Peterson Institute for International Economics, and Dr. Vincent P. Reinhart, American Enterprise Institute (AEI), National Bureau of Economic Research (NBER) Working Paper, *After the Fall* September 2010

“Real per capita GDP growth rates are significantly lower during the decade following a severe financial crisis. In the 10-year window following severe financial crises, unemployment rates are significantly higher than in the decade that preceded the crisis. The decade of relative prosperity prior to the fall was importantly fueled by an expansion in credit and rising leverage that spans about 10 years. It is followed by a lengthy period of retrenchment that most often only begins after the crisis and lasts almost as long as the credit surge.”

In other words, we should expect to see a period of lower-than-normal growth and relatively higher unemployment right now because we are recovering from a severe financial crisis.



If we look at private sector job growth, we see it has improved dramatically from when we were in recession. As I noted in January of 2009, the economy lost more than 800,000 private sector jobs. Private sector job growth returned in March of 2010, and we have now had 22 consecutive months of growth.

## Positive Signs for Economy

- 22 consecutive months of private-sector job growth
- Unemployment claims fall to lowest level since April 2008
- 9 consecutive quarters of real GDP growth
  - 3.1% GDP growth now forecast for 2011 Q4
- Housing starts up 25% since December 2010
- Consumer confidence up sharply in last two months of 2011
- U.S. auto manufacturers returning to profitability
- State revenues showing signs of improvement

There are some additional positive signs that we see in the economy. As I mentioned before, we have had 22 consecutive months of private sector job growth. Last week, unemployment claims fell to their lowest level since April of 2008. We have seen nine consecutive quarters of real GDP growth, and GDP growth is now expected to have risen to 3.1 percent in the fourth quarter of 2011. Housing starts are up 25 percent since December of 2010. Consumer confidence was up sharply in the last 2 months of 2011. U.S. auto manufacturers are returning to profitability, and State revenues are showing signs of improvement.

## Risks to Economy

- Unemployment remains too high
  - threatens to undermine consumer confidence
- Housing continues to pose threat
  - too many homes still in foreclosure or “underwater”
- Political deadlock in Washington could block key measures
  - such as extension of payroll tax cut and UI
- Federal, state, and local budget cuts could add too much near-term fiscal drag
- European debt / fiscal crisis creates uncertainty and threatens exports

But those good-news elements are no reason for complacency. There are serious risks that remain to economic recovery. For example, unemployment and underemployment remain far too high. Housing continues to pose a threat with too many homes still in foreclosure or underwater. Political deadlock in Washington could block key measures. Federal, State, and local budget cuts could add too much near-term fiscal drag. And the European debt and fiscal crisis is creating uncertainty and threatening U.S. exports, as we saw reported on the front page of the Washington Post yesterday. I hope all of our colleagues read the story about what is happening with the slowdown in Europe and how that is affecting U.S. companies as well.

Beyond that, we have what I have termed our own “debt threat.” We have a debt that is too high, growing too fast, and it is imperative that we present a plan to deal with it. I was part of the Fiscal Commission and part of the Group of Six. In both of those efforts, we came up with plans to reduce debt by some \$4 trillion over what would otherwise occur. Let me just say I personally favor an even more ambitious effort than that. My fondest wish would be

that we could come together around a plan that would reduce the debt from what otherwise will occur by about \$5.5 to \$5.6 trillion.

Why do I pick that number? Because we could balance the budget in 10 years if we put in place a plan of that magnitude.

The timing of when it begins is critical because the economy is still weak, so I would not personally start tough medicine until we see the economy doing better. But I would put in place the plan right now to achieve the kind of debt reductions that I have described. I believe that would be a tonic for confidence in the economy. I believe it would help assure markets that we are serious about the fiscal affairs of our country.

With that, I am going to stop. I apologize for the length of that opening statement, but there is a lot to talk about in our first meeting.

Senator Sessions, welcome back.

#### **OPENING STATEMENT OF SENATOR SESSIONS**

Senator SESSIONS. Thank you, and I agree with you that a plan now is needed. I do believe that it would, in fact, provide tonic, as you say, or a confidence in our business world and the world around us that we have our house in order.

One of the things that is destabilizing the recovery is lack of confidence that we have our house in order. And balancing the budget in 10 years would be a really good goal, and I believe we could do it, but it would not be easy, as Mr. Chairman.

So we are entering the budget season for fiscal year 2013. Producing a budget for public accountability and scrutiny represents one of the fundamental duties of our government particularly during times of economic stress.

The last time the chamber's majority authored and presented to the floor a budget plan was in 2009. I believe that was 1,002 days ago.

Senator Conrad, I do appreciate your expressed desire to work on a budget resolution, and I look forward to working with you.

For too long, Washington has been spending what we do not have, borrowing what we are not able to pay back. It has become a habit. Our debt is now greater than our entire gross domestic product—our gross debt is—pulling down growth today and casting a shadow of doubt on our economic future. I believe it is impacting growth today. We would have higher growth today if we did not have so much debt.

Americans were promised that a surge in spending would lead to corresponding job creation. Certainly, the amount of money that has been spent should have provided some help in the short run. But I would point out that our job situation is not good. The number of people working today, 131.9 million, is less than in 2000. That was 132.5 million. We had more people working in the year 2000 than we have today. We are not creating sufficient jobs.

I heard one of the French ministers this morning on BBC saying that they have to get their debt under control but, most importantly, make the French economy more productive and grow.

The middle class is being squeezed from all directions. Real wages are declining. Inflation is at 3 percent, but wages are only growing by 2 percent. That is not a winning combination. Food and

energy prices are rising. Job prospects remain scarce. Health expenditures, which we hoped and were told would go down, are going to be up, for a family of four, by \$200 a month—\$2,400 according to CBO. So after nearly \$5 trillion in new debt over just 3 years, the Government is continuing to grow, while the middle class is continuing to shrink.

The CBO warned us, for instance, that the President's first stimulus package—and they accounted for this carefully—ultimately would be a net drag on the economy. Yes, they said you would have a short-term benefit, but that stimulus is now gone. The money is spent, the short-term benefit is now gone. But we are carrying the burden of that debt still. So we are adopting policies that I am afraid are leaving us weaker not stronger in the long run.

In his State of the Union Tuesday, President Obama had a chance to tell the American people the truth about the depth of the danger we face, as the debt commission told us. He missed perhaps his last opportunity to rally the American people to make some tough decisions that will feel tough but will not require us to savage this Government spending.

I was astonished at how little the President spoke of our mounting debt and fiscal obligations. Over 10 years, the Super Committee finally agreed Mr. Chairman, to only \$2 trillion in deficit reduction instead of the 4 that we have been told repeatedly is the absolute minimum. And you have said you would like to see more. We will spend \$45 trillion in the next 10 years, and we will add \$12.4 trillion to the gross debt. So I do not think a \$4 trillion reduction in that expected growth of debt is too much to ask. I really do not.

The President did not outline a plan to go beyond that \$2.0 trillion. He even called for spending half of the war saving, the money that we were borrowing to fund the war. We were hoping to reduce that amount of borrowing and stop increasing the debt by bringing the war costs down. And now he proposed spending at least half of that on new programs.

We hear the argument that spending cuts should be deferred, but this I think goes against common sense, and the political reality. The American people are ready to hear the truth, and they are willing to take some action. We have to move when we have the consensus to move, and I am really troubled that we might lose the consensus we have to make some real good changes that I thought the last election led us to.

Mr. Chairman, we should focus on solid policies, creating jobs without adding to debt wherever possible. More growth, more jobs, without more debt, that means more domestic energy exploration, American energy; fewer burdensome regulations, the ones that do not work and do not provide benefit; a streamlined Tax Code focused on growth; more free market competition in health care, not more Government domination; a trade and immigration policy that serves our national interest and legitimately protects our American workers. It means making the Government leaner itself and more productive. That would make America stronger and healthier.

The President says he wants America build to last, but we cannot do that on borrowed money. Debt is not an asset. Spending is not the virtue. Borrowing cannot be our future.

Thank you.

Chairman CONRAD. I thank the Senator, and I just want to say there are places where we disagree and, we are going to have a really good debate in this Committee, and hopefully we are going to have a really good debate on the floor of the Senate. But while there are places we disagree, there are places where we are in strong agreement. Especially the place where I see that we are in strong agreement is the need for a substantial plan to deal with the debt over this next 10 years.

You know, if we could find a way to come together on this Committee—and, look, I have been here 25 years. I am not operating under any illusions. This is an election year. But I do believe if we could find a way to come together around this Committee, that in itself would be a boost to confidence in the country. So let us try. You have my commitment. I am eager—this is my last year I am going to be here. I am not burdened with a re-election campaign. I will spend every possible moment focused on trying to achieve a result, and I ask all members—I know it is hard. We all have taken positions on things we feel strongly about. But if none of us are willing to give any ground, we are not going to succeed. It is going to take all of us to give some ground on things we hold dear to find a way to come together. And I say it on both sides. On both sides. And I plead with colleagues: Let us give it our absolute best shot. Let us give it our best shot. I pledge to do that.

Senator SESSIONS. Well, you have taken action, too. You have said we are going forward. You made a decision to go forward with the budget process, and that is real action. I think that is a good first step. Thank you.

Chairman CONRAD. I thank you.

We will go to our witnesses. Dr. Blinder, we will start with you, and we will go right down the table. Seven minutes, if you would try to hold to that. Your full testimony will be made part of the record, and then we will open the panel up to questions. And, again, thank you very, very much for being here. I appreciate it.

Dr. Blinder.

**STATEMENT OF ALAN S. BLINDER, PH.D., GORDON S. RENTSCHLER MEMORIAL PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, PRINCETON UNIVERSITY, AND VICE CHAIRMAN, PROMONTORY INTERFINANCIAL NETWORK**

Mr. BLINDER. Well, Chairman Conrad, Ranking Member Sessions, and members of the Committee, I would like to thank you for the opportunity to share my views on the economy and the budget with you today.

I think even in this very fractious climate, everyone agrees that the recovery from the Great Recession has been far too weak. Both of you spoke to that. We are getting new GDP numbers tomorrow, but the ones we have now show a compound annual growth rate since the recession ended of only 2.4 percent. That is a rate we would be satisfied with if we started at 5-percent unemployment. It is a rate that is just totally unsatisfactory, starting from 10-percent employment, and the growth rate over the last three quarters has only been about half that.

Some observers view this weak macroeconomic performance as unsurprising and maybe even inevitable, given the devastating fi-

nancial crisis that brought about the recession. You have alluded—you have more than alluded to. You mentioned the analysis of Carmen Reinhart and Ken Rogoff, which is justly celebrated, showing that it takes a very long time for economies to recover from banking and financial crises. But what is rarely noticed about that and was pointed out in a very nice paper recently by three researchers at the Fed is that the extraordinarily poor performance over a decade is not so much from the slow recoveries after the bottom; it is that the bottom is so deep, and it just takes a very, very long time to climb out.

And that should be a lesson to all of us. It means that we are not condemned to a sluggish recovery in terms of growth rate, much less one that never gets us back to full unemployment, as you hear some people claiming. There are many, many factors relevant to the speed of any economic recovery, including both national economic policy and luck. I want to start with the first and then finish with the second. It would be nice to have a little luck.

The U.S. policy response to the devastating recession was vigorous, as you said, Mr. Chairman, but it is petering out, as you also mentioned. The Fed deserves a lot of kudos for what it has done, but I want to focus here, of course, on congressional actions.

I realize that, for many members, voting for TARP back in 2008 was about as much fun as root canal work. But I have little doubt that history will record that that vote, the vote for the Recovery Act in February 2009, followed then by the very successful bank stress tests that spring—which, by the way, required the TARP money behind them to be effective really turned the tide, making a horrific situation merely terrible.

That is a hard point to make, right? We wound up at a terrible point. It could have been much, much worse.

In that paper with Mark Zandi that you mentioned, Mr. Chairman, we used a large-scale model of the U.S. economy, not Macro Advisers' model, the Moodyseconomy.com model to estimate the overall impact of all of these policy responses, taken together, on the economy. And I think, as far as I know, it is the only such estimate to this day. There are many estimates of the effects of the Recovery Act, for example, but there were many, many things done on the financial arena.

We estimated that all those policy responses together added 10 million jobs in 2011 and 2012. It is roughly the same number for 2011 and 2012. If you translate that to the unemployment rate, that is roughly 6.5 percentage points. So if that is anywhere near correct, just think about it, that instead of 8.5 we would now be at 15. Maybe that is wrong, but if it is even close to the ballpark, that is just an unthinkable bad outcome that we avoided.

Now, the spending from the TARP, of course, is long gone, and spending from the Recovery Act peaked in 2009 and has been declining ever since. In fiscal year 2011, that amounted to roughly 1 percent of GDP from the Recovery Act; in fiscal 2012, it will be perhaps half that amount, just as a ballpark number.

Correspondingly, if you look at the Federal spending component of GDP, it has been negative. It has been falling since the third quarter of 2010. This comes to the point about the near-term fiscal

drag that you mentioned in your opening statement, Mr. Chairman.

I published an op-ed in the Wall Street Journal a week ago, exploding what I called four myths about the budget deficit. I am not going to go over all four of them now. One was that we have an urgent deficit problem that has to be tackled right away so we do not become the next Greece. That has a corollary the notion that if there is any fiscal stimulus, you have to pay for it immediately, if not sooner, lest we spook the markets.

In fact, if you look at the markets, they are practically falling over themselves to lend money to the Federal Government—the United States Federal Government, not to some other governments—at negative real interest rates. So I suggested there as an example a package that would spend another \$500 billion in the near term and pay for it 10 times over, with \$5 trillion worth of deficit reduction. I would support that kind of a policy if you changed the 5 to a 6, to a 4, to a 3, almost any number.

A second myth, which I know comes straight from your legal mandate to deal with 10-year budget windows, is the obsession on the next 10 years. In fact, if you look at the CBO long-term projections, what happens over the next 5 years is actually quite benign and what happens over the next 10 does not matter very much. It is after that that things explode entirely out of control, almost completely due to health care spending. So that is the issue.

Finally, in the last minute I see on the clock, to the luck issue. My rough outlook for GDP growth in calendar year 2012 is about 2.5 percent, the same tepid pace that we have been experiencing since the recession, minus whatever we lose to bad luck. The biggest threat on the economy is contagion from Europe, financial contagion from Europe. The latest news on that in the last few days or a week or so is pretty good, but it turns good and it turns bad, and we just cannot count on that. It could change any day. And if we get a worst-case scenario, a European financial blowup that looks somewhat like Lehman Brothers—it would not be exactly like Lehman Brothers; the details would be entirely different—I think almost all, if not all of that putative 2.5-percent growth could just evaporate in a worldwide recession.

The other major risk, which I cannot begin to calculate, comes from the Middle East and oil. So far that looks okay, but who knows what might happen there.

So, in sum, I would say the near-term outlook for the economy is for mediocrity if we are lucky and stagnation if we are not lucky. And I would have hoped that the United States of America had higher aspirations than that. And I would also have hoped that fiscal policy would help, not hinder, this recovery.

Thank you very much for listening. I would be happy to answer any questions in the question period.

[The prepared statement of Mr. Blinder follows:]

**Testimony of  
Alan S. Blinder  
Gordon S. Rentschler Memorial Professor of Economics and Public Affairs,  
Princeton University and  
Vice-Chairman, Promontory Interfinancial Network  
to the  
Committee on the Budget  
United States Senate  
January 26, 2012**

Chairman Conrad, Ranking Member Sessions, members of the Committee, I'd like to thank you for the opportunity to share my views on the economy and the budget with you today.

Even in this fractious climate, I think everyone agrees that the recovery from the Great Recession has been far too weak. New GDP numbers are out tomorrow, but the ones in hand today show a compound annual growth rate of real GDP of only 2.4% since the recovery began. That's a rate we should be satisfied with starting from full employment, not from the massive unemployment of mid-2009. And growth over the last three quarters has averaged only about half that pace.

Some observers view this weak macroeconomic performance as unsurprising, maybe even inevitable, given the devastating financial crisis that brought on the recession. In a justly-famous book, Carmen Reinhart and Ken Rogoff emphasized that it takes a long time for economies to recover from banking and financial crises.<sup>1</sup> But what is often not noticed is that the main reason behind this discouraging fact is the extraordinary depth of the recessions that financial crises cause, *not* the slow recoveries thereafter, as three Federal Reserve researchers

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<sup>1</sup> Carmen Reinhart and Kenneth Rogoff, *This Time Is Different*, Princeton University Press, 2009.

have recently pointed out in an important paper.<sup>2</sup> It takes a long time to climb out because the hole is so deep, not because the ascent is so slow.

That should be a lesson to us all. We are not condemned to a sluggish recovery, much less to one that never gets the unemployment rate back below 6% or 7%, as some have claimed. Many factors are relevant to the speed of an economic recovery, including both national economic policy and luck. Let me start with the first and finish with the second.

The U.S. policy response to the devastating recession was vigorous, but is petering out. The Federal Reserve promulgated a veritable laundry list of, first, emergency responses to the crisis and, then, measures to support the recovery. The Fed deserves kudos for all this, and it is probably not finished. But it is down to very weak weapons, and I want to focus here on congressional actions instead.

I realize that, for many members, voting for TARP was about as much fun as root canal work. After all, how many voters have ever thanked their elected representatives for bailing out banks? But I have little doubt that history will record that the votes for TARP in October 2008 and the Recovery Act in February 2009, followed by the highly-successful bank stress tests that spring (which required the availability of TARP funds), turned the tide--making a horrific situation merely terrible.

In a 2010 paper, Mark Zandi and I used a large-scale model of the U.S. economy to estimate the overall impact of all the policy responses, taken together, on the economy.<sup>3</sup> It is still, to my knowledge, the only such estimate. We estimated that the policy responses made

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<sup>2</sup> Greg Howard, Robert Martin, and Beth Anne Wilson, "Are Recoveries from Banking and Financial Crises Really So Different?," International Finance Discussion Papers No. 2011-1037, November 2011.

<sup>3</sup> Alan S. Blinder and Mark Zandi, "How the Great Recession Was Brought to an End," Moody's Analytics, July 2010.

employment about 10 million jobs *higher than it otherwise would have been* in both 2011 and 2012. That translates, roughly, to an unemployment rate about 6½% *lower* than it otherwise would have been.

Spending from the TARP, of course, is long gone, although some funds are still outstanding. Spending and tax cuts from the Recovery Act peaked in the second and third quarters of 2009, and have been more or less declining ever since. In fiscal year 2011, they amounted to about 1% of GDP; in fiscal 2012, they will be perhaps half that amount. In other words, without the December 2010 extension of the payroll and income tax cuts, the *change* in fiscal stimulus would have turned notably *negative*--a drag on growth. Correspondingly, if you look at the major components of real GDP growth, the contribution of Federal government purchases of goods and services has been mostly *negative* since the third quarter of 2010. This fact does not accord at all with the popular notion that we are suffering from a bout of runaway federal spending. It is also one reason why the recovery has been so tepid. (Failure to address the foreclosure problem is another.)

A week ago, I published an op-ed piece in the *Wall Street Journal*, exploding what I called four myths about the budget deficit.<sup>4</sup> One of them is that we have an urgent deficit problem that must be tackled right away, lest we become the next Greece. On this view, any further fiscal stimulus must be "paid for" immediately, lest we spook the markets. But in fact, world financial markets are eager to lend the United States government vast amounts at *negative* real interest rates. That means that, in purchasing power terms, they are paying *us* to borrow *their* money! As an example of sensible budget policy in today's environment, I suggested coupling

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<sup>4</sup> Alan S. Blinder, "Four Deficit Myths and a Frightening Fact," *Wall Street Journal*, January 19, 2012.

another \$500 billion in stimulus spending with \$5 *trillion* in deficit reduction, enacted now but not starting until, say, 2014.

A second myth, which I realize comes straight from the conventional ten-year budget window, is the obsessive focus on the next ten years. In fact, if you look at CBOs long-term projections, what happens over the next five years is fairly benign, and what happens over the next ten barely matters (except as prologue to the future). Our deficit problem is a whopper, but it is much longer-term than that. The deficit and debt only start exploding in the 2020s, the 2030s, and beyond.

Why? The answer is remarkably simple: healthcare costs. As I noted in that *Journal* piece, 100% or more of the projected increase in the *primary* (that is, non-interest) deficit comes from rising healthcare expenditures.

Finally, to the luck issue: My outlook for calendar year 2012 is for roughly 2½% growth, the same tepid pace we have averaged since 2009, *minus* whatever we lose to bad macroeconomic luck. The biggest threat on the horizon is financial contagion from Europe. The latest news on that front is pretty good, if you don't look too hard at Greece. But that could change any day. If the European financial system blows up in post-Lehman fashion, most or all of that putative 2½% growth could go down the drain.

The other major risk--which, to me, is incalculable--comes from the Middle East and oil prices. Modest fluctuations in oil prices are macroeconomically negligible events. But if, say, a closing of the Strait of Hormuz sends oil prices skyrocketing, the damage to the US economy could be consequential.

So, in sum, the near-term outlook is for mediocrity if we are lucky and stagnation if we are not. I would have hoped the United States of America had higher aspirations than that. I would also have hoped that fiscal policy would help, not hinder, the recovery.

Thank you very much for listening. I would be happy to answer any questions.

Chairman CONRAD. Thank you very much.  
Dr. Prakken, again, welcome, and please proceed with your testimony.

**STATEMENT OF JOEL PRAKKEN, PH.D., SENIOR MANAGING  
DIRECTOR, MACROECONOMIC ADVISERS**

Mr. PRAKKEN. Chairman Conrad, distinguished members of the Committee, my name is Joel Prakken, and I am the senior managing director of Macroeconomic Advisers, a forecasting firm in St. Louis that I founded in 1982. Thank you for inviting me to this hearing to discuss the risks and uncertainties surrounding the U.S. and global economic outlook for 2012 and what policymakers might do to improve it.

Our outlook, like Alan's, for 2012 is guarded. We see the Nation's real GDP growing only about 2.25 percent over the year. This is not fast enough to lower the unemployment rate below the current 8.5 percent. Indeed, unemployment could drift up modestly from here over the next 12 months. Given that much slack in labor and product markets, inflation will remain subdued; consumer prices likely will rise only about 1.5 percent over the course of the year. But with unemployment that far above the full employment benchmark and inflation below the 2 percent that we believe the Fed implicitly targets, monetary policy will remain accommodative and interest rates extraordinarily low by historical standards.

Consumer spending will grow at about the same pace as GDP. Private domestic investment will grow somewhat faster. A narrowing trade deficit will be a modest boost to growth, but fiscal policy will restrain the recovery, and this fiscal restraint has three components. First, the stimulus associated with the American Recovery and Reinvestment Act of 2009 is abating. Second, the caps on discretionary spending passed as part of the Budget Control Act of 2011 will start to bite. And, third, in the face of ongoing fiscal pressures, State and local governments will continue to trim spending and boost taxes in order to comply with their balanced budget mandates.

Where are we in the deleveraging process that all of us are concerned with? At least at the aggregate level, there are indications that in the United States we are nearing the end of the first stage of the deleveraging process. Corporations—well, at least large corporations—are flush with internally generated funds and boast well-structured balance sheets. The personal saving rate appears to have stabilized far below the 8 to 10 percent that some pundits were forecasting just a few years back. House prices have fallen back into proximate historical alignment with incomes and rents. And thanks to consumers' retrenchment and very low interest rates, the ratio of households' debt service to disposable income has retreated to a very low level.

Yet this steadily brightening picture masks other legacies of the Great Recession. A sizable percentage of homeowners remain underwater on their mortgages, and there can be little doubt that this is both a drag on consumer spending, the housing rebound, as well as an impediment to labor mobility that contributes to high structural unemployment. Furthermore, the deleveraging process has other secondary dimensions now coming more forcefully into play

as the economy strains to expand. Credit standards have tightened, especially in the residential mortgage market where qualifying credit scores and loan-to-value ratios linger well above recent historical norms. It can prove difficult to secure financing or refinancing for commercial real estate projects, especially those originated or refinanced at the height of the real estate boom 5 years ago. Federal regulations intended to define, identify, and curtail systemic financial risk are now under development. All these secondary dimensions of the deleveraging process might safeguard the economy and improve the quality of the expansion, but they do also restrain the pace of the recovery.

Now, in my 30 years in this business, I have never known as much uncertainty to surround our forecasts as is the case today, and I want to discuss briefly with you several areas of risk and uncertainty that are critical to how the economic environment may evolve over the next several years, areas about which I think many economists actually agree, although there could be some reasonable disagreement on some of these points. But first let me address fiscal policy.

Now, we prepare our forecasts using an economic model that requires us to make explicit assumptions, very explicit assumptions, about future fiscal policies. This was a lot easier in the old days. Changes in the formulas governing mandatory benefits, changes in the Tax Code, and major changes in discretionary spending were relatively infrequent and usually considered permanent in nature. Now the fiscal landscape is cluttered with temporary policies the extensions, modifications, or expirations of which can have measurable, indeed sizable, impacts on our forecast.

Now, I do not know how all these things are going to play out, and I would be suspicious of any forecaster that claims he or she does. But for what it is worth, and to give you a sense of the challenge here, our forecast assumes that the payroll tax holiday and emergency unemployment benefits are extended through December but will be paid for gradually over the next decade, that the AMT will be patched, that docs will be fixed, that health care reform will not be repealed, that most of the Bush tax cuts will be extended, that a full sequester will be avoided, and that a grander bargain on gradual deficit reduction will be achieved. A lot of assumptions there. However, imagine the enormous fiscal drag in 2013—roughly 5 percent of GDP—should, either by political design or political miscalculation, the tax holiday, unemployment benefits, the AMT patch, the doc fix and the Bush tax cuts all expire even as the new health care taxes take hold and discretionary spending is sequestered. Furthermore, all that could happen in a still sputtering economy when the Fed, having already fired most of the arrows in its monetary quiver, cannot respond aggressively or, even worse, might be politically constrained from responding at all. In our modeling, that is a recipe for a recession.

I want to talk about the euro crisis. We view the slow-motion train wreck that is the European sovereign debt crisis as the single largest downside risk to continued economic recovery here in the United States. Slower growth in the EZ means slower growth in U.S. exports to the region; it could also mean a higher value of the dollar, which makes goods and services produced in the U.S. less

competitive in global markets. But far more important would be the financial contagion that could spread around the globe, without regard to borders, if an uncontrolled Lehman event occurs within the European financial system this year. The prices of risky assets around the world would decline together even as the dollar strengthened. If the financial tsunami was severe enough, it could tip the U.S. into the back end of a double-dip recession. And this does not even consider the possibility of the dissolution, either in part or in full, of the euro itself.

House prices, my last point. The issue here is that home buyers and home builders delay buying and building if the expectation is for further declines in house prices. The consensus forecast is for house prices to begin rising modestly, and that certainly would be good news. Rising, rather than falling, house prices would lower the real or inflation-adjusted cost of mortgage finance, and thereby supporting housing demand. They also would boost households' net worth and prevent foreclosures, thereby supporting consumer spending.

Unfortunately, it is difficult to be confident in the consensus forecast for house prices. For one thing, not that long ago the consensus was for house prices to turn up last year. And for another, no one knows for sure how large is the shadow inventory of houses that could be brought to market the moment potential sellers sense that prices have bottomed out, thereby renewing the downward pressure on prices all over again and delaying for even longer the eventual turnaround in housing.

So as the economy approaches the 3-year mark of this recovery, the coming year or two are likely to see growth and utilization rates that, while not especially surprising given the circumstances, will nonetheless feel and be very disappointing. Furthermore, the risks to the forecast and the uncertainties surrounding them have seldom, if ever, been as varied or as prevalent as they now are, and neither our monetary or fiscal authorities are well positioned or even inclined to counter adverse shocks to the economy. In short, these will be very trying times.

Now, you can call me a cockeyed optimist because, at least from my viewpoint, I can imagine worse outcomes than the ones I do consider most likely. But I surely hope not to see those.

Thank you for your kind attention today and for the opportunity to offer my advice.

[The prepared statement of Mr. Prakken follows:]

## The Economic Outlook: Risks and Uncertainties

Testimony of Joel Prakken, Macroeconomic Advisers

Senate Budget Committee

January 26, 2012

Chairman Conrad and distinguished members of the Committee. My name is Joel Prakken. I am Senior Managing Director of Macroeconomic Advisers, a forecasting firm in Saint Louis that I co-founded in 1982. Thank you for inviting me to this hearing to discuss the risks and uncertainties surrounding the U.S. and global economic outlook for 2012, and what policymakers might do to improve it.

### A Guarded Outlook

Our outlook for 2012 is guarded. We see the nation's real Gross Domestic Product growing only about 2¼% over the year. This is not fast enough to lower the unemployment rate below the current 8½%. Indeed, unemployment could drift up modestly from here. Given that much slack in labor (and product) markets, "core" inflation will remain subdued; consumer prices likely will rise only about 1½% over the year. With the unemployment rate above "full employment" and inflation below the 2% we believe the Fed (implicitly) targets, monetary policy will remain accommodative and interest rates extraordinarily low by historical standards.

Consumer spending will grow at about the same pace as GDP. Gross private domestic investment will grow somewhat faster. A narrowing trade deficit will be a modest boost to growth, but fiscal policy will restrain the recovery. This fiscal restraint has three components. First, the stimulus associated with the American Recovery and Reinvestment Act of 2009 is abating. Second, the caps on discretionary spending passed as part of the Budget Control Act of 2011 will start to bite. And third, in the face of ongoing fiscal pressures, state and local governments will continue to trim spending and boost taxes in order to comply with their balanced-budget mandates. For fiscal 2012, we

expect the federal deficit (on a unified budget basis) to top \$1.1 trillion for the fourth consecutive year.

#### Where are We in the Deleveraging Process?

It is generally accepted in the forecasting profession that economic recoveries following recessions precipitated by financial crises are slowed by the process of “deleveraging”. So far, the ongoing recovery in the U.S. appears to be no exception to this rule, especially when compared to the strength of the recovery normally associated with an “output gap” as large as that which developed in 2009.

At least at the aggregate level, there are indications the U.S. is nearing the end of the first stage of the deleveraging process. Corporations — well, at least large corporations—are flush with internally generated funds and boast well-structured balance sheets. The personal saving rate appears to have stabilized far short of the 8% to 10% that some pundits (although not this one!) were forecasting a few years back. House prices have fallen back into proximate historical alignment with incomes and rents. Thanks to consumers’ retrenchment and very low interest rates, the ratio of households’ debt service to disposable income has retreated to a very low level.

Yet this steadily brightening picture masks other legacies of the “great recession.” A sizable percentage of homeowners remain “underwater” on their mortgages, and there can be little doubt this is both a drag on consumer spending and an impediment to labor mobility that contributes to high “structural” unemployment. Furthermore, the deleveraging process has other “secondary” dimensions now coming more forcefully into play as the economy strains to expand. Credit standards have tightened, especially in the residential mortgage market where qualifying credit scores and loan-to-value ratios linger well above recent historical norms. It can prove difficult to secure financing or re-financing for commercial real estate projects, especially those originated or re-financed at the height of the real estate “boom” five years ago. Federal regulations intended to define, identify, and curtail systemic financial risk are under development. These

secondary dimensions of the deleveraging process might safeguard the economy and improve the “quality” of the expansion, but they do also restrain the pace of recovery.

#### Through the Looking Glass

Economists, especially economists with computers (like me; OK, including me!) produce forecasts that can convey a false sense of understanding and precision. In that regard, in my 30 years in this business, I have never known as much uncertainty to surround our forecasts as is the case today. The distribution of possible outcomes is not tightly or even symmetrically clustered around a central tendency. Indeed, recently I find myself thinking that our clients might be better served if we gave them a long list of alternative outcomes or scenarios, each dependent on a particular set of assumptions, and let them choose for themselves the assumptions (and hence outcomes) that they believe are most likely. To clarify my angst over all this, I want to discuss briefly five areas of risk and uncertainty critical to how the economic environment may evolve over the next several years—areas about which many economists disagree.

#### Fiscal Policy

We prepare our forecasts using an economic model that requires us to make explicit assumptions about future fiscal policies. This was a lot easier in the “old days!” Changes in the formulas governing “mandatory” benefits, changes in the tax code, and major changes in discretionary spending were relatively infrequent and usually considered permanent in nature. Now the fiscal landscape is cluttered with temporary policies the extensions, modifications, or expirations of which can have measurable, indeed sizable, impacts on our forecast.

Will the current “payroll” tax holiday and federal emergency unemployment benefits be extended beyond February? If so, will they be extended beyond 2012? How will they be paid for? When will they be paid for? Will the “Bush tax cuts”, either in part or in their entirety, sunset in 2013? Will the “AMT patch” and the “Doc fix” be extended (again)?

Will the Affordable Healthcare Act and the related tax increases scheduled for 2013 be repealed after the upcoming presidential election? Will there be a “sequester” of discretionary spending in 2013 because the Congressional “Super Committee” “failed,” or will some form of that Committee reconvene during 2012 and “succeed?”

I don’t pretend to know for sure how all this will play out, and I’d be suspicious of any forecaster that claims he or she does know. For what it is worth, our forecast assumes the payroll tax holiday and emergency unemployment benefits are extended through December but will be paid for gradually over the next decade, that the AMT will be patched, that “docs” will be fixed, that healthcare reform will not be repealed, that most of the Bush tax cut will be extended, that a full sequester will be avoided, and that a grander bargain on gradual deficit reduction will be achieved. However, imagine the enormous fiscal drag in 2013 — roughly 5% of GDP — should, either by political design or political miscalculation, the tax holiday, unemployment benefits, the AMT patch, the Doc fix and the Bush Tax cuts all expire even as the new health care taxes take hold and discretionary spending is sequestered. Furthermore, all this could occur in a still-sputtering economy when the Fed, having already fired most of the arrows in its monetary quiver, cannot respond aggressively or, even worse, might be politically constrained from responding at all. In our modeling, that is a recipe for at least a “growth recession”, if not an outright one.

And then there is this: a relatively new but growing and interesting empirical literature suggests that the very existence of such policy uncertainty restrains economic growth. The intuition is simple to grasp. If you don’t know in what policy environment you will be spending, saving, investing, and working, there is natural inclination simply to delay important decisions and actions until more clarity is achieved. Alas, with the growing number of temporary provisions clouding the fiscal crystal ball, opaqueness is trumping clarity, and quite handily.

### Monetary Policy

The Federal Reserve Open Market Committee is in uncharted territory, never before having used the unconventional policy tools wielded of late or having to contemplate an “exit strategy” that simultaneously envisions raising short-term interest rates off the “zero bound” and shrinking, as economic conditions dictate, a temporarily bloated balance sheet while restructuring both the composition and the duration of its portfolio. “On paper” the FOMC knows how to do all this while preserving its credibility as stalwart against inflation. Still, the novelty of the situation implies risks not previously encountered. We assume the Fed engineers an eventual graceful return to both normal interest rates and a normal balance sheet, but others are less sanguine about this. In the meantime, however, the FOMC is not well-positioned to respond to a near-term adverse economic “shock”, and this inflexibility heightens downside risks to the outlook.

### Euro Crisis

We view the slow motion train wreck that is the European sovereign debt crisis as the single largest downside risk to continued economic recovery here in the United States. Slower growth in the Euro-zone means slower growth in U.S. exports to the region; it could also mean a higher value of the dollar, which makes goods and services produced in the U.S. less competitive in global markets. But far more important would be the financial contagion that could spread around the globe, without regard to borders, if an uncontrolled “Lehman event” occurs within the European financial system this year. The prices of risky assets around the world would decline together even as the dollar strengthened. If the financial tsunami was severe enough it could tip the U.S. into the back end of a “double dip” recession. And this doesn’t even consider dissolution, either in part or in full, of the Euro itself, the near-term economic consequences of which would, in our judgment, be much more severe.

Our forecast assumes that a sharp but not unprecedented recession in Europe started in the fourth quarter of 2011 but that it will end by mid-year, and that the policy response unfolding in Europe is enough to head off the worse scenario mentioned above. Recent developments out of Europe are promising. In particular, the decision by the European Central Bank to lend to private banks so they, in turn, can buy troubled sovereign debt seems to be working...for now. Alas, this hasn't fixed the fundamental fiscal imbalance at the heart of the problem in the "PIGS" and other peripheral European countries, and circumstances in Europe could quickly deteriorate very quickly and at any moment. Furthermore, colleagues with an ear close to the European third rail, as it were, suggest to us that the odds of something so untoward happening are about as high as the happier outcome we've assumed. I might add, however, that the recent European experience should give pause to those who argue that sharp fiscal contractions are expansionary in the short run!

#### House Prices

During the great recession residential construction fell from roughly 6% of nominal GDP to hardly more than 2%, seemingly too small to even matter anymore. Even so, we believe it unlikely that the U.S. can enjoy really robust growth without housing sharing prominently in the recovery. The issue, of course, is that homebuyers and homebuilders delay buying and building if the expectation is for further declines in house prices. The consensus forecast, which we have adopted, is for house prices to begin rising modestly next year (that is, 2013). That would certainly be good news. Rising, rather than falling, house prices would lower the "real" or inflation-adjusted cost of mortgage finance, thereby supporting housing demand. They also would boost households' net worth and prevent foreclosures, thereby supporting consumer spending. Unfortunately, it is difficult to be confident in the consensus forecast for house prices. For one thing, not that long ago the consensus was for house prices to turn up... in 2011! For another, no one knows for sure how large is the "shadow inventory" of houses that could be brought to market the moment potential sellers sense that prices have bottomed out, thereby renewing the

downward pressure on prices all over again and delaying for even longer the eventual turn-around in housing.

Now when that turnaround finally does come, it could be strong indeed. Steadily accumulating pent-up demographic demand suggests the U.S. will have to build an average of perhaps 1.5 million units per year over the coming decade. This implies about a 300 percent (yes, 300 percent) increase from current levels. Importantly, the tilt of reviving construction could be towards multi-family rental units as today's new financial realities discourage home ownership.

In the meantime, one has to wonder whether more couldn't be done to support house prices with relatively (if any) net risk to taxpayers. The price of a house can fall dramatically when the property enters foreclosure, so policies that prevent foreclosures—especially so-called “strategic foreclosures”—could pay considerable economic dividends. Recent Administration efforts to facilitate mortgage re-financing and modification could and, in our judgment, should be widened to cover as many mortgages as is reasonably possible. Perhaps lenders could be allowed to share in future house price appreciation as a way to coax them to the refinancing table. Proposals for the GSEs to bulk sell properties for rental use also hold some promise.

#### Labor Force Participation

Over the past several years large numbers of people have stopped looking for work. The resulting decline in the labor force participation rate mitigated what otherwise would have been a much larger increase in the unemployment rate. Indeed, over the last year the unemployment rate has declined by about a percentage point despite anemic economic growth well below historical estimates of “trend”.

There is an active debate in the forecasting profession over whether this decline in participation is mostly cyclical—and so likely to be reversed as the economy improves—or more permanent or “structural” in nature. The answer to this question is important

partly because it determines the economy's potential for non-inflationary growth which, in turn, bears importantly on the deficit projections that will serve as the baseline for the fiscal wars sure to be waged over the next several years. Our work suggests there will be a cyclical rebound in labor force participation that will permit strong growth in the middle part of the coming decade—between 4% and 5% in some years—with a decline in the unemployment rate gradual enough to curtail any inflationary threat. Others, including the CBO, have a less optimistic take.

#### Concluding Remarks

As the economy approaches the 3-year mark of this recovery, the coming year or two are likely to see growth and utilization rates that, while not especially surprising given the circumstances, will nonetheless feel disappointing. Furthermore, the risks to the forecast and the uncertainties surrounding it have seldom, if ever, been as varied or as prevalent as they now are, and neither our monetary or fiscal authorities are well-positioned or even inclined to counter adverse shocks to the economy. In short, these will be trying times. But call me a cockeyed optimist because, at least from my viewpoint, I can imagine worse outcomes than the ones I do consider most likely.

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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Chairman CONRAD. Thank you, Dr. Prakken.  
Dr. Brannon.

**STATEMENT OF IKE BRANNON, PH.D., DIRECTOR OF  
ECONOMIC POLICY, AMERICAN ACTION FORUM**

Mr. BRANNON. Chairman Conrad, Ranking Member Sessions, members, thank you very much for the invitation.

As somebody who worked on the Hill nearly a decade as an economist and one of whose jobs was to inform members of economic forecasts, I just want to give the warning that it is really difficult to do economic forecasts, and I always try to caution my bosses not to put too much faith in them. And it is not to denigrate Dr. Prakken, who has by all accounts the best forecast out there. This is just an impossible thing to do.

If you look at forecasts, the way they work, generally people forecast next quarter something close to what this quarter is, and then the quarter after that is some kind of combination between long-run growth and what it was last quarter and then three quarters out it is more or less what they think long-term economic growth is.

This is not really a science, and as Dr. Prakken indicated, it is subject to all kinds of contingencies that might happen. And I think right now if you look at what is going on out there, there are a lot of risks to the economy. I think Dr. Blinder identified that who knows what is going to happen in the Middle East, who knows what is going to happen with oil prices, and I think as everybody who has spoken here has indicated, what happens in Europe is the real wild card.

There have been a few articles in the last few weeks—the Washington Post article yesterday refuted that. This idea that somehow there is a delinkage there, that somehow we are somehow immune from what might happen in Europe. I do not think that is the case at all. I think in an increasingly globalized society we are just very, very much at risk. And this idea that this might somehow benefit us because if capital flight leaves Europe and is looking for another place they will come here, that might be true in the short run, but, I take a little bit of an exception to Dr. Blinder. I just do not think that if we are going to run trillion-dollar deficits for the indefinite future, I think at some point that is going to start spooking markets, especially, as he indicated, if we have an entitlement debt that is growing and growing and growing and there has not really been any real movement to do anything about it.

I am not a big fan of fiscal policy. I think it is an interesting and fun game to play “What if?” What if we made certain changes—if we had not made certain changes in 2009, what would have been the impact? I just do not think the Government is ever going to be very—is going to be nimble enough to enact fiscal policy in a way that it benefits the economy. An example I like to give people has to do with

the favorite restaurant I have in Washington, D.C., which is Loebe’s Deli. It was located for 30 years at 15th and I Street. In early 2010, as part of a stimulus project, that building was remodeled, and all the ground-floor tenants were booted out in early 2010. It is 2012. The work still has not begun, and over 100 people

who worked in these ground-floor businesses ended up losing their jobs. Loebe's eventually a year later found a new place to work, but the Government does things very slowly. It is the nature of the beast. And we simply cannot count on, if there is some kind of new recession out there, caused perhaps by the euro crisis, we simply cannot count on the Government to nimbly respond to this with fiscal policy. And as both my counterparts have noted, the Federal Reserve does not have too many quivers left to deal with the current crisis we have. It is almost impossible to see how they can—they certainly cannot lower interest rates further. The twist is about done. It is really difficult to see what else they can do.

And so what I would like to encourage the Senators to think about, instead of thinking about the very short-run policies that we can do to stimulate the economy for the second or third or fourth quarter, just to think longer term and think what we can do to engender long-run economic growth. And the two things that I think are most obvious are things that have already been cited before. I think it is time to have a true entitlement reform occur. I think the Simpson-Bowles committee made an admirable first attempt at that, and I thought that would have been a wonderful place to begin. The Gang of Six also talked about this. Again, that would have been a great place to start the discussion. I wish that the members on both sides would have picked that up and run with that. I know as Chairman Conrad said, it is a really difficult time to do something like this during an election year, but it just seems to me that waiting one more year is something that we really cannot afford at this time, and for a number of reasons. Not only are health care costs rising, but another good thing that is happening that also happens to have a bad outcome is that longevity is increasing dramatically, especially from age 65 on.

So it is kind of interesting. If you look at the Centers for Disease Control data from 2000 to 2007, longevity increased for people at age 65 by nearly a year over that 7-year period. If longevity is going up for people who hit the retirement age by nearly 2 months a year, that is going to overwhelm our system, and that is something that Social Security and other actuaries really have not been able to account for yet. This is kind of one negative surprise of something that otherwise is a very good trend.

The other thing I would just like to say, since I am by training a tax economist, is it really is beyond time to have a Tax Code that looks like somebody designed it on purpose. As a former Treasury Secretary said so nimbly, "we do not do a very good job at encouraging investment; we do not do a very good job at encouraging all kinds of things." And just the complications that are endemic in the Tax Code is something that needs to be fixed.

To me it is obvious that there is a bipartisan solution that could keep rates relatively low, get rid of a lot of exemptions, things like the mortgage interest deduction, something I have written about quite a bit, or at least carve it down, and end up with more revenue and more reasonable rates and something that actually encourages economic growth rather than discourages economic growth.

It seems like entitlement reform and tax reform are two gigantic things, and I know it is difficult for Congress sometimes to do more

than one thing at a time, but to me it seems like this is a propitious time for the U.S. Senate to bite off as much as it possibly can.

Thank you.

[The prepared statement of Mr. Brannon follows:]

**Testimony to the Senate Budget Committee on the U.S. Economic Outlook**

**January 26<sup>th</sup>, 2012**

**Ike Brannon**

**American Action Forum**

I wish to thank Chairman Conrad and Ranking Member Sessions as well as the other members of the Committee for inviting me to talk about the U.S. Economic Outlook. I want to make clear that my opinions today are solely my own and should not be construed as reflecting the position of my employer, the American Action Forum.

I would like to state at the outset that I am not an economic forecaster, and have successfully avoided doing such activities for all but a small portion of my career. However, I have had reason to use economic forecasts throughout my career as an economist in the Treasury, the Office of Management and Budget, and for the U.S. Congress, among other positions, and have given copious consideration to the strengths and weaknesses of forecasts in general as well as in how they are used by politicians.

**The Problem with Economic Forecasts**

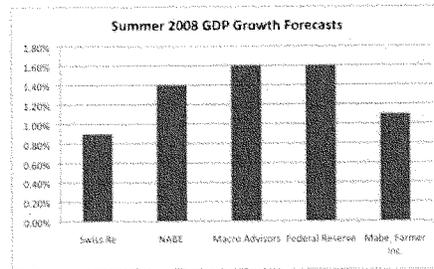
Before I opine on the U.S. economic outlook I'd like to begin by suggesting that most people put too much stock in the forecasts of economists. While some have compared the predictions of economic forecasters to those of meteorologists, to do so does the science of climatology a great disservice. Weather forecasts have improved considerably in the last three decades, thanks to improvements in data, advances in the understanding of their science, and the seismic increases in computing power available today. One meteorologist observed that today's forecast five days out is as reliable today as their two day forecast was just a generation ago.

There has been no such improvement in economic forecasts, despite improvements in data and in computing power available in our profession. I'll leave unexplained but implied the weak link that has hindered progress in economic forecasting. In general, economists are good at forecasting what the economy will be like in the future when there is no reason to think that any significant economic change will impact the economy: in such an absence forecasters generally conclude that the next quarter will be much like this quarter, and the quarter after that will trend towards our long-run equilibrium growth rate, and the quarter after that will probably be at the equilibrium growth rate, which is the same thing as saying "we have no idea what will happen that far in the future but if you have to guess, we'll guess the long-run average and be, on average, correct." This isn't science: it is mere extrapolation.

Figure 1 shows how poor the profession is at forecasting future growth when the economy is at a turning point. In the first and second quarter of 2008, at the precipice of the biggest post-war recession to befall the U.S. economy, none of the major entities that model the U.S. economy anticipated a

recession. By pointing out their amazing lack of perspicacity I do not mean to denigrate the competence of the Fed, Macro advisors, NABE, or anyone else, only to suggest that asking economists to come up with an accurate picture of the economy more than a few months into the future is a fool's errand, and we should take such forecasts with a grain of salt.

Figure 1:



And just as it is beyond the ability of mere economists to forecast the ups and downs of the economy past the immediate future, it is also beyond the ken to forecast how any government stimulus might affect the economy as well. In part it is because stimulus always comes at a turning point in the economy, where the usual formula of forecasting (doing a convex combination of last quarter's growth and long run trend) makes little sense.

The other problem is that I believe that fiscal stimulus is rarely effective at stimulating the economy. Keynesian economists who place credence in the ability of government to manage a business cycle insist that stimulus spending must be targeted and timely, and I submit that this does not in any way describe the 2009 stimulus program. I won't bore the Committee with a litany of examples where stimulus spending prescribed in the stimulus took years to get off the ground—but they are legion, from the home weatherization programs that waited over 18 months for the government to determine the appropriate prevailing wages<sup>1</sup> to a remodeling of a government building that began by evicting every ground floor retail tenant and nearly two years later has yet to begin remodeling.<sup>2</sup> Even this president has acknowledged that the definition of "shovel-ready" in the government does not, in fact, mean shovel-ready.

Even if the government were able to produce targeted and timely fiscal stimulus, I do not believe it would, in fact, have much of an impact on our macro economy. As I have explained elsewhere, most macroeconomists dismiss its impact, based on a perception of the world and the macroeconomy that is at odds with reality. In 2009 I wrote that:

<sup>1</sup> Jonathan Karl: "Stimulus Weatherization Program Boggled down by Red Tape." *ABC News*, February 17<sup>th</sup>, 2010.

<sup>2</sup> Ike Brannon: "What Happened to Loeb's Deli?" *Weekly Standard*, March 14<sup>th</sup> 2011.

*It is difficult to find a macroeconomics textbook these days that discusses Keynesian fiscal stimulus as a policy tool without serious flaws, which is why the current \$800-billion proposal has taken many macroeconomists by surprise. John Cochrane of the University of Chicago recently noted that the idea of fiscal stimulus is "taught only for its fallacies" in university courses these days. Thomas Sargent of New York University noted that "the calculations that I have seen supporting the stimulus package are back-of-the-envelope ones that ignore what we have learned in the last 60 years of macroeconomic research."<sup>3</sup>*

The problem, in short, is that responsible economic actors observing an endless string of trillion dollar deficits should rationally expect future tax increases as necessary to reduce these deficits. Putting more money in people's hands via government borrowing will result in much of that money being set aside to pay for future tax increases without any concomitant increase in aggregate demand, a concept economists call Ricardian Equivalence.

I think that harm has been done to our economy via the urgency to propagate some sort of massive stimulus program in 2009 and the multiple attempts to add stimulus of various sorts since then. Ryan Lizza documents in his recent article in the *New Yorker* that even the Administration recognized how difficult it was to effectively spend the amount of money they allocated in a way that would actually achieve anything useful—but political expediency and the desire for a nice, round number to sell won out over efficacy and frugality.<sup>4</sup> As a result, much of the policy focus has ignored the factors that can contribute to long-run economic growth, which is something that our government *can* do something about—but hasn't, at least over the past few years.

### **My Prognostication**

I would like to offer a few thoughts on where the U.S. economy might be expected to go in 2012 but more importantly I would like to lay out the pitfalls that might slow or stop this disappointingly slow economic expansion.

First, while the topic *du jour* of the economic press seems to be that the U.S. economy may go through a further deterioration of the Euro crisis unscathed, the result of a more tightly integrated global economy is not decoupling. In fact, the opposite is occurring: As financial markets (and major players) become more global in scope, it means that we should expect a greater synchronicity between the various economies of the world.

As a result, to some degree it doesn't matter whether the banks and financial institutions of the United States have labored to insulate themselves from any fallout from a possible collapse of

<sup>3</sup> Ike Brannon and Chris Edwards: "The Troubling Return of Keynesianism." *Cato Tax and Budget Bulletin*, January 2009.

<sup>4</sup> Ryan Lizza: "The Obama Memos: The Making of a Post-Partisan Presidency." *The New Yorker*, January 30 2012.

Greece, Italy, Spain, or the overall Euro-zone economy. Some of them have—despite pretences to the contrary—significant exposure to Europe and will take a hit if the Euro crisis deteriorates, but the fact that the market fears that there is significant U.S. exposure means that such an event will impact our economy regardless of the balance sheet of banks. We too have unsustainable deficits and a lack of political will to address them: It is hard to see why investors frightened of sovereign default risk would leave Euroland for the U.S.

An unraveling of the Greek debt crisis that leads to a contraction of the Euro would more likely trigger a contagion effect, dampening U.S. investment and consumption, as U.S. households hunker down in fear of another round of job losses, absence of raises, and general economic malaise.

There are other downside short-term risks to the U.S. economy: Middle East unrest from either a belligerent Iran or a destabilized Iraq could shoot up global energy prices, as would further instability in Nigeria or a messy aftermath of the Chavez reign, should he perish and descend to Hell.

And I am not sure the U.S. economy is in a spot where it can easily absorb a series of external shocks and continue unscathed. The overhang from the housing crisis continues to be a serious drag on the economy and I do not see that changing in the near future. To have nearly one in four homeowners underwater on their mortgages has created a problem not just for those homeowners but for their communities and the banks. Unemployed workers are more reluctant to move to where there are jobs, banks are more hesitant to lend, and few new homes are being built. I've advocated a fairly radical solution of allowing for a mortgage cramdown in the context of a chapter 13 bankruptcy elsewhere,<sup>5</sup> and I believe that without some sort of radical solution, our economy will at best muddle along at something close to our long-run average, which is not enough to make a dent in our inventory of unemployed workers.

The biggest problem with economic policy in the last few years is that the government has become too involved in the game. Businesses fear the flood of new regulations that the current administration has unleashed; there has been no serious effort to reform a seriously broken tax system, one in which a plethora of important provisions need to be renewed each year, leading to incredible uncertainty; and the one positive economic boon for our economy of late—the dramatic rise in domestic production of oil and gas—has been occurring in spite of opposition from a Democratic Congress and EPA, not because of it.

### **We Need a Better Umpire**

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<sup>5</sup> "A Cure for the Housing Blues," *The Weekly Standard*, November 7<sup>th</sup>, 2011.

Brett Butler was an all-star outfielder for the Braves and Dodgers in the 1990s and had a successful career that stretched over fifteen years. On the eve of his last game he was asked by reporters how the league had changed since he had first been promoted to the Major Leagues. He said—with not a bit of frustration—that earlier in his career he spent most of his preparation time studying the tendencies and abilities of the pitchers he was to face in the next game. However, the last few years in the league he felt the need to devote more and more time studying the predilections of the home plate umpire assigned to the game that night. The complete lack of standardization in the strike zone across leagues—and umpires—made the job of a hitter all the more difficult, and it took complaints from respected players like Brett Butler and others for MLB officials to finally do something about it.

Today, I submit that our economy has reached the same precipice as Major League Baseball did fifteen years ago. The legion of businesses who need to plan for the future find themselves more preoccupied with trying to discern what the government might do in tax and regulatory policy rather than focus on how to attract new business or provide their products more efficiently. Questions as to whether the aggressive regulatory agenda will continue through the election, the resolution of the expiration of the various tax cuts come 2013, or whether EPA will succeed in its efforts to rein in hydraulic fracturing and the construction of future coal plants weigh heavily not just on how forecasters view the economy but on how millions of businesses make future plans. And the uncertainty the government has injected into the economy makes that task all the more difficult.

Chairman CONRAD. Thank you, Dr. Brannon, and thank you very much for your references to the Fiscal Commission and the Group of Six and your references to the need for tax reform. I used to be a tax commissioner. I used to be chairman of the Multistate Tax Commission. And for anybody that is intimately familiar with the Tax Code, as I know you are, we are way past time to fundamentally reform it. It is an abomination. If you were going to sit down and design a Tax Code that would have the worst disincentives to the very things we all want to see happen—savings, investment, and economic growth—you would be hard pressed to do a worse job.

I am going to defer my questioning time to Senator Cardin, and then we will go to Senator Sessions and proceed with other members. I will reserve my time. Senator Cardin?

Senator CARDIN. Mr. Chairman, thank you very much, and let me thank all three of our witnesses. I found the testimony to be very persuasive that if we had not taken action, decisive action, today we would be faced with unemployment rates that are much higher and options that are much fewer. So I also take away from this, Mr. Chairman, from the testimony that has been given, that if we do not extend the unemployment insurance programs, if we do not deal with the payroll tax issue, if we do not deal with AMT, if we do not deal with the physician problems in Medicare, we are going to put a real anchor on our recovery and cost us employment. Our unemployment rates will go up.

So we have a short-term/long-term issue here, and I just want to associate myself with the comments of the Chairman and the Ranking Member that we need a deficit reduction plan over the next 10 years that a minimum reduces the deficit by \$4 trillion. And I agree with that. But in the short term, we have to take steps to counter some of the challenges to our economy. Our State and local governments are going to be reducing their input into the economy. That is for sure. They have no choice, and they really are relying upon the Federal Government to provide some assistance to our economy. We have to figure out a way to do that consistent with the long-term commitment to reduce our debt. And that is what we really need to do.

I want to ask a question, if I might, as it relates to the housing market. You all touched upon it somewhat briefly. We all know that it was the housing bubble that burst that sort of sparked the current recession. It was not the cause for the current recession, but it was certainly a spark. Two of you have commented on it directly, but we may not yet be at the bottom. We hope we are. We hope we will see housing prices increase. What can we do at the Federal Government for policy that would be helpful to encourage a more healthy housing market? We know that there is a lot of inventory that is potentially out there. People have been sitting on the sidelines. We also know that mortgage rates are historically low. What can we do to try to encourage a responsible return in the housing market that will help not only housing sales but also new home starts?

Mr. BLINDER. May I start on that?

Senator CARDIN. Certainly.

Mr. BLINDER. I will not start with pie in the sky, with Congress appropriating huge sums of money to help these people that are underwater in their mortgages, which in an ideal world I would, and in 2008 I advocated that. But that is not going to happen.

There is something much simpler which I would hope that Republicans and Democrats could agree on. When the law in 2008 establishing the FHFA was passed, it provided for conservatorship of Fannie and Freddie if the worst happened. The worst did happen. Fannie and Freddie are now in conservatorship.

Conservatorship perpetrates the fiction that there are shareholders out there whose interests need to be protected, that we are conserving value. So the head of the FHFA who, by the way, has never been confirmed so he is acting, another issue—is under a legal mandate from Congress, from this body, to conserve value. The truth is, as we all know, that Fannie and Freddie are nationalized companies, basically, and the only shareholders that matter are the U.S. taxpayers. And that law should be rewritten. I do not think it would take more than a one-paragraph bill to put that into the law, that the job of the FHFA in taking care of the rest, which will eventually be the demise, of Fannie and Freddie, the one objective should be to serve the citizens of the United States, period. I think that would help.

Senator CARDIN. Dr. Prakken.

Mr. PRAKKEN. A number of things, but we should, I think, start by saying there is no silver bullet that can fix the housing mess. It will under all circumstances be a long and drawn out affair. But I think we could agree that to date the programs intended to facilitate mortgage modifications and refinancings have had disappointing take-up rates. I think that those disappointing take-up rates are partly because of reservations on the lender side to participate in these. So schemes that somehow broadened the number of mortgages that qualify for these plans, perhaps coupled with some approach to sharing future house price appreciation with the lenders, could encourage them to become more actively involved in this—I think that you have written about this—and they are also extremely worried about having the so-called representations and warranties put back to them in the event that they jump into the refinancing game. So some sort of—a better attempt to modify mortgages without actual debt forgiveness, which I think—

Senator CARDIN. On that point, if I just may interrupt for a moment, it is a major issue in my State of Maryland. I have had many housing forums, and I have one again on this Saturday not far from here. There is an inconsistency among the banking institutions. You know, some are very happy to try to work things out because they understand it; others are very remote, and we cannot seem to get their attention.

Is there any way that we can get the attention of the mortgage holders in a more direct way?

Mr. PRAKKEN. Well, it could be that banks that have different views on this have different financial stakes in it, and that could explain their different responses. So better information would be helpful.

I think also there is this notion out there that the GSEs, are sitting on large amounts of properties that have already been fore-

closed and they could put those to the market in bulk sales, perhaps with a provision that they would become rental properties for a certain number of years. My understanding is there are investors and developers who are chomping at the bit to get access to those properties because they understand that demographically demand for housing is cumulating, pent-up cumulating demand, and that it is going to be tilted towards renters rather than owners given today's financial realities about homeownership. So perhaps something like that would go on.

But this is really, really important. There is a housing boom waiting out there. Demographics suggest that we will have to build, I do not know, maybe one and a half million housing units per year on average over the next 10 years. We are only building 500,000 now. There is going to be a 300-percent increase in residential construction out there somewhere. But we have to have a financial system in place that can accommodate that going forward.

The most important thing to do immediately is to do what we can to stem house price declines. The most important thing I think we can do there is to do what we can to prevent particularly the so-called strategic foreclosures because we know that as soon as a house goes into foreclosure, the property value goes down by 30 percent. So any of these programs that could modify mortgages, sell the assets to get them into productive use, share the appreciation, somehow or another to put a floor on the expectation of house prices would really, really be helpful. Then you have to find a model to replace the originate, securitize, and flip model that failed us badly with something that can accommodate this demographic push for housing demand that is going to be coming over the next 10 years.

Senator CARDIN. Let me thank the witnesses. This is an issue that we are going to have to follow up when we have more time.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator SESSIONS.

Senator SESSIONS. Mr. Chairman, I would yield my time to Senator Johnson.

Senator JOHNSON. Thank you, Senator Sessions, and, Mr. Chairman, I would like to agree with you that I think it is crucial that we have a plan. I certainly want to extend my hand. I would like to do everything possible to work out a budget resolution. I think that is just absolutely crucial to restore some confidence and reduce some levels of uncertainty, because as somebody who has been in business for 31 years, made investment decisions, hired people, created jobs, I do not think there is any doubt that really what is holding back our economy is the high level of uncertainty and just a total lack of confidence in what is going to happen with our economy. And I think so much of that is driven by what is going to happen with our Government.

You know, to me it really is—the root cause of our problem is the size, the scope, and all the regulations, all the intrusion of Government into our lives, into economic decisions that businesses have to make, and the cost to Government. I could not disagree more with Dr. Blinder in terms of the fact that debt and deficit does not make a difference. I think it makes a huge level of difference.

When business owners see \$4 trillion in additional debt and deficit accumulate in just the last 3 years, trillions in additional deficit spending occurring over the next 10 years, that scares people.

I guess it was you, Dr. Prakken, talking about the level of uncertainty in economic forecasting. It is making your job harder. Think of a job creator, a business person, the level of uncertainty when he is having to put his own money on the line or her own money on the line to make those investment decisions. That is the problem.

And, Dr. Brannon, I totally agree with you. I do not believe Government can positively affect that in terms of its actions. I do not think we are good enough to say, hey, let us spend another \$300 billion and juice the economy. What Government can do is get out of the way.

So the questions I want to ask you—first of all, thanks for your testimony—the deficit risk, the additional deficit risk that nobody is really talking about. I certainly worked with Douglas Holtz-Eakin in terms of the estimations on the true costs of the health care law. I think one of you were talking about the uncertainty around the health care law. The CBO estimated only a million people would lose their employer-sponsored care and get put on the exchanges under highly subsidized rates. But the McKinsey study found 30 to 50 percent of employers right now are planning on dropping coverage; 180 million Americans get their health insurance through employer-sponsored care. If half of them lose their health care and get dumped on the exchanges, the cost for Obamacare will not be \$95 billion; it will be over \$400 billion. If everybody loses, it will be close to \$1 trillion.

I would just kind of like your comments in terms of that level of risk in your economic forecast in terms of debt and deficit. Dr. Prakken?

Mr. PRAKKEN. Thanks for such an easy question.

Senator JOHNSON. Not a problem.

Mr. PRAKKEN. I have no way of quantifying the impact on an intermediate-term economic forecast of the United States economy of the Affordable Care Act because the name of our firm is Macroeconomic Advisers, and much of what is going on in health care reform is a microeconomic phenomenon, in particular markets, segments of the market, particular populations.

I think I would be a little careful with the example that you just gave. If a firm drops its health care coverage for its employees, what happens to the money that it saves when it makes that decision? Does it simply turn around, as it could, and give that to their workers as a higher wage? In which case the workers could use that higher wage to go out and buy health insurance on one of these exchanges.

So doing these analyses is extremely complicated. I think what you have to come back to is this: We have a huge unfunded Federal liability over the next 75 years as the actuaries account these things. I think we all agree here that the principal source of that is health care, Medicare and Medicaid. Furthermore, given the way CBO estimates these costs, they make very optimistic assumptions about what is sometimes called the excess growth of health care, how fast it grows over the rate of GDP. These unfunded liabilities

are probably even larger than CBO estimates. Yet our response to this unfunded liability is not to tackle head on that issue. It is instead to whack at discretionary spending over the next 10 years.

Senator JOHNSON. No. Excuse me. Our response is to increase the unfunded liability. That is the point I am making.

Mr. PRAKKEN. But not within the system, not within the health care system. SO—

Senator JOHNSON. Dr. Brannon, I would kind of like to have your comments on that. The level of uncertainty caused by these deficit risks that we are not talking about here in Washington because we are simply not even addressing the ones that are already on the table in economic forecasts. I will throw just one more into the hopper. Dr. Blinder, you talked about 2.5-percent growth. There is a study released by The Lindsey Group. If we only achieve 2.5-percent growth, add \$5 trillion to our debt and deficit. The CBO estimates for every 1-percent decrease in economic growth, add \$3 trillion to the 10-year deficit figures. These are the risks, this is the level of uncertainty that is causing job creators not to act, not to invest.

Dr. Brannon.

Mr. BRANNON. I think the biggest problem we have with health care right now was not really dealt with by the Affordable Care Act. It is the rising entitlement costs. I think that is the thing that really threatens the solvency of the Federal Government. Also, I think that is what employers are scared about more than anything.

There is no denying that lots of small businesses in Oshkosh and elsewhere are really worried about—they are trying to figure out what these costs are going to do, and I do not think any of them really believe that their health care costs are going to go down all that much. But the fact that if you look at just the balance sheet of the United States, we might have had a \$1 trillion deficit last year, but the amount of unfunded liabilities went up by \$3 trillion last year alone, I think that is what frightened financial markets. And I think that is really where the Federal Government has to think—make first in terms of their priorities.

You are right. There are a lot of things in the Affordable Care Act, I think, that are not really solving anything.

Senator JOHNSON. Okay. Thank you. I am basically out of time. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

We will go to Senator Begich next.

Senator BEGICH. Just a tail end on your last comment. There is a lot of legislation around here that over the decades does not solve a lot of things either. So you can kind of randomly select legislation. In my State it would be No Child Left Behind, which is thousands—hundreds of pages of junk, in my opinion, but that is another issue, another Committee, another discussion.

Let me first, if I can, before I ask some of the questions, I say this every time I come to this Committee when there are folks talking. They talk about the stimulus, it is petering out, which it is, and it did not really have long-term impact, and that is where I want to take a little exception, just to mention a couple things, and then I am going to get into my questions, because, what I have learned over the years, if you let stuff kind of keep out there in the

media world or cyber world, it becomes fact when it is not necessarily fact. I will give you these three or four projects, and I am talking through you to the broader folks that are listening.

In Alaska, we received one of the two Indian Health Services' hospital projects to construct a \$170 million hospital in Nome, Alaska. Yes, it is true, when the project is done, the stimulus money has been spent. But the end result is we are going to have several hundred people working there for many, many, many, many, many years to come, providing health care—to provide better health care to people, who then have more productive lives, which then in turn work longer, pay taxes, produce product. It has an impact. The problem is CBO, which I have my own problems with CBO, never will analyze that because they do not believe in that. That is not part of the equation. But that is the reality.

Or a small road construction project, an intersection that was the most jammed up intersection in Anchorage, Alaska, now because of stimulus money is completed, it has had—it is the most improved intersection for traffic flow in the city. Why is that important? The less time someone is sitting in a car burning up fuel and burning up time they should be at work or taking their kid to the doctor or whatever it might be, they become more productive. Again, CBO will never score that. But that is a long-term impact to those kind of dollars that we have put out there.

Or GCI, a telecommunications company, build broadband through western Alaska which had no broadband, had no capacity to enter this new world we live in. Well, because that is done, more businesses and individuals will be productive and bring product to market; more people, more kids will have education through the Internet which they cannot get currently, and a variety of other things. So, again, CBO will never score that.

So every time I hear from people who say—and I am not saying you, but some of my colleagues that say the stimulus did not do anything long term, it is just flat out wrong. I can go from project to project. The problem is in this fantasy land of Washington, DC, you cannot score those things; you cannot analyze those things because they do not want to hear about that. So that is my rant for a second here.

There was an article—and if I pronounce your last name wrong, Joel, I apologize. But you had a good quote, and I thought it was interesting, you called the 54,000 jobs a “surge” for small business hiring, on a conference call with reporters, and so forth, a small business surge in the unemployment numbers and what is happening there. As someone who comes from the small business world, still in it, to me that is a very important indicator because small business people who hire people—it does not matter what time of the year—they are not hiring to fire. They are hiring to keep, versus a larger company at Christmastime they hire them, then they fire them, or lay them off. But small business people do not do that. They are hiring to keep. And I thought your comments here were very interesting.

If you can give me some additional feel on that of what you think and how the small business community is starting to play a role in this recovery.

Mr. PRAKKEN. The number you are talking about is part of the ADP National Employment Report—

Senator BEGICH. Yes.

Mr. PRAKKEN. —that we partnered with ADP to produce.

Senator BEGICH. Right.

Mr. PRAKKEN. It shows that small business hiring, which many economists think of as the engine of economic growth, has accelerated over the last several months. That is certainly a good development.

That data in itself does not tell us much more about Southern Managements, but a very interesting regular survey done by the National Federation of Independent Businesses routinely asks small businesses how they are doing on a variety of different fronts, including questions like, “What is your number one challenge? What is your biggest challenge?” And the answers to those questions actually are surprising given the rhetoric that one reads in the paper about what problems confront small businesses.

The number one problem that they say they have to deal with is right now lack of demand. They do not say access to capital. They do not say burdensome regulation is their number one problem. They say their order books are thin.

And, this gets to the point about, can Government somehow stimulate the economy, short run, in return for a long-run deficit reduction that could be really helpful. And I think, I agree with that one, that that is something we should start to think about.

Now, I also like your point about the ongoing return to some forms of Federal spending. Look, the Federal Government can borrow at negative interest rates right now. Are you telling me there are not some worthwhile social projects that have rates of return that are not higher than that?

Senator BEGICH. Right.

Mr. PRAKKEN. I mean, now, you have to pick them carefully, and, there is obviously the opportunity for squandering the funds. But to think that there are not social investments that have rates of return higher than the current costs that the Government faces when it enters capital markets I think is to cut off a variety of policy options that could have long-run benefits.

Senator BEGICH. Very good.

Did you want to add to that? Then I have one broader question on housing.

Mr. BLINDER. I would just like one sentence. I agree with what Joel just said. CBO has tried for the most part to stay away from dynamic scorekeeping because it can be easily abused. CBO has in the past studied the returns on infrastructure spending, and a request from this Committee would generate a CBO study, either with specificity or generality, however the request was made, on the economic returns, not to mention the social returns on infrastructure.

Senator BEGICH. Yes, I just have a broader issue with CBO that I think they have to change the way they do their business, because the way we—I am from the small business world. Some of the ways they do their stuff just do not make sense, but I will leave that there.

Let me ask a quick question on housing, and I want to follow up on what Senator Cardin talked about. I am not one of these ones to necessarily support principal knockdowns. I think that is not necessarily the right approach. The real approach to me seems logical. There is a proposal out there that some folks have talked about, and I think it is a good idea, and that is, if you know for the last 2-1/2 years someone who has underwater property but they have made their payments on time, they have done it even though their rates are higher than what the current market is maybe by a point, two, in some cases three points higher, doesn't it make sense just to create a financial instrument that says you, even though your property is underwater, we do not care whether it is underwater, because obviously you are staying in that home because of several factors, probably job, probably kids in school, neighborhood, a variety of things. Someone who comes from the real estate market, that is what people buy for. Why not just lower the rate? It is an enormous stimulant into the economy. When I say—it might be a Government-backed, but the idea is let us just do it, because we will lower the risk that they will go into foreclosure because we give them more cash flow and it will stimulate the economy, and we do not care what the bankers say because all we are doing is creating another instrument that if you want to refinance, you go over here and go get it done, and then they pay off the bank and that is the end of that story.

Tell me your thoughts on this. It just is so simple, and everyone has all these grand plans that make no sense, and this is all you need to do.

Mr. BLINDER. I would like to jump in on that very quickly. There is no one magic fix in housing, as Joel said.

Senator BEGICH. Correct.

Mr. BLINDER. There are many things. One of them is exactly what you just said. Exactly. And a major—the easiest way to get that done is through Fannie, Freddie, and the FHA, which are basically the only players left in town.

Senator BEGICH. Correct.

Mr. BLINDER. And that comes back to the remark I made earlier. Fannie and Freddie via their regulator are hamstrung by the law. I think they are not quite as hamstrung as they are acting. I do not—

Senator BEGICH. But we write the law.

Mr. BLINDER. You wrote the law. You can change the law.

Senator BEGICH. Right.

Mr. BLINDER. No, but you can change the law.

Senator BEGICH. I am with you.

Mr. BLINDER. I do not believe any Member of Congress back in 2008 wanted to make life more difficult for the American taxpayer. That is the effect now of the law written in 2008, and this is the body that has the ability to change it. Fannie and Freddie cannot change the law.

Senator BEGICH. Very good. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Sessions, back to you.

Senator SESSIONS. I yield my time to Senator Portman. We appreciate Senator Johnson and Senator Portman as new members of this Committee. They both add great talent and expertise.

Senator PORTMAN. Thank you. I appreciate it, Senator Sessions, and I appreciate your letting me take the time ahead of time.

Just on stimulus, I cannot help myself. You know, Dr. Blinder was talking about infrastructure, and if you look at sort of the classic definition of infrastructure, probably it was 4.5 percent of infrastructure in the stimulus package. And to Dr. Prakken's comments about how inexpensive it is for Government to borrow, so shouldn't we be borrowing to spend more, I mean, it is true that we are borrowing more than we should be, of course, and at the Federal level we are now borrowing about 40 cents for every dollar that we spend, and so there is an impact that goes beyond the obvious, which is what the interest rate is. At some point we cannot just keep spending more than we take in and not expect to have an economic impact. So I just have to throw that out.

Also, to throw out the fact that economists, including folks who, Dr. Blinder, were your successors at the Council of Economic Advisers in this administration, of course, predicted that the stimulus is going to work in ways that it has not, and, they predicted, as unemployment would be under 7 percent, and now we are looking at 8.5 percent, and actually it would be 8.7 percent over the last 2 months if we had not had so many people leave the workforce.

So we all hope the economy is improving. I certainly see some positive signs. But I also see some really troubling signs. But you cannot say that the expectations that were set by those who supported this have been met. So I wish there had been more infrastructure in that legislation since it passed, and I certainly wish that we would have seen a better impact from it.

I am curious, if I could go back to the health care debate, because I think all three of you—and I am sorry I did not get to hear your testimony, Dr. Blinder, but I know how you feel about it. All three of you understand the important role of health care in dealing with our fiscal crisis as well as our economic crisis. In other words, this incredibly slow growth we have seen in this recovery compared to other recoveries, really a true jobless recovery. In 2001 and 2002, we called it the jobless recovery. At this point, 48 months after the recession, we have net about 350,000 new jobs. Here we are down about 6.1 million jobs. In 1981 and 1982, the deeper recession, we were up over 6 million jobs at this point in the recovery, and here we are down 6. So I think health care is playing a role, not just in the long-term problems that we face but also in some of the uncertainty you talked about. And I liked what you said, Dr. Prakken, about the fiscal landscape being cluttered with uncertainty, and in your 30 years you had never seen such uncertainty as you see now. I think a lot of it is these huge unfunded liabilities in health care.

So you were starting to go there in response to Senator Johnson's question, and I wonder if you could talk about that. And the first part of your response was that we are focusing too much on the discretionary spending side, as I read it, and I thought you were going to follow that with something about the need for us to focus on the long term.

Mr. PRAKKEN. The real issue in health care is—there are two parts to it. One is the population is aging, and as you get older, you require more medical attention. And the second is that the prices of medical services are rising faster than overall prices.

The issue philosophically that we must address as a society is: Do we think our elderly are somehow entitled to the best available care irregardless of the cost? And if the answer to that is yes, then the resulting game is just one of shifting the cost. Who is going to pay for that? Is it going to be the Government? Is it going to be the private sector? Is the Government going to shift the cost to the private sector?

The other issue is, well, maybe we are just going to tell these folks, these aging folks, that they really are not necessarily entitled to the best medical care that money can buy under all circumstances. And until we really wrestle with that sort of fundamental philosophical debate, it is just hard to see how we are going to make progress on health care.

Now, look, the health care circumstances do not change that much from one year to the next. It cannot be why growth is slower this year than last year. It does not change fast enough. The demographic projections do not change fast enough. The financing terms of health care do not change fast enough for that to explain short-run movements in GDP growth. It just does not make sense that that would be the case. Is it a long-run issue? Could it undermine our standard of living down the road? Sure. But that is not why our forecast is 2.3 percent for next year instead of 3 percent? It is simply not.

Senator PORTMAN. Dr. Prakken, let me, because you talked about not being a micro economist, or at least your firm does not specialize in that. Let me give you a micro example that might counter what you just said.

Mr. PRAKKEN. Okay.

Senator PORTMAN. When I am business roundtables—they had another one in Ohio last week—and health care costs come up all the time, of course. It is a cost of doing business. And so a manufacturer tells me, “Rob, we are getting a little more business, a little tick-up in the business. I am not going to hire somebody, and the reason is health care costs. Instead I am going to go with overtime,” so somebody is, getting overtime, but it is not as cost effective, of course, for that business and you are not hiring somebody new. “We are out bringing in some more part-time people.” So this notion that, our current health care uncertainty—and obviously the cost increases, which exceed inflation, as you talked about, are not impacting the GDP—and you talked about demand earlier. You know, how do you get demand going? You know, part of it is to add some certainty on the health care side. Dr. Brannon talked about it earlier in terms of, what the health care legislation has done to make it worse. I totally agree with you on the long-term impact, but I think we forget that it is impacting today’s economy, too, because it is a cost of doing business. It makes—

Mr. PRAKKEN. But you do need to be careful about this. You know, I am a managing director of a small business, 20 people. Before I left and got on the plane, I went to my CFO, and I said, “How is health care affecting us right now?” And he said, “Well, we pay very generous health care benefits, so we are going to be slapped with this Cadillac tax. Otherwise, it is not an issue because we are basically exempt from it.”

So, I mean, I do not make any hiring or firing decisions based on health care costs within our firm. Maybe bigger firms that have, different circumstances do. But—

Senator PORTMAN. But if you are self-insured, as a lot of big companies are in Ohio, including manufacturers, if you have a health savings account, which a lot of them do, and those tax benefits are made less valuable through this legislation, but there are lots of impacts and, as you say, just a lot of uncertainty.

Dr. Brannon, health care—

Mr. BRANNON. Yes, I think the example you stated is not uncommon. There is a lot of what we call labor hoarding out there, and there has been for a while. Firms are very reluctant at the beginning to lay off workers when a recession comes because they are not going to save all that much. They will have to pay health care costs for a while. But then once they lay them off, they really do not want to bring them on. We just want—ideally we want an employment and a labor market where we do not have high fixed costs of hiring people, and that is one of the things that high health care cost does.

Senator PORTMAN. What I hope we would get to—and my time is done—is a consensus among the three of you, which I am just going to stipulate it is there, which is we have to deal with these costs. And the Chairman and Ranking Member have been leaders on this saying you are not going to get the budget under control until you deal with the biggest part of the budget, which is the mandatory side, and the fastest-growing part, which is health care. So I'd hope that that is one of the conclusions we can all agree with and maybe disagree on some of the issues.

One thing I just have to say is I think the way you put it, Dr. Prakken, is probably accurate in terms of some of the difficult choices we have to make with regard to health care for the elderly, but what you did not talk about is the fact that we need to restructure the way we deliver health care. So it is not just making a tough choice between price and quality and saying how do you get away from the fee-for-service model and a third-party payer model and have very good quality health care but at lower cost by changing the structure.

Mr. PRAKKEN. Because restructuring can bend the cost curve.

Senator PORTMAN. And also improve outcomes and quality rather than focusing on volume and input.

Thank you, Mr. Chairman.

Chairman CONRAD. I just want to say how much I agree with Senator Portman's last statement. If there is one thing that is clear in hundreds of hours of hearing on health care, it is we have to change the way we pay for health care. I mean, we create incredible incentives for waste in our current system. I think virtually everyone is in agreement on that score, so hopefully that could lead to us taking action.

Senator Merkle.

Senator MERKLEY. Thank you very much, Mr. Chair. I wanted to ask about the availability of credit to small businesses. We had the Small Business Lending Fund, which in Oregon many banks applied and not a single one was granted access to it to expand their base and be able to leverage additional loans to Main Street, which

was the whole goal. It is still not clear why so many banks that met the CAMELS ratings and so forth were denied lending, but this was one strategy. We had a second strategy with the Small Business Lending Fund sustaining the 90-percent guarantee. Some banks have started to increase their lines of credit and help restore some funding there, but I would like to know from your perspectives whether that has actually been a significant change. We spent a couple years having businesses come to my town halls and talk to me about their lines being cut in half or eliminated. And, of course, small business, if they cannot borrow on their credit card and they have no equity in their house to borrow on and they cannot get loans from a bank, they basically are still in the water and cannot even manage inventory ups and downs that go with the course of a business year.

So credit to small businesses, any insights?

Mr. PRAKKE. I think one thing that I have observed is the segment of the small business community that is particularly prone to these credit issues are the ones that somehow have exposure to real estate. They are either real estate companies themselves or own assets that were used to collateralize their small business credit lines that have declined sharply in value given the housing bust. And, there I think is a legitimate argument that there is a segment of the small business community that cannot refinance their positions or cannot get access to credit without recapitalizing their businesses.

I will give you an example of this that occurred in St. Louis, at an auto dealership in St. Louis, very successful, there for 30 or 40 years, never missed a payment, blah, blah, blah, blah. They could not refinance their credit line 3 years ago, and the reason that was stated was the market value of the properties that they owned had fallen so significantly, and those properties were used as collateral against the loan, that, yes, you could have the credit, but you had to either put in more equity yourself or you would have to hold a million-dollar line of compensating balances at the bank, essentially raising the cost of the credit.

So I think we need to be careful about distinguishing the kind of companies that have exposure to the real estate boom and bust that is impeding their access to capital and other kinds of businesses.

The banks that I talk to in the Midwest are actively looking for quality opportunities to lend. Now, I think their definition of a quality opportunity is tighter than it was 4 or 5 years ago. But, again, if you look at the survey responses for large numbers of small businesses, they do not rate credit availability even close to the top of their list of significant problems. They rate thin order books as their number one issue.

Senator MERKLEY. Any other comments?

Mr. BLINDER. Yes, I am aware of the fact that the SBLF has not worked in the sense that not nearly as much money as was hoped for was put out from it. I do not know why, although I suspect what Joel just finished on is part of it. But here is something we do know from one program after another, going back to entitlements, to HARP, to HAMP, to almost everything. There needs to be outreach. Believe it or not, people that are entitled to entitle-

ments do not always claim them. They do not know. They are too busy. They have 100 other things to attend to. So if you really want to push something out, it requires quite a bit of outreach. It is not enough to say—just put it on the table and say a certain class of people or a certain class of businesses are eligible for this. I always have a suspicion that when take-up rates on programs are low, that is a major reason.

Senator MERKLEY. Yes. Well, let me just be clear with SBLF. The issue was not banks' not reaching out and applying to the program. They had a huge incentive to apply, only if they intended to lend those funds out the door, because there was a 1-percent versus 7-percent differential based on whether lending increased proportionally for the bank. The issue was the Treasury turning down their application, and we have not had much of an explanation or analysis of that from Treasury.

I want to get a brief comment, and then I want to switch gears.

Mr. BRANNON. So I am from a small town near Peoria, Illinois, called Mossville, and we have a hometown bank, and the president of the hometown bank was calling me last year almost on a weekly basis asking me when Treasury was going to initiate this. Again, it is part of the problem with the bureaucracy. It just took Treasury so long to kind of get their act together to finally issue that before they could actually—before they announced the rules and issued that money out the door. It really would have been a lot more help had they done this a year before they actually ended up doing it.

Senator MERKLEY. And was that bank eventually accepted into the program?

Mr. BRANNON. Eventually it was, after 4 or 5 months of waiting for that money.

Senator MERKLEY. So that is a real positive because in Oregon not a single bank was accepted that applied.

And, Mr. Brannon, you note the issue of changing the ability of bankruptcy judges to modify the terms of the primary residence. This is actually an issue that the President pledged to champion right before he took office. That did not happen. And, indeed, there was a huge pushback on this issue.

You also note that you can do it for second homes; judges can do it on boats and on planes and every other mortgage contract. A lot of concern that has been expressed is that this would have a significant impact on mortgage interest rates in the future, but that has been countered by saying let us do it looking backwards and also by looking at the impact on second houses now where the power exists, and we do not see that large discrepancy.

So why is it so hard for folks to entertain the concept that you have advocated for?

Mr. BRANNON. So I think the biggest problem is that people see that there would be certain people who would be unjustly benefitted from such a thing, people who made basically a real estate bet and they lost it and they are still going to get bailed out. I think far more common is the person who took out a loan for \$500,000 for maybe a house that was worth \$550,000 and then the price fell to \$300,000. And I just think that person is not going to pay—if they are a rational person, they are not going to pay

\$500,000 for that house. They are going to walk away if they do not get some kind of loan modification. And I just think that what we should do is we should acknowledge that fact and we should create a situation so people who are willing to undergo Chapter 13 bankruptcy—which is not available to anybody—if you have assets, you are not allowed to do a Chapter 13 bankruptcy—and set up a procedure so that these people can basically pay what the mortgage holder is eventually going to get for that place, anyway, and that is \$300,000.

Senator MERKLEY. Well, I would note that when this power existed in other types of loans, the second homes and so forth, it is rarely utilized, but it does serve as an instrument—as a lever, if you will, to encourage negotiation. In this case, we have all these modifications in which the servicing agency is not very motivated. But this would create a lot of motivation. Do you both support that concept as well? Dr. Prakken?

Mr. PRAKKEN. Yes, I think you need part carrot and part stick to get widespread mortgage modification. You know, the carrot has not proven very successful. A stick might be helpful.

Mr. BLINDER. I think my honest answer is at this late stage in the game I am ready to support almost anything that would increase the number of mortgage modifications.

Senator MERKLEY. Thank you very much. Thank you.

Chairman CONRAD. Senator Sessions.

Senator SESSIONS. Senator Thune.

Senator THUNE. Thank you, Mr. Chairman and Senator Sessions. Thank you all for being here today and providing your insights. We have not passed a budget resolution here through the Senate in almost 3 years, and I know that the Chairman would argue that we did deem a budget last year in the Budget Control Act. The fact is we did set caps, at least caps for 2 years and put them in place. But we have not passed a formal budget resolution now since 2009, and I hope that this Committee will find its way to do that this year.

The main reason for that, the reason that is problematic, in my view, and Senator Portman mentioned that just previously—is entitlement programs, primarily health care. Medicare and Medicaid are growing at multiples of the rate of inflation, and we cannot sustain that over time. And so doing entitlement reform, doing something on taxes is absolutely critical if we are going to take on what I think are the biggest challenges facing the country from a spending and debt standpoint.

But the other reason I think it is so important that we do a budget is because there is, I think, increasing concern among people out there, investors in the economy, about what Congress is going to do. There was a study of over 1,600 investors that was released on Tuesday that identified the national debt as being one of the top concerns on investors' minds as we head into this new year. The study also found that a significant number of investors believe that deficit spending along with uncertainty coming out of Washington and excessive regulation is holding the economy back. Similar polls conducted for the U.S. Chamber of Commerce earlier this month confirmed that 85 percent of small business executives think the economy is on the wrong track.

And so the question I would have, and perhaps, Dr. Brannon, if you could kick it off, is: Do you agree that a formal budget resolution is important not only because we have to address the issues of entitlement reform and tax reform to help get deficits and debt under control, but also because we need to bring certainty to investors and job creators out there? I think there is a direct correlation between deficits, spending, and the economy and jobs. We all talk about the economy and jobs. I think everybody in the country is concerned about that. It strikes me at least that the uncertainty that comes out of Washington with regard to how we are going to deal with these long-term problems is complicating the ability of the economy to get back on track and to create jobs.

Mr. BRANNON. I think I agree with you. I think it would be—having a real budget resolution would be a good first step and a signal towards investors in small businesses that Congress is really on their way to addressing the problem. It would not be enough. I think we need—to have real fundamental reform, it might take more than that, but it would certainly be a good first step, and it would be a signal that maybe the gridlock that we have seen the last year or so might be a thing of the past.

Senator THUNE. Dr. Prakken.

Mr. PRAKKEN. Anything that you can do to make fiscal policy and, hence, the fiscal environment in which companies are trying to grow their businesses more stable and more predictable has got to be helpful. So there is an interesting—it is a young literature, but it is interesting and it is growing that attempts to measure fiscal uncertainty among other things by looking at how many temporary provisions are in the Tax Code, how valuable they are, when they are going to expire. And this literature does suggest that such measures of fiscal uncertainty can be shown to be correlated with slower economic growth.

I think, the logic of this is pretty straightforward. If you do not know what environment you are going to be working in next year or 2 years from now, your natural inclination is to delay important decisions until more clarity is possible. But it is not easy to have clarity right now.

So it is not just having a budget resolution. I think it is a eliminating the uncertainty for people about what is going to happen at the end of February when this temporary holiday extension expires. What is going to happen in 2013 when you can have a fiscal drag equal to 5 percent of GDP if everything goes badly? I mean, to me that is a huge element of uncertainty that overhangs anyone's willingness to make long-run economic decisions.

So, I think on paper we know what we have to do. We have to reform the Tax Code and make it permanent, we have to address the unfunded liability entitlements, and we have to adopt a process for assessing the value of Government programs so that we do not propagate into the future programs that are unproductive.

Senator THUNE. What level of deficit reduction do you think is necessary? The Budget Control Act had \$2.1 trillion provided, and—

Mr. PRAKKEN. That is not sufficient.

Senator THUNE. Right. And Simpson-Bowles said \$4 trillion. What is your—

Mr. PRAKKEN. Yes, I would put it at between \$4 and \$5 trillion over the next 10 years. We did a study of this a little while back and showed that if you just continue on the current path willy-nilly, within a decade you will see inflation-adjusted interest rates starting to move up and that the amount of deficit reduction that would prevent that from happening and stabilize the debt-to-GDP ratio at the end of the decade should be between \$4 and \$5 trillion, and that would actually be enough that, when projected beyond that, you would make a significant improvement in the unfunded liabilities that really otherwise would start to grow quite rapidly after that period.

So I was heartened by the formation of the Super Committee. I was disappointed that it failed. I am hopeful that it will reconvene in some form this year and get back to the task of coming up with the \$2.4 trillion. But, actually, that is not enough. It is only going to be the opening gambit in what will have to be actually a considerably larger fiscal contraction.

Senator THUNE. Any number, Dr. Brannon?

Mr. BRANNON. So I am not a forecaster. I am not going to try to pull a number out, but I will say this: I think we are underestimating the growth in entitlement spending. I think not only do we have, as Dr. Prakken pointed out, not only do we have the baby-boom generation reaching retirement age, but as I mentioned previously, longevity, especially for people from age 65 on, is increasing by leaps and bounds. And I am not sure anybody at Social Security or CBO is capturing that.

It is kind of interesting. People think, oh, longevity in the United States is not changing all that much if you look at the aggregate number. For people like you and me, men between the ages of 40 and 60, longevity actually has not changed at all in 30 years. The things that kill men—cirrhosis, accidents, suicide, certain acute illnesses—we have not gotten any better at fixing those. But we haven't a lot better at heart disease, at treating cancer, the things that normally befall people at age 65 and on. And that is what is really, I think, going to exacerbate this entitlement problem going forward.

Senator THUNE. I see my time has expired. Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator. The Senator was not here when I opened and said we will go to a markup in this Committee. You know, last year we sort of got "Big Footed" here—my terminology—by negotiations that started early in the year, frankly above our pay grade. We are not in that situation this year.

For the knowledge of members, in terms of the hearings that we are looking forward to, we are going to have the Chairman of the Federal Reserve. We are going to have the head of the Office of Management and Budget. We are going to have the head of CBO. We are going to have the Secretary of Defense. We are trying to get the Secretary of Treasury. We are negotiating on dates with him right now. We are going to have the Secretary of Transportation. We are going to have a hearing on entitlement reform and a separate hearing on tax reform, because I think there is strong interest in those areas, and they really are central features of our

long-term imbalances. And then we are going to have a hearing on income inequality.

We have had another request for a hearing on energy policy. We are going to have to see if we can work that in because this year I think we are going to need to—if we go to the kind of markup I anticipate, we are probably going to need more time for a markup than we have seen in recent years. If we are going to take a real run at doing what members of this Committee have told me individually and collectively they would like to do, it is going to require a longer markup than we have had in previous years. So that is going to have to be factored into our thinking as well.

The final point is CBO has not yet told us when we will get the re-estimates. It initially told us they were shooting for March 9th. That now, we have been told, has slipped. We do not know what it has slipped to. So that is a factor we just have to learn about before we can reach a conclusion.

With that, Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman. I think the Chairman can probably predict what I am going to jump into here, because this discussion of health care is always so frustrating in this Committee because the focus is always on the cost and the trends, which are real, but as Dr. Prakken said, based on demographics and rising prices, and what we always overlook is the fact that we are running the most inefficient health care system in the world by orders of magnitude. I mean, we are at 18 percent of gross domestic product that we burn on health care, and the nearest country, industrialized country to us I think is the Netherlands at 12 percent. Other countries deliver health care that is about as good as ours, on average, for 10 to 12 percent of GDP. It takes 18 percent.

There is bipartisan agreement from really responsible leaders that the savings every single year to our health care system could be somewhere between \$700 billion and \$1 trillion a year by reforming the delivery system in ways that will actually likely improve the quality of care. So I was delighted that Senator Portman raised that issue about restructuring the way we deliver care. And I understand perfectly well that that is a process of innovation and of learning and of reform, and that for those reasons CBO cannot score it. But it is unbelievably tiresome to have witnesses come before us panel after panel, day after day, and never mention this enormous, enormous issue because it is not scorable. Simpson and Bowles agreed that this was an enormous issue, but they had not mentioned it because it is not scorable. Rivlin and Domenici agreed that this was an enormous issue, but they did not discuss it because it was not scorable.

At some point we have to act like grown-ups and look at this as a real problem, take off the CBO blinders, and get to work on this. We cannot burn \$700 billion to \$1 trillion a year in this health care system and do nothing about it when it is going to pay for things like hospital-acquired infections that kill tens of thousands of Americans every year, run up billions of dollars in costs, and are completely preventable. That is the discussion we need to be having, and I cannot—when we get into this stuff, I just cannot help but react to that because it is a constant frustration, and there is so much to be done, and it is such a bipartisan thing that we could

be doing, and hospital and health care systems from California in Kaiser to Gundersen Lutheran in Senator Johnson's State of Wisconsin to Geisinger in Pennsylvania, to Mayo in Florida and Minnesota, all across this country are actually doing it and showing that it works. They are actually saving money by delivering better care, and yet we have these budget discussions that operate in the artificial CBO universe, and we never even take that on.

So vent concluded, but the other—I am sorry. Does the Chairman want to say something?

Chairman CONRAD. I always enjoy the Senator's presentation on this subject, especially since he is right.

Senator WHITEHOUSE. The thing that I wanted to talk about today was the housing predicament that we have, and for a long time, I was the Chair of the Subcommittee in the Judiciary that looked over the bankruptcy system, and it struck me as a pretty unfortunate anomaly that if a bank is underwater or is having financial troubles and needs to renegotiate with its lender the value of its headquarters or of property that it owns, the bank will not hesitate to talk about reducing the principal with its lender as part of a workout; but that same bank will then turn around and tell some poor homeowner, "Nope, we are not going to discuss reducing the principal of what you owe me on your home." And I know that Dr. Brannon has talked about this a lot. In fact, I would like to ask unanimous consent, Mr. Chairman, that Dr. Brannon's article, "A Cure for the Housing Blues," be admitted into the record of this proceeding, and I have a copy of that for the record.

Chairman CONRAD. That will be included.

Senator WHITEHOUSE. Thank you.

[The article follows:]

A Cure for the Housing Blues

x

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## A Cure for the Housing Blues

### The cramdown solution.

Ike Brannon

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The biggest impediment to economic growth is the housing overhang, a fact that's beginning to be acknowledged by both parties. In the last three weeks Glenn Hubbard and Martin Feldstein—two former Council of Economic Advisers chairmen for Republican presidents—published op-eds with plans for writing off some portion of the mortgage debt for homeowners whose mortgage exceeds the value of the house, a status typically referred to as being "under water." Meanwhile, the Obama administration last week chimed in with its latest plan to spur refinancing by homeowners whose under-water loans are held by Fannie Mae and Freddie Mac, hoping that lower interest rates will keep these borrowers from defaulting.

The weight of the collapsed housing sector on the economy means that no amount of stimulus, whether a short-term Keynesian fix or a conventional pro-growth package, will fix this problem. Not only are nearly 25 percent of homeowners holding mortgages for more than their houses are worth, there are also nearly four million households that have stopped making mortgage payments at all. In the time it takes—usually one to two years, sometimes longer—for the legal system to put them into foreclosure and make them move out, these families (and the mortgage holders) find themselves in an uneasy limbo: The mortgage holders aren't getting any money and the families aren't spending all that much either, with the result being that consumption, lending, and the overall economy stagnate.

We don't need another stimulus to fix what ails the economy. We need to fix the housing market. And the way to do that is to allow a mortgage cramdown in the context of a personal bankruptcy. Put simply, someone who owes \$450,000 on a house worth \$300,000 isn't going to be helped that much by a lower interest rate. He would be helped—as would the housing market and the larger economy—if the lender could be compelled in a bankruptcy proceeding to write down the loan amount to \$300,000, which is all the lender would recover in any case were it to foreclose on and then auction off the property.

#### *Bankruptcy Made Simple*

A person who files for bankruptcy can choose to do either a standard or so-called Chapter 7 bankruptcy (named for that portion of the bankruptcy code), or he can file for bankruptcy reorganization, also known as a Chapter 13 bankruptcy. Under the latter plan the debtor and his lawyer present a list of his assets and debts to the judge and bankruptcy trustee, acting on behalf of the creditors, and they negotiate a repayment plan. Such plans usually cover three to five years, with the trustee receiving periodic payments from the debtor and doling them out to his various creditors.

Completing a Chapter 13 bankruptcy plan discharges most debts even if they are not paid in full, save for taxes, student loan debt, and a few other exceptions. Among the most important exceptions are home mortgages. A bankruptcy judge is not allowed to reduce the value of a home mortgage.

In this, a primary mortgage is unique among debt that is secured by some sort of collateral. If the debtor has a car, a boat, or a second home for which he owes more than the current market value of the asset, the judge can reduce the amount of the debt to the market value. It is in both sides' interest for the judge to have this power. Otherwise, debtors who file for bankruptcy would simply relinquish title to the property, and the creditor would then have to go and find a buyer, at some cost to him. Writing down the value of the debt gets the creditor the same amount of money as if he had taken possession himself and sold it, but without the hassle.

Allowing such a cramdown for a mortgage on a primary residence would require us to acknowledge a simple fact: The person who owes \$450,000 on a house that is currently worth \$300,000 is almost assuredly never going to pay the full amount he owes; eventually, he will either be granted a loan modification to reduce the principal or else he

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will walk away—no matter how much we try to shame him into “doing the right thing.” The cost of walking away in most states amounts to little more than the inability to buy another house in the next five years, since most mortgages are in practice nonrecourse loans, meaning that the debtor does not have to make up any deficiency if he returns the house to the mortgage holder and it sells for less than the mortgage.

At the moment, mortgage loan modifications are entirely at the discretion of the lender. But thanks to the disintermediation of the mortgage market in recent decades, negotiations between the mortgage holder and the debtor can be nearly impossible to initiate, despite a plethora of administration programs designed to ameliorate this problem. (The mortgage holder is typically an investment bank or some other investor who holds it along with a host of other mortgages in a mortgage-backed security.)

Ironically, one of the arguments offered for exempting home mortgage loans from being crammed down in the 1978 bankruptcy reform was that the community banks and savings and loans that issued most home loans were well-positioned—and had an incentive—to negotiate with a financially troubled homeowner to avoid foreclosure. As that is no longer the case, bankruptcy judges should be given the power to impose cramdowns.

### *Fairness*

Republicans typically react to suggestions of mortgage cramdowns with indignation, arguing that it sets a bad precedent and rewards speculators and people who didn't play by the rules. There is some truth to this: For instance, economists Michael LaCour-Little, Vincent Yao, and Eric Rosenblatt find that a good portion of foreclosed homeowners in Southern California bought their homes well before the peak of the price bubble and managed to extract a considerable amount of equity from the home before the crash. They estimate that the typical return on equity for those with foreclosed houses approaches 40 percent—not a bad haul.

However, should meting out fiscal justice trump economic expediency? It's a question that policy-makers have asked themselves previously. In his book *The Banking Panics of the Great Depression*, Elmus Wicker notes that the Federal Reserve maintained a tight monetary policy well into the 1930s that they knew would lead to the collapse of banks throughout the country, which in turn would crater the economy. Nevertheless, they held fast to this path not just because of a Darwinian economic perspective but also because of a widely held notion (at least within the Fed) that helping these troubled banks would be rewarding failure.

Phillip Swagel, assistant secretary for policy at Treasury in the latter years of the Bush administration, wrote in a paper for the Brookings Institution that his old bosses rejected any cramdown because they feared its subsequent impact on the lending markets for middle-income households. Resorting to a cramdown, they reasoned, would lead mortgage issuers to tighten credit standards as well as demand higher down-payments. It's safe to say that this ship has sailed. Cramdown or no cramdown, credit standards are tightening and higher down-payments will be the rule.

### *Who Gets a Break?*

Ultimately, America has a choice: Do we continue to insist that the people who made bad bets in the housing market get punished for their wagers, or do we focus on creating policies that have the best chance of ending our economic malaise? Once we decide that the latter should take precedence, the next step is easy: We allow mortgage cramdowns to occur in the context of a Chapter 13 bankruptcy reorganization.

By doing it in the context of bankruptcy, we set a high bar on who takes advantage of a cramdown: Someone who is marginally under water is not going to want to go through the proctology exam that comes with a Chapter 13 bankruptcy or to pay the thousands of dollars of lawyers' fees to file. But someone \$100,000 in the hole is likely to explore the possibility—exactly the incentive we want to create.

The worry that mortgage-holders are going to take a hit is valid: While granting mortgage relief through bankruptcy minimizes the costs of fixing the housing market, the government may still find it necessary to provide some sort of relief to various holders of mortgage-backed securities, which would be politically unpalatable but much less expensive than the president's proposed \$447 billion stimulus plan, while having the advantage of actually providing real stimulus.

But the true cost of a cramdown will not be that significant: At the end of the day the investors holding mortgages aren't likely to get more for their mortgages than what the houses are currently worth. So the real question is who should live in those houses? The people now in them, or the people who would buy them for pennies on the dollar after the wrenching and complicated ordeal of a foreclosure and auction?

When I was a newly minted Ph.D. economist I was asked to meet with my hometown bank on behalf of a lawyer who had some clients who needed auto loans and had recently filed for bankruptcy. The terms we proposed seemed sensible: a loan for half the value of the automobile, secured by the car itself, at an interest rate 50 percent higher than what the bank charged its normal customers.

### A Cure for the Housing Blues

The bank refused, saying they worried that these clients would file for bankruptcy again and stiff them. Impossible, I pointed out—someone can file only once every six years, and besides that, the car would deed to the bank—insured for its full amount—should the client cease payment. And these people were now debt-free, making them good bets for at least the three-year term of the loan. All had steady jobs.

The bank president responded by asking me to leave his office, explaining tersely that it was not a matter of profits or losses—it was a moral matter, and that the bank didn't feel comfortable having clients who had previously reneged on their debts, even if such a stance cost the bank profits.

I left the premises and sold my stock in the bank shortly thereafter. The bank no longer exists, a casualty of a previous downturn, exacerbated by what I imagine were a host of poor decisions made for reasons other than maximizing returns to the shareholders.

Appeals to morality are a poor excuse for inaction. After four years of declining home prices and concomitantly negligible economic growth, it is time to abandon talk of stimulus plans and focus on fixing the housing market. Once we make that transition, the relevant question is how to most quickly and at the least cost reduce the number of homes either being foreclosed on or likely to be foreclosed on because they are so far under water. Allowing mortgage cramdowns in bankruptcy reorganization offers a way out for homeowners who are hopelessly under water and for lenders who are putting off the day of reckoning. Everyone who wants an economic recovery would benefit from this change in our bankruptcy code.

*Ike Brannon is director of economic policy at the American Action Forum.*

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Senator WHITEHOUSE. Could you just talk a little bit about the value of allowing a homeowner who is in bankruptcy to sit down with the lender and negotiate a new principal balance for what they owe in the light of, first of all, if they walk away from it, the bank is going to be written down a lot anyway through the foreclosure process? My take is they would actually probably get a better number in an organized bankruptcy than they would going through the foreclosure process with all of its destruction of the property itself, collateral costs, and so forth.

Mr. BRANNON. Sure. As it stands, my father is actually a bankruptcy lawyer in Peoria, Illinois, so I am well aware that you were in charge of bankruptcy. My father would love to chat with you about this. He has many ideas for bankruptcy reform he would love to run by you. And my idea is simply that I agree with you in the sense that—this is what I told Senator Merkley in the situation where somebody owed \$500,000 on a \$300,000 mortgage, the mortgage holder is not going to get \$300,000. I think we need to acknowledge that. We see this all over America where people are walking away from their mortgages. Whether by law or by custom, people have almost everywhere a non-recourse loan, and it does not seem like that is going to change, at least in the near future. So in my article, I simply said I think we should acknowledge that, and we should create a system so people who are severely underwater can file a Chapter 13 bankruptcy, which is not available to everybody. If you have assets, then you are not allowed to file a Chapter 13 bankruptcy. You are told to go away and allow the court to negotiate something for them, just like they do with other assets.

Senator WHITEHOUSE. Do you think that would have—the prospect of that, do you think that would influence behavior elsewhere? I have lived since the mortgage crisis with innumerable stories from Rhode Islanders who are on the receiving end of the worst bureaucratic treatment I have ever heard of from the big banks about their mortgages: never getting the same person on the line twice, never getting a straight story, up to 19 months in one case of one of my constituents of simply the runaround. And when you have your home at stake, you can imagine how infuriating and frustrating never being able to have a sensible discussion with anybody is. And I think that is one of the reasons that the administration's programs have been so unsuccessful, is that the banks are so unmotivated. We got money into Rhode Island for the hardest-hit plan, and Rhode Island Housing sat down with the biggest banks to design the program for how the hardest-hit plan funds would be distributed. And they agreed on a plan, and then when it came time to go forward, the big banks said, "Well, we may have agreed on the plan, but we are not going to participate," because I do not think they feel any—there is no alternative. So could you react to that?

Chairman CONRAD. Let me, if I could, stop the Senator on that point because we are out of time on this questioning by the Senator. Here is our problem—

Senator WHITEHOUSE. Could I submit for the record—

Chairman CONRAD. Yes, we can do that.

Senator WHITEHOUSE. I apologize.

[The information referred to follows:]

**Dr. Brannon**

**Answer:**

I think what the Senator is asking is whether altering the bankruptcy code ex post to allow judges to modify loans by the market value of their house would possibly limit home lending by banks in the future, knowing that a cramdown is a possible outcome.

The Senator is correct that banks would be a bit warier in lending—but I don't think it would make lending standards any more restrictive than they currently are. As it currently stands it is difficult for people to borrow for more than 80% of the value of the home—and virtually no one appears to be able to borrow more than 90 percent of the value of their home, based on my conversations with various housing economists and bankers throughout the country. I think that would become the norm if we allowed a mortgage cramdown, with banks wanting to insulate themselves from a writedown in the wake of another burst property bubble. And I don't think this would be an unhealthy development—as I said elsewhere in my testimony I think we place too much of an emphasis in our tax code and elsewhere in policy in incentivizing the purchase of homes, and that home ownership buys society relatively little additional salutary behavior.

I also think such a provision would force banks to be much more wary in the wake of any future price boom in who they lend to and how much they lend: in fact, I submit that this might be more of a brake on a future property price bubble than anything found in the Dodd-Frank bill.

Chairman CONRAD. We have been told that the vote is hard-wired for noon. We have four—because Senator Sessions and I have withheld all morning, so we still have four Senators to question, and we only have 12 minutes, so that is a problem.

Senator Sessions.

Senator SESSIONS. Thank you. Well, I remember about a year ago, or a little over, I was at the home of Al Blanton in Marion, Alabama, and we had a town hall-type meeting in his house. And we lost him recently. But everybody talked, and at the last, a man well in his eighties said, “Well, I have lived through the Depression. I lived through World War II. I lived through Korea. I lived through the big inflation and other things that have happened. And I do not believe our problem is the high cost of living. I believe it is the cost of living too high.”

I was at another town hall meeting in Evergreen. An African American stood up and said, “Well, my daddy always told me you cannot borrow your way out of debt.”

We have talked, Dr. Prakken, about the uncertainty that exists. Would you agree that if our debt-to-GDP was one-third of what it is today, there would be less concern and more confidence. We are so highly leveraged, that this is creating uncertainties that we have not seen before?

Mr. PRAKKEN. I would rather we had less debt than more debt.

Senator SESSIONS. In Europe, some are predicting catastrophic events. Hopefully that will not happen. Our debt is not much better than theirs. We are on a path in which we went from a \$161 billion deficit to a \$450 billion deficit to a \$1.3 trillion deficit, I think for the last 3 consecutive years, and we will be over \$1 trillion this year. It is unprecedented. And you tell us you cannot predict the future. Mr. Blinder’s friend and collaborate, Dr. Zandi of Moody’s, predicted 4-percent growth for 2011. It came in at 2 percent.

Dr. Prakken, what was your prediction for 2011?

Mr. PRAKKEN. Too high.

Senator SESSIONS. You do not want to tell us?

Mr. PRAKKEN. Made when, a year ago?

Senator SESSIONS. Yes. Zandi’s was made in January of 2011 for 2011.

Mr. PRAKKEN. Probably close to 3 percent, and then—

Senator SESSIONS. You were a little cautious. So the point is—so, Dr. Blinder, when you say we ought to borrow another \$500 billion, because it will create more growth than uncertainty and damage, it bothers me. I am not saying we need dramatic cuts this year, but I am saying that we need to be very dubious about borrowing more.

I think this past election was seminal. People were shocked by the size of our deficit and are prepared to take a little medicine. It is so disappointing that the President said nothing about our debt at the State of the Union. His own Chairman of the Joint Chiefs said the debt is the greatest threat to our national security. Dr. Brannon, isn’t it a point in time in which this Nation has got to actually worry about this debt course? Are we facing the most predictable financial crisis in our Nation’s history if we do not reduce our debt?

Mr. BRANNON. I believe you are correct.

Senator SESSIONS. Dr. Prakken.

Mr. PRAKKEN. Current fiscal policy is unsustainable, and if we try to sustain the unsustainable, the inevitable consequence will be a gradual rise in interest rates and a gradual decline in our standard of living.

Senator SESSIONS. Thank you. Dr. Blinder.

Mr. BLINDER. That is right, but the emphasis needs to be on the trend, not the level. We have no trouble now financing the level of the deficit that we have now. In fact, we are paying zero interest rates at the short end. The trend is totally unsustainable, completely unthinking, and it is almost entirely, as came up in this hearing, due to rising health care costs. So that is the one thing that needs to be dealt with in terms of long-term deficit control. If we could do that—unfortunately, nobody knows how to do that. If we could do that, almost nothing else would matter.

Senator SESSIONS. Well, Mr. Bowles of the Commission said that we could be facing a debt crisis in 2 years. That was a year ago when he made that statement. And you are talking about medical costs in the next 20, 30 years which are horrendous. But I am worried that the debt is already having an impact on this economy. I think the Europeans have decided they need to retrench now, even though it might cause some short-term pain.

Thank you.

Chairman CONRAD. Let me just ask my colleagues, we have three of us left, the vote is hard-wired at noon. Could we go to 5-minute rounds? Would that be acceptable? I apologize to my colleagues. In fact, I will tell you what. Let us do 6 minutes for the two of you, and I will just either not do a round or have it further truncated.

Senator Wyden.

Senator WYDEN. Mr. Chairman, you are very thoughtful. I am just going to ask one question. I think I can get under 6.

Dr. Brannon, you have worked on the Hill for a long time, and I am going to direct this to you. My concern has long been that the lame duck session of the 2012 Congress would look pretty much like the lame duck session of the 2010 Congress—big economic challenges, a real fight over the bush tax cuts—and, frankly, the 2012 session really has a double whammy because, in addition to the debate about taxes, you have this question of sequestration kicking in, sort of not really looking to target what you are doing in spending in a careful kind of way. And I have been looking at all the possible ways to try to break out of this cycle. For example, I opposed the Bush tax cuts, but I suggested after the 2010 election, why don't we extend the Bush tax cuts for 1 year so that Congress on a bipartisan basis would be forced in 2011 to make some tough choices about tax reform and spending so that both sides would be under pressure to come together. Obviously, we were not successful in it. I would have liked to have seen it. As Senator Coats and I have a bipartisan tax reform plan. There are others who have ideas on how to approach it. But because the Chairman is being very gracious about the time, my one question to you is: What do you think can be done over the next few months to try to drive this kind of bipartisan agreement around tax reform and spending reform so that you do not get this kind of lame duck melt-

down where the choices are only ones that do not really serve the country's interest? Just your thoughts on that.

Mr. BRANNON. You know, the discussion we always have—when I started on the Hill it seemed to happen every 6 months—is how do you tie the hands of a future Congress or even the current Congress in the future, and I think it is impossible. And that is why we end up pushing things to the last minute. And when I was on the staff of the Senate Finance Committee, the last day we were in session we knew we would be here until 4:00 or 5:00 a.m. because the last negotiations would not take place until everybody was too tired to do anything.

I will say this: You know, people have talked about the need for comprehensive tax reform, and people on both sides have acknowledged this, and they say, oh, that takes a year or two to get done. But if you look at what your predecessor, Senator Packwood, did, ultimately it took about a month to really get everything through, and I have talked to him about that. He said if you take much longer to do comprehensive tax reform, everybody starts figuring out precisely how much their ox is gored. And so maybe the thing to do, being an outsider, maybe the thing to do is to try to do comprehensive tax reform in a lame duck session.

Senator WYDEN. Mr. Chairman, thank you.

Chairman CONRAD. I thank the Senator.

Senator Nelson.

Senator NELSON. I happen to agree with you, Dr. Brannon. I think that might be the way to get it done. Otherwise, we would get pecked to death on the Finance Committee.

Tell me, if we have a long, drawn-out fight over this 2-percent payroll tax cut, what is going to be the effect on job creation and our economic recovery?

Mr. PRAKKEN. Well, let us see. It cannot be too long and drawn-out because you only have a month left to make a decision.

Look, the decision is whether the holiday ends at the end of February or whether it is extended through the end of the year, correct?

Senator NELSON. Correct.

Mr. PRAKKEN. In which event the holiday would expire, anyway. To be frank, that is not going to have all that much effect on the economy, I mean, moving up 10 months something that is going to happen at the beginning of next year, anyway. But, it is roughly \$140 billion that would be taken out of the pockets of working men and women and unemployed people, and they would certainly reduce their spending some if they did not have that, and that would reduce demand for goods, and that would in turn, prompt some reduction in the production of goods and some job losses.

Is it a lot? No. But is it a negative if you do not extend this beyond February? Yes. It is just simple. If you take spendable money away from people, they will spend less, and people will produce less.

Mr. BLINDER. Could I just add, Senator, that I think everybody viewed—probably including Members of Coverage—a 2-month extension as economically ridiculous. It was the best that could be done under the political circumstances. And I think there is a very, very widely shared view, which I hold, that the other 10 months

are coming. And I think the main—and I think that will happen. The question is whether you drag it out until after midnight on the last day, which the Congress might.

I frankly think the main thing that is at stake there is not that the 2-percent payroll tax cut is going to happen. It is the reputation of the Congress. It just starts looking ridiculous to people.

Mr. PRAKKEN. And I agree with that one. There is that expectation. But there is uncertain about how and over what time period it will be paid for. If the insistence is made that it be paid for quickly, that then mutes the stimulative effect of extending the holiday. If it is paid for gradually over a number of years at a time when the economy is stronger down the road, you have a more favorable outcome.

Mr. BRANNON. And I just do not believe all that much that fiscal stimulus does a whole lot. I think the Congress is better served thinking about long-run changes in taxes and spending, that the permanent changes that contribute to long-run economic growth and not worrying about the short-term variations in the business cycle, because I do not think they can do that much about it.

Senator NELSON. Tell me what you think is going to happen in Europe, and according to what you think, if you think it is going belly up on the banking system, tell us how bad that is going to affect us. Dr. Blinder?

Mr. BLINDER. Yes, glad to. I alluded to it a little bit in the testimony. I think the best guess—and “guess” is the right word here—is that they continue to manage to muddle through, kicking the can down the road a little further at each stage. They have been remarkably successful at that. This has been going on, in an acute phase, since the spring of 2010, and they keep kicking the can down the road doing just enough to get by. I think that is the best guess for 2012.

The downside risks which you were asking about are enormous. If there is the financial equivalent to Lehman Brothers that starts in Europe, I think that is a recipe for a worldwide recession, starting in Europe but not staying in Europe. And as I suggested in the testimony, the potential to knock down U.S. GDP growth, which might otherwise be, say, 2.5—or pick whatever number—let me not even do a forecast. To knock down U.S. GDP growth by 2, 2.5 percentage points from whatever it would have been in a worst-case scenario.

Senator NELSON. Any different point of view?

Mr. PRAKKEN. Agree with everything Alan said. Hopeful that the ECB’s decision to lend 3-year money to banks in the EZ so that they can either acquire some of this troubled sovereign debt or not sell the assets that they have in a fire sale to recapitalize themselves seems to have worked so far very well, and I think it increases the chance of the muddle-through scenario.

But one of the things that makes putting together forecasts so difficult now is that Europe is the single biggest threat, and you can imagine two or three different scenarios, all of which have roughly equal probabilities of occurring—the muddle-through is one; disaster is another. And either one probably has a 35 or 45 percent chance of occurring. It just makes it very hard to have a base case view of what is the impact on the U.S.

Senator NELSON. Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator. We have 7-1/2 minutes left in this vote now, so I am going to forgo my questioning round. This is really management by the Chairman. I lose my chance to question the witnesses. But I had an extensive statement at the beginning.

I deeply appreciate the contributions of the witnesses here today. You have certainly helped the work of this Committee.

With that, we will stand adjourned.

[Whereupon, at 12:06 p.m., the Committee was adjourned.]



**Questions for the Record  
from Senator Graham  
for Dr. Joel Prakken  
The Outlook for the U.S. and Global Economy  
1/26/2012  
Senate Budget Committee**

1. In your testimony you stated that your forecast assumes a number of policy extensions and fixes including “that a full sequester will be avoided, and that a grander bargain on gradual deficit reduction will be achieved.” With the recent failure of the Joint Select Committee on Deficit Reduction created by the *Budget Control Act of 2011*, why do you assume that a greater deal can and will be reached, and when do you predict that this deal will be reached? Also, why do you assume that Congress will act to prevent sequestration as required by the Budget Control Act? What effects will sequestration have on our economic recovery and future growth if implemented in full, both on the defense and non-defense discretionary spending sides?



Our economic model requires as inputs explicit assumptions about future paths of taxes and spending. This forces us, in these time of great fiscal policy uncertainty, to make policy assumptions that admittedly are more in realm of political science than economics. I cannot claim I have much confidence in our assumptions but, at the risk of sounding flippant, we have to assume something!

(1) In December, and given the economic circumstances, both parties found reason to extend the "payroll tax holiday" and emergency unemployment benefits for two months. Furthermore, we interpreted that decision as a signal that both parties were interested in finding a way to extend these programs through the end of this year. Circumstances have not changed significantly since then, so we continue to assume that, even though the deadline is fast approaching, these programs will be extended through December.

(2) Under current law, there would occur a huge fiscal contraction in 2013 when it is likely that the economy will remain mired in a sub-par recovery, there will be downside risk from the European Debt Crisis, and the Federal Reserve will be limited in its ability to cushion the economy from the adverse near-term effects of such a sharp fiscal contraction. Under these circumstances, we assume both political parties will see a common interest in preventing that sharp fiscal contraction, and that out of this common interest will arise a grander bargain that will spread the fiscal pain across many groups and distribute that pain more gradually over time as the strengthening economy can absorb it and as, with interest rates off the "zero bound", the Federal Reserve can offset some of the fiscal drag.

(3) A critical factor underlying these assumptions is that our economic model suggests that if deficit reduction in excess of \$4 trillion over the next decade is not implemented, inflation-adjusted interest rates will begin rising towards unsustainable levels. We assume that no-one wants to see that happen.

I confess to a real concern that our policy assumptions may prove optimistic given the current contentious political atmosphere. Furthermore, the timing and manner in which these fiscal uncertainties are resolved probably depend on the outcome of the presidential election. All this underscores that there is downside risk to our near-term forecast arising from the possibility of much larger near-term fiscal drag that we have penciled in.

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Joel Prakken, Sr. Managing Director / Co-founder Macroeconomic Advisers, LLC





## THE OUTLOOK FOR THE EUROZONE

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WEDNESDAY, FEBRUARY 1, 2012

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

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, Merkley, Johnson, 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 focus on the outlook for the eurozone and its potential impact on the U.S. and global economy. We have three really distinguished witnesses with us this morning. I want to thank them each for being here.

First, we have Dr. Simon Johnson, senior fellow at the Peterson Institute and professor of entrepreneurship at MIT's Sloan School of Management. Dr. Johnson has testified

before this Committee on several occasions, and we welcome him back this morning.

We also have Dr. Fred Bergsten, director of the Peterson Institute for International Economics. I would note that Dr. Bergsten recently announced that after 31 years of ably leading the Peterson Institute, he will be stepping down as director and focusing more of his time on research and writing. I want to commend Dr. Bergsten for his years of leadership at the institute and wish him well in his future endeavors. And, of course, Dr. Bergsten has testified many times before the Budget Committee as well.

We also have with us this morning Dr. Adam Lerrick, a visiting scholar at the American Enterprise Institute, someone who is deeply knowledgeable on European affairs, having spent the last 2 years there. We look forward very much to your testimony and welcome you to the Senate Budget Committee this morning as well.

I would like to begin by just very briefly reviewing the situation as I see it in Europe. To be clear, what is happening in Europe has ramifications across the globe, certainly including the United States. Here is the front-page story in the Washington Post last week: "IMF fears European crisis poses risk of major recession." The article highlights the International Monetary Fund's concern

that the turmoil in Europe could have serious consequences for the global economy.

**The Washington Post**

WEDNESDAY, JANUARY 25, 2012

## IMF fears European crisis poses risk of major recession

**BY HOWARD SCHNEIDER**

The global economy is slowing sharply and is at far greater risk of recession than was thought just months ago, with Europe's debt crisis creating "fertile ground" for a rapid collapse, the International Monetary Fund warned Tuesday.

In a sobering trio of reports on growth, public debt and financial stability, the agency described global trade and investment as waning and depicted the world as perhaps one shock away from a serious downturn. The epicenter of the economic turmoil remains the euro zone, where political leaders have not committed the money needed to prop up weakened governments and banks, thereby threatening to create a cycle of "self-perpetuating pessimism" that could undermine the recovery, the IMF said.

Whether the trigger is a government default in Greece, a bank failure or some other traumatic event, "the world could be plunged into another recession," said Olivier Blanchard, the IMF's economic counselor. "The world recovery, which was weak in the first place, is in danger of stalling."

The agency's latest forecasts suggest that the process may be underway. Projected worldwide economic growth for 2012 was trimmed to 3.25 percent from the 4 percent rate projected in September. China and India, which have become major engines of global growth, are predicted to cool to around 8.2 percent and 7 percent, respectively. The IMF projects that the euro zone will fall into recession and contract by about 0.5 percent this year.

**IMF CONTINUED ON A16**

Yesterday we saw reports that European leaders had agreed to new measures to address the debt concerns in their countries. Here was the New York Times headline on the agreement: "European leaders agree to new measures to enforce budget discipline." I would very much like to hear the views of our witnesses on this agreement and whether it is the right answer for Europe at this moment.

# The New York Times

TUESDAY, JANUARY 31, 2012

## European Leaders Agree to New Measures to Enforce Budget Discipline

By STEPHEN CASTLE and JAMES HANTER

BRUSSELS — All but two European Union countries agreed Monday to new and tougher measures to enforce budget discipline in the euro zone, but the deal still showed few signs of producing a comprehensive solution for the sovereign debt crisis or a credible plan to revive fragile economies across Europe's weakest Mediterranean tier.

The meeting of 27 European Union heads of state and government here in Brussels was aimed at completing the text of a so-called fiscal compact for the 17 nations relying on or intending to join the euro zone — with only Britain and the Czech Republic opting not to adopt the measures.

After a marathon leading seven hours, the leaders also issued a declaration calling for a new push to restart growth and combat joblessness across the Continent. But a number of politicians and analysts said the pledge by the European leaders to create new jobs was mostly empty, and others complained that the proposed rules to keep deficits under control contained little to actually help nations with high borrowing costs.

The summit declaration also skirted the continuing problems

in Greece, where a second bailout is being held up by the stability of the government in Athens to complete a deal with private holders of Greek bonds over the losses they should accept.

Until Athens and its private-sector creditors can agree on a \$12 billion write-down on Greek government debt, the International Monetary Fund and the European Union are not prepared to sign off on a further bailout. Chancellor Angela Merkel of Germany said the Greek situation would not be addressed until after representatives of Greece's so-called troika of creditors — the European Union, the I.M.F. and the European Central Bank — report back on their investigation into what will be needed for Greece to manage its finances on its own.

Nicolas Sarkozy, the French president, said a news conference at the end of the summit that there would be a "definitive agreement" on the private sector's involvement in reducing Greek debt in coming days. After Monday night's summit meeting, informal talks continued between the Greek prime minister, Lucas Papademos, and European officials.

Despite the various other problems to deal with, an agreement on the fiscal compact could clear



President Nicolas Sarkozy of France, Chancellor Angela Merkel of Germany and Prime Minister Mario Monti of Italy before the European Union leaders meeting in Brussels on Monday.

the way for Germany to accept stronger efforts by the European Central Bank to support ailing countries and a more comprehensive bailout fund aimed at protecting Italy and Spain against the risk of default.

"It is an important step forward to a stability union," Mrs. Merkel told reporters. "For those looking at the union and the euro from the outside, it is a very important to show this commitment." Britain, which clashed openly with France and Germany

last month over the pact, did not give any ground Monday and was joined by the Czech Republic, which also elected to stay outside.

"We are not signing this treaty," David Cameron, the British prime minister, said. "We are not signing it. And it places no obligations" on the United Kingdom, he said.

He added: "Our national interest is that these countries get on and sort out the mess that is the euro."

Mr. Sarkozy sounded philosophical about the British' intransigence. "There are different degrees of integration and everyone is free to choose where they stand," he said.

While European leaders agreed to bring a permanent bailout fund into existence earlier than previously foreseen, they postponed any final decisions on its ultimate size and how it will be financed. The International Monetary Fund has been pressing Europe to commit enough money to provide a credible backstop that would insure that Italy and Spain could pay their bills and continue to finance their debts.

Germany backed away from a suggestion that it wanted the government in Athens to temporarily control over tax and spending decisions to a new, all-powerful, budget commissioner before it can secure further bailout.

Italy won its battle to restrict the scope of the fiscal compact, which calls for making it easier to impose sanctions against countries that break European Union budget rules. The text said the compact would make it harder to block sanctions against countries that exceed annual deficit targets but that the same tough system would not apply to nations with excessive overall debt, like Italy.

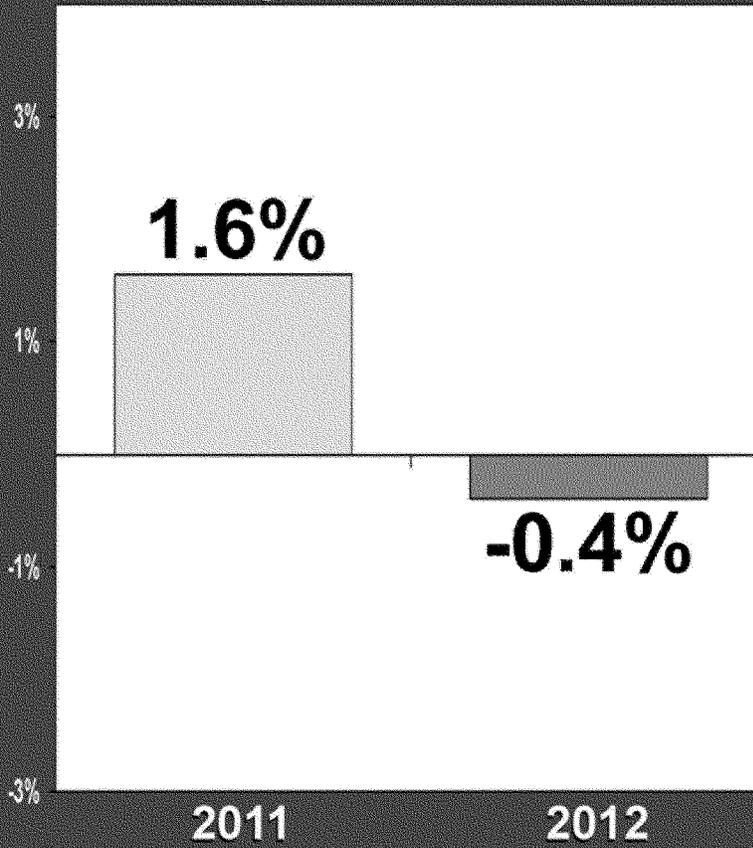
Mr. Verhofstadt, leader of the central liberal and democrat group, and a former prime minister of Belgium, took a similar stand.

"The new agreement constitutes fiscal discipline but omits completely to address the other side of the coin — that of solidarity and investment that will create jobs and growth," Mr. Verhofstadt said. "E.U. leaders should act instead of producing more paper."

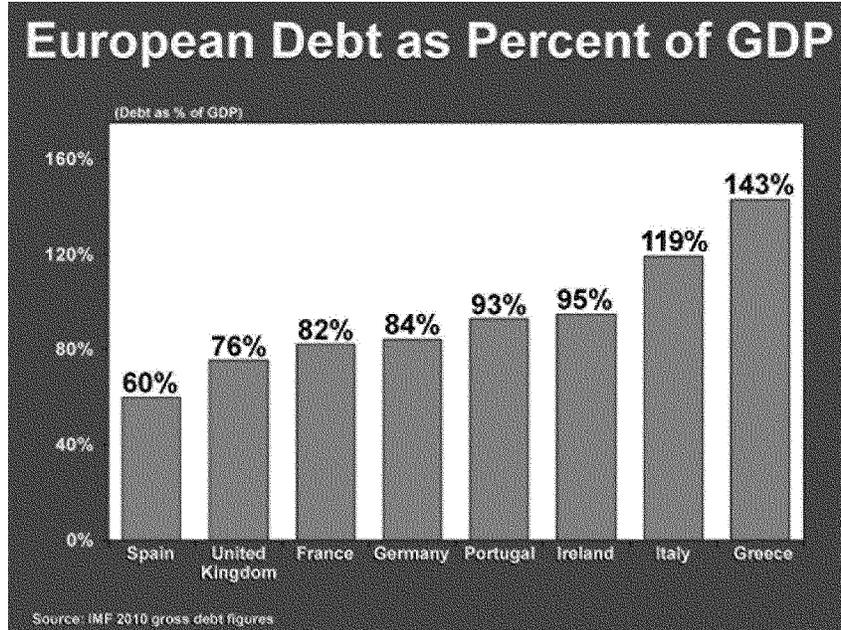
Most economists believe the eurozone is already in recession. We can see the Blue Chip forecast shows eurozone economic growth falling from an anemic 1.6 percent in 2011 to a negative four-tenths of 1 percent in 2012. At the same time, European nations are saddled with large and growing debts that impact their ability to respond to the downturn. We can see that Greece and Italy both face debts well above 100 percent of GDP. Of course, our own circumstance, we now face a gross debt of more than 100 percent of our GDP.

# Eurozone Economy Slowing

(Estimated percent growth of real GDP, annual rate)



Source: Blue Chip Economic Indicators, January 10, 2012



The threat to the U.S. economy is clear. Here is how economist Alan Blinder, the former Vice Chairman of the Federal Reserve, described the situation in his testimony before the Budget Committee last week: “My rough outlook for U.S. GDP growth in calendar year 2012 is about 2.5 percent. The biggest threat to the economic is financial contagion from Europe. If we get a worst-case scenario, a European financial blowup that looks somewhat like Lehman Brothers, I think most, if not all of that putative 2.5-percent growth could just evaporate in a worldwide recession.”

### **Economist Blinder on Threat to U.S. from European Debt / Financial Crisis**

**“My rough outlook for [U.S.] GDP growth in calendar year 2012 is about 2.5 percent.... The biggest threat to the economy is financial contagion from Europe.... [I]f we get a worse case scenario, a European financial blow up that looked somewhat like Lehman brothers ... I think almost all, if not all, of that putative 2.5 percent growth could just evaporate in a worldwide recession.”**

— Former Vice Chairman of Federal Reserve Alan S. Blinder  
Testimony before Senate Budget Committee  
January 26, 2012

I hope people are listening. If Europe implodes, the risk to our economy is serious. We need to remember that almost one-quarter of U.S. exports go to our European trading partners, so what happens to the European economy could have a very real impact on U.S. manufacturers and U.S. workers.



With that, we will turn to Senator Johnson, who is filling in for Senator Sessions this morning, for his opening remarks. Then we will turn to our witnesses for their testimony. And, again, I want to thank Senator Johnson for filling in for Senator Sessions this morning. I would just say to colleagues, there are many competing meetings of other committees this morning, including markups in some, which means that colleagues who would like to be here simply cannot be here and participate in the work of other committees on which they serve. So we understand that this is a meeting in which there are many competing priorities for members of this Committee.

Senator Johnson.

### OPENING STATEMENT OF SENATOR JOHNSON

Senator JOHNSON. Well, thank you, Mr. Chairman. Obviously, I am here because this is my top priority. I think this is—certainly the greatest threat that does face our Nation is our debt and deficit issues, and it all is tied into our need to really achieve economic growth, and that is, of course, what the threat of Europe poses to the U.S.—how is that going to affect our economic growth?

I just want to thank you for your comments at our last Budget meeting where you certainly indicated your desire to work toward passing a budget resolution out of this Committee and one that would hopefully reduce our deficit by as much as \$5.5 trillion. I think that is a great goal. It is one I certainly want to work with you to try and achieve.

I think one of the things we have to do if we are going to achieve that goal is we have to be mindful of our obligations under the Budget Act from 1974 and be mindful of those dates. Of course, the

President in terms of following that law should be presenting a budget on the first Monday in February. We will probably miss that by a week. Okay. Let us not let any other deadlines slip. This Committee has an obligation to pass a resolution by April 1st, and then the Senate should be acting on a concurrent budget by April 15th. I think we really need to hold our feet to the fire to get that done because I think it is the minimum amount—the minimum requirement that the American people should expect from the Senate, is to actually pass a budget so they understand what the plan is, so they can see it on a piece of paper and they know the direction that the Senate will take.

Chairman CONRAD. If I could just interrupt the Senator on that point, one unknown that we still have to deal with is when we will have CBO's re-estimate, and they have not given us an answer on that question. So that is the one unknown that is out there. I agree with you entirely. I would like to get this done as soon as possible. Obviously, we have a hearing scheduled to conclude, which is important, because we are hearing from the head of OMB, the head of CBO, the Secretary of Defense, the Secretary of Treasury, and the rest—the Secretary of Transportation. But the one thing that is out there that is an unknown for us as a Committee is when CBO will provide the re-estimate.

Senator JOHNSON. I guess we have Director Elmendorf here. We should ask him that question and keep his feet to the fire as well, so I will help you do that.

But, Mr. Chairman, you have done such a good job since I have been here of providing graphs, so I guess, I think, imitation is the greatest form of flattery, so I brought a couple graphs here today that certainly I have been showing in Wisconsin to basically describe what I think is the problem facing our Nation in terms of economic growth and our debt and deficit situation.

Certainly, as I was reviewing the testimony that will be given to us here today, my concern is that we are trying to address a problem of fiscal mismanagement with monetary solutions, and I think we are seeing that in Europe, and it just simply is not working that well.

One of the charts that I showed to groups in Wisconsin—I turned smiling faces into frowns—is I describe the history of our debt. And I like using this one because it shows in 1987 our total Federal debt was \$2.3 trillion. It took us 200 years to accumulate \$2.3 trillion worth of debt, and we just entered an agreement last year to basically, give the President the authority to increase the debt ceiling by \$2.1 trillion. We will blow through that limit in less than 2 years. That is a little depressing.

The next chart will show total spending. I know an awful lot of people use the shorthand version that we are cutting spending or we are proposing cuts. Quite honestly, nobody is proposing cuts. This also is kind of a jaw-dropping chart when I show it to groups in Wisconsin because it shows that 10 years ago our Federal Government spent \$1.9 trillion. Last year, we spent \$3.6 trillion. We have doubled spending in just 10 years. And the argument moving forward is, according to President Obama's last budget, he was proposing spending \$5.8 trillion in 2021. The House budget would have spent \$4.7 trillion, and I think the graph is pretty visual from

a standpoint we are not talking about cutting the size of Government, we are just trying to reduce the rate of growth.

Another way of looking at spending is on a 10-year spending level. If we put the next one up, in the 1990s we spent \$16 trillion over a period of 10 years. The last 10 years we spent \$28 trillion. And, again, the argument moving forward is, according to the President's last budget, he was looking to spend \$46 trillion in the next 10 years; the House budget would have spent \$40 trillion. If you have heard about that \$6 trillion in draconian cuts, that is what we are talking about, is the difference between \$46 trillion versus \$40 trillion. But, again, I am an accountant. I can do the math pretty easily. Neither 46 nor 40 is less than 28. We continue to grow Government.

The next to the last chart—this is the really eye-popping one—compares the total liabilities of the United States to the total net assets, private assets. These are last year's figures. I have not revised the chart. I will tell you what the new numbers are. But last year, according to the trustees, according to the balance sheet of the United States, the total Federal liabilities—the unfunded liability of Medicare, Social Security, our total debt, and the liability to Federal retirees—was \$99 trillion. Now, that is an incomprehensible figure, but if you relate it to the size of our asset base—and that is household assets, large and small businesses—it is \$79 trillion. That is the definition of a huge problem right there.

Now, the latest balance sheet of the United States that came out shows the liabilities as \$72 trillion. They have revised the estimate. They have made some actuarial adjustments. They are taking a look at the health care law and actually making the assumption that the health care law will reduce health costs. And I guess the point I would like to make is in many of our estimates here, we are simply deluding ourselves. I do not think it is rational to really believe that the health care law is going to lower health care costs.

The other assumptions we are making, CBO just released their latest baseline, and in that baseline they are assuming that we are actually going to let these tax cuts expire, all of them. That is a \$5 trillion bet. I do not think that is going to happen.

The true cost of health care, I have worked with Douglas Holtz-Eakin on this, I have written some op-eds on it, I have taken a look at it. Again, we are deluding ourselves to think that this thing is going to be deficit neutral. It will not be. It will add trillions of dollars to our debt and deficit over the next 10 years.

I think the other thing we have to worry about is the economic growth assumptions that are put in these baselines. We have seen a couple studies. The CBO itself says to the extent that we miss our growth targets by 1 percent, that adds \$3 trillion to our debt and deficit. We need to be concerned about that.

I think the final thing we need to be concerned about is we are trying to close the deficit. Again, I think in my graphs I pretty well described a spending problem, and I would just caution anybody that wants to increase tax rates. I want to raise more revenue by growing the economy. I want to raise more revenue by significant tax reform that is pro-growth. But if we just raise rates, I think we delude ourselves to think that we will actually have the revenue increases by doing that. I think it would harm economic growth.

In the end—I think that is what we are going to hear in our testimony here today—the solution in Europe is trying to enact governmental policies that will promote economic growth. In the United States, we have the exact same dynamic. We have to make sure that nothing we do here in Washington detracts from economic growth.

So, with that, I just have one final chart. It speaks to the U.S. Government in relationship to the European economies, and to me this is an incredibly key metric. I am a business guy, I am a manager, I am an accountant. So I am looking at key metrics. Certainly, the size of our debt in relationship to our GDP is an important metric, but I think this is even more important.

When you take a look at the Federal Government, its size in relation to our economy, it is right now 24 percent. You add in State and local governments, and total Government is 39.2 percent, which means 39 cents of every dollar that our economy generates filters through some form of Government.

Now, Government does a number of wonderful things, but it is not particular effective, it is not particularly efficient at many things. I think it is a very bad metric when you compare it to European-style socialist nations. You know, congratulations, America. We have arrived. We are at the lower level of European-style socialism. Norway spends 40 percent of government of its GDP, 40 percent. Greece—I think we are going to be hearing about Greece, and Italy. Greece is 47 percent, Italy is 49 percent, France is 53 percent. That is a metric that I believe we need to manage; we need to start reducing the size of Government.

So, with that, Mr. Chairman, I appreciate the indulgence here and turn it over to the witnesses.

Chairman CONRAD. Good. Look, there are lots of things you said there I agree with, some that I do not. I think my sharpest area of disagreement would be the new health care law because CBO has told us that that will reduce deficits and debt by more than \$1 trillion in the second 10 years. And I believe that is the case. I know you do not share that view. That is what makes our democracy vibrant. We have disagreements.

But there is much I agree with, and what I most strongly agree with is that we are on an unsustainable course. And I think it is undeniable that we are on an unsustainable course.

We have had the head of the Congressional Budget Office testify before this Committee that we are on an unsustainable course. We have the head of the Office of Management and Budget so testify. We have had the Chairman of the Federal Reserve testify we are on unsustainable course. We have had the Secretary of Treasury testify we are on an unsustainable course. I think it is undeniable, and it is really the central thrust of your argument as I hear it. And I think you are entirely right about that.

We have an obligation—we have an obligation on this Committee, we have an obligation in this Senate, the House has an obligation, the President does—to try to get us on a more sustainable course. And, it does not take that much to get us to balance. I have said, without advocating it, a 6-percent increase in revenue from what is currently scheduled, a 6-percent reduction in spending

from what is schedule, would save us \$6 trillion over 10 years and balance the budget.

Now, I do not think it should be an even split, revenue and spending, and every body in which I have served—the Fiscal Commission, Group of Six—we have weighted it heavily on the spending cut side of the equation. But I personally believe we do need additional revenue, but as you describe, not with an increase in tax rates. I think that would be counterproductive to our competitive position in the world.

And so, there are places where there is agreement on both sides here. My fondest hope is that we find a way this year to actually make substantial progress. I am leaving after this year. I would like nothing better than to leave behind a legacy of getting America back on track.

Now, one of the things facing us, obviously, is external issues. We are discussing, I think—one of the biggest threats to our economy and deficits and debt is the European economic challenges. Another is what could happen with respect to military engagements around the world. We will be dealing with that at a later hearing.

Let us go to our witnesses this morning. We will start with Simon Johnson. Dr. Johnson, thank you again very much for being here. Please proceed. We will go right through the witnesses, and then we will open it up to questions. We will do 7-minute rounds, and, again, thanks to all the witnesses for being here.

Dr. Johnson, please proceed.

**STATEMENT OF SIMON JOHNSON, PH.D., SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, AND RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, SLOAN SCHOOL OF MANAGEMENT, MIT**

Mr. JOHNSON. Thank you, Senator Conrad and Senator Johnson, and thank you also for placing the conversation today in the context which you just did of the U.S. budget and our unsustainable situation. I think that is absolutely correct, and I would like to frame my remarks very much to respond to that. Let me make three points.

First of all, the eurozone has already failed. The eurozone was established as a bastion of stability and prosperity in the world. It was designed to further cement the European Union and to build a larger, more powerful economy, but this has not worked.

As you said a moment ago, Senator Johnson, fiscal mismanagement lies at the heart of their problems, and I completely agree. They are trying to solve those fiscal problems through—I think you called it “monetary solutions.” I might call it “monetary innovations,” even a less positive word. I do not think this is going to end well for them or for us.

And with regard to your question about the new agreements, the latest rounds of agreements, Senator Conrad, I think this is very small steps—in the right direction but very small steps relative to their problems and relative to what they need to do. So I think we should encourage them to do more, but it is not just a fiscal problem. It is a fiscal problem on top of a competitiveness problem on top of an unsustainable balance of trade within the eurozone and,

of course, on top of debt levels, as you well know, in Greece. And I am afraid also now in Portugal and I think in Ireland, correctly calculated, and arguably also in Italy, these debt levels are not sustainable under their current arrangements.

Now, even my more optimistic colleagues from whom you will hear in a moment I think will agree that the outcome in Europe is going to be deep recession, austerity. That is the good scenario, that you have high unemployment, low growth, and that is not good news for our situation.

The downside scenario that I would emphasize, my second point, is much worse. The spillovers from their sovereign debt problems to their financial system and from their mega banks that, frankly, are very badly run, have far too little capital, those issues were clear already in 2007–08 when I was the chief economist at the IMF, that they have not addressed those issues, they have not made the system safer. It is a dagger pointed directly at our financial system.

And in terms of what you both care about, in terms of the direct negative impact on our economy and on our budget, this is a huge risk. It is a risk that we can take steps to mitigate. We cannot solve the Europeans' problems for them. That would be an illusion, and it would be extreme arrogance on our part to presume. But we can build better protections for ourselves first and foremost around the ability of our financial system.

Now, the Financial Services Roundtable has a report out this morning claiming that all is well in our banks, including in our big banks, and that we have so-called fortress balance sheets in those banks. It is not true. That is not an accurate depiction of the level of capital, the level of equity financing relative to debt, to buffer against losses that we have in our banks.

The Federal Reserve is well aware of this. You showed us the remarks of former Vice Chair Blinder. I am sure that Mr. Bernanke and his colleagues share those sentiments in private with you.

They must, however, take the logical step of suspending bank dividends. It makes no sense in this environment to allow the banks to pay out that capital. They should keep it on their balance sheet, and they should build up their equity relative to the losses they could face, for example, if the euro swap market were to collapse, which I would stress is a very real possibility, and I go into this in my written testimony and other materials I have shared with your staff. If that market were to collapse, we need as much of a buffer as possible in our banks, and the suspension of bank dividends ordered by the Federal Reserve applying on a blanket basis would stabilize and help strengthen our financial system.

Secondly, we should be scoring—this is directly to your point, Senator Johnson. We should be scoring, the CBO should be scoring for you the fiscal impact of financial calamity, and particularly the dangers posed by a financial system that is run irresponsibly. They do score for you important contingent liabilities including, as you showed us, Medicare. That is a contingent liability. We do not know exactly what will be Medicare costs in 20, 30, or 50 years, but we can have a view, and the CBO I think takes a pretty hard look at that and gives you a sensible baseline read. They should do the same for our financial structures as exposed to Europe, what

would happen if there were a serious sovereign debt problem, for example, for Italy, how would that impact our banks? How would that affect our real economy? Even assuming the Dodd-Frank principle holds of no direct costs from bailouts, it would still cause a massive recession. You would still lose a lot of tax revenue. That would still presumably push up the borrowing at the Federal level and at the State and local level, to the extent that that is possible. We should be scoring that. You should be looking at it.

Now, I am not proposing you hold up this year's budget on that basis, but when you talk to Mr. Elmendorf directly and in private, I think you should impress upon him—I am on the CBO's panel of economic advisers. I made this point to them. I think they will be receptive if Congress pushes them hard in that direction. There are serious unfunded liabilities for us in this area.

Third, and finally, with regard to the International Monetary Fund, the IMF should be working to build a firewall—not within the eurozone. They should not lend more money into the dangerous and counterproductive situations we now see in the eurozone. The Europeans run a reserve currency, the euro. They are perfectly capable of sorting out these problems for themselves. They have not done it yet, I grant you. They need a lot of encouragement, and they are getting some of that from the executive branch. Mr. Geithner I think has been quite good on this of late. More encouragement from Congress through all available channels would no doubt be helpful. But, most importantly, the IMF should focus on protecting other countries. Build a firewall outside of the eurozone, protect the innocent bystanders. Let the Europeans sort out their situation for themselves but help other countries with whom we do a lot of trade who also have financial systems that are intertwined with ours, help those countries buffer themselves against calamity that may arise in the European situation.

Now, the IMF leadership has taken this up. They have issued a paper to their membership. Unfortunately, it was a secret paper. The details have been poorly communicated. They have created conflicting opinions, and I strongly advise you to bring senior IMF staff in for a private briefing. I understand they cannot do hearings, but they can brief you in private, and they can communicate their intent. And I would urge you and your staff to impress on them at every available opportunity, build a firewall outside of the eurozone, not attempt to fix the eurozone. The Europeans should do that for themselves.

Thank you very much.

[The prepared statement of Mr. Johnson follows:]

**Testimony to Senate Budget Committee, hearing on “Outlook for the Eurozone,”  
Wednesday, February 1, 2012, 10am (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; co-founder of <http://BaselineScenario.com>; member of the CBO’s Panel of Economic Advisers; and member of the FDIC’s Systemic Resolution Advisory Committee.<sup>1</sup>

**Summary**

- 1) Successive plans to restore confidence in the euro area have failed. The market cost of borrowing is at unsustainable levels for euro banks and a significant number of governments.
- 2) Two major problems loom over the euro area. First, the introduction of sovereign credit risk has made nations and subsequently banks effectively insolvent unless they receive large-scale bailouts. Second, the ensuing credit crunch has exacerbated difficulties in the real economy, causing Europe’s periphery to plunge into recession. This has increased the financing needs of troubled nations well into the future.
- 3) With governments reaching their presumed debt limits, the European Central Bank (ECB) is now treading a dangerous path. It feels compelled to provide adequate “liquidity” to avert systemic financial collapse, yet must presumably limit its activities in order to prevent a loss of confidence in the euro—i.e., a change in market and political sentiment that could lead to a rapid breakup of the euro area.
- 4) Five measures are needed to enable the euro area to survive: (1) an immediate program to deal with excessive sovereign debt, (2) far more aggressive plans to reduce budget deficits and make peripheral nations “hypercompetitive” in the near future, (3) supportive monetary policy from the ECB, (4) the introduction of mechanisms that credibly achieve long-term fiscal sustainability, and (5) institutional change that reduces the scope for excessive leverage and consequent instability in the financial sector.
- 5) Europe’s leaders have mainly focused on a potential long-term fiscal agreement, and the ECB under Mario Draghi is setting a more relaxed credit policy; however, the other elements are essentially ignored.

This crisis is unique due to its size and the need to coordinate 17 disparate nations. We give four examples of economic, social, and political events that could lead to more sovereign defaults and serious danger of systemic collapse. Each trigger has some risk of occurring in the next weeks, months, or years, and these risks will not disappear quickly.

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<sup>1</sup> This testimony draws on heavily on joint work with Peter Boone, particularly “[The European Crisis Deepens](#),” Policy Briefs in International Economics 12-4, January 2012, Peterson Institute for International Economics, and “[Europe on the Brink](#),” Policy Briefs in International Economics 11-13, July 2011, Peterson Institute for International Economics. For more background, please see also our paper “[Will the Politics of Moral Hazard Sink Us Again](#)” (Chapter 10, in the LSE volume on [The Future of Finance](#), July 2010). I also draw on joint work with James Kwak, including [13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#) (Pantheon, 2010) and, on the US fiscal outlook, [White House Burning: The Founding Fathers, The National Debt, And Why It Matters To You](#) (forthcoming, Pantheon, April 2012). 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](#).

## 1. The Euro Area's Last Stand

For over two years Europe's political leaders have promised to do whatever it takes to save the euro area. Yet problems are growing and solutions still seem far off. The October 27 and December 9, 2011 agreements of European leaders failed to change the dangerous trends in Europe's economies or markets. The implicit risk of default priced in sovereign bond markets reached all-time highs in the last three months. The trend is similar with bank default risk. The crisis is continuing to get deeper, broader, and more dangerous.

A combination of misdiagnosis, lack of political will, and dysfunctional politics across 17 nations have all contributed to the failure so far to stem Europe's growing crisis. I begin with our view on the main problems that are pushing the euro area towards collapse. I then turn to potential solutions (although we are very aware that the complexity of the problems in Europe renders any solution questionable), and finally I outline several factors that could trigger rapid financial collapse in the euro area.

## 2. Key Systemic Problems in the Euro Area

Within the complex sphere of Europe's crisis, if we had to pick one issue that turns this crisis from a tough economic adjustment into a potentially calamitous collapse, we would argue it is the transformation of Europe's sovereign debt market. We outline this in section 2.1 and then discuss the economic ramifications in sections 2.2 and 2.3.

### ***2.1. European Sovereign Bonds Are Now Deeply Subordinated Claims on Recessionary Economies***

In July 2011, Peter Boone and I laid out the case that the euro area's immediate problems, in large part, reflect transition from a regime where sovereign debts were perceived to be sacrosanct ("risk-free") to one in which investors perceived that sovereign defaults were possible.<sup>2</sup> Neither investors nor Europe's politicians understood the full ramifications of no bailout clauses in the Maastricht treaty until recently. With the new risk premium needed to compensate for default risk, some European nations will need to radically reduce their debt levels and change its maturity structure.

The treatment of private investors in the upcoming Greek debt restructuring has made it ever clearer that Europe's sovereign bonds bear substantial risk. On July 27, 2011, the EU Council of Ministers finally admitted that a Greek default was needed—although to date they prefer to describe this default as voluntary, referring to it as private sector involvement (PSI).<sup>3</sup> By choosing a default over bailouts, it is as if the politicians have inserted a new clause into all European sovereign bonds:

*In the event that the issuing sovereign cannot adequately finance itself in markets at reasonable interest rates, and if a sufficient plurality of the EU Council of Ministers/Euro*

<sup>2</sup> Peter Boone and Simon Johnson, *Europe on the Brink*, Policy Briefs in International Economics 11-13, July 2011, Peterson Institute for International Economics, available at [www.piie.com](http://www.piie.com).

<sup>3</sup> For the definition of PSI in the euro area context, see page 18 in *European Financial Stability Facility (EFSF)*, available at [www.efsf.europa.eu/attachments/faq\\_en.pdf](http://www.efsf.europa.eu/attachments/faq_en.pdf).

*group/ECB/IMF/the Issuer determine it is economically or politically expedient, then this bond may be restructured.*

Soon after this announcement it was apparent Greece could not afford the proposed deal, and more funds would be needed. At the summit on October 27, 2011, Europe's leaders announced that for Greek debt the PSI "haircut" would rise from 21 to 50 percent in order to provide these funds, while the official creditors promised no additional funds specifically for Greece.<sup>4</sup>

Those nonofficial creditors holding Greek bonds learned a new lesson: They are the residual financiers to European issuers when the troika's programs fail.<sup>5</sup> The Greek press reported that the government was prepared to change laws governing its bonds in order to force nonofficial creditors to bear these losses. For nonofficial creditors, a further clause has thus been effectively and implicitly inserted into European sovereign bonds:

*In the event of default (i) any non-official bond holder is junior to all official creditors and (ii) the issuer reserves the right to change law as needed to negate any rights of the non-official bond holder.*<sup>6</sup>

We should not underestimate the damage these steps have inflicted on Europe's €8.4 trillion sovereign bond markets. For example, the Italian government has issued bonds with a face value of over €1.8 trillion. The groups holding these bonds are banks, pension funds, insurance companies, and Italian households. These investors bought them as safe, low-return instruments that could be used to hedge liabilities and provide for future income needs. It was once hard to imagine these could ever be restructured or default.

Now, however, it is clear they are not safe. They have default risk, and their ultimate value is subject to the political constraint and subjective decisions by a collective of individuals in the Italian government and society, the ECB, the European Union, and the International Monetary Fund (IMF). An investor buying an Italian bond today needs to forecast an immediate, complex process that has been evolving in unpredictable ways. Investors naturally want a high return in order to bear these risks.

Investors must also weigh carefully the costs and benefits to them of official intervention. Each time official creditors provide loans or buy bonds, the nonofficial holders become more subordinated, because official creditors including the IMF, ECB, and now the European Union continue to claim preferential status. Despite large bailout programs in Greece, Portugal, and Ireland, the market yield on their bonds remains well above levels where they are solvent. This is partly due to the subordinated nature of these obligations. De facto, if not de jure, Europe's actions have turned these bonds into junior claims on troubled economies.

Once risk premiums are incorporated in debt, Greece, Ireland, Portugal, and Italy do not appear solvent. For example, with a debt/GDP ratio of 120 percent and a 500-basis-point risk

<sup>4</sup> At the July 21, 2011 summit euro area leaders called for €109 billion of official assistance. On October 26 they committed to €100 billion of official assistance. The IMF did not provide any additional commitment in October.

<sup>5</sup> The troika is the informal name given to the European Union, ECB, and the IMF, which negotiates the terms of external assistance to Greece and other troubled peripheral countries.

<sup>6</sup> To be clear, this "clause" and the preceding clause are just our interpretations – such clauses are nowhere written down, which greatly adds to the prevailing uncertainty.

premium, Italy would need to maintain a 6 percent of GDP larger primary surplus to keep its debt stock stable relative to the size of its economy.<sup>7</sup> This is unlikely to be politically sustainable.

## ***2.2. Crisis Spreads into Europe's Core Banks and Incites Capital Flight from the Periphery***

On August 27, 2011, Christine Lagarde, the managing director of the IMF, shocked European officialdom with a speech decrying inadequate capital levels in European banks.<sup>8</sup> She referred to analysis by IMF staff showing that, if European banks were stressed for market-implied sovereign default risks, they were €200 billion to €300 billion short of capital. Lagarde's speech was courageous and the logic of her analysis raised deep concerns.<sup>9</sup> This was the first time the IMF admitted that sovereign default risk needed to be taken into account for the largest banks in Europe. Europe's regulatory regime does not require banks to have equity capital funding for sovereign debt—there is no capital requirement, in banking jargon—so banks accumulated these debts over many years under the assumption no additional capital would be needed. They must now revisit those portfolios to take account for capital needs on risky sovereign debt. However, the IMF analysis of the capital needs to offset this risk was odd. Markets price in a small risk of sovereign default, yet a major sovereign default would be a large, discrete event. Regulators need to decide: Sovereigns are safe, in which case banks need little capital protection against sovereign default, or they are not safe. If they are not safe, then banks need to accumulate adequate capital—raising their equity relative to total assets—to survive plausible sovereign defaults. For example, Bank for International Settlements (BIS) data show French banks in June 2011 had claims worth \$109 billion (on an ultimate risk basis) on Greece, Ireland, Italy, Portugal, and Spain (GIIPS); if these nations were to default on their sovereign claims, then French banks would surely experience large losses on the entirety of this portfolio while the repercussions for France's own economy would add further domestic losses.<sup>10</sup>

If sovereign default risk is not removed, then banks need nearly full equity funding to cover plausible states of nature where disorderly defaults do happen. The lesson for banks is clear: They need to reduce exposures to troubled nations and batten down the hatches.

In addition, Europe's peripheral banks are suffering large funding losses as capital moves to safer nations – most notably Germany.

<sup>7</sup> A 500-basis-point risk premium is consistent with an annual 10 percent risk that something will trigger a decision to restructure and that there would be a 50 percent mark-to-market loss on bonds under such an event.

<sup>8</sup> Christine Lagarde, speech at Kansas City Federal Reserve conference, Jackson Hole, August 27, 2011, available at [www.imf.org](http://www.imf.org).

<sup>9</sup> European politicians first dismissed Lagarde's analysis and later the European Banking Authority revised down the needs to €114 billion. They argued that the IMF failed to take into account a potential rally in the price of safe haven bonds, such as France and Germany, which banks hold on their balance sheets. We believe the analysis far underestimates the potential capital needs since it does not take into account the full macroeconomic ramifications of sovereign default.

<sup>10</sup> Bank for International Settlements, Table 9D: Consolidated foreign claims of reporting banks—Ultimate risk basis, *BIS Quarterly Review*, December 2011, available at [www.bis.org/publ/qtrpdf/r\\_qa1112\\_anx9d\\_u.pdf](http://www.bis.org/publ/qtrpdf/r_qa1112_anx9d_u.pdf).

### *2.3 Macroeconomic Programs: Too Timid to Restore Confidence or Growth*

While it may already be too late to avoid extensive defaults, we can still consider what needs to be done to reduce the risk of default. To avoid defaults and restructurings, Europe needs to introduce policies that bring market risk premiums on sovereign (and hence bank) debts down. Investors need to feel confident that, with a 2 to 3 percent risk premium, it is worth the risk to hold onto several trillion euros worth of troubled nations' sovereign debts, as well as the much larger non-sovereign debts.

In a nation with a flexible exchange rate, adjustment is usually achieved with budget cuts and a sharp devaluation. Since euro area nations have forgone their right to devalue, they need to regain competitiveness through price and wage cuts, while even more sharply cutting budget spending. In essence, they need to increase volatility of their wages, prices, and budgets if they are prepared to forgo similar changes that could be achieved through the exchange rate.

The available evidence from the outcomes of the troika programs in Portugal, Ireland, and Greece, as well as the recently announced budget plans in Italy and Spain, suggests current policies will fail at this task. These programs all plan for gradual reductions in budget deficits, implying continued buildup of total government debts, while partially substituting private debt for official debt. In Portugal and Ireland the programs rely on external financing until 2013 when it is anticipated the program countries will reenter markets to finance ongoing budget deficits and ever higher debt stocks at modest interest rates. In Italy, optimistic growth assumptions help bring the budget to balance in 2013, but debt stocks remain far too high. Spain announced it would miss its 2011 budget deficit target of 6 percent, raising it to 8 percent. In Greece, budget revenue and GDP growth forecasts are again proving too optimistic.

Any successful program must recognize the fact that appetite for periphery debt amongst investors will not recover to "pre-crisis" levels, because default risk is now a reality that was not foreseen prior to 2009 and because debt stocks are now higher in the periphery. For example, Ireland is currently running a budget deficit measured at 12.5 percent of GNP.<sup>11</sup> The troika program calls for that budget deficit to fall to 10.6 percent of GNP in 2012. Ireland's stock of official debt will reach 145 percent of GNP in 2013, while it also has contingent liabilities to its banking sector that amount to over 100 percent of GNP. An investor looking at these numbers must recognize there is serious risk of default. Since market access is highly unlikely, who will finance Ireland from 2013 onwards?

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<sup>11</sup> Ireland's GNP is substantially smaller than its GDP. Due to its role as a tax haven, many foreign companies have set up operations in Ireland, with a controlling shell company located in a tax-free nation, in order to take advantage of Ireland's regulations that specify that the controlling owner, rather than the resident company, is subject to tax. For this reason companies such as Google, Yahoo, Microsoft, Forest Labs, and many others channel license revenues and royalties through Irish subsidiaries. These royalties and revenues are in large part excluded from the tax base in Ireland. These companies would move if Ireland changed rules and made such revenues taxable. Since the relevant concept for fiscal sustainability is the taxable base, it makes sense that this should be used to measure Ireland's indicators. No other nation in Europe has a large difference between GNP and GDP. The IMF regularly reported Irish GNP in its staff reports but abruptly removed all reference to GNP in the most recent report. This raises concerns that the IMF is attempting to mask fiscal sustainability problems by not reporting these data.

A successful program must also take steps to quickly improve competitiveness.<sup>12</sup> The only nation that shows moderate improvement in relative unit labor costs is Ireland, but this is largely a statistical artifact driven by the decline of unproductive industry in the weighting.<sup>13</sup> Italian Prime Minister Mario Monti's program includes no general wage cuts.<sup>14</sup> In Portugal, the government abandoned attempts to engineer unit labor cost reductions through "internal devaluation" after meeting political opposition. In Ireland, the Croke Park accord prevents the government from further reducing public-sector wages.<sup>15</sup> Despite nearly two years of troika programs, Greek unit labor costs have hardly budged.

With sovereign risk premiums rising, and capital flowing out of the periphery from banks while deficits and competitiveness improve little, it is not surprising that peripheral economies are in trouble. The Purchasing Managers' Index (PMI) indicates a bleak picture. It is no coincidence that a new major "downturn" started soon after German politicians made clear they were planning to let Greece default. It is also clear that the troika programs are failing to restore growth.

The stark contrast between unemployment in Germany and the periphery reflects the dynamics of the crisis. The strong core is becoming stronger – German unemployment is lower than it was in 2008 – while Greece, Ireland, Portugal, and Spain have high unemployment that continues to rise.<sup>16</sup> Italy's troubles are recent, so with a sharp recession beginning, we anticipate Italian unemployment will soon rise sharply also.

### 3. Solutions

Europe may continue to veer towards a major financial collapse. European economies are in decline due to capital outflows from fear of sovereign and bank defaults. Recessions and continued budget deficits only raise the risk of default. Macroeconomic adjustment programs are not strong enough and do not reflect the large measures needed given the lack of exchange rate devaluation. As the GIIPS decline, there is serious risk that other indebted and heavily banked nations in the euro area, such as France, Belgium, and Austria, could be pulled into trouble themselves.

#### 3.1. *The Big Bazooka*

Some analysts are now calling for a massive ECB-led bailout to arrest sovereign risk and stop this dangerous trend. The general hope is that, if the ECB offered to massively finance the

<sup>12</sup> Unit labor costs are the best measure of competitiveness in this context. These also include nontraded goods and are not a perfect measure of competitiveness, but the general pattern is clear – over the past decade Germany has really diverged from its European trading partners by becoming more competitive.

<sup>13</sup> Ireland's nontraded goods sector is less productive than its traded goods sector (which includes companies such as Google that choose to report earnings in this low corporate tax environment.) As part of the Irish recession, the nontraded goods sector has contracted while "exports" from large multinationals have remained relatively robust.

<sup>14</sup> See, for example, Alex Roe, "Monti's Measures for Italy," *Italy Chronicles*, December 5, 2011, available at <http://italychronicles.com>.

<sup>15</sup> See Harry McGee, "Freeze on cuts after Croke Park accord," *Irish Times*, July 21, 2011, available at [www.irishtimes.com](http://www.irishtimes.com).

<sup>16</sup> The latest unemployment numbers are bad, including 22 percent in Spain and 14 percent in Ireland.

periphery, investors would return to buying those sovereign and bank bonds. Lower interest rates would give breathing space for sovereigns to correct budget deficits and banks to build capital.

To see how feasible this is, first consider the sums required. Any bailout would need to unequivocally convince investors that for several years these nations will simply not see serious financial problems. This means the bailout would need to have enough funds to buy up a large portion of the existing stock of “risky sovereign debts” plus finance those nations for, say, five years. The bailout must buy the debt, rather than simply refinance debt rollovers, since otherwise secondary market interest rates would stay high. The secondary market rates will determine the lending capacity of local banks and their creditworthiness.

We have calculated the sums required to purchase 75 percent of the outstanding government debts of the troubled nations (leaving aside debt owed to official lenders), plus finance their deficits over five years. In this base case we assume troika programs are implemented and deficits decline gradually over five years. The total adds to €2.8 trillion, or 29 percent of euro area GDP.

We can then contrast this with alternative assumptions.<sup>17</sup> The most dangerous risk facing the euro area is if a “bazooka” is employed and yet the troika programs fail to restore growth and improve budgets. We assume budget deficits decline only modestly, and we calculate the financing needed to cover deficits until 2020. Our negative outcome implies nearly €5 trillion would be needed just for GIIPS, something the IMF implicitly flagged when they reported recently that Greece alone may need €500 billion (one half trillion) by 2020.<sup>18</sup>

Successful “bazooka” interventions often occur when the extra financing is no longer needed, so that the financing acts as a backstop but is hardly used. For example, when Poland launched its stabilization program in early 1990, the \$1 billion stabilization fund was never spent. The US Troubled Asset Relief Program (TARP) was quickly repaid by almost all banks. This is not possible for the euro area. Some euro area nations have too much debt in the new regime with default risk. In the early days of such a program we expect large purchases would be needed. The ECB would have to drive market interest rates down to levels where private creditors would not be well rewarded to hold the debts. As the ECB purchased the debts, private creditors would be further subordinated, and this would add to their desire to sell their bonds.

There are many reasons we believe such ECB “bazooka” programs won’t occur and are potentially dangerous to euro area survival. First, while using the ECB balance sheet may make such risks more opaque, any large bailout still poses potential heavy losses for Germany and other healthy members of the euro area. In the event there is default in the GIIPS, Germany would be responsible for 43 percent of the capital needs of the ECB. Hence with a bailout fund of €2.8 trillion, Germany would be assuming €1.2 trillion, or 45 percent of German GDP, in credit risk. The Bundesbank and other national central banks are likely to refuse.

Second, this measure on its own does not resolve competitiveness problems or large budget deficits in the periphery. It would undoubtedly cause the euro to fall but the benefits of euro depreciation are somewhat muted since Germany would remain relatively competitive compared with the periphery. The periphery will still need aggressive fiscal and wage cuts to improve their deficits and competitiveness relative to Germany.

<sup>17</sup> For more detail, please see Peter Boone and Simon Johnson, “The European Crisis Deepens”, referenced in footnote 1 above.

<sup>18</sup> This is a stress scenario in the IMF’s debt sustainability analysis for Greece. In our view, this scenario could reasonably be regarded as something closer to a baseline forecast.

Third, it would place the unelected ECB governors in a political role they were never destined to play and were legally forbidden to play according to the Maastricht treaty. The ECB could quickly become the largest creditor to peripheral nations, and as their financier it would ultimately need to negotiate budget programs, wage cuts, and structural change. It may choose to relinquish those powers to the IMF, but it would be the true power behind all these negotiations.

Finally, the bazooka could well incite an eventual crash of the euro area. If the ECB embarked on a program to backstop troubled nations, observers would quickly recognize that the potential sums needed to maintain stability could be large. Our bad case scenario implies over 341 percent of the ECB monetary base and 46 percent of euro area GDP might be needed.

For markets, what matters are the perceived future bailout costs. Hence, an announcement of a “bazooka” will lead to varying reactions in markets as the perceived bailout needs rise and fall. Investors could become very afraid if peripheral adjustment programs appear to fail or bailout needs spread to more nations. Such concerns could rapidly cause financial-market turmoil and euro area collapse (see section 4).

### *3.2 A More Comprehensive Solution*

If the bazooka is unlikely and probably won’t work, while the status quo is failing, what is an alternative? The focus needs to be on returning the relevant sovereigns to solvency. Once the sovereigns are solvent, most commercial banks will have breathing space to rebuild capital through operating profits and retained earnings.

However, there is no easy means to achieve this. In our assessment, the GIIPS will need to restructure their debts by extending maturities and reducing coupons to levels that they can afford. There is some scope for official assistance to offset the total costs of such restructuring by subsidizing debt swaps. However, the Greek example suggests Europe’s politicians have little appetite to provide more taxpayer funds for this purpose.

While preemptive restructuring seems attractive, the needed extent and scope is unclear. Carmen Reinhart and Kenneth Rogoff argue that countries with no lenders of last resort typically run into problems when debt levels reach 60 percent of GDP. Even if we assume advanced European economies could manage more debt, it would not be higher than the 90 percent that Reinhart and Rogoff flag as a threshold for developed markets. Such figures imply that greater than 50 percent writedowns of nonofficial debt in Portugal and Ireland may be needed, while Italian debt writedowns might be close to 50 percent.

If the GIIPS followed preemptive restructurings, Europe’s core banks, insurance companies, and pensions funds would need substantial recapitalizations, and the costs of this could draw France and other core nations into debt crises of their own. Hence, any plan to preemptively restructure debts would need to be applied carefully across Europe.

The second ingredient is a far more aggressive program to reduce budget deficits and improve competitiveness in the periphery. These nations need to be highly competitive if they are to generate growth soon given the large risks overhanging their economics. This requires large wage cuts, public-sector spending cuts, changes in tax policy to attract investment and business, and stable politics.

If these two steps were implemented, then a bailout program from the ECB would pose lower risks. The debt restructuring and measures to improve competitiveness would mean far less funds were needed. The ECB’s role could be to provide confidence that stability would be

maintained—a sensible central bank role—rather than to refinance large amounts of debt and deficits.

While these steps would be a major improvement on current programs, they are hardly likely to be implemented. As discussed in section 2, the troubled nations have declined to implement large budget and wage cuts. Political conditions have prevented them. Meanwhile, creditor nations are claiming there will be no more debt restructurings beyond Greece, and at the same time the creditors are refusing to substantially raise bailout funds needed to prevent high interest rates and default. None of this leads to a credible path out of crisis.

#### **4. Playing with Fire: Ways the Euro Area Could Come to an End**

Policymakers often have trouble grasping the danger that small tail risks pose to leveraged systems. As we discussed above, a mere 10 percent annual risk of an Italian crisis is already inconsistent with Italian long-term solvency. If Italy has a disorderly crisis, how safe are French banks? And if those banks aren't safe, how safe is France's sovereign debt? Low-probability bad events can very quickly generate a wave of collapse through leveraged systems.

Our concern is that, when compared with financial crises elsewhere, the potential triggers for a euro area collapse are numerous.

##### ***4.1 A Unilateral Exit, or the Credible Threat of One***

At a midnight press conference on November 2, 2011 in southern France, German Chancellor Angela Merkel and French President Nicolas Sarkozy for the first time entertained the idea that a nation could leave the euro area. Merkel and Sarkozy chose to take a hard line with Greek politicians and their electorate: either complete the existing agreement or leave. The background to this threat was the tough politics in Greece. After 18 months of large budget cuts and some structural reforms, Greece's economy remains in decline. Prime Minister George Papandreou's government was weak, and in a last desperate gesture he attempted to force further reforms through by offering Greek citizens a referendum with an implicit choice of "reform or exit."

An exit from the euro area can be forced in minutes. The Eurosystem only needs to cut off a national central bank from the payments system and prevent that nation from printing new cash euros. Once this is achieved, a bank deposit in Greece would no longer be the same as a deposit in Germany, because one would not be able to get cash for a Greek deposit and one would not be able to transfer it to a non-Greek bank. Of course, the moment people understand such a change could be imminent in their nation, they would run to their banks and attempt to withdraw cash or transfer funds. This is what is now happening in Greece. The country is losing 2.5 percent of GDP monthly in deposits from banks.<sup>19</sup>

There would be enormous, painful ramifications for all of Europe if Greece or another nation made a disorderly exit. Since there is no legal basis for exit, all financial contracts and indebtedness between Greek and non-Greek entities would have uncertain value as the parties could dispute whether these are to be paid in drachmas or euros. Trade between the exiting nation and the rest of the euro area would dry up. The mere fact that a country did exit would have ramifications for the other troubled nations, most likely inciting further capital flight from

<sup>19</sup>Deposits have declined by €61 billion, or 24 percent of GDP, since spring 2009. See Bank of Greece, "Aggregated balance sheets of monetary financial institutions (MFIs)," available at [www.bankofgreece.gr](http://www.bankofgreece.gr).

those nations and producing sharp economic downturns. This in turn would question the viability of Europe's core banks and some of the core sovereigns. The euro itself would probably weaken sharply, and "currency risk" would be added into the euro.

#### ***4.2 The Weak Periphery Lashes Out against Germany, while Germany Fights Back***

The political dynamics of crisis invariably pit creditors against debtors, potentially leading to flare-ups that cause creditors to give up. In Ireland, against strong popular opposition, the ECB is forcing Irish citizens to take on further debt in order to bail out creditors of bankrupt banks. In Greece, Prime Minister Papandreou was essentially ordered to revoke his planned referendum, while Greece's opposition leader was ordered to write a letter promising he supported Greece's troika program, despite the fact that he clearly did not support it nor did he participate actively in any negotiations to agree to it. French and German politicians are also playing an instrumental role in supporting Italy's new technocratic prime minister, while they eschewed former prime minister Silvio Berlusconi towards the end of his term. Meanwhile in Germany, "bailout fatigue" has set in as electorates and politicians turn against more funds to nations that, they perceive, are failing to reform sufficiently quickly.

While there are many outcomes of such discord, one possibility is that it leads to a messy grab for power. The troubled nations already have the power to take over decision making at the ECB. They may well usurp control in order to provide much larger ECB bailouts. This would raise concerns in financial markets and could lead to rising long-term yields on all euro-denominated debts. Germany would be forced to pay more to finance itself, and German savers would ultimately be paying for the periphery bailouts through inflation and a weak euro. In Germany this would lead to rising calls to leave the euro area.

Once there is a small risk that Germany could leave, market prices for euro-denominated assets would again change sharply. New risk premiums would need to be added to national debts where nations are expected to have weak currencies, while Germany and other strong nations might see their risk premiums fall even further. Such changes would reinforce the recent trends in which the core nations continue to strengthen relative to the periphery, but those changes would also be highly destabilizing for financial markets.

#### ***4.3 Economics of Austerity May Fail***

The third risk for the euro area is that economic, political, and social realities eventually prove that the system simply cannot work. After all, the euro area is a dream of political leaders that has been imposed on disparate economies. Few nations sought popular support to create the euro. The German leadership avoided a referendum, and in France the Maastricht treaty was passed with a thin majority of 51 percent. Marine Le Pen, who is third in opinion polls for the spring 2012 French presidential election, is calling for France to leave the euro area and reintroduce the franc. Even though most European leaders are highly committed to maintaining this dream, no one can be sure what the costs are in order to keep it.

A plausible negative scenario is that those costs, in the eyes of the electorate, eventually appear too high. The evidence to date suggests Europe's periphery, even in a fairly benign outcome, will be condemned to many years or even a decade of tough austerity, high unemployment, and little hope for future growth. A good comparison is the "lost decade" of the 1980s in Latin America when nations hardly grew due to the large debt overhangs from

unaffordable debts. However, those nations had the benefit of flexible exchange rates, while Europe's periphery faces a more difficult period with uncompetitive economies. Latin America's problems ended only when the creditor nations accepted large writedowns and debt restructuring.

Another comparison would be the heavily indebted United Kingdom during the 1920s when the government managed policies to restore currency convertibility after the war. Britain suffered with a weak economy for a decade, before ending in the Great Depression, despite a booming global economy throughout the 1920s. However, this too is not a good comparison since Britain had far more flexible wages and prices than Europe's periphery, with nominal wages falling 28 percent during the 1920–21 recession.

#### **4.4 Markets Lose Patience**

Our final scenario is the most likely. Faced with the reality of failing adjustment programs, difficult politics, and rising risks that one or more peripheral nations may rebel, or Germany may rescind its support, investors may simply decide that the cumulative risks mean the euro area has a moderate risk of failing.

If investors decide there is a low but significant probability that the euro area might fail, we would encounter another version of Rudi Dornbusch's astute observation: "The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought." Here's why: The failure of the euro area will be a calamitous financial event. As Dornbusch famously remarked of the Mexican 1994-95 crisis, "It took forever and then it took a night."

If one believes the euro might fail, one should avoid being invested in European financial institutions, and in euro-denominated assets, until the outcome of the new pattern of currencies is clearer. As a result, a large swathe of euro-denominated assets would quickly fall in value. The euro itself would cheapen sharply, but so would the value of European bank debt and European shares, and most sovereigns would see their bonds trade off sharply. This in turn would make it expensive for even the Germans to raise finance in euros. Despite their impeccable credit record, they would be attempting to issue bonds in what is perceived as a flawed currency.

A small risk of the euro "breaking up" would have great importance for the euro swap market. This market is used by Europe's insurance companies, banks, and pension funds to hedge their interest rate risk. A swap contract allows, for example, a pension fund to lock in a long-term interest rate for their investments, in return for promising to pay short-term interest rates to their contract counterparty. It is an important market that underlies the ability of insurance companies, pension funds, and others to make long-term commitments to provide society with annuities, pensions, and savings from insurance policies. The notional value of these swaps is many times euro area GDP.

The euro swap market could quickly collapse if markets begin to question the survival of the euro. Euro swap rates are calculated as the average interest rate paid on euro-denominated interbank loans for 44 of Europe's banks. Approximately half of these banks are in "troubled nations." So the interest rate will reflect both inflation risk and credit risk of the participating banks. If investors decided that the euro may not exist in several years' time, swap interest rates would naturally rise because people would be concerned that banks could fail and that the "euro" interest rate could turn into something else—for example, the average of a basket of new currencies with some, such as the Greek drachma, likely to be highly inflationary.

If euro swap interest rates start to reflect bank credit risk and inflation risk from a euro breakup, then the market would no longer function. A pension fund could no longer use it to lock in an interest rate on German pensions since it would not reflect the new German currency rates. The holders of these contracts would, effectively, have little idea what they would be in a few years' time. Hence, investors would try to unwind their swap contracts, while the turmoil from dislocations in this massive market would cause disruptive and rapid wealth transfers as some holders made gains while others lost. If the euro swap market ran into trouble, Europe's financial system would undoubtedly face risk of rapid systemic collapse.

This example illustrates why a small perceived risk of a euro area breakup could rapidly cause systemic financial collapse. The swap market is only one mechanism through which collapse could ensue.

On November 23, 2011 Germany was unable to sell as many bonds as it wished.<sup>20</sup> The auction failure caused an immediate steepening in the German sovereign bond yield curve. Some German officials argued this failure was due to "volatile markets," but there is a more fundamental concern. Germany's ability to pay low interest rates in euro-denominated assets requires the euro area be a financially stable region. Today, German yields remain very low and are not at worrying levels. However, if these rates were to rise due to fears of currency breakup risk, then the euro area would quickly enter deep crisis as even Germany would have trouble financing itself.

##### **5. Dreams versus Reality**

There is no doubt that European political leaders are highly committed to keeping the euro area together, and so far, there is widespread support from business leaders and the population to maintain it. There is also, rightly, great fear that disorderly collapse of the euro area would impose untold costs on the global economy. All these factors suggest the euro area will hold together.

However, many financial collapses started this way. A far more dramatic creation and collapse was the downfall of the ruble zone when the Soviet Union collapsed in 1991. Argentina's attempt to peg its currency to the dollar in the 1990s was initially highly successful but ended when its politicians and society could not make the adjustments needed to hold the structure together. The Baltic nations—Estonia, Latvia, and Lithuania—have managed to maintain their pegs but only after dramatic wage adjustments and recessions.

More relevant, the various exchange rate arrangements that Europe created prior to the euro all failed. With the creation of the euro, Europe's leaders raised the stakes by ensuring the costs of a new round of failures would be far greater than those of the past, but otherwise arguably little has changed to make this attempt more likely to succeed than the previous one. Small probabilities of very negative events can be destabilizing. A lot of things can go wrong at the level of individual countries within the euro area—and one country's debacle can easily spill over to affect default risk and interest rates in the other 16 countries. The euro swap market is based, in part, on interest rates charged by 44 banks in a range of countries; about half of these banks may be considered to be located in troubled or potentially troubled countries. If the euro

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<sup>20</sup> Paul Dobson, "German Auction 'Disaster' Stirs Crisis Concern," Bloomberg News, November 23, 2011, available at [www.bloomberg.com](http://www.bloomberg.com).

swap market comes under pressure or ceases to function, this would have major implications for the funding of all European sovereigns—including those that are a relatively good credit risk.

At the least, we expect several more sovereign defaults and multiple further crises to plague Europe in the next several years. There is simply too much debt, and adjustment programs are too slow to prevent it. But this prediction implies that the long-term social costs, including unemployment and recessions rather than growth, attributable to this currency union are serious. Sometimes it is easier to make these adjustments through flexible exchange rates, and we certainly would have seen more rapid recovery if peripheral nations had the leeway to use exchange rates.

When we combine multiple years of stagnation with leveraged financial institutions and nervous financial markets, a rapid shift from low-level crisis to collapse is very plausible. European leaders could take measures to reduce this risk (through further actions on sovereign debt restructurings, more aggressive economic adjustment, and increased bailout funds). However, so far, there is little political will to take these necessary measures. Europe's economy remains, therefore, in a dangerous state.

Chairman CONRAD. Thank you for, once again, excellent testimony.

Dr. Bergsten, welcome back. Please proceed.

**STATEMENT OF C. FRED BERGSTEN, PH.D., DIRECTOR,  
PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS**

Mr. BERGSTEN. Thank you, Mr. Chairman, kind remarks on my stewardship of the Peterson Institute for International Economics, in fact for 30 years, but I am not leaving. I am stepping down as director. I will stay on as a senior fellow, and I hope to continue to participate in activities like this. One of the great privileges I have had over that period has been to work many times with you, this Committee, and I thank you for the opportunity to do so again.

I share the view that Simon, you, and Senator Johnson have expressed, that Europe is in deep economic difficulty. There is no doubt it is headed for a prolong recession. Europeans have failed to get ahead of the crisis and restore market confidence.

However—and here is what passes for optimism these days—I take the view that none of the apocalyptic forecasts will, in fact, be realized. I disagree with Simon that the eurozone has failed. I do not think there will be serial defaults. I certainly do not think the euro will break up. Greece might drop out or be kicked out, but I do not think there will be any widespread defections from the eurozone. In fact, as I will indicate, Europe is going to come out of the crisis stronger and over time will restore its position as a key pole of the world economy.

I say that for three reasons. I have watched the evolution of the whole European integration project for the last 50 years. Everyone has faced a series of crises, frequently existential, that have threatened the continued existence of Europe. It has overcome every one and, indeed, come out of them stronger and moved forward.

Secondly, every time the current crisis reached a pivot point, where there was much commentary that Europeans it is going to collapse if it did not shape up, every time that has happened, they have done enough to avoid the apocalypse. They have kept going forward. They have built new institutions. They have built a firewall. They have avoided financial disaster. And I think that will continue, for a very simple reason. The overwhelming imperative in all European countries is to hold the European Union together, and that now means holding the eurozone together. That has become for all practical purposes the definition of Europe. They know that the future of Europe is wrapped up in sustaining the euro, and I am confident they will do it. And there are two simple reasons for that. One is the ghastly history of Europe. Remember why they created the European Union in the first place: to overcome the previous millennium of slaughter within Europe, most dramatically the first half of the last century. I happened to visit the Holocaust Museum again. If you have done that recently, it gives you plenty of memory of why the Europeans have pulled together to avoid letting Europe again explode into the kind of holocaust and disaster that they experienced. So they are going to hold Europe together.

But in addition to that, they have an overwhelming economic interest. Germany, which is the pivotal country, has a nirvana economic situation in Europe in the euro. Germany is the world's larg-

est trade surplus country, and it bases its whole economy on an export-led growth model.

In the old days, when they had their own deutsche mark, it would rise sharply in value when those surpluses rose, choke off a lot of their competitiveness, and frustrate the Germans. I always used to debate this actively with Helmut Schmidt when he was chancellor. Now the Germans have the world's largest trade surplus and a weak currency, which for them is the perfect outcome. And every German knows it, and they are going to continue it, and virtually any price would be worth paying for them to keep that situation together. If you went to a new deutsche mark, it would explode upward in value, and the whole German economic progress, which has been so impressive in these last few years, would collapse.

So the bottom line is both Germany and Europe as a whole have huge, huge interest in holding the eurozone together. And so my conclusion—and it is, I think, supported by the evolution of the current crisis—is that Germany will pay whatever is necessary to keep the eurozone together. The European Central Bank will put in whatever amount of resources is necessary and will play lender of last resort even though they cannot say it.

Now, there is one problem with this scenario. Neither the Germans nor the European Central Bank nor the Europeans more broadly can say that they are going to do what I am confident they will do. Why not? First, it would be the epitome of moral hazard if the Germans pronounced that they were going to rescue everybody no matter what the cost. That would take the pressure off. Mario Monti is coming and speaking at our institute a week from Friday. He is going to lay out the Italian adjustment program. Mario Monti wants to keep the pressure on his country so that the domestic politics will support the reform program that they all know they need. So the Germans and the ECB cannot say they will provide all the resources, even though I am confident they will.

Secondly, there is the usual juggling among the creditors. There are four groups of creditors: Germany and the other successful Northern Europeans; the European Central Bank; the private banks, who are now negotiating the haircut in Greece; and the International Monetary fund. They are all trying to fob off shares of the rescue packages to the others and preserve their own negotiating position to do so; therefore, none of them wants to say he or she will take care of the whole problem even though, in fact, they will.

So the result is a situation very unsatisfactory for the markets. The markets want to hear assurances and firm words of rescue. Those cannot be given even though I am confident that those rescues will take place. And, therefore, the market situation is likely to remain unsettled and volatile even though I am confident that the outcome will be successful in the sense of successful financial engineering to avoid financial breakdown. But that is not getting to the recession and the underlying economic problem, which is still there.

I want to draw just two or three major conclusions for the United States, and then I am happy to answer more questions on the European situation per se.

First, as you said, Mr. Chairman, the United States has a huge interest in this situation being resolved successfully, so we have to do whatever we can to support a successful resolution of the European problem. I agree with my friend Simon that the Europeans themselves should provide the bulk of the resources to do that, and they have certainly got the wherewithal. But I disagree with him that the International Monetary Fund should not be available, if necessary—we do not know yet—to lend more to help resolve the problem. The IMF did pick up one-third of the original support packages for Greece, Portugal, and Ireland. I think that was very helpful, not so much in terms of the resources but bringing the IMF conditionality into play and helping promote the necessary adjustment in the debtor countries.

And, incidentally, when I say necessary adjustment, I do not mean just fiscal austerity, which has to be part of it, but structural reforms which are necessary to restore growth. What Italy, Greece, and all the debtor countries need in order to restore growth, which we all would say is the priority objective, is structural reform of their labor markets, their uncompetitive private sectors, their own financial systems. All those structural reforms are needed, and the IMF is very helpful in promoting that given its experience and also the resources it can bring to bear.

So I believe the U.S. should support, if it turns out to be necessary, additional IMF financial contributions to the European problem on a minority basis, maybe the one-third that was done in the previous cases, maybe less, but certainly it could be significant. And I, therefore, think the United States should support the current efforts of the IMF to create a new fund, \$500 to \$600 billion, which in conjunction with the funds the Europeans are raising would take the firewall to beyond \$1 trillion, which should convince the markets that there will be enough there to avoid any significant financial disruption, even from Italy or Spain. So I think the U.S. should support that.

However, I do not think the United States itself should contribute. The funding the IMF needs should be borrowed from the big surplus and creditor countries—China, Japan, Korea, Singapore, Hong Kong, Brazil, Russia, Mexico. Many of those countries have already said they will lend. They should, in fact, be tapped. They have big surplus, big foreign exchange reserves, so we should support the effort, but we should not put in our money.

A final point. The U.S. really does need to take this as a wakeup call itself, and you suggested that, Mr. Chairman. If you take those CBO realistic projections—and I would say even add a little more dose of realism—you have U.S. budget deficits exceeding \$1 trillion a year, more than 5 percent of GDP for the decade to come, and then it gets worse because of aging. So if you project the numbers, our debt and deficit numbers within 10 years look like Greece's did as it entered into its crisis.

Now, the European crisis has shielded us from our own follies because Europe's weakness meant that foreign capital, global capital, moved into the dollar, pushed our interest rates lower despite our inability so far to put our own house in order. But remember that only 3 or 4 years ago Greek interest rates were at the same level as German interest rates because the omnipotent markets that we

like to extol the virtue of got it totally wrong. The markets thought that Greek debt was as good as German debt because Greece was part of a eurozone led by Germany. And then all of a sudden they realized that was wrong, and Greek interest rates went to triple the level of Germany's.

The United States is very happy at the moment to have very low interest rates, in large part because Europe and Japan are so weak, and so the other financial markets do not attract the capital. But that worm could turn very fast, very viciously, and if the European crisis teaches us anything, it is that we have to learn from that example and not simply delight in the fact that we have some more time but, rather, use that time.

This Committee has played a major leadership role in trying to deal with that. With your lead, Mr. Chairman, I urge and implore you to take the time that is now available to do that. If not, we, too, 2 or 3 years from now, certainly within the next 5 to 10 years, could go the way of some of the Europeans whose travails we now bewail.

[The prepared statement of Mr. Bergsten follows:]

THE OUTLOOK FOR THE EURO CRISIS  
and  
IMPLICATIONS FOR THE UNITED STATES

Statement by  
C. Fred Bergsten  
Director, Peterson Institute for International Economics<sup>1</sup>

Before the Hearing on

THE OUTLOOK FOR THE EUROZONE

Senate Budget Committee  
United States Senate

February 1, 2012

SUMMARY

Doom and gloom about the euro abounds. An increasing number of commentators and economists have begun to question whether the common currency can survive.

The economic and financial problems in the euro area are clearly serious and plentiful. The area is in the midst of multiple, frequently overlapping, and mutually reinforcing crises. A fiscal crisis is centered on Greece but visible across the southern euro area and Ireland. A competitiveness crisis is manifest in large and persistent current account deficits in the euro area periphery and even larger current account imbalances. A banking crisis was first evident in Ireland but has now spread throughout the area via accelerating concerns over sovereign solvencies.

I believe that these fears are vastly overblown. The European crisis is political, and even largely presentational, which is key to understanding how the crisis has developed and how it will be resolved.

The lack of confidence in the euro is first and foremost rooted in a crisis of fundamental institutional design. The Economic and Monetary Union (EMU) adopted in the 1990s comprised an extensive (though still incomplete) monetary union, with the euro and the European Central Bank (ECB). But it included virtually no economic union: no fiscal union, no economic governance institutions, and no meaningful coordination of structural economic policies.

It was assumed by the architects that economic union would inexorably follow monetary union. However, there was no pressure to create an economic union during the expansion period prior to the Great Recession. When the crisis hit, the contradiction triggered severe market reactions that continue to this day.

There are only two alternatives. Europe can jettison the monetary union. Or it can adopt a complementary economic union. For all the turmoil, I believe that Europe is well on its way

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<sup>1</sup> The statement draws heavily on C. Fred Bergsten and Jacob F. Kirkegaard, 2012, *The Coming Resolution of the European Crisis*, PIIE Policy Brief 12-1, Washington: Peterson Institute for International Economics. Available at <http://piie.com/publications/pb/pb12-1.pdf>

to completing the original concept of a comprehensive economic and monetary union and that Europe will indeed emerge from the crisis much stronger as a result.

The key to understanding the evolution of the euro crisis is to observe and analyze what the Europeans do rather than what they say. They have resolved all of the many crises that have threatened the European integration project, throughout its history of more than half a century, in ways that strengthened the institution and moved the project forward. At each key stage of the current crisis, they have in fact done whatever is necessary to avoid collapse. I have complete confidence that, in the crunch, both Germany and the ECB will pay whatever is necessary to avert disaster. The politics of each, as described below, assure this result.

The problem for the markets is that these central players cannot say that this is what they will do. There are two reasons. First, a commitment to bailouts without limit would represent the ultimate in moral hazard. It would relieve the debtor countries of the pressure necessary to compel them to take tough political decisions and maintain effective adjustment policies. Second, each of the four main classes of creditors—Germany and the other northern European governments, the ECB, private sector lenders, and the International Monetary Fund (as a conduit for non-EU governments like China)—will naturally try to transfer as many of the financial losses on Greek government bonds or European banks as possible onto the other three, limiting their own costs and risks in the process.

Every policymaker in Europe knows that the collapse of the euro would be a political and economic disaster for all and thus totally unacceptable. Fortunately, Europe is an affluent region with ample resources to solve its crisis—it is a matter of mobilizing the political will to pay rather than the economic ability to pay. Europe's key political actors in Berlin, Frankfurt, Paris, Rome, Athens, and elsewhere will thus quite rationally exhaust all alternative options in searching for the best possible deal but at the last minute come to an agreement.

This is a messy and indeed cacophonous process that is understandably unsettling to markets and inherently produces enormous instability. Miscalculation, and thus disaster, is always possible under such a scenario. But the process in fact relies on financial market volatility to incentivize solutions that will ultimately resolve the crisis. Europe's overriding political imperative to preserve the integration project will surely drive its leaders to ultimately secure the euro and restore the economic health of the continent.

#### THE EUROPEAN INTERGRATION PROJECT

The entire European project was of course driven by the existential geopolitical goal of halting the intra-European carnage that had persisted for at least a millennium and reached its murderous zenith in the first half of the 20th century. The postwar European leadership, driven primarily by Germany and France, chose the policy instrument of economic integration “to make future wars impossible.” The project has experienced repeated severe crises over its initial half century but each was overcome, indeed giving way to renewed forward momentum for Europe as a whole. The overriding security imperative drove successive generations of political leaders to subordinate their national sovereign interests to the greater good of maintaining, and in fact extending, the European project.

Germany also has an overwhelming economic interest in the survival, and indeed strengthening, of the Eurozone. Its entire economic model is based on export-led growth and world-class international competitiveness. Before the euro, however, its large trade surpluses would often lead to sharp appreciation in the exchange rate of its national currency, the Deutsche Mark, that would to an important degree dampen its competitiveness and thus its growth.

Now, however, Germany enjoys the best of all worlds: the largest trade surplus of any country (even China) and a weak currency, as the euro reflects the much weaker economies of the periphery (and even France) as well as muscular Germany. Every German realizes that this unusual juxtaposition explains much of his country's ability to prosper through the Great Recession, and the current European phase thereof, that has severely retarded growth and job creation in almost every other country in Europe. They thus realize that it is imperative, in purely economic and financial terms of the national interest, to pay any conceivable price to hold the euro together.

The concept of a common currency was always an element in the region's vision of the ultimate goals of the integration project. Concrete thinking about an economic and monetary union in Europe goes back to 1970, when the *Werner Report*<sup>2</sup> laid out a detailed three-stage plan for the establishment of EMU by 1980. Members of the European Community would gradually increase coordination of economic and fiscal policies while reducing exchange-rate fluctuations and finally fixing their currencies irrevocably. The collapse of the Bretton Woods system and the first oil crisis in the early 1970s, however, caused the *Werner Report* proposals to be set aside for a time.

By the mid-1980s, following the creation of the European Monetary System in 1979 and the initiation of Europe's internal market, European policymakers again took up the idea of an economic and monetary union. The *Delors Report*<sup>3</sup> from 1989 envisioned the achievement of EMU by 1999, moving gradually (in three stages) towards closer economic coordination among the EU members with binding constraints on member states' national budgets and a single currency managed by an independent European Central Bank (ECB).

Optimal Currency Area (OCA) theory<sup>4</sup> prescribes the characteristics required for a geographic area to obtain maximum economic benefits from adopting the same currency. It can offer guidance to economically rational leaders about whether it makes sense for their country to join a common currency. But it was not a carefully considered and detailed economic analysis that ultimately led to the creation of the euro. It was geopolitics and the completely unforeseen shock of German reunification in October 1990 that provided the political impetus for the creation of the Maastricht Treaty,<sup>5</sup> which in 1992 laid the legal foundation and detailed design for today's euro area.

With the historical parity in Europe between (West) Germany and France no longer a political and economic reality, after German reunification, French president Francois Mitterrand and German Chancellor Helmut Kohl intensified the EMU process as a political project to complete the integration of the French, German, and other European economies in an economic and monetary union that would accomplish full and irrevocable European unity.

This political imperative for launching the euro by 1999 frequently required that politically necessary compromises, rather than theoretically unambiguous rules, make up the institutional framework for the euro. OCA theory, and the earlier Werner and Delors reports discussing the design of EMU, had been explicit about the requirement to complement a European monetary union with a European economic union complete with binding constraints on member states' behavior. Political realities in Europe, however, made this goal unattainable within the time frame dictated by political leaders following German reunification.

<sup>2</sup> Available at [http://aei.pitt.edu/1002/1/monetary\\_werner\\_final.pdf](http://aei.pitt.edu/1002/1/monetary_werner_final.pdf)

<sup>3</sup> Available at [http://aei.pitt.edu/1007/1/monetary\\_delors.pdf](http://aei.pitt.edu/1007/1/monetary_delors.pdf).

<sup>4</sup> See Mundell, R. A. 1961. A Theory of Optimum Currency Areas. *American Economic Review* 51 no. 4: 657-665.

<sup>5</sup> Available at <http://www.eurotreaties.com/maastrichtec.pdf>.

The divergence in the economic starting points among the politically prerequisite “founding members” of the euro area made the imposition of firm fiscal criteria for membership in the euro area politically infeasible. The Maastricht Treaty in principle included at least two hard convergence criteria for euro area membership—a 3 percent limit on general government annual deficits and 60 percent limit on general government gross debt limit.<sup>6</sup> However, in reality, these threshold values were anything but fixed as the Maastricht Treaty Article 104c stated that countries could exceed the 3 percent deficit target if “the ratio has declined substantially and continuously and reached a level that comes close to the reference value” or “excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.” Euro area countries could similarly exceed the 60 percent gross debt target provided that “the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.”

In other words, it was a wholly political decision whether a country could become a member of the euro area or not. Membership was not objectively determined by the fundamental economic strengths and reform record of the country in question. And it was politically inconceivable to launch the euro without Italy, the third largest economy in continental Europe, or Belgium, home of the European capital Brussels. Hence both countries became members despite having gross debt levels of almost twice the Maastricht Treaty reference value of 60 percent in 1997–98.

As a result, Europe’s monetary union was launched in 1999 with a set of countries that were far more diverse in their economic fundamentals, and far less economically integrated, than had been envisioned in the earlier Werner and Delors reports or would be dictated by OCA theories. Moreover, shortly after the launch of the euro, European political leaders further undermined the credibility of the rules-based framework for the coordination of national fiscal policies in the euro area. Building on the euro area convergence criteria, the Stability and Growth Pact (SGP) was intended to safeguard sound public finances, prevent individual euro area members from running unsustainable fiscal policies, and thus guard against moral hazard by enforcing budget discipline. However, faced with breaching the 3 percent deficit limit in 2002–04, France and Germany pushed through a watering down of the SGP rules in March 2005<sup>7</sup> that, as in the Maastricht Treaty, introduced sufficient flexibility into the interpretation of SGP that its enforcement became wholly political and with only limited reference to objective economic criteria and data.

In sum, the euro area by 2005 was, as a result of numerous shortcuts taken to achieve and sustain a political goal, a common currency area consisting of a very dissimilar set of countries without a central fiscal authority, without any credible enforcement of budget discipline, and without any real deepening of economic convergence.

Initially, however, none of these fundamental design flaws mattered. The financing costs in private financial markets of all euro area members quickly fell towards the traditionally low interest rates of Germany.

<sup>6</sup> The actual numerical reference values to article 104c of the Maastricht Treaty are in a protocol on the Excessive Deficit Procedure to the treaty. Available at <http://eurotreaties.com/maastrichtprotocols.pdf>. The Maastricht Convergence Criteria for euro area membership eligibility included three other metrics: inflation (within 1.5 percent of the three EU countries with the lowest inflation rate), long-term interest rates (within 2 percent of the three lowest interest rates in the European Union), and exchange-rate fluctuations (participation for two years in the ERM II narrow band of exchange-rate fluctuations).

<sup>7</sup> See EU Council Conclusions March 23, 2005, available at [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/84335.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/84335.pdf).

It is beyond the scope of this policy brief to interpret the causes of this colossal and sustained mispricing of credit risk in the euro area sovereign debt markets by private investors in the first years after the introduction of the euro. But the financial effects were obvious: Euro area governments and private investors were able to finance themselves at historically low (often significantly negative real) interest rates seemingly irrespective of their economic fundamentals.

Valéry Giscard d'Estaing, when he was finance minister of France, criticized the “exorbitant privilege” enjoyed by the United States as the issuer of the world’s reserve currency, enabling it to pay for imports (and foreign investments) in its own currency and making it seemingly oblivious to balance of payment constraints. With sudden access to “German interest rates,” many new euro area members suddenly enjoyed their own supercharged “exorbitant privilege.” Large public and private debt overhangs were correspondingly built up in the euro area in the first years of the new currency and in the run-up to the global financial crisis in 2008.

European policymakers’ initial denial and self-congratulations, coupled with financial markets’ failure to properly assess the riskiness of different euro area countries and tendency to ignore the common currency’s design flaws, thus conspired to ensure that the euro area, when it was finally struck by its first serious financial crisis in 2008–09, was hit by a double whammy of huge pre-crisis public and private debt overhangs and a faulty institutional design that prevented an expeditious solution that would be credible to those same markets.

#### THE POLITICAL BATTLE TO SAVE THE EURO

During its first decade, the euro area institutional framework was that of a “fair weather currency.” The area entered the Great Recession woefully under-institutionalized as a common currency flying on just one engine—the ECB—but without the unified fiscal entity that traditionally plays a critical role in combating large financial crises. The euro area leaders have had to build their crisis-fighting capacity and bailout institutions (the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM)) from scratch, and in the midst of crisis, to prevent their immediate financial predicament from getting out of control while simultaneously reforming the flawed foundational institutions of the area. Achieving the dual policy goals of solving a current crisis while trying also to prevent the next one—and using the same policy tools to do both—is rarely easy.

This marks a crucial difference from the United States. Once the Troubled Asset Relief Program (TARP) was finally passed, close collaboration between the multiple existing institutions in the United States (Treasury, Federal Reserve, Federal Deposit Insurance Corporation) ultimately restored market confidence and stabilized the situation in March 2009. In the United States in 2008 – 09, the economic crisis compelled the Fed to immediately apply the so-called Powell Doctrine—overwhelming firepower—to restore shaken market confidence and give the federal government time to formulate a longer-term response in fits and starts through the TARP. This is a fairly well established crisis response function. The central bank comes out with monetary guns blazing and then sits back and prays that the politicians do the right thing. (Congress did of course pass TARP after initially rejecting it but has not yet chosen to institute a sustainable fiscal response for the United States.)

The ECB, as the only euro area institution capable of affecting financial markets in real time, is a uniquely powerful central bank. Its institutional independence is enshrined in the EU treaty and it is not answerable to any individual government. This has enabled it to function as a fully independent political actor, interacting with elected officials during the crisis in a manner inconceivable among its peers. Quite unlike normal central banks, which always have

to worry about losing their institutional independence, in this crisis the ECB has been able to issue direct political demands to euro area leaders—as with the reform ultimatum conveyed to Silvio Berlusconi last August—and demand that they take action accordingly.

On the other hand, the ECB has not had the luxury of adopting the straightforward crisis tactics of the Federal Reserve and the US government within a fixed set of national institutions. The ECB cannot perform a “bridge function” until the proper authorities take over because no euro area fiscal entity exists. Moreover, to commit to a major “bridging monetary stimulus,” as some have called for, would undermine chances of a permanent political resolution to the euro area’s underlying under-institutionalization problem. Were the ECB to cap governments’ financing costs at no more than 5 percent, for instance, euro area politicians would probably never make the painful but essential decisions.

Saddled with administering a common currency, and endowed with governing institutions flawed by early political compromises, it is hardly surprising that the ECB’s dominant concern as it manages this crisis has been to prevent “political moral hazard” and not let euro area leaders off the hook. Precisely because Silvio Berlusconi would still be prime minister of Italy if the ECB had purchased unlimited amounts of Italian government bonds at an earlier time, the central bank is highly unlikely to provide the necessary assistance to euro area elected leaders to end the crisis—including the Italian successors of Silvio Berlusconi—unless and until they offer and implement a suitable quid pro quo.

It is imperative to understand that it is not the primary purpose of the ECB, as a political actor, to end market anxieties and thus the euro area crisis as soon as possible. It is instead focused on achieving its priority goals of getting government leaders to fundamentally reform the euro area institutions and structurally overhaul many euro area economies. Frankfurt cannot directly compel democratically elected European leaders to comply with its wishes but it can refuse to implement a “crisis bazooka” and thereby permit the euro area crisis to continue to put pressure on them to act. A famous American politician has said that “no crisis should be wasted” and the ECB is implementing such a strategy resolutely.

So far the ECB has been reasonably effective in this strategic bargaining with euro area governments. It has also consistently been willing to reverse itself when circumstances demanded. The initial Greek crisis in May 2010 led to the first “grand bargain” between the ECB (which agreed to set up the bond purchasing Securities Market Program) and euro area governments. Their agreement produced strong commitments for structural reforms in Spain and elsewhere. It also produced €440 billion in resources for the newly created EFSF, which proved to be an effective euro area fiscal agent when the problem was Greece, Ireland, and Portugal. Again, one must watch what they do rather than solely what they say.

The EFSF is inadequate when the problem becomes Italy and Spain, however. The ECB and euro area governments have therefore for some time been engaged in a new round of strategic bargaining to put together a sufficiently large financial rescue package, secure structural reform of the two big debtors (especially Italy) and, perhaps most importantly, to complete the euro area institutional house. The EU Summit on December 9, 2011 represented the latest round in this game of political poker.

#### THE DECEMBER 2011 SUMMIT

The real economy in the euro area has gradually deteriorated as regional policymakers dithered in their management of the complex crisis. This rising “economic collateral damage” has increased the pressure to act and led many to speculate that the euro is facing collapse.

This is nonsense. It is abundantly evident that all the key political decision makers in Europe—the ECB, the German government, the French government, Italy, and even Greece—are keenly aware of the catastrophic costs of such an outcome. Greek politicians know that, without the euro and outside the European Union, their country would collapse into a politically vulnerable economic wasteland and/or experience a military coup (the collapse would be far worse than the economic crisis seen since 2009). Angela Merkel knows that, were the euro to collapse, Germany's banks would collapse too under the weight of their losses on loans to the euro-area periphery; the new Deutsche mark would skyrocket, undermining the entire German export economy; and Germany would once again be blamed for destroying Europe. The ECB of course would not want to put itself out of business.

Those political games of chicken are repeatedly being played by all actors to try to extract the best possible deal for themselves. In the end, all will compromise. It is not a coincidence that Greek political leaders, once threatened with expulsion from the euro by Angela Merkel and Nicolas Sarkozy at the G-20 meeting in Cannes, formed the previously elusive national unity government in one week. Italy moved in the same manner within days of its *diktat* from the ECB. Once Germany and the ECB feel they have gotten the best possible deal, or have run out of alternatives, they will pay whatever it takes to hold the euro together. Neither can afford not to. But neither can say so in advance or, at the other extreme, risk seeing their bluff called.

Seen through these lenses, the EU Summit on December 9, 2011 developed in an understandable and promising manner. Two issues were central.

First, after 18 months of accelerating economic crisis, EU leaders finally began detailed political discussions about how to reform the flawed euro area institutions. At German (and implicitly ECB) insistence, the talks focused on a new “fiscal compact” aimed at finally producing for the euro area a set of binding budget rules that will constrain member states’ policy in the future. Due to the reluctance of the United Kingdom to accept a revision of the existing EU treaty, a new intergovernmental “coalition of the willing” compact may have to be negotiated among a sub-group of the 27 members of the European Union. Substantial legal and institutional uncertainty and “implementation risk” consequently surround these preliminary political decisions and the crucial legal details remain unfinalized. Yet the fact that 26 (or even 23) European heads of state and government declared their political intention to enter into a new fiscal compact, which will severely constrain their future fiscal sovereignty, is testament to the unflinching will to do whatever it takes to save the euro.

Many were disappointed by this narrow agenda and the lack of discussion of a larger centralized EU budget, like in the United States, or the immediate creation of joint eurobonds. However, it must be recalled that, as discussed earlier, Europe does not have the democratic legitimacy to collect taxes for a centralized budget at this point. Similarly, Europe lacks the compelling “endured in a common cause” (i.e., the Revolutionary War) political narrative that enabled Alexander Hamilton to pool together the debts of individual US states into common Treasury bills and bonds. Italy's debts have been run up to benefit Italians and other European taxpayers will surely revolt if suddenly compelled to pay part of them.

The reality in the euro area is that, for the foreseeable future and unlike in the United States, the overwhelming majority of government taxation and spending will continue to reside at the member state level for reasons of political legitimacy. Only a minor part will be pooled at the supra-national level. Restricting this spending via a new fiscal compact is consequently the only pragmatic route for now, leaving other aspects of euro area fiscal integration to the future.

Second, EU leaders tried to thrash out a sufficiently large financial firewall to restore confidence in the solvency of Italy and Spain. This issue was addressed in several ways. For one, euro area leaders reversed their initial intent to insert Private Sector Involvement (PSI) clauses into the new permanent ESM treaty. This should make it clear that private sovereign bond market investors face the same legal environment in the euro area as elsewhere, making the case for “Greece being a unique case” legally and politically more credible. This should ultimately help restore fleeting investor confidence in euro area sovereign bonds. In the grand game of distributing the costs of the euro area bailouts, private investors will not be asked to take haircuts other than in Greece in the hope they will then lend new money to the other debtor countries as the latter undertake the needed adjustments.

#### THE ROLE OF THE INTERNATIONAL MONETARY FUND

EU leaders further continued their sparring about the ultimate distribution of the costs of extending the euro area financial rescue by pledging €200 billion (€150 billion from the euro area) in new general resources to the International Monetary Fund (IMF). This would come in the form of loans from EU central banks<sup>8</sup> with the political understanding that the resources would be utilized predominantly to stabilize Italy and Spain. This attempt to involve the IMF directly in the rescue of the two larger euro area economies is in many ways reminiscent of the two-thirds/one-third financing split between the euro area and the rest of the world (as shareholders of the IMF<sup>9</sup>) for the existing IMF programs for Greece, Ireland, and Portugal.

However, given the better economic fundamentals in Italy and Spain and the prohibitively high costs of extending to them the type of traditional IMF programs granted to the three smaller euro area economies, a less politically intrusive and less expensive vehicle for IMF involvement may be found. This will still presumably entail special IMF borrowing from surplus and creditor countries around the world. A number have already said they will participate in such an initiative: Brazil, new G-20 chair Mexico, Russia, and a number of non-euro Europeans. China and other large Asian holders of foreign exchange have been more coy. They have also clearly indicated a desire to diversify their huge reserves away from dollars, however, so new claims on the IMF would presumably look quite attractive to them from a purely financial management point of view.

Total IMF borrowing, and the creation of a “firewall” to insure against default by major euro area countries, should and probably will exceed €1 trillion. Taken in combination with the €500 billion in the EFSF/ESM, the €700 billion or more from the ECB from its previous programs (€211 billion in sovereign bond purchases through the Securities Markets Programme (SMP), €489 billion in three-year loans<sup>10</sup>), and its essentially unlimited liquidity provisions to the euro area banking system, this amount should convince even the most skeptical market participants that the “firewall” is adequate even for Italy and Spain.

In now turning to the IMF, the euro area leaders acknowledge that their previous “euro area governments only” EFSF bailout vehicle will not be an efficient mechanism through

<sup>8</sup> Note that this means that any loans made to the IMF by euro area central banks will expand the consolidated European System of Central Banks’ (ESCB) balance sheet, even if the loans are not disbursed by the ECB itself.

<sup>9</sup> The two-thirds/one-third breakdown is not entirely accurate, as the euro area members are sizable shareholders of the IMF themselves and hence in total contribute more than two-thirds of the total financing of these programs.

<sup>10</sup> One might arguably also add the two ECB-covered bond purchase programs (–€62 billion) with unlimited liquidity of less than a three-year duration to these central bank support measures.

which to provide assistance to Italy and Spain. While this may seem like a political setback, going through the IMF rather than the (leveraged) EFSF in fact provides the euro area with significant credit enhancement because it makes it much more likely that other IMF member governments, e.g., China and other surplus countries, will choose to contribute.

In that way the IMF will quite likely serve as a far better leverage mechanism for the euro area's own resources (€150 billion) than had this money instead simply been added to the EFSF itself.<sup>11</sup> Euro area governments will have successfully shifted part of the costs of any future financial rescues onto the rest of the world. The rest of the world will of course extract a suitable price from the euro area for this service in the form of European political concessions in other policy areas. This could, for instance, be a good time to demand that the euro area consolidate its representation on the IMF board to a single seat (from its current eight) and accelerate the transfer of its quota shares to the financially contributing emerging markets.

#### MOVING TOWARD FISCAL UNION

Recent ECB policies have similarly tried to shift the bailout cost to other entities. In his December 1, 2011 testimony before the EU Parliament Mario Draghi famously stated "We might be asked whether a new fiscal compact would be enough to stabilize markets and how a credible longer term vision can be helpful in the short term. Our answer is that it is definitely the most important element to start restoring credibility. Other elements might follow, but the sequencing matters."<sup>12</sup> This was immediately taken by markets to mean that, provided EU leaders agree on a new "fiscal compact," the ECB would be willing to step up its sovereign bond market interventions and largely pick up the tab for bailing out Italy and Spain.

Unsurprisingly, euro area bond markets rallied strongly in the expectation of an official sector bailout from the ECB until the next Mario Draghi press conference on December 8, 2011, when he walked back his earlier comments by stating in response to a question that: "The purpose of the SMP is to reactivate the transmission channels of monetary policy. As I said in the statement to the European Parliament, the SMP is neither eternal nor infinite. We must keep this in mind and we do not want to circumvent Article 123 of the treaty, which prohibits the monetary financing of governments... the need to respect the spirit of the treaty should always be present in our minds."<sup>13</sup> Hence the ECB would not be willing to proactively bail out private investors in the Italian and Spanish debt markets. Those markets fell dramatically on the very day of the EU Summit.

The ECB signal thus sent to EU leaders ahead of their summit seemed unambiguous: It is up to the fiscal authorities, not the monetary authorities, to pay to restore market confidence in the Italian and Spanish bond markets. By turning to the IMF at their summit, euro area leaders indicated that they had clearly gotten the message.

The ECB refused to intervene directly and more forcefully in the euro area sovereign bond markets on December 8, 2011. But the central bank did effectively bail out the entire EU banking system, and with it many of the private sovereign bond creditors, through a series of additional enhanced credit support measures to support bank lending and liquidity in the euro area. These included unlimited liquidity provisions for three years, compared to a previous

<sup>11</sup>. Routing euro area central bank loans through the IMF general resources also provides governments a better "legal fig-leaf" against political charges of "monetary financing" (voiced by, for instance, the German Bundesbank) than if such loans had been used to leverage the EFSF directly.

<sup>12</sup>. Available at <http://www.ecb.int/press/key/date/2011/html/sp111201.en.html>.

<sup>13</sup>. Available at <http://www.ecb.int/press/pressconf/2011/html/is111208.en.html>.

maximum of one year, expanded ECB collateral eligibility to include bank loans, and cutting the reserve ratio in half to 1 percent.<sup>14</sup>

These forceful ECB liquidity measures were clearly warranted given the stress in the inter-bank credit markets in the euro area. However, they also provide a potential back door for euro area banks to use some of the funding available from the ECB to purchase additional euro area sovereign bonds and thereby stabilize markets. In this way, assuming that euro area banks can be morally swayed to make such purchases, the ECB would indirectly provide the financing for private banks to support the euro area sovereigns. This would constitute a below-the-radar bailout of governments by the ECB through the private banking system with the political benefits to the central bank that it does not violate the EU treaty ban on monetary financing.

In summary, the December 9, 2011 EU Summit shows how the key actors in the euro area crisis are still positioning themselves to force others to pick up as much of the costs of the euro area crisis as possible. In the meantime, the crisis continues and may superficially appear to be insoluble. There are in fact several possible solutions to stave off a near term meltdown, however, when Italy and Spain begin their large bond rollovers in early 2012:

- Germany can write a check and agree to expand the EFSF/ESM and/or give it a banking license.
- The IMF can write a check using new resources from the euro area and rest of the world to put together a sizable new support program for Italy and/or Spain.
- The ECB can write a check and begin to purchase much larger amounts of the relevant sovereign bonds.

It remains to be seen which solution will ultimately be chosen. It is possible, indeed likely, that the ultimate package will combine parts of each of the above. But it is obvious that none of these solutions are even remotely as costly for any of the main actors involved, inside or outside the euro area, as a sovereign default in Italy and/or collapse of the euro. That is why, once the political pre-positioning is over and the alternatives are exhausted, the games of chicken will end and the political decision on how to split the bill for securing the euro's survival will be made.

#### THE REMAINING AGENDA

Even the most successful financial engineering in the euro area will ultimately fail, however, if the debtor countries, and indeed the region as a whole, are unable to restore at least modest economic growth in the fairly near future. This requires at least three major steps:

- The borrowing countries must adopt convincing pro-growth structural reforms, especially in their labor markets, as well as budgetary austerity.
- The strong economies in the northern core of Europe, especially Germany, must terminate their own fiscal consolidations for a while and adopt new expansionary measures, i.e., they should buy more Italian and Greek goods and services rather than debt instruments.

<sup>14</sup>. Available at [http://www.ecb.int/press/pr/date/2011/html/pr111208\\_1.en.html](http://www.ecb.int/press/pr/date/2011/html/pr111208_1.en.html).

- The ECB must promptly reduce its policy interest rate by at least another 50 basis points and buy sufficient amounts of periphery bonds through the SMP to help push their interest rates down to sustainable levels.

There has been much talk about the infeasibility of achieving the needed “internal devaluations.” Germany has achieved just such an adjustment over the past two decades, however, probably amounting to about 20 percent of the (overvalued) exchange rate at which it entered the ERM/euro, through a combination of budget tightening and structural changes like the Hartz labor reforms. At the other end of the size spectrum, Latvia achieved an even speedier and more spectacular correction of its huge current account deficit of 25 percent of GDP and, only three years later, is now combining renewed growth with an external surplus. Italy has previously achieved dramatic adjustment, notably to qualify for the euro in the first place. (Greece never did so and its ability to remain within the zone is clearly more problematic.)

The agenda for the euro area, and indeed Europe more broadly, thus ranges well beyond the financial engineering that is clearly the most urgent requirement to overcome the crisis. Both the history of the integration project and the revealed responses at each stage of the current turmoil, however, suggest that both the historical imperatives and economic self-interest of all the key countries, both creditor and debtor, will coalesce successfully. Watch what they do rather than what they say as the drama continues to unfold.

The final major political challenge on the euro area agenda for 2012 goes beyond measures to address the immediate crisis but rather focuses on the longer-term continuation and direction of euro area institutional reform. During 2012, the euro area is likely to adopt a new and considerably more credible set of fiscal rules and budget oversight regulation. This has been a clear demand from both the ECB and Germany. But while the new fiscal compact will undoubtedly help stabilize the euro area in the future, it must be thought of as merely a beginning of the institutional reforms needed in the region. Fiscal consolidation is not everything and the movement toward further and symmetrical deepening of euro area fiscal integration must be maintained. Following the “fiscal rules first” down payment, euro area leaders must consequently take further concrete steps in 2012 on a reasonable timetable toward the introduction of measures such as eurobonds.

It took ten years for the first serious economic and political crisis to arrive after the euro was introduced. The most challenging part of today’s crisis is to use the political opportunity it presents to get the basic economic institutions right and complete the euro’s half built house for the long term. In this process the euro will develop in a different manner from the full economic and monetary union established in the United States. It will require additional substantial treaty and institutional revisions in the future. But as the US Constitution’s 27 current amendments clearly show, faulty initial designs need not preclude long-term success. If the history of the integration exercise and its crisis responses to date are any guide, Europe will emerge from its current turmoil not only with the euro intact but with far stronger institutions and economic prospects for the future.

#### THE IMPLICATIONS FOR THE UNITED STATES AND US POLICY

The United States has a major national interest in successful resolution of the European crisis. Europe is the largest market for US exports and by far the largest locus of US foreign investment. There are extensive financial linkages between US banks, and other financial institutions, and their European counterparts. A breakup of the Eurozone would push Europe

into a sharp recession or worse with sufficient spillover to the United States to sharply truncate our (already weak) growth as well. Europe of course remains our major international ally as well and any recrudescence of intra-European conflict, which only the European integration project has been able to check, could be disastrous for US foreign policy and indeed national security.

The Europeans should of course provide the bulk of the resources needed to resolve their crisis. They are doing so already and I have suggested that they will do whatever else is needed.

But there may be domestic political limits on those contributions in Europe, as everywhere else, and the rest of the world may thus need to help. It did so quite usefully in the initial phase of the crisis when the International Monetary Fund provided one third of the external financing required for Greece, Ireland and Portugal. IMF involvement is highly valuable for a second reason that may be even more important than its money (although the two necessarily go hand in hand): its greater ability to devise and enforce the needed disciplines on the borrowing countries, due to its long experience with such programs and far greater ability to adopt a tough stance toward the borrowers.

There is a growing consensus that the IMF should position itself to play a similar role in Italy and Spain, the two large Eurozone borrowers, both became IMF conditionality would then be even more crucial and because their financial needs, which together could total €1 trillion, could be beyond the capability of even Germany and the other strong eurozone countries. Even if the money were never used, moreover, the creation of such a substantial “firewall” could be crucial in convincing markets that defaults by these large economies would be inconceivable and thus restoring confidence in the overall outlook.

The IMF now has about \$400 billion of usable reserves. It is planning to seek loans from its member countries of \$500-600 billion to create a “firewall” of the desired magnitude. The United States has a major interest in the success of this project and should support it strongly.

Many people believe that the United States, as a rich country and the traditional leader of the international monetary system, should also contribute to the exercise itself. This would be inappropriate, however. The objective is for the IMF to borrow from creditor countries that are running large trade and current account surpluses (and to channel these funds to debtor countries that are running large deficits and undertaking serious adjustment programs). The main targets should be countries with very large foreign exchange reserves: most notably China but also Japan, Russia, oil exporters in the Middle East, Korea, Brazil, Singapore, Hong Kong and several others in Asia. Several of these countries, such as Brazil and Russia, have already indicated their readiness to contribute.

By contrast, the United States is the world’s largest debtor country. We are running annual current account deficits of \$500 billion or more. If we were to lend to the IMF, we would have to borrow even more from China and our own foreign creditors. It would be far better for the Fund to borrow from those countries directly.

At the same time, it is imperative that the Congress work with the Administration to pass the legislation needed to implement the IMF quota reforms agreed at the G-20 summit in Seoul in November 2011. That agreement included a doubling of the IMF’s quotas, and thus its basic resources, though without any increase in total US financing for the Fund because our increased quota would be fully offset by a reduction in our commitment to one of its earlier borrowing agreements. Even more importantly, it redistributes quotas and thus voting rights at the Fund away from the grossly over-represented Europeans to the grossly under-represented emerging markets, which will be an essential part of the “grand bargain” under which they will

lend substantial additional resources to the Fund to enable it help Europe on the needed scale. The US quota and voting share would change very little and we will continue to have veto power over any major IMF decisions, which is why our vote is required to implement the reform package and Congressional approval thereof is so important to promote US interests.

The United States can thus provide crucial support for resolving the European economic and financial crisis through the IMF, without spending any additional money, by supporting both the agreed quota reforms and the proposed new borrowings from major surplus countries. I strongly recommend that the Congress support both steps as quickly as possible.

The final, and very important, point is that we should understand that the euro crisis is a wakeup call for the United States as well. In the short run, the travails of the Europeans have led to large capital flows into the United States and the dollar that have contributed substantially to our very low interest rates despite our failure to seriously address our own budget problem and the related downgrade by Standard and Poor. Hence Europe has shielded us from much of the adverse effect of our own policy failures.

But we must remember that the financial markets were pricing Greek (and Irish and Portuguese and Spanish and Italian) debt at virtually the same rate as German debt only a few years ago. When reality set in, the crisis exploded very quickly and those countries were forced to adopt drastic fiscal adjustments at the worst possible time – when their own economies, and the neighborhood, were already very weak. On realistic current projections, the US deficit and debt numbers will look as bad in less than ten years than Greece's did at the onset of its national nightmare.

Hence we should regard the euro crisis as a wakeup call for ourselves rather than a source of solace that enables us to put off our day of reckoning a bit longer. The current weakness of our economy and the fact that we do have time to adjust means that we should combine short-term stimulus with decisive actions now, not just words and new procedures, that will correct our budget imbalance and debt buildup over the next three to five years. A failure to do so would mean that we have learned nothing from the euro crisis and will come to rue our failures to act as much as Greece, Italy and the other periphery debtors in Europe are now doing.

Chairman CONRAD. Thank you very much, Dr. Bergsten.  
Dr. Lerrick, thank you for coming, and we look forward to hearing your testimony.

**STATEMENT OF ADAM LERRICK, PH.D., VISITING SCHOLAR,  
AMERICAN ENTERPRISE INSTITUTE**

Mr. LERRICK. Thank you, Mr. Chairman. I think, first of all, since there are so many lessons to learn from what is happening in Europe for our economy, I would like to just recapitulate sort of what happened.

First, Europe's crisis is not a currency crisis. The euro has maintained its value. It is now about \$1.3. That is within its historic range of 85 cents to \$1.60. Europe has a fiscal crisis compounded by a failure to take corrective action that has just destroyed its credibility in the capital markets.

It is a self-inflicted crisis. The European Monetary Union set out rules that limited deficits to 3 percent of GDP and debts to 60 percent of GDP, and the markets accepted this as a fiscal performance guarantee. They thought that homogenized the credit risk throughout the union. You saw the interest rates on Greece's debt fall from 8 percent above Germany's to less than a quarter of 1 percent above Germany's with the access to the union. But these rules were never enforced. By 2007 you had 7 of the original 12 members over the debt limit. By 2010 it was 10 of the members. What had happened was weak governments had used massive borrowing to offer their citizens a standard of living their productivity could not deliver.

And so what you now have, when the crisis really started in Greece in 2009, Greece just announced, "Our deficit is 2 times what we told you a few months ago," and the markets recognized there was a problem. What should have happened 2 years ago is Greece should have defaulted on its debt, and the other countries should have just tightened up their budgets.

The fundamental problem in Europe really is that European policymakers do not understand markets, do not like markets, and think they can dominate markets. And that is why you have seen a mess over the last 2 to 3 years.

The inability of Europe to address its crisis stems from a fundamental disagreement over the responsibilities of members of the eurozone. Without a fundamental agreement, all you have seen is a series of political compromises that have only further eroded market credibility because they failed. Germany leads the North. They believe that the cause of the crisis is simply a lack of discipline in the South. Profligate members should cut their spending, lower their wages, increase their productivity, which is the exact path that Germany took approximately 10 years ago, and that is the source of Germany's current prosperity.

Under the German view, each member is responsible for its own fiscal well-being and growth. If markets see credible action, interest rates will fall and the crisis will end.

Southern Europe believes that their troubles are actually caused by Germany's success, that if Germany had not done so well, they would be in good shape. It is an interesting way of accountability, but that is their view. They think that union solidarity requires

massive transfers from the strong members to the weak and that what they need is a collectivized euro bond which will lower their financing costs and reduce the adjustment pain.

What is interesting is the role France has played in this. France, instead of siding with the other AAA countries, has decided to be the head of the South. The reason for this is they see this as the way of gaining political leadership of Europe while leaving the costs of bailouts with Germany. As one of the Germans told me, the French are very bad at economics but very good at diplomacy.

The great danger is that you now have a conflict within Europe. Germany wants immediate fiscal correction by the individual governments. The rest of Europe and the Obama administration want the European Central Bank to simply print up 2 trillion euros and buy every weak government bond in sight to drive interest rates down to 4 percent. They believe that the real problem of Europe can be dealt with later. This is basically mimicking the Federal Reserve's policy of just driving interest rates down and flooding the economy with cash. Germany disagrees. If a long-term solution is not offered, there is no amount of money that will solve this problem, and I believe that if Germany capitulates, as my colleague Mr. Bergsten believes they will, you will wind up with a currency crisis on top of a fiscal crisis.

The issue then becomes what is the next level of Europe. Germany has a clear view of what the future of Europe is going to be, and they have now found two tools that will force union fiscal discipline after 2 years of reasoning, threatening, and pleading had no effect on their fellow members.

First, they see that market forces can prevail where diplomacy has failed, that if you keep painfully high interest rates on the politicians, that will compel them to make the difficult choices that need to be made.

The second step they have done is they have removed the unanimity requirement on all major eurozone decisions. Before, the weak members—a single weak member could stop any adjustment throughout the euro with a veto right. And, therefore, they have set up a system where there will be no access to emergency funding unless a member agrees to the fiscal compact. And what will happen is the fear of being left behind without support is going to force submission to this fiscal reform.

And so what you will see over the next 2 to 3 years is Germany will drive the eurozone toward a fiscal union with central control over national budgets and strong automatic sanctions against spending offenders. This is a difficult path. The greatest danger is that a crisis will loom in the interim, that what you are seeing is a very difficult process, and that there are going to be missteps, there are going to be obstacles, and what you will see is that the markets will become frightened. And the great danger is that the politicians will confuse the end of their world with the end of the world and rush out and bail out every government and bank in sight, and you will set back economic stability by a decade.

So what really should happen is the ECB should act as a support for this difficult path to adjustment as the Europeans go toward a fiscal compact, and this way they will maintain stability in very fragile markets. What the ECB has to do is not just flood the mar-

ket. What they should do is announce a rule of intervention that removes the risk of financial panic but preserves the incentives for governments and for investors and safeguards their inflation-fighting credibility.

The great problem in Europe is not a problem of deficits or debt. Europe has a much more serious long-term problem. You can solve the debt easily. You write it off. You can solve the deficits easily. I am saying economically, not politically. You cut spending. The difficult problem is that Southern Europe's populations expect a lifestyle their productivity cannot supply. Greeks do not have to be Germans, but they cannot expect to be paid like Germans. And so you have a 25-percent gap between Southern Europe and German labor costs that can only be closed by nominal deflation because devaluation is not possible within the eurozone. This is a long, painful process that will precipitate a 5- to 7-year recession in the Southern European countries, and there you are talking about close to 40 percent of Europe's GDP.

The only other alternative is a long-term transfer from Europe's productive North to the South. The reunification of Germany posed the same problem of differing productivity. What the Germans decided was they proposed a solidarity tax imposed on West Germany to bring East Germany up to West German standards. It was envisaged as a temporary transition mechanism. It has been in place for 20 years, and there is no concept of withdrawing it even at this stage. What you are going to see is a transfer from Northern Europe through taxes and payments and aid directly, and indirectly through higher inflation, in order to reduce Southern Europe's debt.

One point that both you, Mr. Chairman, and you, Senator Johnson, raised is: Can this happen in the United States? Absolutely. And the fact is if we do not take corrective action, it is going to happen. You raised the concept of unsustainable trends. One of the Nobel Prize winners had a famous quote about unsustainable trends: "They end." And the fact of the matter is the only reason we have not had a crisis so far is because of the U.S. dollar's role as the reserve currency in the world. But that cannot go on. The reason it has not ended is because it is very difficult to replace a reserve currency.

The only other alternative right now would have been the euro, and the Europeans have their own problems, so that saved us. But there is a compact when you are the reserve currency. There is a privilege, which is that the rest of the world gives you television sets, lends you money to buy cars and houses at very low interest rates, in return for pieces of paper you print up in the basement of the Federal Reserve. The agreement is you have to maintain the value of those pieces of paper by sound fiscal and monetary policies. We have not kept up our end of the bargain. So over time you will the world withdraw from the reserve currency. When that happens, U.S. dollar interest rates will start rising very quickly. The U.S. dollar will start falling very quickly. And we will have a problem very similar to what the weak European countries have right now.

Thank you.

[The prepared statement of Mr. Lerrick follows:]

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Europe's Crisis of Credibility

Statement Presented to the  
United States Senate  
Committee on the Budget

by

Adam Lerrick

Scholar  
American Enterprise Institute

1 February 2012

It is a privilege to appear before the Senate Committee on the Budget.

Europe's crisis is not a currency crisis. Sound monetary policy has kept the Euro at \$1.30 within its past range of \$0.85-1.60. Europe has a fiscal crisis compounded by a failure to take corrective action that has destroyed its credibility in the capital markets.

**I. Self-Inflicted Crisis: No Discipline and Credulous Markets**

The European monetary union limited government deficits to 3% of GDP and national debt to 60% of GDP. Markets accepted this fiscal performance guarantee at face value and believed sovereign credit risk was homogenized. The interest rate differential between the strongest member Germany and the weakest member Greece fell from 8% per annum to 0.2%.

However, the fiscal rules were never enforced. By 2006, 7 of the original 12 members were over the 60% debt limit. By 2010, 10 exceeded the limit. Weak governments used massive borrowing to offer their citizens a standard of living their productivity could not deliver. The crisis began in October 2009 when Greece announced a doubling of its fiscal deficit and markets saw their error. Two years ago, Greece should have defaulted on its debt and other spendthrift governments should have tightened their budgets.

The fundamental problem is that European policymakers do not understand markets, do not like markets and believe they can control markets. They live in financial pre-history and always choose pressure and regulation over incentives and market forces.

**II. Disagreement over the Responsibility of Members: Accountability Versus Solidarity**

Europe's inability to act in the face of a crisis stems from a core disagreement over the responsibilities of Union members. Without fundamental agreement, all actions have been failed political compromises that further erode market credibility.

Germany leads the North. The cause of the crisis is a lack of discipline in the South. Profligate members must cut spending, lower wages and increase productivity. The path Germany itself used to gain its current prosperity. Each member is responsible for its own fiscal and economic wellbeing. If markets see credible action, interest rates will fall and the crisis will end.

Southern Europe believes their troubles are caused by Germany's success. Union solidarity requires massive transfers from strong members to the weak. A collectivized Eurobond will lower financing costs and minimize adjustment pain.

France, instead of siding with other AAA members, has appointed itself head of the South to capture European political leadership while leaving the cost of bailouts with Germany.

**III. The Monetary Printing Press: Mimicking the Federal Reserve**

Germany wants immediate strong fiscal correction by individual governments. The rest of Europe and the Obama administration want a quick fix where the European Central Bank

(ECB) prints EUR 2 trillion and buys every weak government bond in sight until yields are driven down to 4%. They believe the real problem can be dealt with later.

Germany disagrees. If a long term solution is not offered, no amount of money will make stop-gap measures work. If Germany capitulates, a currency crisis will be added to Europe's fiscal crisis.

#### **IV. Stable Monetary Union and Collectivized Euro-bonds**

Since the Euro's inception, members have struggled with the conflict between central control and national sovereignty.

There are two forms of stable monetary union:

1. Members share a currency but each government stands on its own before its creditors. Markets take losses, impose discipline and set borrowing limits; or
2. The Union underwrites all its members. Then the Union takes losses and must impose discipline and set member debt and spending limits.

A monetary union that cannot make up its mind is a crisis waiting to happen and Europe is still struggling to make up its mind.

The debate over the creation of common liability Euro-bonds is a false argument. If fiscal control is achieved: There is no need. All members will be AAA. Without control: Euro-bonds are not viable. As one of the German Parliament's Economic Policy leaders said: "They are the devil's work".

**V. Germany's Vision: The Next Level of Europe**

Germany has now found the tools to force Union fiscal discipline after two years of reasoning, threatening and pleading had no effect.

Market forces can succeed where diplomacy fails. Painfully high interest rates compel politicians to make necessary choices. Removal of the unanimity requirement on Euro-zone decisions takes away the veto right of prodigal members. There will be no access to emergency aid without agreement to the fiscal compact. The fear of being left behind without support will force submission to fiscal reform.

Over the next 2-3 years, Germany will drive the Euro-zone toward a fiscal union with central control over national budgets and strong automatic sanctions against spending offenders.

This is a difficult path. The greatest danger is that if a crisis looms, politicians will confuse the end of their world with the end of the world, bail out every government and bank in sight and set economic stability back a decade.

The strong arm of the ECB is needed to support the path to the European fiscal compact and maintain stability in fragile markets. The ECB should announce a rule of intervention that removes the risk of financial panic but preserves incentives for investors and politicians and safe-guards its inflation-fighting credibility.

**VI. Europe's Long Term Problem**

Europe's excess debt can be solved: write it down. Europe's excess deficits can be solved: cut spending.

The difficult problem is that Southern Europe's populations expect a life-style their productivity cannot supply. Greeks don't have to be Germans but then they cannot expect to be paid like Germans.

The 25% gap between Southern Europe and German labor costs can only be closed by nominal deflation because devaluation is not possible within the currency union. This is a long painful process that will precipitate a 5-7 year recession in the uncompetitive economies.

The only other alternative is a long term transfer from Europe's productive North to the easy-going South. The reunification of Germany posed the same problem of differing productivity. A solidarity tax was imposed to bring the former East Germany up to West German standards. Envisaged as a temporary transition mechanism, it is still in full force 20 years later.

Northern Europe will pay the transfer directly through taxes and aid and indirectly through higher inflation to reduce Southern Europe's debt.

Chairman CONRAD. Thank you. Terrific, all three. I really appreciate your contributions to the Committee.

Let me ask this: What is your assessment how the Basel rounds impact the European response to the current crisis? What is your assessment of what those changes require and how that interacts with what is currently happening? Dr. Johnson?

Mr. JOHNSON. Senator, I presume you are talking about the Basel accords on capital requirements for the banks.

Chairman CONRAD. Yes. Just so the reason I ask the question, we have had a lot of commentary among colleagues asking the question: What are the effects of the increased capital requirements? Are they sufficient? Are they insufficient? What effect are they having on the current challenges?

Mr. JOHNSON. Thank you, Senator. It is a very good question and highly appropriate to ask it and keep asking it at this moment.

Unfortunately, the problem with Basel is not just the latest agreement, not just this increase in capital requirements, which I think is insufficient. There is a much deeper problem with the way that Basel and this international agreement between major governments, the way they have agreed to think about how much capital you need. They use a concept of risk-weighted assets, and risk-weighted assets means that if you are holding something that is AAA, you do not have to have a lot of equity relative to that position.

Well, what is a AAA asset in the European context? Sovereign debt, including Greek debt, and as Mr. Lerrick laid out for you, people were convinced—and Mr. Bergsten said the same thing. People were convinced, the markets were convinced that Greek and German debt were very, very similar in their credit risk. Well, they are not. They are fundamentally different, and we are looking at a situation where there is real credit risk across a wide range of European sovereign debt.

So the entire approach in Basel is deeply flawed. Not only that, Senator Conrad, but the way it is being implemented is very problematic. The French and the Germans by all accounts are backing away from even what they signed up to in Basel.

Now, this does not necessarily limit what we do. I would argue strongly that we should go further, and the Federal Reserve has for systemically important financial institutions indicated that there will be some so-called surcharge. But that is not enough relative to the losses that we potentially face.

Chairman CONRAD. And remind us, what the capital requirements in the Basel round?

Mr. JOHNSON. Well, it depends on exactly—it is a very complex arrangement. It depends on exactly what kind of financial institutions you are talking about. The headline number is between 10 and 12 percent relative to risk-weighted assets, but I would say the devil is in the risk-weighted assets, in the risk weights. And if the risk weighting is so fundamentally flawed that they miss completely the sovereign debt crisis and the true risks that all these European banks face and that our banks face because they are exposed to the European banks, and to the extent that any American bank tells you to hedge this risk, they have hedged it through some offsetting derivative contract, such as a credit default swap, the

counterparty risk in that swap is probably with the European Bank, at least in part. How big is that? How profound is that risk? We do not know.

I talk to the senior regulators on this issue. I am a member of the FDIC's Systemic Resolution Advisory Committee that met most recently last week. I do not know the regulators would tell me even if they knew, but I am pretty confident they do not know. And that should give us all pause. That is why we should not be—I am not saying move everyone immediately to 20-percent capital requirements. You cannot do that politically. I understand that. You can suspend dividend payments, absolutely, across the board as an emergency measure given the European situation. That would be well received. That would bolster financial stability and growth prospects in the United States. It would not be a negative in this environment if it is applied across the board because of the risks posed by Europe and the uncertainty that we all agree still looms.

Chairman CONRAD. Dr. Bergsten, what is your assessment of Basel and the capital requirements? Sufficient? Insufficient? Do you share Dr. Johnson's view of this?

Mr. BERGSTEN. Yes, I very much share his view. I do think capital adequacy is at the heart of restoring financial stability here, Europe, everywhere else, and we should err on the side of caution, going to higher rather than lower capital requirements in order to achieve that outcome.

There is a fascinating implication from the events of the last 3 or 4 years we should keep in mind. This last crisis, of course, was rooted in financial instability in the United States and Europe. It turns out there was very little spillover to the emerging markets and developing countries. They got some effect from the recession and the weakening of trade flows, but their financial system stood up much better than ours. Why was that? Well, they had crises in the past. The Asians had crises in the late 1990s, the Latin Americans in the 1980s, and in response to those, they did to a large extent get their acts together. They opted to have financial systems that were not as exotic and high-flying and maybe as innovative as ours. They explicitly and determinedly opted for more risk-averse systems, including much higher capital requirements. And that paid off.

Chairman CONRAD. What is their level of capital requirements?

Mr. BERGSTEN. It differs from country to country. Simon, do you know? But the numbers are much higher than ours. They were all put in place after those earlier crises as a lesson from those crises and seem to have paid off very heavily.

Chairman CONRAD. Simon, do you know the answer?

Mr. JOHNSON. Twenty percent is not an unusual level of capital in these conservative systems that have previously faced serious crises.

Chairman CONRAD. And 20 percent measured—do they measure on a risk-weighted asset basis as well?

Mr. JOHNSON. Yes. That is a deep methodological problem across all these systems, but they are much more careful, have been much more careful about what they will count as risk-weighted assets. The Europeans made a huge mistake on sovereign debt. Of course, we made a huge mistake relative to—

Chairman CONRAD. We just had a company go down in part because of bets on sovereign debt.

Dr. Lerrick.

Mr. LERRICK. First of all, I echo Simon's comments about the Basel rule. I would raise two points.

First, there is one true law of economics that was first enunciated by a governor of the Bank of England in the 19th century, and that is, every regulation will be circumvented. So when you start setting out very precise rules, you are setting in motion an entire system of people who are certainly spending their lives thinking about how to circumvent them. And, remember, regulator are always one crisis behind. They are always thinking about the last crisis. They do not know where the next crisis is coming from. And they are paid far less, work far less hard, and are not as highly skilled as the people that are attempting to get around the regulations. So you must keep in mind that when you set out clear regulations, you have a problem.

The second is, I saw an old photograph of a bank that had been closed back in the 1920s, but the window front was very interesting. Before the Federal Reserve, in the 1920s, on the front window of every bank it said, "Capital, \$10 million," or \$12 million or \$5 million. Now when you look at a bank, it says, "FDIC Insured." That is a fundamental problem. You have a system where very few people pay attention to the capital of banks.

Simon raised that the levels are much higher in developing countries, many emerging market countries. Look at Switzerland. Switzerland is the developed country that has the greatest interest in preserving the integrity of its banking system. The Swiss economy lives off its banking system. They proposed, before anyone else, raising capital standards to 16 percent and probably will go higher in order to establish the absolute credibility of their banks in the world, and that is one of the key issues. Banking should be a boring business. It should not be a high-flying business where you take risks, where you trade, where you do all these things. It is a boring business, very similar to a utility. They are supplying payments, they are supplying checking, they are supplying loans to small businesses. This is not an exciting business. It is not a highly profitable business, but it is a fundamental business for the economy. And the job of the Government is to make sure that banks are not in danger, and that is why you should make it a boring business.

Chairman CONRAD. Thank you very much.

Senator Johnson.

Senator JOHNSON. Thanks, Mr. Chairman.

This was fascinating testimony. I am new here, so let me quick ask a question on the Asian banks and what they did to solve their problem.

When we passed Dodd-Frank—I am a great believer in not reinventing the wheel—did we take a look at what regulations or what new rules the Asian banks put in place as we designed Dodd-Frank, and whether that made sense and does it still make sense to do so if we have not?

Mr. JOHNSON. Senator, you would have to ask your colleagues what they did and did not look at. My impression, as somebody

who followed it closely and who testified to Congress on a number of occasions, is that we were very taken with the exceptional nature of the United States, and there were, of course, various lessons we could have also drawn from Scandinavia with regard—Mr. Lerrick hit the nail absolutely on the head. Make banking boring, absolutely. And the Scandinavians have come through this crisis in relatively good shape from a fiscal point of view and from a growth point of view, in part because they had terrible problems with their banks in the 1990s, got completely out of control, just like emerging markets had this problem, and they cleaned them up and they made them much more conservative and much more careful, including much higher levels of capital.

So I fear that we either did not look enough at international experiences or did not draw in this dimension the right lessons.

Mr. BERGSTEN. Senator, there is a great irony here. What the Asians and other emerging markets adopted after their financial crises was an idea called “an international banking standard,” which was actually invented by one of our staff at our Peterson Institute for International Economics, Morris Goldstein. And the idea was then picked up and heavily promoted with the emerging markets by the U.S. Government, by the International Monetary Fund, and by all right-thinking people who wanted greater global financial stability.

But we viewed it as they are kind of adopting our ideas, and the implication, as Simon said, was our systems were fine and should be the model. And then over the succeeding decade or so, whether or not our systems were fine back then, our systems certainly eroded and failed to keep up with the technology in the industry. The regulatory zeal dropped sharply. Everything was fine, we were exceptional. But it was actually the U.S. and the West with its more sophisticated financial systems that developed, promoted those ideas, and then, as often happens in history, the people that adopted them got well ahead of the curve.

Senator JOHNSON. We turned our backs on them, basically. Again, the question I am asking: Would we be smart to look at those and adopt those?

Mr. BERGSTEN. Certainly, you should look at it carefully, and Simon rightly mentioned there are some other high-income countries, including European countries, which have actually done this quite well, and Sweden and Finland are two cases in point where they had incredibly deep financial crises in the early 1990s, put their houses in order, dramatically reformed their economies. You know, we used to think Sweden, the socialist economy, how could it ever succeed? Sweden has been the star in the whole—even more than Germany, in this recent European economic situation, which has come through this current crisis not totally unscathed because the neighborhood is rough, but largely unscathed, doing very, very well. And their Finance Minister has been voted Finance Minister of the Year around the world, et cetera.

And so having gone through a crisis, taken a serious reform in your financial system and your macro policy, pays off heavily when you then get hit again. And my fear, just to reiterate the obvious—we have all said it—is that the U.S., which has so far escaped that

existential crisis, may be lagging badly and may wind up paying a very heavy price as a result.

Mr. JOHNSON. Senator, a specific suggestion for you. I can connect your staff with the relevant people in Singapore. They have a relatively large financial sector. They know they live in a dangerous world. They are extremely careful with regard to how they operate. They learned a lot of hard lessons along the way. They think the way we operate—they will tell you in private. They are not going to say this in public. They think the way we operate our system is reckless and irresponsible and poses big dangers to ourselves and to everyone else. And, remember, Singapore in terms of fiscal prudence is a model that we should all aspire to, even though it would be pretty hard for us to get there. So if you want those connections, I am happy to provide them.

Senator JOHNSON. I cannot help but ask the question: How many pages was their piece of banking legislation?

Mr. JOHNSON. That I would have to get back to you on, Senator. There is no question, though, that they have a very tough, skeptical body of regulators who are absolutely not captured by the financial sector. In fact, it is the one place in the world where the regulators are paid as much as the people who work in the private sector and work harder. I am not suggesting you would want to go there for the United States, but it is a model—

Senator JOHNSON. No, obviously bank regulators do not have the incentive that the bankers have in terms of circumventing.

Dr. Bergsten, I was fascinated by your assessment of Europe, and the thought that kept going through my mind was that past performance does not guarantee future results. I hope you are right. But I am assuming Dr. Lerrick and Dr. Johnson probably are in agreement with you in terms of what I guess I would call a rosy scenario. Dr. Lerrick, do you want to comment on Dr. Bergsten's—

Mr. LERRICK. Oh, I think I am actually more optimistic than Dr. Bergsten because I believe the Germans are going to drive Europe to a stable fiscal union. It will take a number of years. We were debating before the conference whether this was the 17th summit and the 19th Republican debate, Republican Presidential candidate debate, or the 19th summit and the 17th Republican Presidential candidate debate.

We have many more summits to go, but they will get there, I believe. But there is a large risk. One of my colleagues at AEI, John Makin, uses an analogy. He said, "This is a dangerous operation. You could have the most skilled surgeon in the world, but things can go wrong." And so something could go wrong.

I believe that the Europeans will manage this process. I think the Germans have now found the tools to do that, which are just to keep interest rates really high on all the politicians of the weak countries, and that will force them to do what German threats and pleading and reasoning did not succeed in doing for 2 years. And, secondly, the new strategy, which is if you agree, that is great and you will get our support; if you do not, go with God, you are on your own.

Senator JOHNSON. And that is basically the same discipline that will be imposed on the U.S. Our creditors will increase our interest rates to force us to do what we need to do.

Mr. LERRICK. Hopefully we will do—yes, that will be what will happen in the end.

Senator JOHNSON. Okay. Thank you.

Chairman CONRAD. Can I just take a moment, Senator Merkley? Not on your time.

I do not want to miss this chance. I am going to turn to Senator Merkley immediately, so I do not want to go through your answers at this point. I just want to put on the table, I would like for you to tell us what Sweden did, because my recollection is they did something with getting the toxic assets off the books of their banks, and I cannot remember what it was. But at the time we were going through our TARP, I was very intrigued by what Sweden did. So I do not want this moment to slip.

Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and I am going to ask you all to be very brief because I have to leave in 5 minutes.

Mr. Johnson, you highlighted the unknown nature of the derivative exposures, and there has been a lot of discussion about this. Every expert I have talked to has said we really have no idea of how the dominoes are lined up. It is an incredible thing that just in this European and American sector we cannot quite get our hands around who is underwriting, who is holding, and what happens if companies have to perform on those insurance contracts.

In that context, there has been a lot of discussion in Europe about the banning of naked shorts, that is, not being able to buy a credit default swap unless you own the underlying investment. I believe that one step in that direction was taken back in October, and if the proposal is ratified, I think it would go into effect in November of this year, something like that.

Can you bring us up to date on that? And there is a fierce argument going back and forth as to whether that is valuable or not.

Mr. JOHNSON. It is a good question, Senator. I would like to come back to you on the very precise details and the latest information. I can do that quickly. My understanding is that some financial entities in Europe are still banned from shorting sovereign debt.

Senator MERKLEY. Sovereign debt, yes.

Mr. JOHNSON. And particularly the Europeans obviously have hedge funds in their sights.

I think, to be frank, it is a somewhat misguided approach. A lot of people in financial markets want to be able to ensure against risk, and they want to be able to use the credit default swap market to that end. If this were a transparent market, if you could trace through underlying exposures both on a gross and net basis in real time, I think from a systemic stability point of view we could become more comfortable with it. It is a lack of transparency around derivatives. It is the ability of mega banks, as to quickly take proprietary trading positions, for example, betting the house. Senator Conrad made a reference to MF Global, which, of course, failed because of bets made by senior management.

It does not have to be through a naked short position or through CDS contracts necessarily. There are other ways to do it. I think that we should move toward transparency in all these markets rather than banning this or that financial instrument because you

just shift the risks into other ways that are more murky and that we live to regret.

Senator MERKLEY. Well, and in that context, under Dodd-Frank we are setting up a more transparent derivatives market in the United States. Are there parallel efforts underway in Europe to create both an exchange and a clearinghouse?

Mr. JOHNSON. Not at the level and for the instruments that would really matter. There is a lot of cross-border trading. There is a lot of trading we have not talked about. The United Kingdom, they are dragging their feet on key parts of this. And so, for example, take the euro swap market, interest rate swaps. There is over \$300 trillion in total exposure there. No one can tell you who exactly owes what to whom, either on a gross basis, which is what really matters when there is a failure, or on a net basis, which is, the bare minimum that you should be able to report.

So the lack of transparency in this huge market that has become actually the basis for much of the European financial system, that is deeply, deeply troubling, and if that is not keeping the regulators in this country awake at night, then they are not paying close attention.

Senator MERKLEY. And I think it does highlight a point that the U.S., to the degree possible, needs to be involved in a discussion that helps establish that transparency and that trading regime, if you will, in Europe as well as in the United States.

Mr. Bergsten.

Mr. BERGSTEN. I just wanted to add one point. A fundamental problem in the European financial regulatory context is that they still do it largely at the national level. They still have not been able to get the European Monetary Union to encompass European-wide financial regulation. And so the problems that we have, as you are describing, are compounded in the European case by their failure to add that dimension across borders.

Senator MERKLEY. Yes.

Mr. BERGSTEN. Now, there is a similar global problem because the derivative trading in particular and all these exotic financial instruments really do cry out for international regulation, and that is what Basel tries to do, but it has been very inadequate. And so one of these days we have to take the big leap to do a globalized Dodd-Frank because, without it, the kind of slipping around the controls that Adam Lerrick mentioned takes place across borders, and you have another escape hatch from whatever domestic regulatory regime is put in place.

Senator MERKLEY. Yes. I have to dash away, so I apologize for that. I just wanted to close by saying it has been a great discussion. I hope we can really continue to wrestle with these issues of international monetary strategies and institutions. And I wanted to mention, Mr. Lerrick, that it was a number of years ago that I remember an article in which Warren Buffett was re-placing his investments to be denominated in foreign currency because of his very expectation that the dollar was no longer going to be held as a reserve currency. That threat is out there and could have profound consequences, both enormous shocks but it is also an instrument or a change that would have an impact on the cost of our goods to the world, to the degree the dollar becomes weaker, mak-

ing them more affordable to the world. So that is another interesting conversation I would love to have, and I am sorry I am going to miss the Sweden solution, but I look forward to hearing about it.

Thank you.

Chairman CONRAD. Thank you, Senator Merkley.

Senator Thune, would you like to take questioning time now or would you want to withhold for a moment and we can come back to you?

Senator THUNE. It is up to you. If I can ask a couple quick questions, it will not take long, if you want.

Chairman CONRAD. Okay. Then we are going to go to a second round, so if you are prepared, go ahead.

Senator THUNE. Thank you, Mr. Chairman, and thanks for holding the hearing. I think this is a really important subject. This ongoing crisis in the eurozone is something that is critically important to our country both in terms of the impact on our economy but also helping us to recognize the fiscal challenges that we face in the long term as well.

I would like to get your perspective, if I might, on the panel to something that has been reported, and that is that many of the U.S. banks and money market funds have significantly cut their exposure to eurozone bank debt in recent months, which I believe is a positive sign given the ongoing crisis that we see in the eurozone, but there is significant exposure that remains. And I am curious to know what your estimate is of the current total U.S. exposure to the European banking system and what level of reduction do you believe is necessary in order to protect financial institutions in this country.

Mr. JOHNSON. That is a great question, Senator, and I think the honest answer is I do not know, and I do not know anybody else who knows. I spent time with officials at the FDIC, the New York Fed, and other bodies recently. I am not convinced that they know.

You are right that the mutual funds have cut back their exposure, and that, of course, is part of the reason why the European banks have wanted to draw on the Federal Reserve indirectly through credit provided to the ECB in order to get dollar funding. So that part I think we should worry about a little bit less.

I would focus on the derivative transactions, on the counterparty risk, on U.S. bank exposure, for example, to the interest rate swap market in euros—it is a huge market—direct exposure and indirect exposure. And I would urge you strongly, in public, or in private if you prefer, to bring the relevant regulators before you and discuss this as a matter of top priority for the budget, because this is a huge fiscal risk that you are facing.

So I cannot give you a number, and that is not because I do not follow this closely. I follow it very closely. Those numbers are not public. If the regulators have them, they should be sharing them with you on some basis. And if they do not have them, if they do not know how to calculate that, you should be asking, I would suggest, very, very hard questions to them: Why not? What would it take to figure this out? And perhaps you can also ask the big banks to come in and testify about this as well. What is their exposure? How do they think about their exposure? How do they model it? We

still give them enormous authority to handle their own risk management. I am very skeptical that they have a handle on this at all.

Senator THUNE. Does anybody else want to comment on that? Is there anybody who knows—I suspect you are right, that that maybe cannot be quantified without bringing them in. I would hope that they would have some idea about that, but does anybody else care to comment on that?

Mr. LERRICK. Well, first, Senator, those numbers are not public, certainly. As Dr. Johnson said, it is unlikely even our regulators know for sure. I would say two things, though.

One, the U.S. financial system exposure to European sovereign debt is not very great. The exposure—or the mutual funds. They have cut back. The exposure is through the banking systems, either their credit lines, their swap lines. One thing that the Europeans have announced publicly is that each national government will stand behind its large banks no matter what; and, secondly, if a national government is not capable, that guarantee will move to the eurozone itself. They have actually made that statement a few months ago.

The issue that Mr. Johnson raised about derivatives is an important one and comes back to a question that Senator Merkley raised. One issue about CDS which is everyone is very disturbed about—and the Europeans, because I think they do not understand how markets work, are trying to ban naked CDS—is that, first of all, it is very good that CDS should be in centralized depositories so we know where they are. It is very good that people should have to account for them correctly. Three important aspects.

First, CDS, unlike bonds—which is one of the big problems for eurozone banks—are marked to market every day, so that you could have—for instance, up until very recently, you had banks in Europe carrying their Greek bonds at 100 cents on the dollar even though in the market they were quoted at 40. However, the CDS had to be marked to the 40. So every day that is reflected in real time.

Secondly, 90 percent of CDS contracts are collateralized by other securities or cash for the counterparty risk.

And, third, what is important in CDS, the way the CDS market works is you have the gross amount of CDS and then you have the net amount. And the way the net amounts are calculated is institution by institution. So if an institution has sold \$100 million of CDS but has bought back \$80 million of CDS, the net number is only 20, their exposure. And the way the CDS market works, in addition to the collateral, is there is bilateral netting so that if a CDS—if one of the issuers, meaning Greece or Italy, defaults, what happens is the institutions go to each other one by one, and they net it against each other. That eliminates to a large extent the danger of cascading through the system. There is not, however—what would be very good—multilateral netting, which would mean that you would be able to net out the entire system across many institutions, and then the next exposure would be your only concern. But the bilateral netting does reduce the risk substantially.

Mr. JOHNSON. Senator, could I interject two things?

First of all, I agree with Mr. Lerrick, the Europeans have promised to take over some of these national commitments to the banks. But I think we would agree that the Greek banks are about to default. In other words, they will not be guaranteed in full. That is the information that I have seen. The eurozone is not going to back the Greek banks. Therefore, why do you think they would necessarily back Portuguese, Irish, or Italian banks as the circumstances evolve?

The second point is on the netting, which I think is hugely important. Remember that—I do not want to get too much into the weeds, but if you and I both have contracts and I fail and you do not, you get to accelerate typically across CDS contracts and other derivative contracts, so I have to pay you immediately. But I do not get to accelerate my contract on you because you have not failed. And that is why—and, again, you can bring in the people from the FDIC who are very good on systemic resolution. They stress gross exposure through derivatives because at the moment of systemic weakness, the gross can actually cascade through. You should have the system that Mr. Lerrick emphasized. There are ways *ex ante* agreed to net it out properly. That is not in place within Europe. It is not in place across borders. It is not, according to my FDIC colleagues in the public hearing we had last week, in place fully for the United States, and that is a major weakness in the financial system that, again, will spill over and have fiscal risks for you.

Senator THUNE. If I could ask one quickly—and I know I am out of time, but, you know—

Chairman CONRAD. Go ahead, Senator. We have been very—

Senator THUNE. We have seen countries like Spain, Italy, and Portugal that have enacted significant fiscal consolidation packages to balance their budgets and have enjoyed, in some of the sovereign bond auctions recently some pretty significant demands relative to what people would have expected, suggesting that these austerity steps and measures were the right approach. And their debt-to-GDP ratios are over 100 percent in some cases; Greece is 143. We are at over 100 percent. And we have had ample warning about where we are and what we need to do. What level of debt reduction do you think is necessary over a 10-year period to get our country back on a more sustainable path?

Mr. BERGSTEN. Well, lots of people have tried to analyze that. We have published a lot of work at our institute, including by Carmen Reinhart, who is one of the great experts on this. The conclusions depend a lot on the method of analysis, but the bottom lines are that if your national debt-to-GDP ratio exceeds 60 percent, you are at risk. If it exceeds 90 percent, you are almost certainly going to take a significant hit to your long-term growth. Her database, which goes back a long way, shows that countries whose debt-to-GDP ratios get beyond 90 percent—

Chairman CONRAD. Gross debt.

Mr. BERGSTEN. Gross debt beyond 90 percent leads to growth rates 1 to 1.5 percentage points per year lower. And if your baseline is 2.5 to 3 like ours, that means you are cutting it in half and getting to a level that is almost what we have tended to call a growth recession, certainly not one that keeps the unemployment rate from rising.

So somewhere in that range—you cannot be too precise, but somewhere in that range, 60 to, say, 100, you clearly do not want to be beyond that. We are already beyond it. All the trajectories take us just off the charts beyond that, and that is why your basic point is so right.

Mr. JOHNSON. Senator, I have actually written a book that is coming out in April that partly addresses this question. I would suggest you aim for 50 percent debt-to-GDP by 2030. That is a total—

Chairman CONRAD. Gross debt or publicly held?

Mr. JOHNSON. Held by the private sector, so excluding the trust funds, which is—

Chairman CONRAD. So that would translate into 80 percent gross debt.

Mr. JOHNSON. That is right, and there is a little problem with the way that you compare these numbers across countries. Again, we can go to the technical details afterwards. In some countries, such as Japan, you should look at the gross number. In the United States, we should look at the net debt held by the private sector, which is what the CBO emphasizes. And I think that is a fiscal goal that is entirely achievable, and that is the right time frame, and that would not cause massive problems for the economy and I think is consistent with sustaining growth, 50 percent of GDP.

But on the Spain, Italy, and Portugal point you made, I would suggest that the slightly lower yields of late have not been particularly because they have done fiscal adjustment. Actually, they have done very little. Senator Johnson before you came in, I think, coined a great phrase for what is actually happening: monetary innovations or solutions to deal with fiscal mismanagement. It is the ECB providing cheap credit to the banks and the banks then buying up the debt with a lot of arm twisting because the Government is running or pushing the banks very hard, the quid pro quo. It is not a solution. It is, the cliché is, kicking the can down the road. That is what they are doing with monetary policy. As if you let monetary policy become subservient to fiscal policy and fiscal mismanagement, it will end in high inflation and many other problems that we have experienced in all these countries before. So I do not think Spain, Italy, and Portugal are on a more stable path.

Mr. LERRICK. Senator, I think Mr. Johnson raised a very simple point. The reason yields are down in the peripheral countries is being the ECB has given unlimited 3-year funding at a highly subsidized interest rate. That is why you are seeing the interest rates on the short-term bills and bonds come down much more than long term because they can buy out to 3 years, have no mismatch, and do fine.

I would raise two other points to the question you raised, Senator. The level of debt depends on two other factors; that is, first the question is: What is sustainable? That depends on what the savings rate of the economy is. It makes a very—Japan and Italy are very different than the United States. They can support much higher debt levels because their private sector saves a much higher level of their income. That does not mean it is good. It just means it is sustainable. You will have lower growth. It will be very bad.

You are diverting resources from the private sector to the inefficient public sector. But it is sustainable.

The second issue is what percentage of the debt is held by foreigners. In this country, a large percentage of the debt is held by foreigners. That means that every day an increasing share of every American's life is spent working to pay the Chinese, is effectively working for the Chinese. That is what we are doing. And as our debt increases, as the interest expense goes up, that money is just shifted out of the economy. If that debt was held by other Americans, you would just be transferring money from one group of Americans to another group of Americans, but it would stay in the U.S. economy. But when it is owned by foreigners, you are basically taking all that economic output and just sending it abroad. And that makes it even more unsustainable—that makes it unsustainable, and it means that our standard of living is going to fall unless we correct that.

Mr. BERGSTEN. I just want to add one caveat on the Italy-Spain point. My colleagues have both tended to denigrate—or implied they were denigrating the European Central Bank's money creation to in part push down the yield on those bonds. I think that is a good thing. I think that is avoiding the apocalyptic outcome we talked about before. It is also buying time for those countries to put adjustment programs into place. They cannot be just austerity programs. They have to be economic reforms, structural change to get reasonable economic growth going again. But they cannot do it overnight in the best of worlds, and so the fact that the European Central Bank is in this way acting as a lender of last resort I think is a good thing to be applauded, and it is actually part of the scenario I spelled out in my opening statement why I think that the apocalypse will not happen because, among other things, the European Central Bank will play that role.

Senator THUNE. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Let us go to a second round now and ask the witnesses to continue. We appreciate that. It has been incredibly valuable. I hope other members' staffs are here listening because there is a lot of educating going on here today that is important to us.

I would like to go back to what Sweden did, if you could remind us of the steps that they took that have proved so effective. Dr. Johnson?

Mr. JOHNSON. Yes, Senator. Of course, this is the route not taken by the Obama administration. Remember, it was considered in January and February, perhaps into March of 2009. The Swedes took over the banks. People use the word "national." That is a Swedish word that we do not like to use here. I would say they resolved them. They did an FDIC-type takeover, and they liquidated the banks, make them bankrupt in a government-managed process. They took what we would call the "toxic assets"—the bad loans—out of the balance sheets of those banks. They created asset management companies, just like we had the Resolution Trust Corporation after the S&Ls in the 1980s. The job there is recover some value over 3 to 5 years, sell the assets, get rid of them.

They launched three cleaned-up banks, new balance sheets, new management, new owners. Of course, the old owners were wiped out as part of the deal, and they privatized them. They sold them back to the private sector. The government never wanted to run the credit system.

So the word “nationalization” I think was misunderstood and misused somewhat in our debate. It was an FDIC-type resolution process that went pretty well. You end up with banks that are not encumbered by bad loans or by litigation around those loans. That all gets stuffed into the asset management company, which does its best to recover value for you.

But the main point in terms of what Fred Bergsten was emphasizing earlier is that they came out of this with a totally different approach to the financial system, a much tougher regulatory approach, not 1,500 pages—you are probably right on that, Senator Johnson, but a much more skeptical view of the bankers. They got rid of the previous powerful interests that had controlled those banks, that had captured the hearts and minds of regulators, had been allowed to take on egregious risk, totally shifted the balance of power relative to the bank system.

Swedish banking became boring, super-boring, which is Mr. Lerrick’s advice here. I think it is extremely good advice. If you are a young, aggressive Swedish person and you want to go into the risk-taking financial sector, you go to London or New York. You do not do it in Stockholm.

Chairman CONRAD. Let me go to another set of questions. If, God forbid, we would have another financial crisis, would our Federal Reserve have the ability along with the U.S. Treasury to take over AIG the way they did in our crisis?

Mr. JOHNSON. Well, my understanding of the precise legal situation and where the FDIC and other regulators are in terms of developing their relevant authorities is that you cannot bail out individual companies in the way that AIG was bailed out. You cannot put taxpayer money at risk in the same way that was done for AIG. However, there is a broad authority to deal with any systemically important financial institution, including, I presume, institutions that you did not think were systemically important until 4 o’clock on a Friday afternoon you realize they are about to fail and you need to do something by Monday.

So there are greater powers now to take over and liquidate such institutions—not run them, not run a conservatorship. I think this is an important misunderstanding sometimes. You can liquidate that institution. You can liquidate it in an orderly manner, and you can buffer the rest of the financial system against the consequences of that liquidation.

Now, whether those mechanisms are sufficiently detailed, sufficiently credible, I have my doubts, and on the Systemic Resolution Advisory Committee I might stand out as one of the skeptics about what the FDIC had put on the table so far. But they are moving in the right direction. The ability to credibly threaten to bankrupt such a company without necessarily using the bankruptcy code because that is part of what can lead to the cataclysmic post Lehman-type consequences, that is a very sensible goal. If the markets believed really that Bank of America, Citigroup, Goldman Sachs, and

other mega banks could fail like MF Global failed, then those mega banks would not be able to borrow so cheaply. They would not be able to take on these big risks. They would not be able to build these massive, dangerous exposures across borders.

We are not there yet. We are moving in that direction. I think we need to expedite it. I think we need to have much more capital in the system. We should not be bound by this sort of lowest-common-denominator approach of Basel and the way they negotiate capital standards. That is absolutely a blind alley.

Chairman CONRAD. So just to be clear, if we had—and I will never forget as long as I live being called to a meeting in the Leader's office. There were the leaders of the House and the Senate, Republican and Democrat, the Chairman of the Federal Reserve, the Secretary of the Treasury. They informed us they were taking over AIG the next morning. They told us they believed if they did not that there would be a global financial collapse in days. That is pretty sobering. But if we had a repeat scenario, the Federal Reserve and the Secretary of Treasury would not have the ability to do what they did with AIG. They have a new authority which allows them to liquidate a systemically risky enterprise.

Second question: If, God forbid, we had a second crisis, would the Federal Reserve operating with the Treasury have the ability to guarantee money market funds, as they did in 2008?

Mr. JOHNSON. The Federal—

Chairman CONRAD. Stop a run?

Mr. JOHNSON. That is a good question on the money market funds. I believe—I think your description of—the first part of your description around liquidating—what the options are for AIG and the liquidation of systemically risky enterprises or failing enterprises is—I believe that is absolutely correct.

On the guarantee of money markets, the use of the Federal Reserve emergency powers, the so-called 13(3) under the Federal Reserve Act, are now much more constrained. And the view that I get from talking to officials—they can speak for themselves, obviously, but this is my impression—is that they would feel much more constrained on the use of those powers relative to the fall of 2008, but they do say, both former officials and current officials in private will say that, when needed, we will come in and save the day, which I think would include guaranteeing money markets.

Chairman CONRAD. Let me just say to you, the Chairman of the Federal Reserve told me yesterday—the Chairman of the Federal Reserve—that he does not believe they would be able to guarantee money market funds as they did in the 2008 crisis. He does not believe.

Mr. JOHNSON. I am sure that is what he believes. Of course, there is the problem or the issue that we have a very powerful and resourceful country with extremely smart people running the executive branch, which is what you want. If there is a deep enough crisis, there are many innovations that they would be able to come up with, and the key to any credible ability to manage failure in our system is we have to be able to have individual banks or maybe a small group of banks fail, be liquidated, without that massively damaging the rest of the system and bringing down the real economy and massively worsening our budget.

If you can credibly threaten that to yourself, to everyone, to the markets, then you are in relatively good shape because the markets will understand and they will price risk in a more appropriate manner.

If you get into a situation where they think there is going to be a bailout and you are playing chicken with them, well, I would submit to you that the very smart people who will then be running the Fed and the Treasury and the White House will propose to you, Congress, that they find some emergency powers to provide unanticipated forms of bailout in order to prevent a global collapse. And if they give you the choice of a 20-or 30-percent decline in GDP or some innovative interpretation of their legal powers, I am not sure which way you will go, but I suspect you do not want the 30-percent collapse in GDP.

So all of this should be moving much faster towards making failure possible. Capitalism without failure is not capitalism. It is a form of socialism—it is a really bad form of socialism, to be frank, and that is what we have with regard to the mega banks and certain other humongous financial institutions in our economy.

Chairman CONRAD. Dr. Lerrick.

Mr. LERRICK. Senator Conrad, no matter what the regulations say, no matter what law Congress has written, no matter what Executive order has been published, when they call the Secretary of Treasury and the head of the Federal Reserve and the President and the leaders of the Congress into a room and say, “If you do not do this, it is going to be the end of the world,” you will do it. The rule of law—one thing I have learned looking at financial crises over the last 15 years in person is that when push comes to shove and the danger is great enough, every government will forgo the rule of law and change the law and change the rules right then and there. It is a sad fact. We all like to think we live by the rule of law. And the only difference between a banana republic and a stable democracy is how big the danger has to be before the government rewrites the rule of law.

Mr. BERGSTEN. Let me—

Chairman CONRAD. Well, I think—

Mr. BERGSTEN. I just want to add one sentence.

Chairman CONRAD. Dr. Bergsten.

Mr. BERGSTEN. I am not sure you would even have to ignore the law because there are laws that sometimes are not even mentioned in this context that could be invoked. The International Economic Emergency Powers Act, which applies in principle to U.S. international financial and economic involvement but is often invoked for much broader purposes and would be directly relevant if there was a currency dimension to the crisis, any international dimension, that law can be invoked, in fact, to do almost anything. And so it was the successor of the old Trading with the Enemy Act, which was changed in the 1970s. I happened to be involved. But it does give authority to an executive branch to do almost anything under the guise of dealing with an international economic emergency, which the situation you hypothesized would certainly be.

So whether one has to violate the law or come up with creative interpretations of existing law, I think Adam is right.

Chairman CONRAD. I hope Adam is right.

Mr. LERRICK. Well, Senator, we have an example in this country. When you had the Chrysler bankruptcy, the Government rewrote the bankruptcy code in terms of priority of creditors, putting unsecured creditors ahead of secured creditors.

Chairman CONRAD. Let me say that before we ever get there, my hope is that we take steps necessary to prevent ever getting in that spot again, which is really in large part what this hearing is about.

Let me go back to each of you. If you had the power to take a series of steps to protect the United States, given the risks that are known and those that are unknown, what

would be the advice that you would give to this Committee on what we should do to protect the United States?

Mr. BERGSTEN. I think it is conceptually simple and actually doable politically. You should prepare for enactment right after the elections later this year, in 2013, a budget plan which simultaneously provided some support to economic growth in the short run by continuing, for example, the payroll tax cuts for another year or so, but—and that is the huge “but”—put into place concrete, tangible measures that would reduce the budget deficit to achieve the 50 or 60 percent debt-to-GDP ratio over the next 5 to 7 years. And I do not mean procedures like you did last summer where you commissioned certain deficit reduction that is supposed to going on now, set up a super committee, and put in place sequestration. What that did was put in place procedures, not budget correction.

So I think you need to actually vote two or three major measures that would phase in over a 5- to 10-year period and concretely reduce the budget deficit to the targeted limit over that time.

For example, Social Security reform, where you would change the indexation formula, increase the retirement age, maybe one or two other elements to that, which would, by definition, phase in over a number of years, which is what you want, but would take 1 to 1.5 percent of budget deficit—of GDP off the budget deficit over that time, which is what the markets want to hear. That is one.

Secondly, if you could agree on some revenue increases, which I think will be necessary as part of the package, then you come up with the kind of tax change that is necessary to do that and phase it in over 10 years so it has a gradual impact on the economy, can be accommodated by the private sector, not disrupt either growth or their business transactions because it is phased in, but get to an endpoint which has a significant impact in reducing the budget deficit. If you could find similar measures on the health care side, obviously it would be desirable to do that, the point being, however, to actually vote substantive, tangible, concrete measures, put them in law, that sets you on a path to phase in the budget correction over the desired time period. That, it seems to me, squares the short term with the longer term, and I think only that will avoid the risk to our country that continuing to kick our can down the road otherwise generates.

Chairman CONRAD. Dr. Johnson.

Mr. JOHNSON. I agree that making progress on the budget would be huge, particularly in this context. The extent of fiscal adjustment that you would need to hit if you are roughly going to a 50-percent debt-to-GDP target by 2030 is about a six percentage point

fiscal adjustment. It is pretty large by historical standards, large relative to what the U.S. has managed to do before.

The one step that—and I think there are many ideas on the table, and I do not see a lot of political traction for any of them at the moment, which is a good reason to be concerned. The one thing that you may do, depending on how circumstances evolve, is you might not extend the so-called Bush era tax cuts—perhaps we should start calling it “the Bush-Obama tax cuts”—because that obviously requires agreement between both House of Congress and the President in order to extend them. I understand you do not want to go there at this point, but if you were to do that, that would be huge. If you look at that relative to the fiscal adjustment the United States needs to make, this would take the issue off the table. It is about half—depending on if you really do not extend any of them, slightly more than half the fiscal adjustment you would need to make.

It is not the whole story. Fred is right. There are other things that would need to be considered. I would go after many of the tax expenditures and phase them out over a decade, totally responsible. But the question is: Can you communicate politically, can you communicate to the markets that I think we all agree will be looking increasingly skeptically at the United States in the future that we can do some fiscal adjustment? We did it in the 1990s in the United States. We did it in the past, but the somewhat distant past. The markets are going to question us, and I agree also with what both my colleagues have said, that when the markets wake up and start pushing us around, that comes very quickly. We do not get a letter saying in 90 days the markets will turn against you. Absolutely not. They turn against you very, very quickly, and we should get ahead of that. Otherwise, we will be forced into precipitous and self-defeating austerity, which is where the Europeans are.

Chairman CONRAD. Let me just say, the CBO told us yesterday that if we were to let all the Bush era tax cuts lapse and if we were to allow sequestration to proceed, as is currently in the law, economic growth in this country would drop dramatically, that we would go from, 2.2-, 2.5-percent growth this year to just over 1-percent growth next year. So that kind of precipitous change to me does not make sense.

What does make sense is to have—Fred, I like what you described, Dr. Bergsten, which is something in the short term that gives additional lift. By the way, I personally believe we should look at infrastructure. I know economists have resistance to that because of the time necessary. I tell you, if you told the States of this country there was going to be priority funding available for projects that have national importance in the transportation infrastructure of the United States and you gave them a certain amount of time to obligate those funds, it would happen, but only—only—if simultaneously you put in place a policy that made the adjustments to entitlement and, yes, revenue that to me—I like the goal of balancing in 10 years, because that would take us a long way in the direction to getting to a debt-to-GDP that is sustainable.

Dr. Lerrick, your recommendation to us?

Mr. LERRICK. First of all, Senator, I think that the U.S. Government is lulled into a false sense of security by how low interest rates are on our debt.

Chairman CONRAD. Right now.

Mr. LERRICK. Right now. It is driven by basically three factors: one, the mess in Europe, so there is no other place for international investors to place their funds; two, the fact that the dollar is a reserve currency so foreigners are forced to buy huge amounts of our treasuries; and, finally, that the Federal Reserve is buying so many of them themselves. You have very few private investors in the United States buying U.S. treasuries.

I think, going back, what is lacking in this country from a Government policy standpoint is a simple program that answers five questions. Those questions are: What are you trying to do? How are you going to do it? Why is it going to work? How much is it going to cost? And where are you going to get the money?

Congress has not answered that question. The administration has not answered that question. The markets are waiting for an answer to that question. The great innovation in economic science over the last practically 50 years has been the role of expectations in how people in the economy and financial markets work. If the U.S. Government were able to announce a program that answered those five questions, the markets would immediately—and it was credible—the markets would immediately take that expectation of future stability and give us stability today. And until we answer those questions, any stability will be short-lived and could vanish at any moment, as Mr. Johnson said.

Chairman CONRAD. Thank you.

Senator JOHNSON is recognized for the equivalent of the amount of time as I just consumed.

Senator JOHNSON. I will be quick because your line of questioning covered an awful lot of what I wanted to talk about.

We are obviously talking about structural reform here, and we have talked about Carmen Reinhart and the book they wrote, "This Time Is Different." The question, as I was reading that book, that popped into my brain, past history, nation states that haven't got high levels of debt by and large got themselves out by inflating their currency and devaluing the debt. Our debt, though, is structural in terms of entitlements, our liabilities that are tied to inflation. I just kind of want to—from my standpoint, we cannot really inflate our way out of this debt. That is the question I am asking. I would just kind of like your comments on are we in a bigger pickle than past nations that could inflate their way out of the debt. Dr. Johnson, you are shaking your head, so I will go to you first.

Mr. JOHNSON. No, I think it is—I was nodding my head, actually, but we are certainly in a big pickle. There is no question about that. And I like your point that you cannot inflate your way out of some of the liabilities. You can try to inflate your way out of some of the debt obligations, but also remember our debt maturity is pretty short. The average period is about 4 years. The U.K. is about 14 years. The U.K. has much more incentive to inflate in the classic Reinhart way than we do.

Ultimately we need to look at the liabilities and the revenues that we are willing to raise to back those, and clearly there is an

imbalance. We have a huge advantage potentially relative to other countries, countries in the Reinhart and Rogoff book, which is we are the reserve currency, we are able to borrow internationally, we have a credit line unsurpassed by anything any country has ever had, and we earned that credit line.

However, we are in the process of wasting that credit line. We are not investing in productive assets. We are not upgrading our education system. We are not boosting growth in other ways you might prefer to boost it. We are just spending that, borrowing to finance consumption in excess of our income. And that will absolutely end badly.

So the pickle we are in could well end up being a very large one and may be bigger than what other countries have had. We have an opportunity to fix it, an opportunity that the Europeans do not have right now. The Europeans are in a different place from us, in a much, much tougher place, and we should take that as a cautionary tale and use that to fix our own budget today. So I think we are all on the same page with regard to your general point, Senator.

Senator JOHNSON. You touched on my next point I wanted to ask, which is about the reserve currency. I know some countries are talking about maybe a basket of currencies. How long do we have? I realize you really cannot answer that, but, I mean, is there really a concerted effort to move away from the U.S. dollar?

Mr. BERGSTEN. I wrote a book on that a long time ago, so I try to keep close to it. It is critical to remember that the reserve currency role is a two-edged sword. It buys us more time, as colleagues have said, but that also means we tend not to have the pressure that we need to adjust. So even in sort of fundamental terms is it a good thing in the national interest, it is ambiguous.

But once the worm does turn, if it inevitably does as we all think, then the reserve currency role can be a huge Sword of Damocles. There are about \$25 trillion of foreign-held dollars floating around the world economy. That is the sum of the accumulation over the years that let us run the deficits that we are talking about. But we used to call that a dollar overhang, which implies, correctly, that it could come cascading down.

And so if the worm turned and the markets began to look askance at what we are doing, then the great reserve currency role of the dollar provides additional huge ammunition to intensify the pressure on us as people around the world sell those dollars that they have accumulated over the past decades.

Now, whether that happens depends on two things: A, is there an alternative to the dollar? In underlying structure terms, the euro certainly is one. It is a bigger economy. It has got deep financial markets. It meets all the criteria. Right now it is not an attractive alternative, but if they do get their act together, get their house in order, 2 or 3 years out they certainly could be.

And comes China, which is going to be the biggest economy, is going to have by far the world's largest trade and foreign investment flows. Once they decide to move off capital controls and make their currency convertible, that is another alternative.

So we are headed toward at least a three-part global monetary system. Call it a multiple currency system, dollar and euro and

RMB, over different time periods. But if we are thinking even 5 years, certainly the euro is in the picture. If we think 10, the RMB probably is in it, too.

And so the non-alternative that Adam rightly pointed to now does become very different. So even in an annual flow sense, people are not going to be compelled to put their money in dollars. And to the extent the reserve currency role is an asset, as it certainly is in the short run, that, too, will be fading. And then, as I say, if the worm turns, it could become a huge liability.

So I would never really very much on that one to deal with the sustainability of our situation over any reasonable period of time.

Mr. LERRICK. Senator, I spent 5 years in Argentina on their debt restructuring. Every Argentine school child knows—because the ones that do not know this have been killed off by Darwinian survival. Every Argentine school child knows there are only three solutions to an overly indebted economy: you write down the debt, you raise the surplus to pay the debt, or you inflate the debt away. There are no other solutions. We have learned that after 200 years.

The question of the reserve currency, you asked the question of should there be a basket as an alternative.

Senator JOHNSON. No, I am saying they are talking about it.

Mr. LERRICK. Talking about it. Every person in the world can create their own reserve basket. If you think that you like a basket of reserves that is 20 percent yen and 40 percent euros and, 30 percent dollars, and throw in the Brazilian real, you can create that yourself. Central banks do that all the time. The idea of creating an “official” reserve currency basket, such as the SDR, the special drawing right, at the IMF was supposed to be, that is a very inefficient outcome because that is saying we have decided what the optimal basket is, we have set the weights, the percentage of each currency. Well, I may like those weights. Fred may think, “I do not like those weights. I want a different basket.” And Simon may say, “I want a third basket.” The markets can create their own basket. There is no purpose in creating a basket currency today.

Finally, as Fred pointed out, the reserve currency can change very quickly. What has held us up and what has taken the pressure off the U.S. Government to actually make the decisions it should have made years ago is because there has been no viable alternative. The euro was viable alternative. It now is not for the moment, but as Fred said, if over the next 3 years, as I believe, they do actually put in place a stable system, then it will be, and you will see massive flows. The only thing that will surprise you more than the size of the flows as they move out of the dollars into the euro will be the speed with which it will take place.

Senator JOHNSON. I would just beg your indulgence for one more question.

Chairman CONRAD. Absolutely.

Senator JOHNSON. This is about taxes and the effect on growth. During my lifetime the highest marginal tax rate has been 90 percent, 70 percent, 50, 28, 31, 35, 39.6, 35. For the last 50 years, prior to 2008, the average amount of revenue generated or extracted from the economy has been 18.1 percent, and the variation has been really pretty tight around that mean. If it goes up too

much, you end up with a recession. I am not sure what the cause is, but just looking at the data, very tight around that 18.1 percent.

I am not sure what causes that. You know, I realize tax policy drives it, and when you have high marginal rates, you have all kinds of deductions. But I have a suspicion as well that just like with capital gains taxes, when you raise them higher, people expose less of their income to that capital gains tax.

So I am highly concerned if we raise taxes we are going to harm economic growth, and I really do sincerely believe that the number one component of a solution is economic growth.

So if you could just sort of speak to the effect of marginal tax rates, the ability of the United States Government really to extract much more than that 50-year average over any kind of long period of time and really speak to increasing tax rates basically to try to drive more revenue. I know that is kind of a big subject, but in 30 seconds or less.

[Laughter.]

Mr. JOHNSON. That is a huge and terrific subject, Senator, and, again, I take this on in this new book that is coming. I think you and I may disagree on how to read the evidence and on the ability at the Federal level to raise revenue.

I take your point, though, you are absolutely right that there has been a stability around Federal revenues for a long time prior to the crisis, and we should reflect on that. Of course, there is not stability to our future medical costs, and that is the big collision if you look over a 20-or 30-year time profile. If you are really going to cap Federal revenue at 18 or 19 percent, that has major consequences for what you are able to pay in terms of the health care costs of elderly Americans. And I think we should have that conversation. I would go on the side of covering more of those health care costs, personally. We should also control the costs, obviously, but those are tough to control, and demographic changes and technological changes mean those costs are going to increase. And the CBO, by the way, relative to the Europeans, the European Commission, CBO is very honest about what those future costs are going to be. The Europeans not so much. So at least that is on the table.

But I would go a little bit more towards allowing revenue to increase, and I think there are ways to do that over the medium term. I take Senator Conrad's points about the dangers of precipitous austerity. But I think over the medium term we can do that without damaging growth. We can actually do that in a way that is pro-growth and also quite reasonable. But I do not expect that you and I will agree on that in the end, Senator. I think that is fine. I think now is a good year to have that discussion and to get these issues out in the open and to show people what is the menu—in our book we lay out a menu of options. We give you a house recommendation from the menu, but you can also pick whatever you want off the menu, as long as you get on to what I think all of us today have agreed on is a path to fiscal sustainability and a debt-to-GDP level that is under control.

Senator JOHNSON. Does everyone agree with me?

Mr. BERGSTEN. Well, just partly. Two one-sentence responses.

One, I think it is more important to get the overall budget into sustainability balance than it is to avoid an increase in Government revenues as a share of the economy.

Point two, I think we can get a contribution to that outcome with higher Government revenues without raising marginal tax rates, which you stressed, getting rid of a lot of tax expenditures, and finding a lot of base broadening to go along with maintaining or even possibly cutting, like in the corporate case, some of the tax rates.

So I think there is a perfectly doable package here that addresses at least what seemed to be your main concern, marginal rates, at the same time increasing revenues as part of an overall budget package, which to me is the most important priority.

Mr. LERRICK. Senator, I think your concern about tax rates is very well focused. I think two things.

One, we are going to have to pay for what we have wasted over the last 30 years. Your chart showed our debt has gone up, our deficits have gone up. Someone has to pay for that, right? It was a mistake. We all agree we should not have done it, but we have to now pay for it. That is going to require a rise in tax revenue—not in tax rates. Fred is absolutely right. And the fact of the matter is if you raise marginal tax rates, especially on high-income people, you are not going to generate the revenue—first, there is a question of how much more revenue you will generate, and you will certainly not generate anywhere near the amount of revenue you need to close the gaps significantly. So you have to think of how do you broaden the tax base and how do you broaden the tax base without affecting economic growth or with minimal impact on economic growth, and that is the key issue.

Raising marginal tax rates can be politically attractive. It can be politically popular. In this country 50 percent of U.S. voters do not pay any Federal income taxes; 60 percent receive more from the Government than they pay in income taxes. So raising taxes on the remaining 20—the highest 20 or 30 percent can be politically expeditious. But I think you have to broaden—any meaningful reduction in the deficit is going to require a broadening of the tax base. Raising tax rates will not help it.

Mr. JOHNSON. But even though people do not pay what is called “Federal income tax,” they pay payroll taxes, and it is a historical accident, actually, that we make this distinction between payroll taxes and income taxes. Most other countries do not make that distinction. You are funding Social Security, you are funding Medicare out of the payroll taxes. That is an important Federal tax obligation that most voters actually do pay.

Mr. LERRICK. I would raise one quick point on that. I view Medicare and payroll taxes, those are pension funds and health care costs. Those are not taxes to pay for general government expenditures.

Senator JOHNSON. I agree.

Chairman CONRAD. Let me just make this point, because this is where we have a disagreement. When I look back at the 5 years we have balanced the budget in the last 30 years, tax revenue was close to 20 percent of GDP—19.7 one year, 19.8, 20.6. So the years

we have actually balanced the budget, tax revenue has not been 18.1. It has been close to 20 percent of GDP.

We have the additional problem of the demographics of the country changing, an aging population. So my personal belief is we have to be in the high 19 percent of GDP range to get a package.

I agree entirely that the way to do that is not raising marginal tax rates, and, if you look at somebody like Martin Feldstein, a pretty credible conservative he says do not raise marginal tax rates, broaden the base, reduce and in some cases eliminate tax expenditures—I do not want to put words in his mouth. He says you ought to focus like a laser on tax expenditures because it is just spending by a different name. And some of these tax expenditures, now we are running over \$1 trillion a year in tax expenditures. We are spending more money through the Tax Code than we are through all the appropriated accounts, and it gets almost no attention. I am on the Finance Committee, and I can tell you, we do not pay—we pay much less attention to expenditures through the Tax Code than we do through the appropriated accounts.

Now, I do not for a minute suggest that means we do not have to cut the appropriated accounts, and we certainly have to have as part of any serious package a focus on entitlements, because, 30 years ago the share of our budget going for mandatory spending was the smallest share. The biggest share was the appropriated accounts. Now it has flipped. We are over 60 percent the mandatory accounts—Social Security, Medicare. The discretionary accounts are now the smaller share.

Senator JOHNSON. That is one my charts.

Chairman CONRAD. Yes. You know, it is strange the way we operate around here, because when we look at a solution, nobody wants to kind of talk about the elephant in the room. Nobody wants to talk about the entitlements. We want to focus on discretionary spending, which I would argue is much less the problem. But, we all understand politics.

Senator Johnson.

Senator JOHNSON. I just want to add one caution in terms of percentage of GDP and revenue during boom times. That is when your percentage of revenue is going to increase, and obviously in tough economic times it goes down 15 percent. So it is not necessarily that we balanced our budget because we increased taxes to that level. It is because the economy was booming and allowed that much revenue to be extracted from the economy. Again, it is all subject to debate, but that would be my caution.

Chairman CONRAD. You know, here we are in a situation in which our spending right now is over 24 percent of GDP. Our revenue is between 14 and 15 percent of GDP. So spending as a share of the economy is at or near a 60-year high. Revenue is at or near a 60-year low. No wonder we have record deficits. And, really, I do not know which one of you mentioned—maybe it was you, Dr. Lerrick. If you look at the 10-year outlook here, I think on a realistic basis we are looking at trillion dollar deficits as far as the eye can see.

Mr. BERGSTEN. I said that.

Chairman CONRAD. You said that, Dr. Bergsten. Okay. I always like to attribute to the right place.

Thank you all. I know we committed to ending at noon. Somebody has got to make a plane. But we appreciate very, very much the testimony. I think this has been an outstanding hearing.

Senator JOHNSON. Yes. Thank you very much.

Chairman CONRAD. Thank you.

[Whereupon, at 12:05 p.m., the Committee was adjourned.]



## **THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2012–2022**

**THURSDAY, FEBRUARY 2, 2012**

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

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, Nelson, Stabenow, Whitehouse, Begich, Sessions, Thune, Portman, Toomey, Johnson, and Ayotte.

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 today. Today's hearing will focus on CBO's new Budget and Economic Outlook, which was released on Tuesday. Our witness is CBO's Director Doug Elmendorf, I might say a very distinguished Director. And I want to say how much I appreciate the work of the Congressional Budget Office, how credible I find it to be, how transparent I find it to be. And, look, sometimes they strenuously disagree with me. I remember very well on health care, my major initiative CBO critiqued very heavily. So that is the way it should be—not that my proposal should have been critiqued as heavily as it was, but that is the way it works. That is why they have credibility, and they have credibility on both sides because they tell it the way they see it. And that is really absolutely critical to the process. We have to have some independent scorekeeper here.

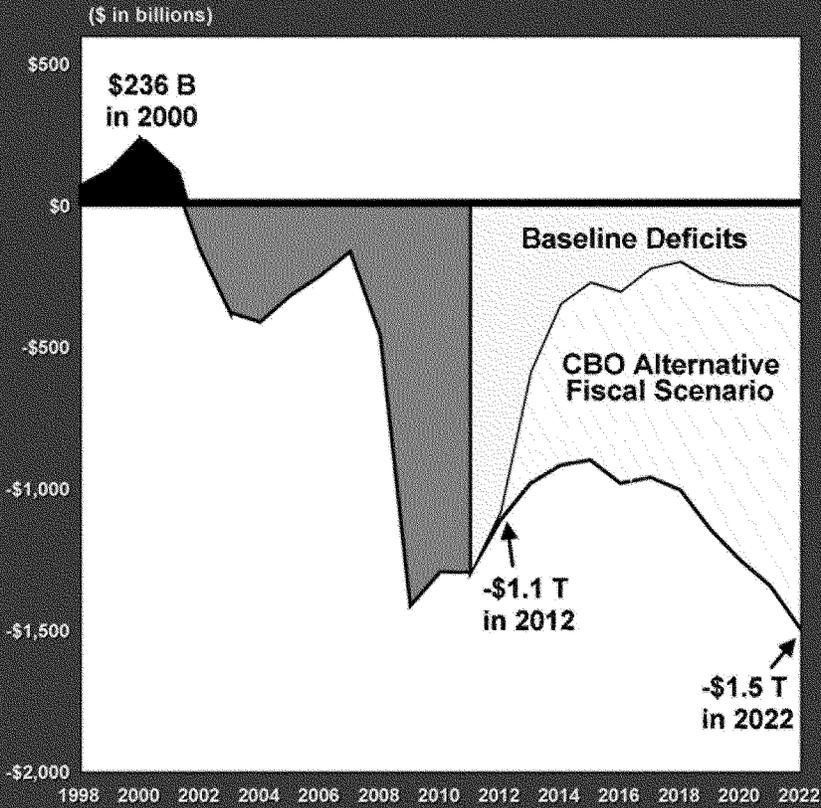
Are they always right? No. This is the work of men and women, and none of us are perfect. So, no, their work is not perfect. It would be impossible to have any entity on matters of this complexity be completely right every time. But they are independent, they are credible, they are serious people, and they are doing very important work for all of us.

So, Director Elmendorf, welcome back to the Committee. I want to thank you again for the outstanding work that you and your team have been doing and with an extraordinarily heavy workload—really extraordinarily heavy. I believe you are leading CBO in an incredibly challenging time and have absolutely risen to the occasion.

As I said, many times I disagree. I make my disagreements known. Sometimes you react to that. Most of the time you do not, and that is fine. And I think Senator Sessions would say the same thing, that you guys play it straight.

I want to begin by highlighting what I believe are the key findings in CBO's report. This first chart depicts the 10-year budget outlook under CBO's new alternative fiscal scenario. It shows the deficit falling to \$1.1 trillion in 2012, continuing to fall through 2015, and then rising through the latter half of the decade, reaching \$1.5 trillion in 2022.

# Ten-Year Budget Outlook



Sources: CBO and SBC

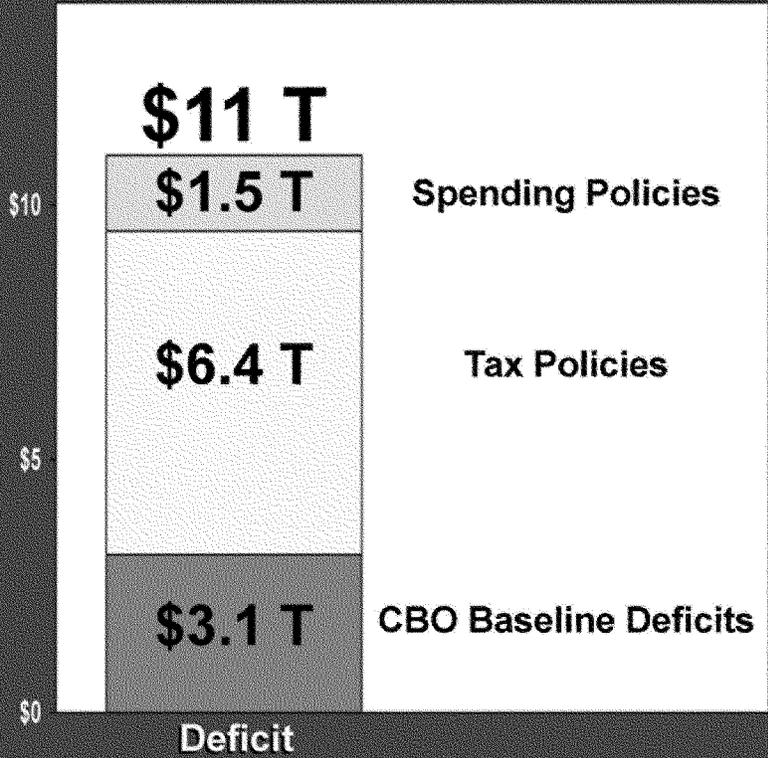
Note: CBO's January 2012 baseline, adjusted to reflect its alternative fiscal scenario: extension of 2001 and 2003 tax cuts, tax extenders, AMT reform, SGR reform, and reversal of automatic spending reductions required by Budget Control Act.

We cannot permit that to happen. Please, colleagues, let us find a way to get this country back on track. We can do better than this. We are better than this, and we have an absolute obligation to try to find a way to come together to get this country back on track.

It is important to note that most of the increased deficit over the next 10 years under CBO's alternative fiscal scenario can be attributed to tax policies, not spending policies. Specifically, we can see that \$6.4 trillion of the increased deficit under this scenario can be attributed to the extension of the 2001 and 2003 tax cuts, alternative minimum tax relief, other tax extenders, and related debt service.

# Impact of Alternative Policies on Deficit 2013 - 2022

(\$ in trillions)

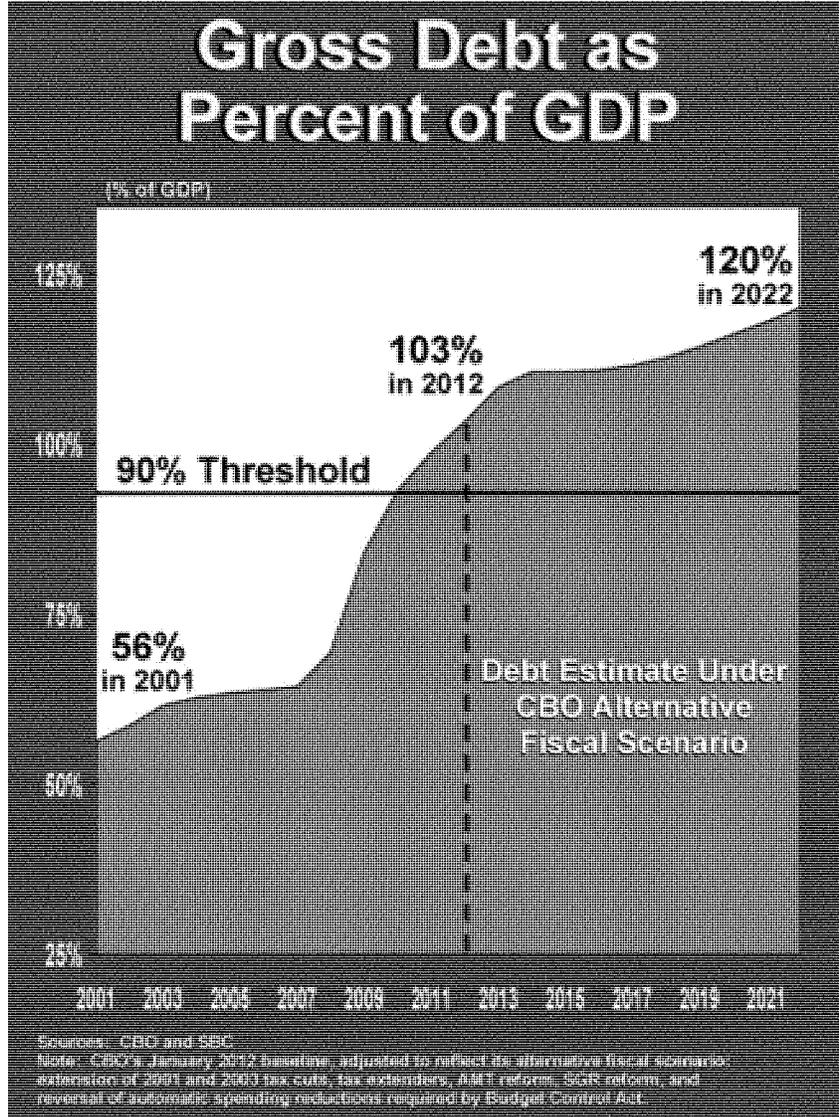


Sources: CBO and SBC

Note: Starts with CBO's January 2012 baseline, and adds the costs of following alternative fiscal policies: 1) extending expiring tax policies (2001/2003 tax cuts, AMT relief, other extenders, and related debt service) and 2) modifying current spending policies (extending SGR relief, reversing automatic spending reductions required by the Budget Control Act, and related debt service.)

In comparison, only \$1.5 trillion of the increased deficit under this scenario can be attributed to spending policies, including extending the so-called doc fix—that is the reimbursement rate for doctors who treat Medicare patients—reversing the sequester required by the Budget Control Act, and, again, related debt service, that is, the interest savings that applies to those policies.

Under the alternative fiscal scenario, gross Federal debt is expected to reach 103 percent of gross domestic product this year and then continue rising to 120 percent of GDP by 2022. Let me just indicate Greece is about 140 percent of GDP on their debt, their sovereign debt. Many economists regard anything above the 90-percent threshold as the danger zone, and as disturbing as those near-term deficits and debt are, the long-term outlook is even more dire.



In addition to our budget outlook, I look forward to Director Elmendorf's views on the state of the economy. I believe there are some positive signs we are now seeing for the economy. For example, we have experienced 22 consecutive months of private sector job growth. That is good. The unemployment rate has come down. That is good. We have seen 10 consecutive quarters of real GDP growth. That is good. Housing starts are up 25 percent since December of 2010. Consumer confidence is showing signs of improvement. U.S. auto manufacturers are returning to profitability and reported very strong sales in January. And State revenues are showing modest signs of improvement.

## Positive Signs for Economy

- 22 consecutive months of private-sector job growth
- Unemployment rate has come down
- 10 consecutive quarters of real GDP growth
- Housing starts up 25% since December 2010
- Consumer confidence showing signs of improvement
- U.S. auto manufacturers returning to profitability
- State revenues showing signs of improvement

But we cannot become complacent. Please, let no one take my reference to some positive indicators that we have solved these problems. There are serious risks out there to fuller economic recovery. Unemployment remains far too high and threatens to undermine consumer confidence. Housing continues to pose a threat, as we heard in yesterday's hearing, with too many homes still in foreclosure or underwater, with people owing more on the house than the house is worth.

## Risks to Economy

- Unemployment remains too high
  - threatens to undermine consumer confidence
- Housing continues to pose threat
  - too many homes still in foreclosure or “underwater”
- Political deadlock in Washington could block key measures
  - such as extension of payroll tax cut and UI
- Federal, state, and local budget cuts could add too much near-term fiscal drag
- European debt / fiscal crisis creates uncertainty and threatens exports

The political deadlock in Washington could block key measures. Federal, State, and local budget cuts could add to the near-term fiscal drag. And the European debt and fiscal crisis is creating uncertainty and threatening U.S. exports and threatening to pull us into recession as Europe heads into recession. And I hope Director El-mendorf will comment on these positive signs and the risks to the economy in his testimony.

I believe we need a policy that stresses both the fragility of the near-term economy and the need for long-term debt reduction. Let me say that again. My personal strong belief is we have to be able to walk and chew gum at the same time. We need to take steps now to give additional lift to the economy. What I am hearing from business is the problem with their deploying the \$2 trillion on their balance sheets is a lack of demand. A lack of demand: thin order books.

So the Federal Reserve Chairman made very clear in his testimony before the Joint Economic Committee last fall—and let me quote from it: “Our crucial objective is to achieve long-run fiscal sustainability. The Federal budget is clearly not on a sustainable path at present. A second important objective is to avoid fiscal actions that could impede the ongoing economic recovery.”

## Fed Chairman Bernanke on Addressing Long-Term Budget and Near-Term Economy

“One crucial objective is to achieve long-run fiscal sustainability. The federal budget is clearly not on a sustainable path at present.... A second important objective is to avoid fiscal actions that could impede the ongoing economic recovery.

“These first two objectives are certainly not incompatible, as putting in place a credible plan for reducing future deficits over the longer term does not preclude attending to the implications of fiscal choices for the recovery in the near term.”

—Federal Reserve Chairman Ben S. Bernanke  
Testimony before Joint Economic Committee  
October 4, 2011

So in the short term, we need more steps to strengthen the economy. In the medium and longer term, we need credible, serious action to address the debt threat.

The first two objectives are certainly not incompatible, although to some people’s ears they sound incompatible. “Putting in place a credible plan for reducing future deficits over the longer term does not preclude attending to the implications of fiscal choices for the recovery in the near term.”

That, again, is a direct quote from the Chairman of the Federal Reserve. I believe he has it right. We must find a way to come together on a comprehensive and balanced plan to put our long-term fiscal house in order. That is critically important. At the same time, we must be careful not to take steps that could create additional fiscal drag in the near term, pushing us toward recession. That would make our deficit and debt situation worse, as our friends in England are finding out, where they put austerity measures in place and their economic growth is slipping, and slipping markedly, and making their deficit and debt situation worse. Let us not repeat that mistake.

That is why I believe it is so important that we extend the payroll tax cut, emergency unemployment benefits through the rest of this year, and perhaps even more important, that we engage in a Rebuild America plan to strengthen the infrastructure, because we not only have fiscal deficit, we have an infrastructure deficit in this country, and anybody who does not believe it, just go out in I-95 here in Washington, D.C., after 3:30 in the afternoon.

That is why I believe it is so important we extend, as I said before, the payroll tax cut and emergency unemployment benefits and put together a Build America plan to invest in infrastructure.

By the way, Chairman Bernanke has made clear that he believes we ought to be thinking seriously about additional investments in infrastructure at this time. It is a two-fer. Not only do you get increased demand at a time of weak demand, but right now you can get very good prices. And it improves the competitive position of the United States. We have had report after report that our infrastructure will not allow us to be fully competitive. And if you doubt that, go to China and see what they are doing with infrastructure.

With that, we will now turn to Senator Toomey. Senator Toomey is here filling in for Senator Sessions. Senator Sessions could not be with us at the early part of this morning, so Senator Toomey is filling in for him. Welcome. Good to have you here.

#### OPENING STATEMENT OF SENATOR TOOMEY

Senator TOOMEY. Thank you very much, Mr. Chairman, and I apologize for getting here a little bit late. I was reminded of how challenging it can be to extricate oneself from the prayer breakfast, but it was a terrific event. I think Senator Sessions will be joining us shortly.

Dr. Elmendorf, thank you for being here, and if I could just take a brief moment, Mr. Chairman, I would like to thank Dr. Elmendorf and his staff for their terrific cooperation and support during the work of the Joint Select

Committee on Deficit Reduction. That was a difficult and frustrating experience for me, but not because of your doing, and I just want to commend you and your staff for the really very, very professional, prompt, and thorough and thoughtful work that you provided and the responsiveness that you gave us.

Chairman CONRAD. Could I just interrupt and ask, did you find that Director Elmendorf was always in agreement with your assessment on these matters, or did you have the experience like mine that I often find he does not agree with my position?

Senator TOOMEY. It was my experience that in the most civil and diplomatic way, he expressed his disagreement.

[Laughter.]

Senator TOOMEY. But I appreciated his candor and his help. Just a few thoughts, if I could, Mr. Chairman.

First, I would suggest that comments have been attributed to you that suggest that you may be considering pursuing a budget resolution within the Committee, and you and I have not had a chance to discuss that, but I would just want to encourage you as strongly as I possibly can. I think that is something the Committee should take up. I hope we will. And then I hope very much that we will take this up as a full body, and I have to say I am very, very disappointed that we are going into our third year without a budget. And I think that is a failure to accept the

responsibility that the United States Senate has. I hope we will at least remedy that for this year and going forward.

I understand that the Budget Control Act does provide, as a substitute in certain respects but it is certainly not a full substitute, for a budget resolution, and I happen to be a fan of establishing discretionary spending caps, and that legislation, as does that. But there are many other things that a budget resolution sort of

uniquely addresses, and I hope that we will take it up in Committee and then the full body will.

Chairman CONRAD. If I could just answer you on that point, Senator Toomey.

Number one, I believe the Budget Control Act has put in place for 2 years a deeming resolution, which has been used in the past, to set budget aggregates, and that is in place, and it is the law. It also provides the enforcement mechanism. It also provides, as you indicated, 10 years of spending caps.

I am committed to going to markup in this Committee. I think it is important. The only year we did not do it was last year when, in effect, we got big-footed by negotiations above our pay level with leaders of the House and the Senate, Republican and Democrat, and the White House. And I look very much forward to our trying in this Committee to find agreement.

You have struggled with this. I did on the Fiscal Commission and have in the Group of Six. I think it would be healthy for the body, healthy for the country, and I am looking forward to it.

One of the things we need to establish today is when we might get the re-estimates from CBO because that could affect the timing of when we go to markup in the Committee. I hope that is one thing that we can learn today what the best estimate of the Director is.

Senator TOOMEY. Thank you.

Chairman CONRAD. I do not want this to interrupt Senator Toomey's time.

Senator TOOMEY. Well, I will not take up too much more time. We have other members who want to speak, so let me just say a couple of points that I think are worth stressing.

One is I think it is very hard to overstate the fiscal danger we have ten ourselves into, the severity of the challenge that we face. 2012 will be the fourth straight year with a \$1 trillion plus deficit. Under any scenario, we are going to add trillions of dollars of additional debt over the coming years. Under any plausible scenario, it certainly looks like our debt-to-GDP ratio will continue to worsen in the absence of structural reform of the big programs that are driving this program. And I would suggest that the debt-to-GDP ratio is probably the single most important metric we should be looking at from the point of view of our budget.

We are on a path such that by the end of this fiscal year, this administration and the Congress, working together or not, will have added nearly as much to our Nation's debt as all the previous administrations in the history of the Republic.

A quick observation. I know we all know this on the Committee, but I think it bears reinforcing the point that the current law baseline is not meant to be any kind of a prediction. It is a yardstick, in a way; it is a measuring tool—that is the way I look at it, anyway—against which we compare policy alternatives. And I think that is important because if you look at that, at some level one might take a quick glance and suggest that it suggests a relatively benign outlook. In fact, the outlook is anything but benign. It is very, very serious and very, very troubling, and even the current law baseline projection shows in the latter years of this 10-year

window an accelerating size of deficits and mounting debt and a trajectory that becomes all the more worrisome.

The alternative fiscal scenario is also not really meant to be anybody's prediction of the future, I think it is fair to say, but it is probably a somewhat closer approximation to what is more likely to occur. And when you look at that picture, of course, it is very grim indeed. By 2022, under the alternative fiscal scenario, spending exceeds \$6 trillion. It is 24.4 percent of GDP. This is a post-war structural high. It has the debt reaching 94 percent of GDP, and as with the current law scenario, the deficits are accelerating. They are ramping up, they are trending up in the latter years. And, frankly, that is the case regardless of what set of assumptions you use because in the absence of structural reform of the big entitlement programs, that is exactly what is going to happen.

It is my view that the problem that we have is a spending problem. It is more specifically a mandatory spending problem. It is interesting to note that if you look at these scenarios, over time discretionary spending actually drops considerably as a percentage of GDP. And despite that we have huge spending, a huge deficit, huge debt problems. There is only one possible explanation, and that is, it is being driven by the mandatory spending side. And I would say, to be more precise, it is health care spending that is the real driver of this problem.

The President himself said, and I will quote: "Our long-term debt and deficits are caused primarily by escalating health care costs that we see in Medicare and Medicaid that is putting huge pressure on the overall budget."

The President also said, and this is a quote: "If you look at the numbers, Medicare in particular will run out of money, and we will not be able to sustain that program no matter how much taxes go up." I think that is a very important observation. I think it is exactly correct, and I think it is very unfortunate that he has, nevertheless, failed to give us a proposal that would change the architecture of these programs in a way that makes them sustainable and viable for the budget and also for future generations of Americans that will need it.

The fact is Medicare is growing at several multiples of the rate of economic growth. Medicaid is growing faster than that. And no significant program can grow faster than the economy for an extended period of time. It is just arithmetically not possible to sustain that. So I hope we will use this occasion to reinforce the need to pursue in a bipartisan fashion the kind of architectural reform to these programs that is needed.

The last point I would just make is that—and I think this is consistent with some of the things the Chairman said, although we have different views of how to get there, and that is just the importance of maximizing economic growth. It is, of course, primarily important to maximize growth because this is how we create jobs and elevate the standard of living of the people that we represent, the people across America. But, of course, it is also enormously important from a budgetary point of view.

The CBO estimates on page 108, I think, of the report that a one-tenth of a percentage point increase in economic growth, in GDP growth, over the 10-year period of time generates in their es-

timate over \$300 billion of additional revenue. I know this is not purely linear, but let us just roughly say that means that 1 percent of economic growth, sustained stronger growth, is worth about \$3 trillion in deficit reduction. There is no better way to reduce the size of our deficits and help to contribute to a sustainable path than through stronger economic growth. So I certainly hope that we will pursue the policies that will maximize growth and change the architecture of the programs that are fundamentally driving our deficits.

With that, Mr. Chairman, I will yield the balance of my time.

Chairman CONRAD. Thank you, Senator.

Let me just say, one place where we are in strong agreement is economic growth has got to be the cornerstone of any policy that we advance. That has got to be the goal because that helps us with deficits and debt more than any other thing we could do. If we do not have growth, our deficits and debt become more dire, more serious.

So I think one place we might agree with respect to economic growth is we have a tax system that was never designed with that in mind. We have a tax system that was designed when, frankly, we did not have to worry about America's competitive position. Now we do. And so I would put high on the agenda the need for fundamental tax reform with economic growth in mind as well as fairness, but also with an understanding that we are in a different world. It is a global economy, and we have real competition. That is a place I think we might find agreement.

Let me just say, the place where I disagree is this is just a spending problem. As I look at our current condition, our spending, yes, is a problem, without question. We are at or near a 60-year high as a share of GDP on the spending side. But on the revenue side, we are at or near a 60-year low. So I do not know, if one is concerned about the gap between spending and revenue, how one can just focus on one side of the equation. I think we have to focus on both sides of the equation, and I think we have to find ways to generate more revenue without increasing tax rates, because that would hurt our competitive position.

I think the place we ought to look is tax expenditures, which are running now well over \$1 trillion a year. We are spending more through the Tax Code than we are spending in all of the appropriated accounts, and we give it much less review. I am on the Finance Committee, and one thing that just strikes you is how wasteful some of it is.

So, look, I think we have a charge here. Yes, we have to get tough on the spending side of the equation. Yes, entitlements I believe have to be reformed. I agree entirely with your analysis. Health care is the 800-pound gorilla in the room. But it is not just the Federal accounts. It is health care expenditures across the economy. We are now spending 18 percent of our GDP on health care, one of every 6 dollars. So we have a big societal challenge.

With that, Director Elmendorf, please proceed with your testimony, and then we are going to go to questions. And, again, thank you for your service.

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

Mr. ELMENDORF. Thank you, Mr. Chairman, Senator Toomey, and thanks to both of you for your kind words about the work of my colleagues. I am very lucky to have this opportunity to lead such exceptionally talented and dedicated public servants. All of us at CBO are very appreciative of the support that you, Mr. Chairman, Senator, Toomey, Senator Sessions, and all the members of the Committee have shown for our work, and we will continue to do our very best to give you and the rest of the Congress the information that you need in making the very important decisions the country faces.

I will be referring this morning to the charts in front of you. Let me begin by noting—and Senator Toomey said this quite eloquently—that our baseline economic and budgetary projections are conditioned on current law, not because we expect there will be no changes in law but because this approach provides a benchmark against which potential changes can be measured. What we are presenting is a benchmark, not a forecast, and that distinction has important implications in reading our projections.

What is our assessment of the economic outlook? The pace of the recovery has been slow since the recession ended 2-1/2 years ago, and we project that it will continue to be slow for the next 2 years, reflecting both the lingering effects of the financial crisis and recession and the fiscal restraint that will arise under current law.

Specifically, current law fiscal policy will reduce the growth of output slightly in 2012 and significantly in 2013 through a combination of large tax increases and large spending cuts. Our projections incorporate the upcoming expiration of the payroll tax cuts and emergency unemployment benefits; the expiration of the tax cuts enacted in 2001, 2003, and 2009, as well as other expiring tax provisions; the constraints on spending imposed in last year's Budget Control Act; and the winding down of the budgetary effects of the 2009 Recovery Act. Taken together, those policies will generate a sharp fiscal contraction.

In addition, the excess number of houses, loss of wealth, run-up in debt, and other legacies of the economic downturn are continuing to weigh on household and business spending.

If you look at the first chart in the packet, we project that real GDP will grow by only 2 percent this year and only about 1 percent next year. We expect economic activity to quicken after 2013 but real GDP to remain below the economy's potential through 2017. According to our projections, the economy is only about halfway through the cumulative shortfall in output that will result from the recession and its aftermath.

The costs associated with that persistent output gap are immense, and they are borne disproportionately by people who lose their jobs, who are displaced from their homes, or who own businesses that fail. In particular, the labor market has a great deal of slack, mainly as a consequence of continued weakness in demand for goods and services.

You can see in the second picture in our forecast the unemployment rate remains above 8 percent both this year and next. As economic growth picks up after 2013, the unemployment rate declines

in our projection, but remains above 7 percent until 2015, before dropping to 5.25 percent by the end of the coming decade. While the economy continues to be weak during the next few years, inflation and interest rates will remain low.

Let me turn now to our budget projections. In the next slide, under current law we expect that this year's deficit will be about \$1.1 trillion. At 7 percent of GDP, that is nearly 2 percentage points less than the deficit recorded last year, but still larger than any deficit between 1947 and 2008.

Over the next few years, projected deficits in our baseline narrow sharply, averaging 1.5 percent of GDP and totaling about \$3 trillion between 2013 and 2022. With deficits small relative to the size of the economy, debt held by the public drops a little as a share of GDP but remains quite high. Much of the projected decline in the deficit occurs because under current law revenues will rise considerably. In particular, between 2012 and 2014, revenues in our baseline shoot up by more than 30 percent because of the recent rescheduled expirations of various tax provisions and new taxes and other collections that are scheduled to go into effect.

Federal spending in the baseline declines modestly relative to GDP in the next few years as the economy expands and statutory caps constrain discretionary appropriations. Later in the decade, spending turns up again relative to GDP because of increasing expenses generated by the aging of the population and rising costs for health care, and because the accumulation of debt and rising interest rates will cause a surge in the Government's interest costs.

Of course, these baseline projections are heavily influenced by the changes in tax and spending policies that are embodied in current law, changes that in some cases represent a significant departure from recent policies.

To illustrate the budgetary consequences of maintaining some tax and spending policies that have recently been in effect, CBO developed projections under an alternative fiscal scenario. Look at the next slide. That scenario incorporates the following assumptions:

First, that all expiring tax provisions other than the payroll tax reduction are extended;

Second, that the alternative minimum tax, or AMT, is indexed for inflation after 2011;

Third, that Medicare's payment rates for physician services are held constant at their current level rather than dropping by 27 percent in March and more thereafter, as scheduled under current law;

And, fourth, that the automatic spending reductions required by the Budget Control Act in the absence of legislation from the Joint Select Committee on Deficit Reduction do not take effect, although this scenario assumes that the original caps on discretionary spending would remain in place.

The next slide shows under that alternative fiscal scenario deficits the 2013–22 period would be far higher than in the baseline, averaging 5.5 percent of GDP rather than 1.5 percent, and totaling \$11 trillion rather than roughly \$3 trillion. And the following slide shows the debt held by the public would climb on an unsustainable

path under that scenario, reaching 94 percent of GDP in 2022, the highest figure since just after the Second World War.

I want to emphasize that this scenario, like the baseline, is not a prediction or a recommendation. We put it together just to illustrate for you the effects of an alternative set of policies.

Under that scenario, the economy would be noticeably stronger during the next few years than under current law, but noticeably weaker later in the decade. The report presents estimates of those effects using ranges of numbers to reflect the uncertainty involved. The midpoints of the ranges for the end of 2013 show GNP that is 2 percent higher and an unemployment rate that is 1 percent lower—1 percentage point lower than would be the case under current law. However, the midpoint of the range for 2022 shows GNP that is almost 2.5 percent lower than under current law because with the crowding out of investment that would be caused by the escalating debt.

It bears emphasis that projecting economic outcomes for any path of fiscal policy and the budget outcomes that would result is very difficult. Many things could happen to cause the economy and the budget to turn out better or worse than we project. However, there is no plausible economic outcome under which the policies of the alternative fiscal scenario would lead to a sustainable budget outcome.

The fundamental fiscal challenge, as both Chairman Conrad and Senator Toomey have noted, remains the aging of the people and rising costs for health care. The number of people age 65 or older will increase by one-third in the coming decade, substantially raising the costs of Social Security, Medicare, and Medicaid. In addition, the Affordable Care Act will significantly increase the number of non-elderly people receiving assistance through Federal health care programs.

Furthermore, CBO projects that the costs per enrollee for Social Security and especially the major health care programs will continue to rise both over the coming decade and beyond. Because of these forces, the set of budget policies that were in effect in the past cannot be maintained in the future.

If we turn to the next slide, we offer one way to think about the problem using CBO's projections under the alternative fiscal scenario, which, as I have said, represents a continuation of many recent and current policies.

In this bar chart, each pair of bars represents a broad component to the Federal budget as a share of GDP, with the left pair of the bars showing the average during the past 40 years and the right bar our projection for 2022 under this alternative scenario.

In that scenario, outlays for Social Security and the health care programs, the first set of bars, would be much higher than in the past—5.5 percent of GDP higher on average during the past 40 years. Outlays for all other Federal programs—meaning both defense and nondefense discretionary spending and all entitlements except for the particular large ones in the first set of bars—outlays for all those programs together are projected to be much lower than in the past but 8 percent of GDP. That is below any year in the past 40 years and well below the 11 percent of GDP that such outlays have averaged over that period.

Yet the budget deficit under this scenario, shown on the far right, is projected to be 6.1 percent of GDP. As I have shown under that scenario, debt rises rapidly relative to GDP. To keep debt from rising relative to GDP, the deficit would need to be about 3.5 percent of GDP smaller in 2022 than we project under this scenario. That is \$900 billion in 2022 alone relative to this scenario. Therefore, to put the Federal budget on a sustainable path, policymakers will need to allow Federal revenues to increase to a much higher percentage of GDP on average over the past 40 years or make very large changes to Social Security and Federal health care programs or pursue some combination of those strategies.

Let me close by highlighting the consequential choices that you and your colleagues face this year.

On the one hand, if policymakers leave current law unchanged, the Federal debt will probably recede slowly relative to the size of the economy, as shown in our baseline. That will occur because of a large increase in revenues and sharper strains on Federal spending apart from the particular programs I have highlighted.

However, both of those changes from historical patterns will have significant economic and social effects. Moreover, the sharp fiscal restraint will markedly slow the economic recovery.

On the other hand, changing current laws to let current policies continue would boost the economy and allow people to pay less in taxes and benefit more from Government programs and services in the next few years, but would put the Nation on an unsustainable fiscal course. If policymakers wanted to achieve both a short-term economic boost and medium-term and long-term fiscal sustainability, they would need to enact policies that leave deficits significantly wider than our current law baseline during the next few years but significantly narrower than under our alternative scenario by later in the decade.

In conclusion, how much and how quickly the budget deficit declines over the coming decade will depend in part on how well the economy does. Probably more critical, though, will be the choices made by you and your colleagues as you face the substantial changes to tax and spending policies slated to take effect this year.

Thank you. I am happy to take your questions.

[The prepared statement of Mr. Elmendorf follows:]



Congressional Budget Office

**Testimony on the  
Budget and Economic Outlook:  
Fiscal Years 2012 to 2022**

**Douglas W. Elmendorf  
Director**

**Before the Committee on the Budget  
United States Senate**

**February 2, 2012**

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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 2012 to 2022. Those estimates were released two days ago in the report titled *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*.

The federal budget deficit—although starting to shrink—remains very large by historical standards. How much and how quickly the deficit declines will depend in part on how well the economy does over the next few years. Probably more critical, though, will be the fiscal policy choices made by lawmakers as they face the substantial changes to tax and spending policies that are slated to take effect within the next year under current law.

The pace of the economic recovery has been slow since the recession ended in June 2009, and CBO expects that, under current laws governing taxes and spending, the economy will continue to grow at a sluggish pace over the next two years. That pace of growth partly reflects the dampening effect on economic activity from the higher tax rates and curbs on spending scheduled to occur this year and especially next. Although CBO projects that growth will pick up after 2013, the agency expects that the economy's output will remain below its potential until 2018 and that the unemployment rate will remain above 7 percent until 2015.

### The Budget Outlook

As specified in law, and to provide a benchmark against which potential policy changes can be measured, CBO constructs its baseline estimates of federal revenues and spending under the assumption that current laws generally remain unchanged. On that basis, the federal budget will show a deficit of nearly \$1.1 trillion in fiscal year 2012 (see Table 1). Measured as a share of gross domestic product (GDP), that shortfall will be 7.0 percent, which is nearly 2 percentage points below the deficit recorded last year but still higher than any deficit between 1947 and 2008. Over the next few years, projected deficits in CBO's baseline drop markedly, averaging 1.5 percent of GDP over the 2013–2022 period. With deficits small relative to the size of the economy, debt held by the public drops—from about 75 percent of GDP in 2013 to

62 percent in 2022, which is still higher than in any year between 1952 and 2009.

Much of the projected decline in the deficit occurs because, under current law, revenues will rise considerably as a share of GDP—from 16.3 percent in 2012 to 20.0 percent in 2014 and 21.0 percent in 2022. In particular, between 2012 and 2014, revenues in CBO's baseline shoot up by more than 30 percent, mostly because of the recent or scheduled expirations of tax provisions, such as those that lower income tax rates and limit the reach of the alternative minimum tax (AMT), and the imposition of new taxes, fees, and penalties that are scheduled to go into effect. Revenues continue to rise relative to GDP after 2014 largely because increases in taxpayers' real (inflation-adjusted) income are projected to push more of them into higher tax brackets and because more taxpayers become subject to the AMT.

As the economy expands in the next several years and as statutory caps constrain discretionary appropriations, federal spending in CBO's baseline projections declines modestly relative to GDP before turning up again because of increasing expenses generated by the aging of the population and rising costs for health care. Projected spending averages 21.9 percent of GDP over the 2013–2022 period, a percentage that is less than the 23.2 percent CBO estimates for 2012 but that is still elevated by historical standards. Spending resulting from the American Recovery and Reinvestment Act and outlays for unemployment compensation and other benefits that tend to increase during economic downturns will continue to ebb over the next few years. Caps on discretionary spending and other procedures established in the recently enacted Budget Control Act also will hold down growth in federal spending. In the baseline, discretionary spending is projected to decline to 5.6 percent of GDP in 2022—the lowest level in the past 50 years. Those constraining factors will be partially offset by increases in spending for mandatory programs, particularly Social Security, Medicare, Medicaid, and other federal health care programs: Mandatory spending is projected to climb from 13.3 percent of GDP in 2013 to 14.3 percent in 2022.

Although the projected deficits under current law are much smaller than those of the past few years, in CBO's baseline the federal budget remains out of balance throughout the decade. The resulting accumulation of

**Table 1.**  
**CBO's Baseline Budget Outlook**

	Actual,											Total		
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2013-	2013-
	In Billions of Dollars													
Revenues	2,302	2,523	2,988	3,313	3,568	3,784	4,039	4,243	4,456	4,680	4,926	5,181	17,692	41,179
Outlays	3,598	3,601	3,573	3,658	3,836	4,086	4,259	4,439	4,714	4,960	5,205	5,520	19,413	44,251
<b>Deficit (-) or Surplus</b>	<b>-1,296</b>	<b>-1,079</b>	<b>-585</b>	<b>-345</b>	<b>-269</b>	<b>-302</b>	<b>-220</b>	<b>-196</b>	<b>-258</b>	<b>-280</b>	<b>-279</b>	<b>-339</b>	<b>-1,721</b>	<b>-3,072</b>
On-budget	-1,363	-1,130	-619	-363	-282	-318	-235	-206	-258	-265	-245	-283	-1,818	-3,074
Off-budget <sup>a</sup>	67	52	34	19	13	16	15	10	*	-16	-34	-55	97	2
Debt Held by the Public at the End of the Year	10,128	11,242	11,945	12,401	12,783	13,188	13,509	13,801	14,148	14,512	14,872	15,291	n.a.	n.a.
	As a Percentage of Gross Domestic Product													
Revenues	15.4	16.3	18.8	20.0	20.2	20.2	20.5	20.5	20.6	20.7	20.9	21.0	20.0	20.4
Outlays	24.1	23.2	22.5	22.1	21.8	21.8	21.6	21.5	21.8	21.9	22.0	22.4	21.9	21.9
<b>Deficit</b>	<b>-8.7</b>	<b>-7.0</b>	<b>-3.7</b>	<b>-2.1</b>	<b>-1.5</b>	<b>-1.6</b>	<b>-1.1</b>	<b>-0.9</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.4</b>	<b>-1.9</b>	<b>-1.5</b>
Debt Held by the Public at the End of the Year	67.7	72.5	75.1	74.8	72.6	70.5	68.5	66.8	65.5	64.2	63.0	62.0	n.a.	n.a.

Source: Congressional Budget Office.

Note: \* = between -\$500 million and zero; n.a. = not applicable.

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

debt, along with rising interest rates, drives up the cost of financing that debt; in CBO's projections, net interest costs grow significantly from 1.4 percent of GDP this year to 2.5 percent in 2022.

CBO's baseline projections are heavily influenced by changes in tax and spending policies that are embodied in current law—changes that in some cases represent a significant departure from recent policies. As a result, those projections show much higher revenues and lower outlays than would occur if the lower tax rates now in effect were extended and if provisions constraining future spending were not implemented. To illustrate the budgetary consequences of maintaining some tax and spending policies that have recently been in effect, CBO developed projections under an "alternative fiscal scenario." That scenario incorporates the following assumptions:

- Expiring tax provisions (other than the payroll tax reduction) are extended;
- The AMT is indexed for inflation after 2011;

- Medicare's payment rates for physicians' services are held constant at their current level (rather than dropping by 27 percent in March 2012 and more thereafter, as scheduled under current law); and

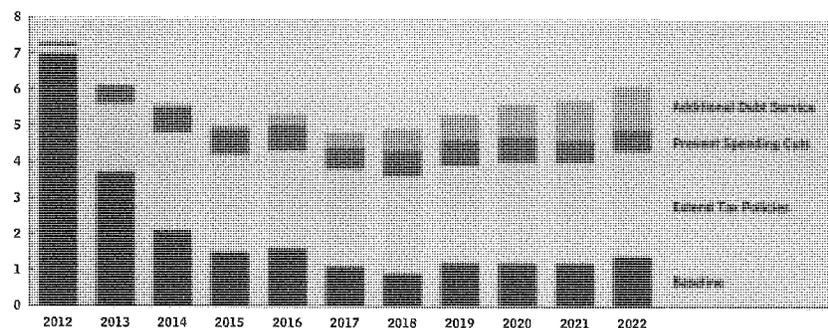
- The automatic spending reductions required by the Budget Control Act in the absence of legislation reported by the Joint Select Committee on Deficit Reduction do not take effect (thereby leaving in place the discretionary caps established by the act, which would otherwise be subject to those reductions).

Under that alternative fiscal scenario, deficits over the 2013–2022 period would be much higher, averaging 5.4 percent of GDP, rather than the 1.5 percent reflected in CBO's baseline projections (see Figure 1). Debt held by the public would climb to 94 percent of GDP in 2022, the highest figure since just after World War II (see Figure 2).

Even if the fiscal policies specified by current law come to pass, budgetary challenges over the longer term remain—

**Figure 1.**  
**Deficits Projected in CBO's Baseline and Under an Alternative Fiscal Scenario**

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: "Additional Debt Service" is the amount of interest payments on the additional debt issued to the public that would result from the policies in the alternative fiscal scenario. "Prevent Spending Cuts" involves holding Medicare's payment rates for physicians' services at their current level (rather than permitting them to drop, as scheduled under current law) and preventing the cuts to federal spending that will occur under the automatic enforcement procedures of the Budget Control Act of 2011 from taking effect (but leaving in place the original caps on discretionary appropriations in that legislation). "Extend Tax Policies" reflects the assumptions that expiring tax provisions (other than the payroll tax reduction) are instead extended and that the alternative minimum tax is indexed for inflation.

and the challenges will be much more acute if those policies do not remain in place. Under both CBO's baseline and its alternative fiscal scenario, the aging of the population and rising costs for health care will push spending for Social Security, Medicare, Medicaid, and other federal health care programs considerably higher as a percentage of GDP. If that rising level of spending is coupled with revenues that are held close to the average share of GDP that they have represented for the past 40 years (rather than being allowed to increase, as under current law), the resulting deficits will increase federal debt to unsupportable levels. To prevent that outcome, policymakers will have to substantially restrain the growth of spending for those programs, raise revenues above their historical share of GDP, or pursue some combination of those two approaches.

### The Economic Outlook

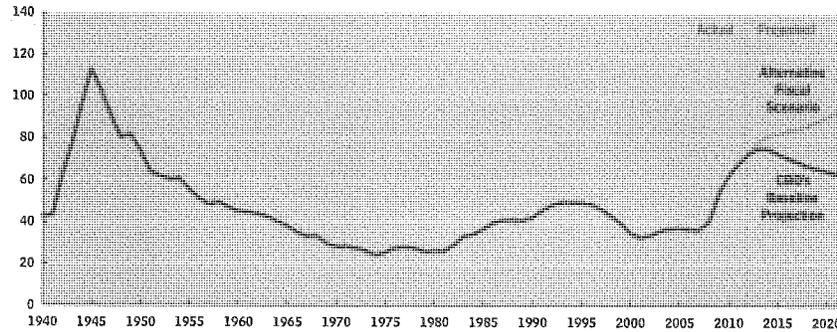
The continued slow recovery that CBO projects for the next two years reflects the lingering effects of the financial

crisis and the recession, as well as the fiscal restraint that will arise under current law. According to CBO's projections, real GDP will grow by 2.0 percent this year (as measured by the change from the fourth quarter of the previous calendar year) and by 1.1 percent next year (see Table 2). CBO expects economic activity to quicken after 2013 but real GDP to remain below the economy's potential until 2018. As of late 2011, according to the agency's projections, the economy was only about halfway through the cumulative shortfall in total output that will result from the recession and its aftermath.

Considerable slack remains in the labor market, mainly as a consequence of continued weakness in demand for goods and services. In CBO's forecast, the unemployment rate remains above 8 percent both this year and next. As economic growth picks up after 2013, the unemployment rate will gradually decline, but it will still be around 7 percent at the end of calendar year 2015, before dropping to near 5½ percent by the end of 2017 and 5¼ percent by the end of 2022.

**Figure 2.****Federal Debt Held by the Public Projected in CBO's Baseline and Under an Alternative Fiscal Scenario**

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. The budgetary effects under the alternative fiscal scenario also include the incremental interest costs associated with projected additional borrowing.

While the economy continues to recover during the next few years, inflation and interest rates will remain low. In CBO's forecast, the price index for personal consumption expenditures (PCE) increases by just 1.2 percent in 2012 and 1.3 percent in 2013, and rates on 10-year Treasury notes average 2.3 percent in 2012 and 2.5 percent in 2013. As the economy's output approaches its potential later in the decade, inflation and interest rates will rise to more normal levels. In CBO's projections for the 2018–2022 period, the annual change in the PCE price index averages 2.0 percent per year, and interest rates on 10-year Treasury notes average 5.0 percent.

Many developments could cause economic outcomes to differ substantially, in one direction or another, from those that CBO has projected. For example, the economy could grow considerably faster than the agency has

forecast if the forces that have restrained the recovery fade more rapidly than anticipated. Alternatively, a significant worsening of the banking and fiscal problems in Europe could lead to further turmoil in international financial markets that could spill over to those in the United States and greatly weaken the economy here.

Furthermore, changes in fiscal policy that diverge from the path assumed in CBO's baseline also could have a significant impact on economic growth. Under CBO's alternative fiscal scenario, real GDP would be noticeably higher in the next few years than it is in CBO's baseline economic forecast. Over time, however, real GDP under that scenario would fall increasingly below the level in CBO's baseline projections because the larger budget deficits would reduce private investment in productive capital.

**Table 2.****CBO's Economic Projections for Calendar Years 2012 to 2022**

	Estimated, 2011	Forecast		Projected Annual Average	
		2012	2013	2014-2017	2018-2022
<b>Fourth Quarter to Fourth Quarter (Percentage change)</b>					
Real GDP	1.6	2.0	1.1	4.1	2.5
Inflation					
PCE price index	2.6	1.2	1.3	1.7	2.0
Core PCE price index <sup>a</sup>	1.8	1.2	1.4	1.6	2.0
Consumer price index <sup>b</sup>	3.3 <sup>c</sup>	1.4	1.5	1.9	2.3
Core consumer price index <sup>b</sup>	2.2 <sup>c</sup>	1.4	1.6	1.9	2.2
<b>Fourth-Quarter Level (Percent)</b>					
Unemployment Rate	8.7 <sup>c</sup>	8.9	9.2	5.6 <sup>d</sup>	5.3 <sup>e</sup>
<b>Calendar Year Average (Percent)</b>					
Interest Rates					
Three-month Treasury bills	0.1 <sup>c</sup>	0.1	0.1	2.0	3.7
Ten-year Treasury notes	2.8 <sup>c</sup>	2.3	2.5	3.8	5.0

Source: Congressional Budget Office.

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

- a. Excludes prices for food and energy.
- b. The consumer price index for all urban consumers.
- c. Actual value for 2011.
- d. Value for 2017.
- e. Value for 2022.

Chairman CONRAD. Thank you, Director Elmendorf. Let me start out, if I could, by saying you have said repeatedly your report shows that we are on a budget track that is unsustainable. Deficits are too high, too much debt. But you also say in this report that if we let the tax cuts expire, as is provided for in current law, and if we impose the spending cuts required by current law, economic growth, according to your analysis, will actually plunge.

Now, we started out with Senator Toomey and I agreeing on one thing, that we have to have policies that strengthen economic growth. And yet you are saying that current law, which ends the Bush era tax cuts at the end of this year, and current law also imposes spending cuts, sequestration that is in line, that would cut economic growth about in half. Is that correct?

Mr. ELMENDORF. Yes, that is right, Mr. Chairman.

Chairman CONRAD. So, I think it is very confusing to people because it sounds like double-talk to them. How can it be that, on the one hand, we are saying deficits and debt are a big problem, but on the other hand, if we cut spending and raise revenue, which over time will reduce deficits, that if we did it now, it will dramatically reduce economic growth and make our economic situation worse? How can both those things be true?

Mr. ELMENDORF. As Mr. Chairman, it is not double-talk, but it is complicated. In the short term, especially given the state of our economy today, the constraint on output and jobs is really the demand for goods and services, which plummeted in the financial crisis and recession and is only slowly coming back.

Over the medium term and long term, the constraint on output in this economy is not particularly the demand for goods and services; it is the ability of the economy to supply those goods and services. It is the size and skill of the labor force, the quantity of capital with which they work, the productivity with which the labor and capital are combined to produce output.

This is actually a consensus part of economic thinking that in the short term, in economies that have a lot of underused and unused people, factories, houses, and so on, that efforts to boost the demand for goods and services can help put people back to work, but that over time the bigger issue is whether people are doing enough saving, whether there are people who are coming to work who can find jobs.

And so what countries have found is that very rapid imposition of fiscal constraints tends—not always, but tends to slow economies in the short term.

Now, some countries have no choice. I am not trying to second-guess the decisions made by policymakers in Europe. When countries cannot sell their debt or fear that they may not be able to sell their debt tomorrow, then they sometimes need to make drastic changes in fiscal policy overnight. And in our issue brief on the risk of a fiscal crisis in this country a few years ago, we highlighted the fact that if one waits to address fiscal problems until the creditors will not lend you money anymore, that often happens right when the economies are weakest and it is hardest to address the problem. So once countries haveten to that point, sometimes they have no choice but to make that sort of overnight change. But if one can

plan ahead, then it helps households and businesses and State and local governments to adjust to the change in policies.

I want to say this is not in any case an argument for deferring decision making. There really is not a downside to Congress deciding how it wants to put the country on a sustainable fiscal path. The issue is, given a plan, how quickly should the pieces take effect, and there are reasons for waiting, which I am laying out. There are also, of course, for not waiting too long. We have written a lot and talked a lot about the dangers of the escalating debt. But there is a balancing act in how quickly the policies take effect.

Chairman CONRAD. So why wouldn't one conclude from what you have said here that the best policy in the short term would be to extend tax cuts, at least some significant part of the tax cuts, and defer some of the spending cuts, for example, part of the sequester, for several years, but right now agree to a plan that will raise revenue and cut spending so that at the end of the 10 years we have dramatically reduced deficits and reduced the growth of debt?

Mr. ELMENDORF. I do not want to speak to a specific combination of policies that the Congress might choose to extend or let expire. That is a decision for you. As we have done analysis of the stimulative effects for output and employment of particular sets of policies, and we can talk about that if you would like. But on your general point, I think agreement about how the country's budget will be put on a sustainable path would be a good thing for the economy in the short run because it would give people some confidence that they knew where policies were headed, which is very hard to have in the current environment. And if a set of policies was put in place that put the country on a sustainable fiscal path and people believed that those policies would be allowed to take effect when they were scheduled to do so, then I think that would be a good thing for business investment in hiring and for consumer spending and would help to boost the economy right away.

Chairman CONRAD. But wouldn't the logical conclusion of the testimony you have provided be that in the short term we should take steps that might actually increase the deficits and debt if that was married with a longer-term plan that credibly substantially reduced deficits and debt?

Mr. ELMENDORF. Well, yes, I think so, if I understand you right. The policies that would widen the deficit relative to the very sharp fiscal restraint in our current law baseline, relative to that benchmark, the policies that widen the deficit for a few years would be beneficial for the economy over that period if they were—especially if they were, as you say, combined with a plan that later narrowed deficits relative to the current policy projections that we have shown you here. Combining those pieces is important because people might otherwise interpret short-term widening of the deficit as simply a precursor for further widening down the road. And so the proposal that you mentioned about having those pieces together I think would be the strongest—provide the strongest boost to economic activity in the short term.

Chairman CONRAD. But those longer steps to deal with deficits and debt would have to be credible and there would have to be an assurance that they were put in place.

Mr. ELMENDORF. Yes. I think we have written and I have said in previous testimonies that to make intended future actions matter for people's behavior today, they need to be credible. Part of that is they need to be specific, and they need to have, I think, reasonably widespread support so that people did not think that they would be quickly overturned down the road.

Chairman CONRAD. Senator Toomey.

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

I think one of the problems with the solution along the lines of what you have described arises from the fact that, of course, the only Congress we control is the one that we are a member of, and it—

Chairman CONRAD. And we are not so sure about that.

Senator TOOMEY. And we are not so sure about that. So the idea of widening the deficit on the promise that it will be narrowed in the future is one that would be challenging for me to accept that we have a good reason to believe that it will actually be carried through.

Having said that, statutory changes in the architecture of the programs driving this that passed with bipartisan support and were signed into law, those would tend to be enduring. And I think that we could have some reason to be confident that such changes that would go into effect, not tomorrow or even next year but years down the road, could, in fact, solve the problem and would be credible if they were done that way.

Just quickly on this vein, though, in this discussion that you had with the Chairman, I think sometimes there is a suggestion that from the point of view of economic growth Government spending and lower taxes are somehow equivalent because, from a sort of Keynesian demand side, they both provide a stimulus that generates economic growth. And I understand that analysis, but I would suggest—and I do not know if you agree or not, Dr. Elmen-dorf, but my own view is there is one very important way in which they differ and in which lower tax—specifically lower marginal tax rates and lower taxes on investment have an effect on economic growth, a positive effect that spending does not have, and that is in the incentive component, the extent to which lower marginal rates encourage more work, more savings, more investment, more risk taking, in a way that more Government spending does not; and that, therefore, while I can acknowledge the Keynesian argument that they are somehow equivalent from a demand side, they are not equivalent on the supply side.

I do not know if you share that view or have a different view.

Mr. ELMENDORF. I think you are correct, Senator. Even on the demand side, in the analysis we have done for this Committee, presented in testimony last fall, different sorts of specific changes in tax policy or spending policy could have very different effects, we estimate, on the economy in the short run.

Senator TOOMEY. Right.

Mr. ELMENDORF. So even within one of those categories, not everything is alike, and I think you are right to emphasize the importance of the incentive effects of the changes in tax rates for medium-term and long-term growth.

Certain aspects of Government spending can matter as well, like infrastructure spending and so on, but you are right to emphasize the importance of tax rates.

Senator TOOMEY. Now, earlier the Chairman challenged my assertion that what we have is a spending problem, and he observed, correctly, that revenue is at a relatively low point, a multi-year low as a percentage of GDP. But the tax regime that we have in place has been in place now for almost 10 years, and it seems to me that the low revenue number that we have as a percentage of GDP is a function of a weak economy—slow growth, lesser output, far more people unemployed, therefore not paying taxes—and that that is by far the main driver of why we do not have greater revenue coming from the current rate structure.

Is it your view that the economic slowdown has been a big driver of the decline in revenue as a percentage of GDP?

Mr. ELMENDORF. Yes, the economic slowdown has been the principal factor. Of course, for a given set of—for higher tax rates, one might collect more revenue from our given tax base.

Senator TOOMEY. Yes.

Mr. ELMENDORF. But you are right about the sharp decline in taxable income.

Senator TOOMEY. Right. And the other point that I would make is that if you look at your alternative fiscal scenario in which you assume that all the current rates remain in place, in fact, revenue returns to its historical norm, and really within a few years actually it exceeds the 18 percent of GDP that has been the historical average. So in that sense, we are on a course with the current tax rates for revenue to be normal again, at least normal as measured by America's history.

What does not revert to normal is spending. Spending stays at an elevated percentage of GDP indefinitely, and then it gets worse, it accelerates. Do I have that right?

Mr. ELMENDORF. Yes, that is right. And I show in the bar chart particular—and you have highlighted particular types of spending.

Senator TOOMEY. So that is why, if you believe that fundamentally spending needs to be and ought to be a greater share of our economy and taxes ought to be a greater share than historically they have been, okay, that is a perfectly legitimate point of view. But that is a departure from what has been the norm in this country for decades.

The last point I would make in this is that as recently as 2007, the current tax regime generated more than 18 percent of GDP in revenue to the Government and a deficit of only 1.2 percent of GDP, a deficit that was adding to the debt at a rate slower than the economy was growing and, therefore, establishing that goal that I think should be our goal of debt-to-GDP, that would be declining.

Mr. ELMENDORF. Yes.

Senator TOOMEY. I will yield, Mr. Chairman.

Chairman CONRAD. Let me pick upon the point, because I think it is hugely important, and this is where we have a difference of opinion.

Average revenue over 40 years, about 18 percent of GDP, I think 18.1 percent. The problem with that is there have been only five

times we have balanced in the last 30 years, and every time we have balanced, revenue was not at 18 percent or 19 percent. Revenue was at 19.6, 19.7, 19.8, 20.6. And that is before the demographic time bomb that is going on in this country, the aging of the baby-boom generation, and that is not a projection. Those people have been born. They are alive today. They are going to be eligible for Medicare and Social Security. And so that to me has got to be taken into account on what kind of revenue level we need to achieve to take on this debt threat and have the kinds of Medicare and Social Security programs that the vast majority of Americans say they support.

I entirely agree with the Senator that spending is going to have to come down, in nominal terms, in real terms, because it is at or near a 60-year high. But I personally do not believe we are going to bell this cat or that we are going to achieve agreement to make changes on entitlements if we do not also make changes on the revenue side. And I for one am ready to deal with entitlements. It is entirely clear to me that what we have been doing so far is trying to solve this on the discretionary side of the equation. The Senator quite appropriately mentioned what is happening there. That spending is actually going down, and going down quite markedly. But we have not been able to deal with the entitlement side.

Senator Stabenow.

Senator STABENOW. Well, thank you very much, Mr. Chairman, and thank you as always for your thoughtful perspective. And, Mr. Elmendorf, we thank you and your team for their work.

Mr. ELMENDORF. Thank you.

Senator STABENOW. I think over and over again what you are saying is we needed the super committee to work, we need to have a long-term plan that both deals with the short term in terms of what is happening around jobs. We know we will never get out of debt with 13 million people out of work, but we also have to focus on the long term. So I want to thank you for that.

I also want to say, Mr. Chairman, just to reiterate, thank you for your work on the Budget Control Act and, in fact, it may have been a little different process, but we did pass a budget last year, just for the record, and I think there has been a manufactured political issue around whether or not it was done in the normal process or through something called the Budget Control Act, but it certainly was done with budget caps, and we can go further this year. But we certainly have put in place both a budget framework and appropriations.

Within that, let me also just say for a moment that we in Agriculture did our part, and just because we did a lot of hard work together with CBO, I want to thank you very much for burning the late-night candles, the people who were in your shop working with us around the clock. We made a commitment, Chairman Lucas and I and Senator Roberts and Congressman Peterson, to come up with a bipartisan, bicameral deficit reduction proposal. We did that. We are very proud that we did that. Agriculture is slightly less than 2 percent of Federal outlays, and the \$23 billion that we recommended with CBO scoring and legislative language was slightly less than 2 percent of the cut required. So we met our fair share, and I want to thank your staff for all of their efforts in that effort.

Mr. ELMENDORF. Thank you, Senator. I will pass that along.

Senator STABENOW. Yes. There are a couple of other things and I want to ask a question, but let me also say that when we look long term, I think it is important for us also to look at the fact that we have begun to tackle some things. Within the Affordable Care Act, we tackled overpayments on Medicare Advantage. Some said it would not work. I am very pleased to see the numbers that have just come out for 2011 that premiums are down 7 percent, even though enrollment is up 10 percent. So we are beginning that projection that came from your shop of \$143 billion over 10 years in reduction in health care costs. It looks like it is beginning to happen. The second decade I understand was accorded to a half a percent of GDP, which translates to about \$1.3 trillion. So I am pleased to see that at least in part there is more that needs to be done, but what was done under the Affordable Care Act certainly has moved us in a direction of bringing down costs, and I am pleased to see that.

I would like to ask you about the economy and certainly in the short run. You know, coming from Michigan, we have had the biggest swing. Three years ago we were tapped out at 15.7 percent unemployment. It is now 9.3 percent, certainly the biggest drop in the country, but still way too high. And I wonder if you might just talk more about the importance of creating jobs and the impact on the deficit and the economy, because what you have been talking about on the demand side, that is jobs. That is people having money in their pocket so they can buy things, care for their families. And it is so critical, I think, that we focus immediately on jobs and the economy if we are going to get out of this deficit hole. If you could speak more to that.

Mr. ELMENDORF. So, Senator, stronger economic performance is very good for the Federal budget, mostly because it increases tax receipts—people have more income on which they pay tax—also because it reduces spending for unemployment benefits and other things.

It is separately the case that certain sorts of reductions in taxes or increases in Government spending can spur economic growth, and we have provided this Committee and others with estimates of that.

One should not, though, put those pieces together and assume that, therefore, some lower taxes or higher spending will boost the economy so much that that will raise tax revenue enough to pay for the entire extra fiscal costs. That is not the case. So there is some benefit to the Federal budget of budgetary actions that spur the economy, but in almost every case not enough to pay for the direct costs of those actions.

We have provided, both in an appendix to this report and in a letter we wrote to Congressman Van Hollen in October, some more specific estimates of how certain amounts of improvement in economic performance would benefit the budget, and we would be happy to talk with you about those more carefully if you would like.

Senator STABENOW. I appreciate that. Thank you very much.

Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman.

Mr. Director, thanks for your testimony. I agree with you that if we are really going to move ourselves in the direction of economic growth and heal this deficit, we need a credible and specific plan. And, of course, the first step in that is going to actually have the Congress pass a budget and specifically the Senate pass a budget.

Unfortunately, we are going to be starting a week late in terms of the timetable set out in the

Congressional Budget Act of 1974. The President is going to be 1 week late in submitting his budget. I certainly want to keep this Committee's feet to the fire to try and get our work done with our budget proposal submitted by April 1st. In talking with Chairman Conrad, he said one of the problems that might hold us up there is CBO's re-estimation of the budget. So can you give me some sort of timeline and give me assurances you will not hold up our work here?

Mr. ELMENDORF. Well, Senator, just as you want to hold the Committee's feet to the fire, this Committee and the House Budget Committee are holding our feet to the fire. We are starting a week late, as you said.

Senator JOHNSON. Right.

Mr. ELMENDORF. We will push along just as fast as we can. In conversations that we have had with the Budget Committees, we have said that we are aiming to release our March baseline and our analysis of the President's budget by the middle of March.

Senator JOHNSON. Okay.

Mr. ELMENDORF. Whether we can keep to that depends importantly on what turns up in the budget, which we have not seen, and how hard it is for us to do the analysis of it. It also depends on what else Congress demands of us. We have made a tour of the leadership in the Democratic and Republican sides in the Senate and the House and pleaded for forbearance in doing estimates of other sorts of legislation over the next month and a half so we can focus on providing this new baseline, which is crucial for your legislative work of the year and our estimates.

Senator JOHNSON. Well, I appreciate that, and, of course, I did not make a demand, but I did have a request that we spoke about earlier.

Mr. ELMENDORF. Yes.

Senator JOHNSON. I am certainly concerned and want to ask you in general about the risks to the budget that you see. In addition to the baseline, what are the risks? You know, certainly from my standpoint—and we have had this discussion—I am highly concerned about what the true cost of the health care law is. Specifically, we had conversations about, I believe, credible evidence that this is underestimated in terms of the number of employees that will lose their employer-sponsored care. It sounds like your office has been working on that. Can you just give me an update in terms of when we might have a reassessment of that estimate?

Mr. ELMENDORF. Yes. The first thing is that this outlook does not include a comprehensive re-estimate of the coverage provisions of the Affordable Care Act. That will be part of our March baseline. It is a very involved process. We actually get more health data this

time of year. So it is not in here. It will be in the March baseline. So you will see in that our assessment, our best assessment at that point, of the effects of the law.

We are also separately working on an analysis that is well along but not yet finished of the consequences for the budget if we are wrong in our assessment of the effects of the legislation, and we are looking at a range of alternative parameter values of some of the crucial assumptions. Each of those requires us to do a whole separate set of estimates, essentially, so it takes some time. But we are pushing hard on that, and as soon as that is done, we will give that to the Congress. A number of people have asked—

Senator JOHNSON. I really would encourage you to take a look at a realistic worst-case scenario because we are far, far from that with the million-person estimate right now. Douglas Holtz-Eakin talked about 35 million—I would argue far higher—having bought health care and making those decisions, so, again, I encourage you to really take a hard look at that.

Mr. ELMENDORF. I understand, Senator.

Senator JOHNSON. In terms of risk to the budget, from my standpoint the cost of health care, interest rate risk—I am looking at your interest rate assumptions—they certainly do not take into account should we hit a European-style debt crisis. Speaking of Europe, I do not see anything—or I am certainly concerned about what could happen, budgetary effects of European contagion. We had an excellent hearing here yesterday to that effect, and the suggestion really was from those witnesses have CBO take a look at that as potentially an alternate scenario, and then just growth projections.

What is, by the way, the last 50 years, the average growth rate of the U.S. economy?

Chairman CONRAD. Senator Johnson, could I just stop you on that point?

Senator JOHNSON. Sure.

Chairman CONRAD. Because Senator Johnson has said something and I do not want to let this moment pass by without riveting the point. I do not want it to just kind of float by here.

What he is saying is exactly correct with respect to yesterday's hearing, and they suggested that we ask CBO to take a look at what we might expect if we have a further erosion in Europe. And I think that is absolutely critical because it is one of the biggest risk factors that we face out there. I want to make sure this does not come off Senator Johnson's time so restore his time.

Senator JOHNSON. That took about 5 minutes, by the way.

[Laughter.]

Senator JOHNSON. Thank you, Senator Conrad. That is important, so just getting back to my primary point, I have just listed four things. I would encourage CBO to really take a look at what are significant risks and give us some sort of feedback on that.

Mr. ELMENDORF. As Senator, these projections that we make are fraught with uncertainty and the uncertainty is very wide. In particular, projections of the deficit are projections of the difference between two very, very large numbers, and one does not have to be off by very much in the projection of revenues or the projection of spending to be off by a large multiple of the projected deficit.

We work very hard to have projections that are in the middle of the distribution of possible outcomes. It is not our objective, as described by the Congress, for us to deliver the worst-case projection, but we do think about alternatives.

We were not able in this report to illustrate the effects of alternatives quantitatively. We have, as in the appendix a table that looks at some rules of thumb, but we did not go all the way from what particular things happen in Europe or elsewhere, how would that matter.

For what it is worth, the projection is conditioned on what we say is a shallow recession in the eurozone. I think that is consistent with the current consensus forecasts of what is going on in Europe.

The effects of Europe on the U.S. economy or the effects of a European financial implosion on the U.S. economy are, of course, very complicated. Part of that—you mentioned this earlier, Mr. Chairman—is the effect on our next exports. If they are out of work, buying less, one place they will buy less from is here.

But we think a more important channel of transmission from their problems to us is actually through the financial system. We have had a number of conversations on this topic with our Panel of Economic Advisers in the past several meetings, and their view is that it is really on the financial side.

I think the current understanding is that U.S. financial institutions do not have a lot of direct exposure to the most troubled economies in Europe. But as we saw in the financial crisis here, the dangers come not just from sort of the one link away; it is two links or three links away in this very interconnected financial system.

Senator JOHNSON. Okay. Let me sneak one last point in here. Currently, a huge debate really is about the expiration of the Bush tax cuts and differentiating them between the wealthy and the less well off. What is the effect of the Bush tax cuts expiration on the top \$250,000 income earners? How many dollars is that per year over a 10-year window versus the rest of the tax cuts?

Mr. ELMENDORF. I do not have a precise number, but roughly, from the last time I have seen estimates of this

sort from the staff of the Joint Committee on Taxation—who are the people who do those estimates—about one-fifth of the total amount of revenue related to the extension of the 2001 and 2003 and so on tax cuts is attributable to the top tax rates and four-fifths is attributable to all the other—

Senator JOHNSON. Put some numbers on that. What are the top tax rates and how many dollars are we talking about?

Mr. ELMENDORF. So the total number that we show in the outlook is about \$4.5 trillion for extending certain income tax and estate and gift tax provisions and indexing the AMT for inflation. So a fifth of \$4.5 trillion is about \$900 billion.

Senator JOHNSON. Okay. And—

Mr. ELMENDORF. And then there is some debt service that—

Senator JOHNSON. And when you say top income tax rates, that is income earners over—what is the cutoff point?

Mr. ELMENDORF. I do not remember the exact cutoff, to be honest. Again, these are estimates that the staff of the

Joint Committee on Taxation does. They do not come directly from us. I do not have those numbers in hand.

Senator JOHNSON. Okay. Thank you. I appreciate it.

Chairman CONRAD. Thank you, Senator.

Senator Begich.

Senator BEGICH. Thank you very much. Thank you for being here.

Let me first ask kind of—it is interesting as I am sitting here listening. I have now been here 3 years. It is kind of deja-vu, the debate that we are going to have here, and the real question is: How do we craft the right package? And you have given some scenarios. Let me ask it in a question. Do you believe to move this economy forward, get better revenue streams, reduce the deficit, create the right kind of mix, can you cut your way out of this?

Mr. ELMENDORF. Well, in the—

Senator BEGICH. If that is the only scenario you have, that we are just going to cut the budget.

Mr. ELMENDORF. So our estimates say that if you were to have sharper cuts in spending than those already embodied in current law, then we would come back to you with—

Senator BEGICH. And that means the automatic caps.

Mr. ELMENDORF. Then we would come back to you with a lower projection of economic growth in the next few years. Depending on what happened to those policies over time, we might have different sorts of answers to the effect on the economy later in the decade. It depends whether those policies were sustained, what other changes might be made in the budget. But in the next few years, further cuts in spending beyond those in the Budget Control Act or increases in taxes beyond those in current law would lead to even weaker economic growth.

Senator BEGICH. Would impact economic growth in a negative way?

Mr. ELMENDORF. Yes.

Senator BEGICH. Let me ask you also, where we are today—and I actually went back and got the last two—the testimony you have done the last two times, which is always interesting. You know, I am sure you review it and you kind of go, “Did I really estimate that? But it is interesting. You have a pattern and a trend, which I kind of like, what I am going to cite to you, and that is, when you do your baseline budget outlook tonight—and I noted your comment. You said these are benchmarks, not forecasts. But, the problem with that is, of course, when you see an article and it says, “CBO projects” in the headline, and then it says, “There are much dimmer forecasts.” And I understand the difference. There is a clear difference between these. But in your documents—and I am going to use your words—you actually talk about forecasts. That is the phrase you use. So we have to help us help you make sure that people understand there is a big difference between forecast and saying here is a benchmark, because a benchmark is just what it is based on the information you have at that time and some assumptions. Forecasts are using all kinds of other methods to get to that. But when you read the document that says forecast, help us—as you do your reports—

Mr. ELMENDORF. I see the problem. It is just very hard. We use the word “project” or “forecast” about 50,000 times in those 150 pages.

Senator BEGICH. Right.

Mr. ELMENDORF. And it is hard to say in every case the parenthetical of “conditional on current law.”

Senator BEGICH. Right, and the benchmark is a very important differentiation. But this is interesting. In 2010, in your report 2 years ago, you said projected 2010 deficit, \$1.3 trillion; actual \$1.29 trillion. And then last year you projected deficit for 2011, \$1.48 trillion; actual deficit, \$1.29.

Now, there are variations. Revenue went up, and we actually spent less. We actually had a combination of the two that are moving us.

So I have great hope as you project out this next year at 8.9 that it is going to be about half a point less on—the deficit is going to be less than what you project, a little over \$1 trillion. But also your unemployment projection was always about half a point off lower, which, again, I think is great because anytime you overproject and it goes down it is good news.

So help me—I mean, I assuming you take probably a much more middle conservative view on these numbers because we are a very unpredictable group here, and you have to bank that, right? Is that a fair—

Mr. ELMENDORF. Well, so in terms of what you and your colleagues—

Senator BEGICH. You can criticize us. It is okay.

Mr. ELMENDORF. —will do, we simply follow current law.

Senator BEGICH. I understand.

Mr. ELMENDORF. So we make no attempt to guess what you and your colleagues might do. It is just simply based on current law.

Senator BEGICH. Right.

Mr. ELMENDORF. For all the other things that we do in our projections, we try to be in the middle of the distribution of possible outcomes.

Senator BEGICH. Right.

Mr. ELMENDORF. We are not trying to be conservative. I am not even sure quite what that means all the time in this context. We see a range of possibilities. We want to give you a sense about what the middle of that distribution is. And I hope everybody understands that the distribution is very wide, and lots of things could happen.

The unemployment rate, for example, rose a little more than one would have expected given the weakness of GDP earlier in this downturn, and that has been reversed. That is part of why the unemployment rate came in a little lower than we thought it would, say, at the end of last year.

Senator BEGICH. Right, and the year—actually, in all three of these projections, you were half a point too high. I am just looking off of your documents. I am not—

Mr. ELMENDORF. I have not checked all of them, and I am glad—

Senator BEGICH. 10.1 was one of your projections, and then it was—that is good news. I am just saying I like the way you project because my view is your trend line is the right trend line, and I

think that is a good point, that your projections may be higher than what may happen. That is my opinion, so I just want to put that out. But here are—

Mr. ELMENDORF. I am rooting for good news, too, Senator.

Senator BEGICH. We are all rooting for good news. Let me ask you just a couple quick things, and that is, have you done an analysis—there is this discussion, which I oppose, and that is domestic BRACs. In other words, again going through this whole process of what could happen with domestic bases. I oppose it. I think there are a lot of folks, bipartisan, who oppose it.

Have you done any analysis now or are you planning to in the future to give us an impact what that might do to the economy if these are implemented over a period of time? Or is it worth it? Let me ask it that way, I guess.

Mr. ELMENDORF. I am not aware of any work we are doing on that specific topic. It depends how many changes the Government makes and how large those changes are. We have a very large economy even—

Senator BEGICH. Right.

Mr. ELMENDORF. Although not as large as it could be at the moment.

Senator BEGICH. But military is a sizable amount of the—

Mr. ELMENDORF. It is a sizable amount. But what would be important would be the magnitude of changes that such a process would consider, and also just what those changes were, I mean, the extent to which—

Senator BEGICH. Are they—

Mr. ELMENDORF. —closing bases and people do not have jobs in the military anywhere, or are you closing bases and moving people to jobs at other locations? That is the sort of thing we would have to look at.

Senator BEGICH. But if somehow this materializes, you have the capacity to analyze that based on information you are given, if there is enough information?

Mr. ELMENDORF. We can look at some of that. Again, it depends whether—

Senator BEGICH. There are a lot of variables, I guess, in this.

Mr. ELMENDORF. Yes, and whether the macroeconomic analysis is appropriate depends on the scale of the activity. We did an analysis a few years ago of the way that the military manages its arsenals today, which involves some complicated public-private interactions, and we were asked but were not really able to provide an answer to the overall economic effects because there were too many unknowns and we did not have really an ability, we thought, to do the sort of analysis that we would have liked to do.

Senator BEGICH. Very good. I will end there. I do have some questions regarding impacts on natural resource development, obviously oil and gas, and what that could mean as my State and the Chairman's State have a huge growth potential, job potential, and actually revenue stream for the Federal Government. So I will hold that. I will give it to you in writing so we can get a little more detail of what that impacts—

Mr. ELMENDORF. We are happy to speak to that, Senator.

Senator BEGICH. Thank you very much.

Chairman CONRAD. Thank you, Senator.  
Senator PORTMAN.

Senator PORTMAN. Thank you, Mr. Chairman.

Dr. Elmendorf, thank you for your testimony today and all the work you did in relationship to the so-called super committee, which turned out to be not that super, but we really appreciated the work of your team, some of whom are with you today. We did, as do a lot of good analysis that I think can be helpful going forward. As you said in answer to the Chairman's question and the Ranking Member's question, the confidence that people are looking for in this economy would be helped enormously by having a plan, and part of that plan, of course, is what the super committee was not able to arrive at, but what we still have to do. The problem does not go away. It gets worse. And in my view, part of that plan includes tax reform, not just tax increases. And so in the context of that, let me ask you a couple questions about the tax side.

First, with regard to your report this week, which was very helpful, the alternative baseline, as shows that the tax extension basically would save jobs, and you apparently, looking at your testimony, referred to that.

Basically, as I look at it, you are saying that under your Table 2.2, which is the alternative baseline, if you let the tax cuts expire it will play a significant role in having economic growth be reduced substantially. And in essence, when you look at it, because you are projecting unemployment rates of 8.9, 9.2, and 8.3 percent over the next few years, you are saying that with growth about 3 points higher in 2013 and unemployment a full percentage point lower with the tax cuts continuing, the tax cuts really played a lead role in costing about 1.5 million jobs. And, admittedly, there are other factors here. The BCA sequestrations were canceled the Medicare doc fix continues, but the tax cuts are by far the largest part of that.

Can you comment on that? And, also, since you have calculated the growth impacts of keeping the tax cuts—which, again, I think is helpful work—why didn't you incorporate those growth effects into the estimated cost of keeping the tax cuts? Clearly, those growth effects would create feedback revenues and thereby lower the cost of keeping the tax cuts. Did you think about including that as well as the growth impacts of keeping them?

Mr. ELMENDORF. So two quick points, Senator. The first, as from this table, we talk about the economic effects in 2013 and also the economic effects in 2022. You have highlighted the effects in 2013, in which case extending the expiring tax provisions and to implementing all the cuts and spending under current law would provide a boost in 2013. And our estimate of the tax part of that alone is that it would add—extending those provisions would add between half and 2.5 million full-time equivalent jobs in 2013.

But in 2022, the effects are quite different. In 2022, this alternative scenario has significantly lower GNP than in the baseline, and that is because the accumulating debt weighs on the economy more than the lower tax rates boost the economy, in our estimates.

On the matter of why we did not do an estimate of the alternative fiscal scenario that incorporated its economic effects, I think that is basically—the answer to that is, as a practical matter, in

the time we have to put this outlook together, to do an entire second set of budget estimates on a different economic baseline is just too complicated. As you know even better than I perhaps from your experience at OMB, there are an awful lot of accounts in the Federal budget, so we do a very detailed job of looking at each of those as part of our baselines on a single set of economic assumptions. And then we try to illustrate the effects of alternatives, but it is just not possible to do all that original work again on a second set of economic assumptions.

I think you are right to say that in 2013 that stronger economy would itself make the budget a little better off. It is also true, though, that in 2022 the weaker economy will make the budget a little worse off than we are showing here. So it is not the case that we are systematically on one side. It depends what year you look at. It just illustrates the complexity for us of trying to do this sort of analysis on two—the full analysis on two distinct economic baselines.

Senator PORTMAN. Okay. Well, I appreciate that. I do think it is obviously a significant impact. You are talking about 500,000 to 2.5 million jobs in 2013 alone, which is something that we ought to be cognizant of as we look at these tax cuts, and in particular the pro-growth ones. And I would say the 2003 tax cuts might be different in kind. As you talked about earlier, not all spending is equal; not all tax cuts are equal. And that is something that this Committee needs to be looking at as we talk about the budget going forward because it is a huge impact on jobs at a time when, as you say, short term we need a boost. And clearly the tax cuts provide that.

We talked earlier about times at which the spending was at 20 percent and times at which the taxes as a percent of our GDP were at 18 percent, and the Chairman talked about the fact that we have not had a balanced budget when the revenue was a historic level, which is about 18.3 percent of GDP. I would say that in 2007—again, I happened to be at OMB at the time, but that is where we were. And although we had a budget deficit, it was 1.2 percent of the economy, which many economists would view as minimal. So we have had times like that where we have had growth in the economy and were able at 18.3 percent to achieve at least very close to a balanced budget. And the fact is, we had a 5-year plan to get to that balance.

The tax cuts are often blamed for fiscal woes notwithstanding that, and when I look at your analysis, of course, it shows that even if all of the current tax relief, 2001 and 2003, continued, we would get back up to that 18.3-percent level.

On the flip side, the current policy baseline shows us spending at 23.2 percent of GDP by 2022, which is about 3 percent above the historic average. So this notion as to what the issue is, spending or taxes, based on the historic average, obviously the spending is going higher and the taxes are back to the historic level.

So, in a way, the reason the deficit is going to be about 3 percent of GDP higher than average is because spending is about 3 percent of GDP higher than the historic average. And there is no long-term revenue decline at all. It is really all from the rising spending.

So, again, I am supportive of tax reform, but I do think we need to take that into account, and since my time is up, I look forward

to your response to maybe other folks on that issue. But I think through tax reform you can generate more economic growth and, therefore, more revenue, and that would be the better way to go rather than looking at raising taxes at a time of a tough economy.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Whitehouse.

Senator WHITEHOUSE. Thank you very much, Chairman. Dr. Elmendorf, welcome back.

Mr. ELMENDORF. Thank you, Senator.

Senator WHITEHOUSE. First a comment, then a question. The comment is that as we face these issues, the problem of our health care system remains enormous. You and I have discussed beforehand the scoring problems of addressing delivery system reform, and I appreciate and I understand those. I just hope that as you, as an important voice in this debate, go around and talk about this, that you do not become the captive of your methodology and avoid discussing the potential benefits to our economy of delivery system reform simply because it is not quantifiable by the metrics of your organization.

I think that we have two separate questions here. One is what you can score, and the other is what is the right thing to do. And I hope that you will point out as often as you can that solving the excessive cost in our health care system by improving the quality of care is a very good thing to do, even if OMB cannot score it—CBO cannot—

Mr. ELMENDORF. Or CBO.

Senator WHITEHOUSE. CBO cannot score it.

Mr. ELMENDORF. Yes, Senator, of course, there is a tremendous distinction between things that we estimate and the effects we estimate and the set of issues that you and other of our elected leaders should take into account in making decisions. I think it is a universal view among analysts of the U.S. health care system that improvements in the delivery of health care are critical to our getting greater value for our dollar. And I would certainly not speak against that point at all.

The harder question for us which specific sorts of Government policies that are brought to us to analyze would have what effects on the delivery system, and those are—and we do a lot of work, as to try to learn all we can to make the best estimates that we can, but it is a very uncertain business.

As we just released an issue brief with two backup working papers reviewing some of the recent Medicare demonstration projects on coordinating the delivery of care and on paying providers not just for the quantity of services but paying them for doing a good job. So we are studying that literature very carefully and talking with practitioners all the time.

Senator WHITEHOUSE. Let me switch to a different topic, which is the so-called Buffett Rule. The President spoke about it in his State of the Union. I have been working on a statute, a bill, for a while now that we have just filed. There is obviously a direct revenue effect when, to use one of the examples, the 400 highest-income earners in the country who earned on average over a quarter of a billion dollars each during that reported year turned out to

have paid net 18.2 percent on average in total Federal taxes. And, you look at what middle-income people pay, and it is very often higher than that. So there is an upside down quality for certain people in our supposedly progressive Tax Code, and when you bring them up closer to the nominal level with a minimum, the way the Buffett Rule would, obviously that will create additional revenues for the Government that can be used to address the deficit and other issues. We have a request in to the Joint

Committee on Taxation right now on that, and we will find out what that number is.

The argument against it is that the folks who are involved in these hedge funds and so forth are such magnificent job creators that we should indulge the favored treatment in the Tax Code in favor of that job creation that they create. I am wondering if that is an issue that you look at, if there is an offset of some kind that is appropriate to the revenues based on diminished job creation when folks like that have to pay a 30-percent instead of a 15-or an 18-or a 14-percent or, I guess in Mr. Buffett's case one year, an 11-percent tax rate. How do you evaluate those two priorities? And what kind of an offset should we be thinking about in terms of diminished job growth when these so-called job creators are no longer treated so munificently under the Tax Code?

Mr. ELMENDORF. Senator, I think we would be very hard pressed to provide any analysis of the effect of a tax change as narrowly targeted as the one that you seem to be discussing. The evidence that economists have collected on the effects of changes in tax rates and other features of the Tax Code and people's behavior generally involves fairly broad swaths of the population. In an average data set, you do not get a lot of people who are in the top 400 in the country.

So I think as the tax policy focuses more and more in your example on a smaller and smaller group, then our ability to analyze the economic effects of that become increasingly attenuated. So I do not know what we could do on that topic at all.

Senator WHITEHOUSE. As a practical matter, does it make a lot of sense to think that somebody who was making \$270 million a year, which was the average number in the 400 for the last reported year, would significantly change their behavior because their tax rate moved from 18 to 30 percent?

Mr. ELMENDORF. I do not know; I just do not know, Senator. I mean, what is often noted is that some people have a lot of flexibility in how they arrange their financial affairs so that taxable income can be more sensitive than underlying work behavior or saving behavior. But it also means it is hard to disentangle from tax return data how much of the changes that one might see reflect underlying economic behavior versus accounting changes. I do not envy our colleagues of the staff of the Joint

Committee on Taxation to try to estimate the revenue effects, and I do not know what we can do beyond that. I am sorry.

Senator WHITEHOUSE. Thank you, Chairman. Thank you, Doctor. Chairman CONRAD. Thank you, Senator.

Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman. I would yield. I believe Senator Thune is next and then Senator Ayotte.

Chairman CONRAD. I thank Senator Sessions.

Senator THUNE.

Senator THUNE. Thank you, Mr. Chairman, and thank you, Mr. Elmendorf, for being with us today.

I want to ask you some questions about what is perhaps the biggest news on the health care front, and that is the CBO decision to remove the CLASS program from the January 2012 baseline. Despite that development, there was no mention of CLASS in your testimony, and as in the final cost estimate of the health care legislation, which was issued March 20, 2010, CBO projected that CLASS would save \$70 billion in its first decade. Those savings represented nearly 60 percent of the total and 75 percent of the on-budget deficit reduction shown in CBO's estimate of the health care law over the 10-year window.

CBO's estimate of CLASS in subsequent baseline updates did not take into account the substantial risk that the program would be insolvent and workable, even though a significant amount of evidence suggested that that was the likely outcome. And as recently as the last baseline update in August of 2011, you stood by CBO's original CLASS estimate; that is that in August you only assumed that the program's implementation would be delayed by about a year.

On September 22nd, the CLASS actuary indicated that the CLASS office at HHS was closing. On October 14th, the Secretary of HHS, Kathleen Sebelius, officially notified Congress that there was no viable path forward to implement the CLASS program. And then on October 17th, CBO responded to the administration's announcement by indicating that it would remove CLASS from its baseline in January.

My question is: Why did CBO's estimate of CLASS during the health care debate fail to account for the significant risk that the program could not be made solvent or workable?

Mr. ELMENDORF. So, Senator, I respectfully disagree with the premise of the question. The estimate that we made for the CLASS program, and for all the pieces of the health care legislation, recognized that there was substantial uncertainty. And in the multiple letters that we wrote about the CLASS program over the course of its evolution into law, we emphasized the uncertainty around that.

The challenge for us, when faced with uncertainty, is to try to determine what a reasonable middle point is in the range of possible outcomes. We recognized there was some risk the program would never get off the ground. There was some chance the program would get off the ground and would later crumble. There was some chance the program would get off the ground and would not crumble.

And so for us to have actually said in our estimate that the effect would be zero on the budget, we would have had to have great confidence that the program not only would ultimately fail but that it would be recognized before it started that it would fail. And I do not think that actually was the middle of the distribution of possible outcomes.

Now, obviously, after the fact, it was not a good estimate. After the fact, it turned out that the thing could not be made viable. And

I wish we had known that going in, but I do not think it is actually reasonable to say that we should have known that.

For example, the Office of the Actuary at CMS, who also spoke about the—Rick Foster spoke about his concerns about the viability of the program, but their estimate of the effects of the legislation showed about \$40 billion of net receipts for the Government in the first decade from the CLASS program. That is less than our seventy-something. So they were closer to the ultimate answer of zero. But they did not put down zero at that time either because—I do not know. I have not talked with Rick about this. I do not want to put words in his mouth. But my guess would be that they, like we, were not sure what was going to happen. And so since zero was sort of one end of the possible distribution over the first decade, that was not the middle of the distribution.

Also, as we are very clear in these letters to emphasize that the program would turn around later in time, and that if one looked over a longer time horizon, it would ultimately become—even if it were working in the sense in which it was intended to work, it would ultimately become a drag on the budget. And we emphasized that in the letters that we wrote to a number of your colleagues when that process was going on.

Senator THUNE. What was the evidence that CBO used in determining its key assumptions in designing the CLASS model? Because I understand what you are saying about, of course, in the early years when you are getting premium income in, you are going to show positive, perhaps, cash flow. But it was abundantly clear from the statements of the Actuary that when you got into the second decade and beyond, this thing was a sure loser. And he made that very clear. He said, “In 36 years of actuarial experience, I cannot come to any other conclusion but that this thing is going to fail.” That is what Foster said at the time.

And so, the score, because of the front-loading of this, I understand, how you came up with the score. But it seems to me at least that there should have been some suggestion to the Congress, at least, that this thing was likely to fail. That is what the Actuary was saying. So what were your assumptions in determining—

Mr. ELMENDORF. Again, Senator, I do not have them in hand, but I think if you go back to the letters that we wrote to a number of Senators over the course of that period, we deliberately emphasized that the cash flow of the program in the first decade was not representative of what it would be in subsequent decades, that it would, in fact, turn around. We took some pains to explain why that was the case, even in a program that was actuarially working, because, as you say, the money comes in up front and is paid out later. So we took some pains to emphasize that point.

When we constructed the estimate, we talked with outside—we have some expertise in long-term care issues a little, but we also talked a great deal with outside actuaries and other experts. I think all of them raised concerns that it might not work. But as we talked with people, we did not get a—I think we had very few people who were convinced it would be so obvious it would not work that it would never be started and I think a fair number who thought it would be started but then would ultimately fail. So we had a range of views. And, again, we tried in the writing we did

to explain that this was a very uncertain part of what we were doing.

In retrospect, it was not a good estimate. I am not trying to—I am not saying we had the right number. Obviously we did not. But I do not think it is so obvious that we should have known that much better then. And, again, I emphasize that the Actuary—not to hold out—not to try to pull him in with us, necessarily, but just to say that for all the skepticism that Rick Foster expressed—and he did that clearly—they themselves did not view zero, apparently, as the best middle-ground estimate to provide.

Do I wish that we had known more then? Yes, no doubt. I do not take lightly projections of ours that turn out to be wrong. But I also think that it was not so obvious at the time we were making that estimate that the program would never be launched.

Senator THUNE. Good. I see my time has expired. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Could I just say on this point to my colleague, in the original iteration of the CLASS Act, I called it a “Ponzi scheme.” I think the Senator quoted me on the floor.

Senator SESSIONS. More than once.

[Laughter.]

Chairman CONRAD. I remember quite often those words coming up. And part of my analysis was based on CBO analysis and the Actuary’s analysis that told me in the early years it was cash flow positive because premiums come in, but that that worm turned, especially when you got to the second 10 years. It was very clear to me that it would not work.

But, I mean, I must say part of my analysis was based on what CBO provided us, I think a number of us, in writing, acknowledging, yes, you get money on the front end, but then that worm turns, and the work of the Actuary.

Senator SESSIONS. Mr. Chairman, I congratulate you and thank you for that courageous statement, actually. I think it was an important thing for you to say.

Also, my prior colleague here, Judd Gregg, got in language that required the Secretary to certify that it would be sound over a long period of time, and she could not certify it. So hopefully we have avoided this result.

I would just say one thing, and Mr. Elmendorf knows this. There are a lot of very, very skilled people in this town that know how to read your reports, and it, taken out of context or improperly, allowed the debate to continue on the floor of the Senate and the President to assert that this was a program that was going to make money for the Government. And that was not accurate.

Senator Thune led the battle on it to try to point out that it was not going to make money for the Government, but that surplus that CBO scored was used to reduce the costs of the President’s plan. In the short run, maybe it would have if it had been implemented, but in the long run it would have been a cost. We do need to figure out how to use your scores more objectively.

Thank you.

Mr. ELMENDORF. We work hard to try to explain ourselves and explain our numbers in a way that makes the most possible people understand them and the fewest possible people misuse them. But

as you know—and I do not think that we always get that language just right, but we work very hard at it. And we are at least as bothered as anyone else if we think that numbers we have done and an analysis we have done are being used out of context to convey things that we have not said.

Senator THUNE. Mr. Chairman, I have a bill to repeal that, so I am happy to have you on board as a cosponsor, if you would like.

Chairman CONRAD. You know, I am always interested in the legislative offerings of my colleague from South Dakota. At some point we are going to have a hearing on the history of North and South Dakota before this Committee.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Dr. Elmendorf, you essentially lay out these two scenarios in your testimony:

First, the Congress does nothing to change current law, the Bush tax cuts sunset, AMT patch collapses, and the Budget Control Act's in effect spending cuts kick in. Bad for the economy, good for the deficit is essentially where you go.

The second one is your alternative scenario: Congress extends the Bush tax cuts and the AMT patch, while it blocks most of the spending cuts required by the Budget Control Act. Something like this, according to your analysis, makes the deficit much worse, but it is better for the economy.

So that leaves us with these two scenarios that are singularly unappealing and probably compounded by the fact that if the Congress does nothing, you have this kind of meltdown in the lame-duck session of 2012, much like the lame-duck session of 2010. So it will not surprise you I want to ask you about the third scenario and pick up on Senator Portman's point with respect to tax reform.

On this, I understood your answer, and respect it, that you could not do a full kind of quantitative analysis of a third approach. So I want to start by picking up on statements you have made that are on the public record that ought to be encouraging for those of us in this kind of third space where we would like to have pro-growth of tax reform.

For example, I was very pleased that in the discussion that came up in connection with the super committee that you said it was possible to write a pro-growth and progressive tax reform that would generate revenue for the Government. You were asked that at the super committee. Again, absent the details, that was something that was useful for those of us that have tried to constantly come back to this third path between the sort of parade of horrors.

So let us pick up on that. Are there any reasons, for example, that you can give us based on the analyses that you have done thus far that would suggest that pro-growth tax reform would be a problem? You and I have talked about the outcome in 1986 when a big group of liberal Democrats and Ronald Reagan got together and we created 6.3 million new jobs in 2 years.

So let me steer clear of you having to give an quantitative analysis of a third path. Let me note the fact you said something that was pretty encouraging to tax reformers in the context of the super committee where you said it could actually score revenue, a view

that I share. Are there any factors that you know of based on the work you have done thus far that would suggest that the kind of pro-growth tax reform where you clean out the special interests breaks, hold down rates for everybody, and keep progressivity, that that would be problematic if we can muster the support for this third kind of path?

Mr. ELMENDORF. So, of course, depending on the specifics, Senator, I think analysts would widely agree that reform of the Tax Code that broadened the base and brought down rates would be a positive force for economic growth, both in the short term and over a longer period.

Senator WYDEN. And with respect to any kind of warning signals—I mean, it would seem to me, for example, precipitous action—Chairman Conrad and I have talked about this. If you had poorly drafted transition rules, for example, as part of a tax reform, and Chairman Baucus is certainly going to be very sensitive to this, as would Senator Hatch. I mean, I cannot see any kind of warning lights other than those kinds of issues which I think there would be a lot of sensitivity on both sides of the aisle. Any other kind of warning lights? And, again, we respect you the absence of being able to do a quantitative analysis, like what you said in the super committee. Any warning lights?

Mr. ELMENDORF. Well, again, so it is not just the quantitative analysis. Even the qualitative statement does depend on the specifics, as I said carefully at the beginning of my last sentence. But I think in general it is quite possible to design a reform of the Tax Code that would have the characteristics of broadening the base and lowering rates with appropriate transition rules. That would make the economy stronger. It is also possible to do it badly and end up making the economy worse off. But your presumption seemed to be that it would be done in a sensible fashion.

Senator WYDEN. Well, my hope is that you get asked to do the quantitative analysis of this third path sooner rather than later, because I think this has been very helpful today to have you lay out the two alternatives, both of which should strike any reasonable person, regardless of their political views, as unacceptable for the country, unacceptable; and particularly given the challenges in Europe, I mean, these two paths are bad news for America. And there is a path, and I have been encouraged about what have had to say in the past, and I hope you are going to get asked for that quantitative analysis by people whose pay grade is above mine, because I think history and the psychology of the country seeing something big and bipartisan—and, by the way, I think Senator Whitehouse has made a number of good points, ironically, with respect to the Buffett Rule, I was struck—in talking about tax reform, Senator Coats and I have a top rate which is lower than the rate—excuse me, that is higher than the rate that Senator Whitehouse has been talking about. So there are plenty of opportunities here for some common ground, and I look forward to continuing the discussion.

Thank you, Mr. Chairman.

Chairman CONRAD. I want to just take this moment to recognize once again the remarkable amount of serious work that Senator Wyden has produced without the benefit of a committee chairman-

ship on fundamental tax reform and on health care reform. And I just want to thank him for it. You know, I think it is an enormous contribution.

Senator Sessions.

Senator SESSIONS. Senator Ayotte. And while she is preparing, I would join in that. It is a tremendous amount of effort that it takes, and, Senator Wyden, I appreciate your leadership. And all of us in the Senate are watching your work, and we appreciate it.

Chairman CONRAD. Senator Ayotte is recognized.

Senator AYOTTE. Thank you, Mr. Chairman. Thank you, Senator Sessions.

Dr. Elmendorf, I understand that you testified before the House committee yesterday that we can get to 2013 without raising the debt ceiling again or without additional extraordinary measures. So my question to you is this: We are at a point where we have—the President has requested and the Congress has allowed the debt ceiling to go to \$16.4 trillion. Our total debt right now is about \$15.3 trillion and surpasses the size of our economy. It is a huge number.

You have issued this estimate that we will not have to have another increase of the debt ceiling before 2013, and I simply have this question for you: What could further balloon our debt? And what keeps you awake at night when it comes to the issues you are most worried about in terms of having our debt get out of control and also further increasing in a way that you have not been able to estimate?

Mr. ELMENDORF. So, Senator, what I said yesterday is that we think, given our current projections, that the Government can get to 2013 without needing to raise the debt ceiling. I also emphasized a great deal of uncertainty about what will happen in the economy and tax collections and spending over the coming year, as well as, of course, actions the Congress may take that may lead to additional Government borrowing. So nobody should think that that estimate is somewhat cast in stone. It is at the very least conditional on current law and on our current economic outlook.

A lot of things keep me awake at night worrying about the State of the Federal budget. You are paying me partly to do that. I think a particular risk over the coming decade is that interest rates will rise further and more sharply than we have in the projection. I do not think the risk on interest rates is one-sided. Our projection of interest rates over the second half of the decade is actually well above the interest rates that are implicit in the current prices of Treasury securities being traded in financial markets. So there is downside risk as well, but I worry about the chance that creditors or potential creditors of the United States Government will become concerned about the trajectory of the debt and concerned about whether policymakers are willing and able to confront the challenges and change course. And I think when you see other countries that have encountered fiscal crises, it is not just that something special happens in the numbers, although sometimes that is the case, but also it can be because investors' perception of the ability of a government to manage its finances can turn very rapidly and in ways that are very hard to predict.

Beyond that, the budget projection we have, under either of the scenarios for policy choices, could be way off because the economy could rebound more quickly than we think. This has already been a very long downturn by historical standards. Progress is being made, we think, in clearing out some of the problems that have been hanging over the economy. The economy could grow more rapidly. It is also true, though, that in economies that have suffered from financial crises of the sort that ours did, some countries took many more years to finally climb out of the hole their economies fell into than we have in this projection. So there are uncertainties on both sides.

Senator AYOTTE. Can you help me in terms of when we talk about the rise in interest rates, just to give us a sense of a number? So let us say the interest rates increase 1 percent. What does it do in terms of what we have to pay back? You know, and I understand this is an estimate, but if you can give me a sense, just so people in the public understand. There is an urgency to us addressing our debt because when the interest rates rise, what we have to pay back is so much greater, and we have scuffles around here—last March, we had a scuffle around here over \$60 billion in reductions and just 1 percent in increase in interest rates. If you can give us a sense of that, I think it puts in perspective that our scuffles are really minor compared to the issue we have to address.

Mr. ELMENDORF. So we do, in fact, show in the outlook a table of how certain economic changes might affect the budget, and our estimate is that if interest rates were 1 percentage point higher throughout the coming decade, that would add nearly \$1 trillion to the cumulative deficit over the decade.

Senator AYOTTE. It really puts it into perspective when we are fighting over cutting, reducing spending by \$60 billion, that we have to do a lot better around here in terms of the decisions that we have to make, and—

Chairman CONRAD. Senator Ayotte, might I just interrupt, and not on your time, to ask the Director to repeat that? Because I think the question you have asked is so important that that message be understood by those listening, our colleagues, staffs, and people who might be listening via television. If you would repeat the point.

Mr. ELMENDORF. So our estimates are that if the Treasury interest rates were 1 percentage point higher throughout the coming decade, that would add about \$1 trillion to the cumulative deficit over the decade.

Senator AYOTTE. It is really staggering, and it points out the urgency of us going forward with a debt reduction, a bipartisan debt reduction plan that addresses where we are going and the sustainability of our debt. And I have been a supporter of the efforts—and I know the Chairman has been as well—to go big and really address this issue head on.

I want to ask one other quick question, which is: What is your view on the impact of what is happening in Europe? And how could that impact here in terms of our fiscal health?

Mr. ELMENDORF. So the situation in Europe has—there are some cross-currents on how it affects our economy. If European econo-

mies suffer from a worse recession than we are projecting, that will reduce their demand for our goods and services, reduce our exports.

It is also true that if their financial system suffers from yet larger problems, that could affect the health of financial institutions in the United States and thereby affect the flow of credit to private borrowers, businesses and households, in the United States.

At the same time, though, the concerns of investors about the situation in Europe has so far led them to invest more in the United States and in U.S. Treasury securities. So one of the factors that has pushed down the interest rates the U.S. Treasury is now paying is actually fear of what is happening in Europe, and investors' desire to come to a place that they think is in better shape.

So if the situation in Europe were to worsen, there would be some important factors that could be very bad for our economy. There are also some channels through which in a perverse sort of way we would be better off because we would be viewed as being relatively a better investment than Europe would be.

I think we do worry about the risks to the U.S. economy of a worse outcome in Europe. I think that is a topic we have discussed a number of times on our Panel of Economic Advisers. We have built into this projection a shallow recession in Europe, which is consistent, I think, with the latest consensus forecasts. We did not find a way to quantify a particular alternative European scenario, and part of that is that we are very unsure what the financial connections are, and just how a particular sort of financial debacle in Europe would reverberate on U.S. financial institutions is a very hard thing for us to know.

Senator AYOTTE. Thank you.

Chairman CONRAD. I thank the Senator

Senator Sessions? And I want to thank Senator Sessions for his courtesy. Knowing that I need to leave here at noon, I appreciate very much how he held off in his round in case we needed the time. I appreciate that.

Senator SESSIONS. Thank you, Mr. Chairman, and, Mr. Elmen-dorf, I appreciate CBO's work. I think you do very valuable work. You missed the GDP this year. I think you were at 2.7 predicting it, and it came in at 1.7. But Mr. Zandi at the great Moody's was at 4 percent, and it came in at 1.7, so I give you credit for being a bit more accurate than some of the other experts.

I would just say that all of us need to understand that the challenges we face with regard to debt and the unsustainable fiscal course we are on is that debt creates risk throughout the system and puts us in a more dangerous area if some unexpected shock occurs. Would you agree with that?

Mr. ELMENDORF. Yes, absolutely, Senator.

Senator SESSIONS. Things that you cannot predict, you just cannot predict them, but periodically history shows do happen.

Mr. ELMENDORF. Yes, and that is one of the costs of higher debt that we highlighted in our issue brief, as on the risk of a fiscal crisis.

Senator SESSIONS. So I think we need to get that debt down. We need larger margin between what the maximum debt this Nation can possibly carry and our actual debt level so we are in a position to avoid shock.

You know, you cannot borrow your way out of debt. We are living beyond our means. Bill Gross at PIMCO was quoted recently that we are at a 5-to 15-year period of below-normal growth because of deleveraging, and he says that families will have to use more of their income than they used to in order to pay down their debt rather than consume. The Government has taken on huge amounts of debt, which has to be reduced.

Would you agree that the deleveraging process is going to take many years? And will that deleveraging process pretty inevitably mean that whatever economic growth would have otherwise been if people continues to consume as they had in the past, growth would instead be somewhat lower?

Mr. ELMENDORF. Yes, Senator, we think that the deleveraging process is holding down consumer spending now, and that is part of why the recovery is proceeding slowly.

How long it will go on for is very difficult for us to know. We have a project underway trying to examine the causes of the slow economic recovery, and we are doing that partly just to inform you, but partly to inform ourselves so our future economic forecasts will benefit from a better understanding of just what has been going on in the past few years.

It is difficult to know. As I mentioned to Senator Ayotte, if you across countries that have experienced financial crises, they tend to have very slow recoveries. But they differ a lot in what happens, and they differ partly because of Government policies and partly because of underlying economic conditions. So we are trying to extract lessons from that, but it is a challenge.

Senator SESSIONS. Well, I am worried about it. The Europeans seem to have decided and entered a compact recently that they were going to bring down their spending and their debt. That is the correct approach. But in the U.S. the Presidents approach is to borrow more and spend more so the economy will not get weaker. I think that is a dangerous policy.

On the defense situation, I missed yesterday's, Budget Committee hearing Mr. Chairman, because of the Defense Department's major briefing to the Armed Services Committee, of which I am a member. Because of enactment of the Budget Control Act, the Defense Department is planning to reduce spending by about \$489 billion compared to the levels in the President's 2012 budget request. The President sort of indicated in his State of the Union indirectly that that may be all, that is all they are planning to cut. But if the sequester occurs, that is almost another \$500 billion.

The way we calculate it, Mr. Elmendorf, if I am off—or if you can give an opinion, I would appreciate it. The way we calculate it, the sequester in inflation-adjusted real dollars, would result in about a 20-percent cut to DOD compared to the President's request for 2012-2021. Does that sound correct to you?

Mr. ELMENDORF. So I do not know the precise numbers, Senator. As the Budget Control Act exempted Social Security and Medicaid from the sequester, and in some other programs limited the sequester ability for Medicare. Our estimates are that defense spending would come in about—over the decade would come in about 10 percent—under the sequester relative to what would have been our traditional baseline projection of spending growing with inflation,

I think the gap between that traditional projection and the effects of the sequester is about 10 percent in terms of defense spending over the coming decade.

Senator SESSIONS. It sounds like we were using the President's budget for defense and you are using a baseline number.

Mr. ELMENDORF. That is a complication in considering these costs. We show this in Table 3.5 in the report, so if I have my math wrong—

Senator SESSIONS. If you do that, you probably would show even greater growth—I do not know what you would show in the other programs. But I guess Medicare and Social Security today represent about 48 percent of the total budget. Is that right?

Mr. ELMENDORF. I am not sure. It is very large share. That sounds about right.

Senator SESSIONS. The reason I say that, Mr. Chairman, is that the share of entitlement programs in the budget is growing. But there are other entitlements. There are pension plans. The fastest growing entitlement is food stamps. It has gone from \$20 to \$80 billion in 10 years. That is the fourth largest entitlement program. Some of the Pell grants are entitlement programs. So you put all the entitlements together, it is about close to 60 percent.

I guess from that you would say, would you not, to get this country on a sound fiscal path, we would need to address the entitlement programs?

Mr. ELMENDORF. I think the combination of past policies regarding entitlements and taxes are not sustainable in combination in the future, particularly because, as I emphasized earlier, the aging of the population and rising costs for health care are ballooning the costs of certain Federal programs.

Senator SESSIONS. Not only are we having medical costs going up for Medicare, but more people are coming on the program demanding their benefit that—

Mr. ELMENDORF. And that latter fact is actually especially important over the coming decade. There will be a one-third increase in the number of Social Security beneficiaries and the number of Medicare beneficiaries over the coming decade.

Senator SESSIONS. This is one of these—

Chairman CONRAD. That is not a projection. They have been born.

Mr. ELMENDORF. Well, I cannot be precise, but they are out there, and they—

Chairman CONRAD. They are born. They are alive.

Mr. ELMENDORF. Yes.

Senator SESSIONS. So I guess I would conclude. The matter is that I do think that the Chairman and others who have said it are correct. We will have to address entitlements and discretionary spending. Defense is the only area that is taking substantial cuts at this point, and it cannot sustain, in my opinion, the full sequester. We are going to have to revisit the defense spending sequester without giving up on the total reductions in spending that the sequester called for.

And I would say I do express disappointment that in the State of the Union address the President talked not at all about those huge issues facing our country.

I went over. Thank you.

Chairman CONRAD. Thank you, Director Elmendorf. Thanks to all of the colleagues for participate in an excellent hearing. We have more hearings next week. I hope colleagues will come and participate. We have a lot of discussion that needs to occur in this Committee to see if we cannot find a way to come together.

Again, I thank the Director. The Committee stands in adjournment.

Mr. ELMENDORF. Thank you, Mr. Chairman.

[Whereupon, at 12:05 a.m., the Committee was adjourned.]

**Questions for the record to Dr. Elmendorf from Sen. Ron Wyden (D-Ore.) following the Budget Committee's Feb. 2, 2012 hearing on the Budget and Economic Outlook.**

**Question: While each economy is different, wouldn't it be fair to say that the fiscal policies the US has been pursuing have done a better job of promoting economic growth and job creation than the more austerity oriented policies that many European countries are currently pursuing and if the US were to follow the approach of Europe wouldn't that have negative impacts on economic growth and employment?**

**Answer:** The Congressional Budget Office (CBO) monitors the economic outlook of countries that are major U.S. trading partners in order to construct its projection of the U.S. economy, but CBO has not studied the situations of those countries closely enough to comment on their fiscal policy choices.

In general, the short-run and long-run effects of fiscal policies can differ. In the short term for the United States today, while the economy is relatively weak and economic growth is restrained primarily by a shortfall in demand for goods and services, an increase in federal spending or reduction in taxes would increase the demand for goods and services and thus increase economic output and income even as the policy increases the federal deficit. Over the medium term and long term for the United States, when we expect that economic output will be determined primarily by the supply of labor and capital and the productivity of those inputs, the increase in federal borrowing that would result from increases in federal spending or reductions in taxes would induce a reduction in national saving and investment and thereby decrease output and income.

**Question: I recognize that you can't make policy recommendations, but as an economist, isn't there a sweet spot somewhere between the two scenarios you lay out in your testimony where the economy can continue to grow and create enough jobs to bring down unemployment without adding unnecessarily to the deficit?**

**Answer:** Some policymakers and analysts have advocated near-term reductions in taxes or increases in federal spending to boost output and employment in the next few years. At the same time, many are concerned about the prospect of a further rise in federal debt. There is no inherent contradiction, however, between using fiscal policy to support the economy today, while unemployment is high and many factories and offices are underused, and imposing fiscal restraint some years from now, when output and employment will probably be close to their potential. In November 2011, CBO presented estimates of the economic impact of different policies to promote economic growth and employment in 2012 and 2013.<sup>1</sup>

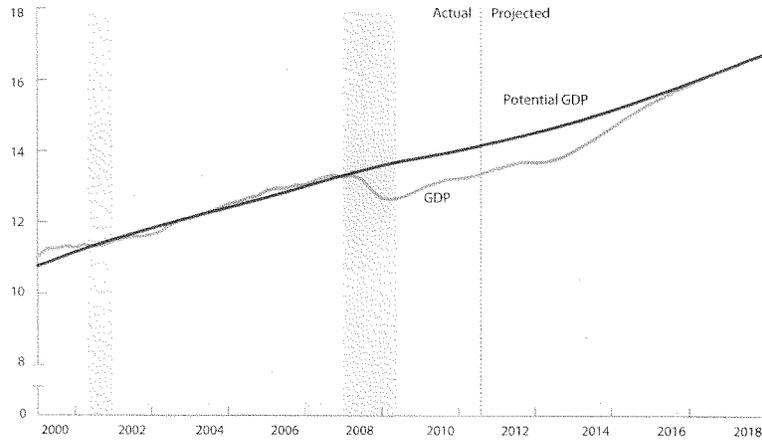
The current challenge for policymakers is that the reductions in taxes and increases in federal spending that would boost demand for goods and services in the short term would also increase government debt, which in turn would reduce the capital stock in the medium term and long term. Moreover, if people believed that policy changes that increased near-term deficits presaged larger deficits in the future and thus that the federal budget outlook had become even bleaker, the

<sup>1</sup> See the Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Budget Committee, *Policies for Increasing Economic Growth and Employment in 2012 and 2013* (November 15, 2011).

economy could be hurt in the near term by a faltering of business and consumer confidence and an increase in interest rates. Therefore, if policymakers wanted to use fiscal policy to provide a short-term economic boost without hindering the economy later, a combination of policies would be required: changes in taxes and spending that would widen the deficit now but reduce it later in the decade.

### Real Gross Domestic Product

(Trillions of 2005 dollars)



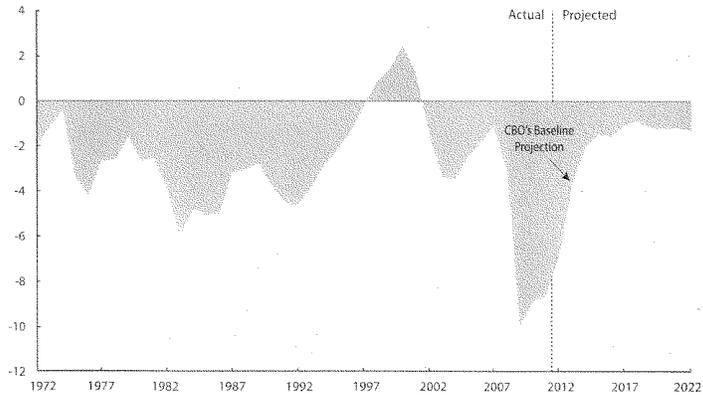
### Unemployment Rate

(Percent)



### Deficits or Surpluses, Historically and As Projected in CBO's Baseline

(Percentage of GDP)



**What Policy Assumptions Underlie the Baseline and the Alternative Fiscal Scenario?**

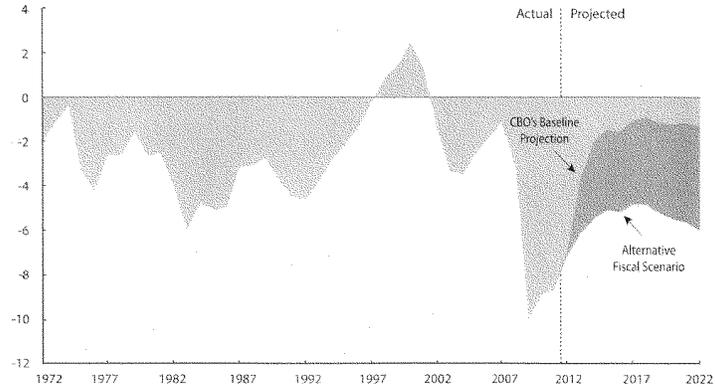
**Baseline Projections: Current law**

**Alternative Fiscal Scenario:**

- All expiring tax provisions (other than the payroll tax reduction) are extended.
- The alternative minimum tax (AMT) is indexed for inflation after 2011.
- Medicare's payment rates for physicians' services are held constant at current level.
- The automatic spending reductions required by the Budget Control Act do not take effect (although the original caps on discretionary appropriations remain in place).

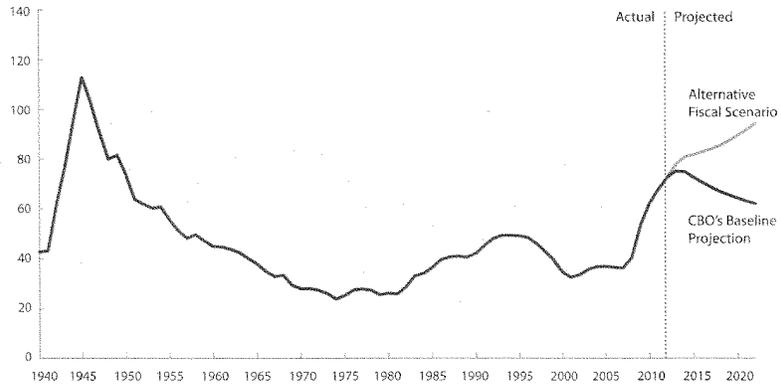
### Deficits or Surpluses, Historically and As Projected in CBO's Baseline and Under an Alternative Fiscal Scenario

(Percentage of GDP)



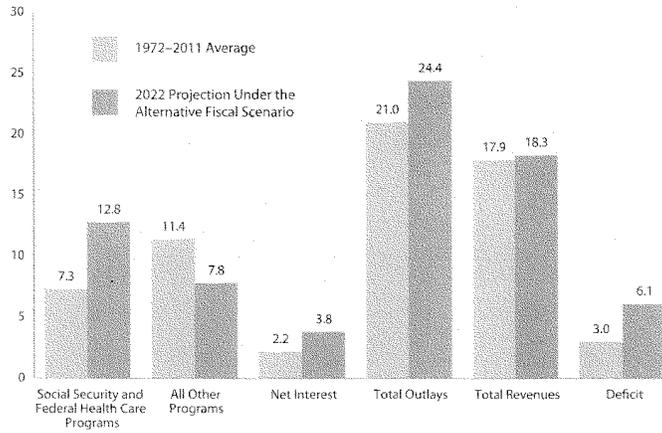
### Federal Debt Held by the Public, Historically and Projected in CBO's Baseline and Under an Alternative Fiscal Scenario

(Percentage of GDP)



**Components of the Federal Budget as Shares of GDP:  
1972-2011 Average and 2022 Projection Under the  
Alternative Fiscal Scenario**

(Percentage of GDP)



# THE OUTLOOK FOR U.S. MONETARY AND FISCAL POLICY

TUESDAY, FEBRUARY 7, 2012

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

The committee met, pursuant to notice, at 10:01 a.m., in Room 608, Dirksen Senate Office Building, Hon. Bill Nelson, presiding.

Present: Senators Nelson, Wyden, Whitehouse, Warner, Merkley, Begich, Sessions, Grassley, Enzi, Cornyn, Thune, Portman, Toomey, Johnson, and Ayotte.

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

Senator NELSON. Good morning. Senator Conrad is in bed with the flu and he has asked me to chair today for him for the first part of the hearing. Senator Sessions, thank you, as the Ranking Member.

We want to welcome the Federal Reserve Chairman, Ben Bernanke, back to this committee. This is the fourth time that you have testified before the committee and we are very, very pleased to have you again. This is timely for your appearance because of the nature of the recovery.

I will, without objection, insert the full remarks of Senator Conrad's opening statement.

Senator NELSON. I am going to turn to the Ranking Member for his statement before mine. Senator Sessions.

## OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Mr. Chairman. I hope Chairman Conrad feels better, I value his leadership in this committee, as I know you do.

Good morning, Chairman Bernanke. I thank you for joining us today. I am eager to hear your thoughts about our financial situation.

The Congressional Budget Office's new outlook confirms that our deficit will top \$1 trillion for the fourth consecutive year. We have never seen anything like that. In just three years, we have accumulated almost \$5 trillion in gross debt, during which time the total number of Americans actually working has decreased by 1.2 million people. So we have fewer people working today than we did 11 years ago. That goes across administrations of both parties.

The deficit we face over the next decade, is even more daunting. Federal spending in real dollars has increased 53 percent in ten years, while real wages for the average American have declined

seven percent. The government is getting bigger and the middle class is getting smaller.

The problem I have, the concern I am wrestling with, is that even our financial experts are often very wrong as to the danger facing the American people and our economy. Yet some in Washington and on Wall Street tell us we should delay reforms and not take action now.

In 2006, as America was on the verge of a massive housing meltdown, now-Secretary Geithner, then President of the New York Federal Reserve, told his colleagues that, quote, "We just do not see troubling signs yet of collateral damage and we are not expecting much." Two months later, he was announcing that, quote, "The fundamentals of the expansion going forward still look good."

Janet Yellen, President of the San Francisco Reserve Bank, was perhaps even more enthusiastic. When Chairman Greenspan left, she beamed, quote, "It is fitting for Chairman Greenspan to leave office with the economy in such solid shape. The situation you are handing off to your successor is a lot like a tennis racket with a gigantic sweet spot."

I also recall in 2001 then-Chairman Greenspan testified before this committee that we were looking at more than a decade of projected surpluses and he wrestled with the question of what we would do after we have completely paid down our debt.

We are not always as good at predicting the future as we would like to be. The minutes show that you were also wrong during some of these periods. Common sense tells us, at least me that more borrowing and more debt will make us weaker, not stronger. As the last financial crisis proves, the future is hard to predict. While we cannot predict when a debt crisis will erupt or what unknown event might set it off, we do know that we are on a collision course with reality. The longer we wait to change that course, to develop a plan for a sensible financial future, the graver the danger becomes.

Yet our Majority Leader has closed the ship's bridge and locked the wheel. He says the Democratic Senate will decline to offer a budget resolution on the floor for the third straight year. Not once has this occurred since the Congressional Budget Act was passed in 1974.

So I am glad that Chairman Conrad has indicated he will mark up a budget in committee, but the mark-up will be a doomed exercise if your own Majority Leader, decrees that the budget process will be shut down. Majority Leader Reid has effectively declared a Senate Democrat budget and the President's budget dead on arrival. If we do not have a different approach, then the majority party is failing in the fundamental requirement of leadership and basically asks that their leadership be taken from them.

The President's budget submission on Monday will also be a defining test. Either the President will rise to the occasion or he will again shirk his duties and accelerate our dangerous debt course. The choice is his. I find it beyond imagining that the President at this critical time in our nation's economic life will not lay out a serious budget plan for a future that will get us off this unsustainable debt path, a path to decline. But he did not even mention this in his third State of the Union Address, the danger

of the debt, what his Chairman of the Joint Chiefs, Admiral Mullen, called the greatest threat to our national security.

Alice Rivlin in Kiplinger's recently was very critical of the President's lack of leadership. Real change will not occur without the leadership of the President. And he has not only not led, but he attacked those like brilliant Congressman Paul Ryan who has led, or tried to lead. We must hope the President's proposal, his budget, will lay out a plan to change our unsustainable debt course. Based on history, I am not optimistic.

So we face a difficult challenge. I am hopeful that the President's budget will do what a budget should do, lay out a sound course for America's financial future. It has not yet. Last year's budget did not do that. But I hope he will this year but I am not confident.

Mr. Chairman, thank you for letting me share those remarks. We, Chairman Bernanke, value your opinion and you can help us work our way through the most dangerous systemic debt challenge I believe the nation has ever faced. Thank you.

Senator NELSON. Thank you, Senator Sessions.

Senator Sessions, I am optimistic. You said you are not optimistic. I am optimistic.

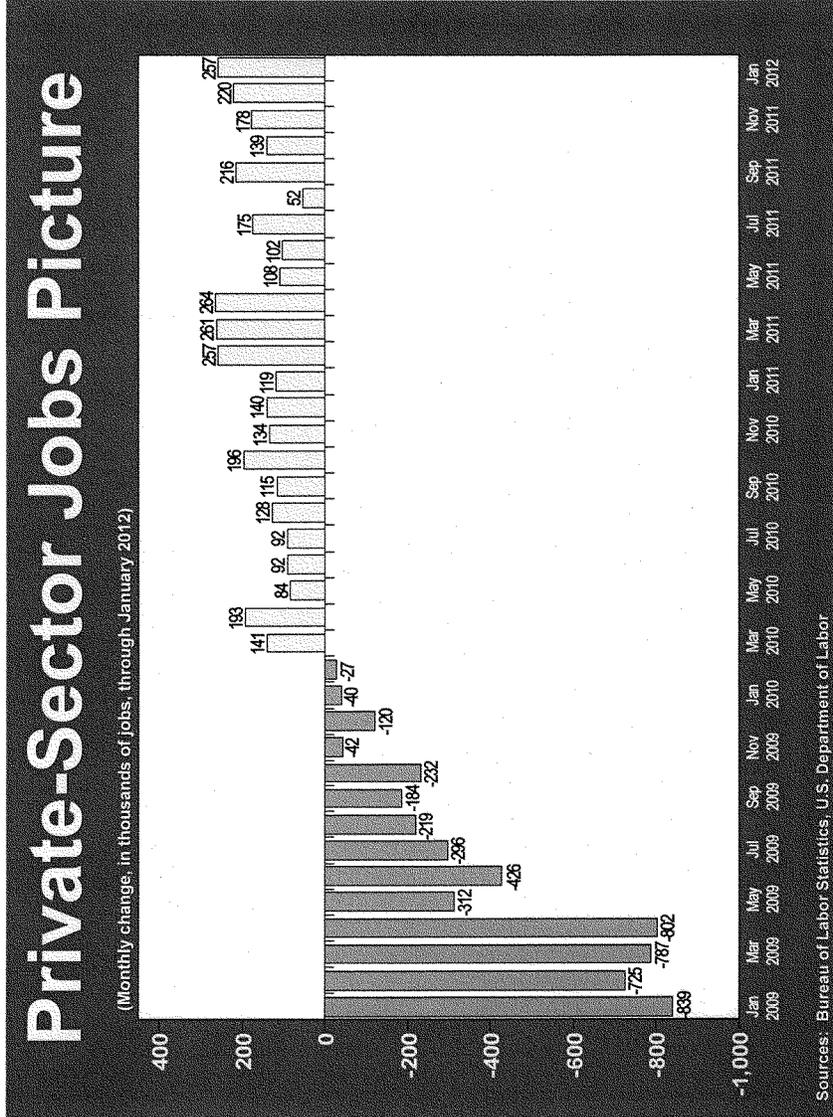
Senator SESSIONS. About the budget the President submitted?

Senator NELSON. About the overall economy.

Senator SESSIONS. Oh, okay. That is different. I said I was not optimistic he would lay out a plan to get us off an unsustainable debt course.

#### **OPENING STATEMENT OF SENATOR NELSON**

Senator NELSON. Well, I am optimistic and the President's budget that is going to come out, I think, is going to reflect the overall optimism that is rising in the country with regard to the economy, and I think it is all summed up in this chart.



This is private sector jobs, and you can see for about a year and a half, there were massive job losses in the private sector in each of the months. Of course, this only starts in January of 2009 on this chart. You can take it back even further into 2008 and that is when the crisis started, in the fall of 2008. And this tells us along about March of 2010, the jobs picture dramatically changed and there is the trend line, to the point at which it is now 257,000 in this past month on job increases. That, to me, shows a trend that is, I think, reflecting the optimism that is starting to bubble up across America.

Mr. Chairman Bernanke, your job has been very tough over the last few years with the consumer confidence that has been shaken, the events in Japan and Europe threatening to derail our economy, and, of course, the partisan bickering that we have seen on the national stage and even on State stages from time to time. And I truly believe that when the history of this period is written that you, sir, are going to be remembered as a critical figure because your role has been so prominent in helping avert the complete collapse of our financial system. And for that, we are enormously grateful.

We continue to have major fiscal challenges facing the country, a long-term budget crisis brought on primarily from the rising cost of health care, an outdated tax system, and years of political expedience and a near-term economic challenge of a slow recovery, as the chart indicates, from that 2008 financial crisis which, if it had not been for, by the way, the bipartisan cooperation after September of 2008, when we nearly went into a financial death spiral, and the cooperation of an outgoing Republican administration with the incoming Democratic administration, the two of them working together to reverse that death spiral.

Now, CBO's report last week shed some new light on the long-term budget challenge. Under their estimates, if we continue on our current path without letting current law come into effect, gross Federal debt is expected to reach 103 percent of GDP this year and will then rise to 120 percent of GDP by 2022. As for the economy, it is clear that we have come a long way from the depths of 2008 and 2009 and the recovery has recently shown these signs of the upward trend of strengthening. But it is a long and difficult road back.

This is a frustratingly slow pace of the recovery. The economists have testified here that they have found that recessions found by or accompanied by a severe financial crisis like we have had, and in particular a crisis steeped in the housing sector, which is ours, tend to last longer and require a greater amount of recovery efforts than typical recessions.

And so I think not only that this chart has shown the positive signs that we are seeing, we are also seeing the unemployment rate coming down. We have seen ten consecutive quarters of real GDP growth. Consumer confidence is showing signs of improvement. U.S. auto manufacturers are returning to profitability. And State revenues are showing signs of improvement. It is amazing to me how a two-minute commercial during the Super Bowl can generate such political controversy when it is, in fact, celebrating the fact of the recovery of Detroit and the auto manufacturers.

So in all of these good signs, we cannot become complacent. There is serious risk. Certainly, unemployment remains too high. Housing continues to pose a threat. And time after time on things that have been tried, they have only been partially successful, at best. Too many homes are still in foreclosure or underwater. Obviously, the political deadlock that we have here, that many of us on this dais have tried to break by coming together in a bipartisan approach, in what a lot of us urge the super committee to do, and by the way, Senator Sessions, there was a Budget Act and that was in the Budget Control Act and that set the course for ten years of caps and had a disciplined process which was the super committee, which we had desperately hoped would work. But the deadlock was there.

There is an imbalance of budget cuts that could be a drag on this economy. And then, of course, the situation in the Middle East could result in a disruption of oil supplies. The European debt and fiscal crisis. And all of these elements are uncertain elements that could disrupt the recovery.

Two of the most important steps that we could take to shore up the recovery would be to extend the payroll tax cut and the emergency unemployment benefits for the remainder of this year, and then in the process seriously move to redo the tax code and to reform this bloated tax code. And we should also reconsider efforts to rebuild the country's infrastructure.

And so, Mr. Chairman Bernanke, in looking forward, it is clear that we have to pursue policies that both strengthen the near-term economic recovery and address the long-term fiscal imbalance. These policies are not incompatible. In fact, the CBO Director who testified here last week, this is what he said, and I quote. "A policy that widened the deficit for a few years would be beneficial for the economy over that period, especially if it were combined with a plan that would later narrowed deficits relative to the current policy projection. Combining those pieces is important. Having those pieces together would provide the strongest boost to economic activity in the short term." That is CBO Director Elmendorf's words.

And so, Mr. Chairman Bernanke, we want to hear your views and I hope you will speak further about what Director Elmendorf said.

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

Mr. BERNANKE. Thank you very much, Mr. Chairman.

Acting Chairman Nelson, Ranking Member Sessions, and other members of the Committee, I appreciate this opportunity to discuss my views on the economic outlook, monetary policy, and the challenges facing fiscal policymakers.

Over the past 2-1/2 years, the U.S. economy has been gradually recovering from the recent deep recession. While conditions have certainly improved over this period, the pace of the recovery has been frustratingly slow, particularly from the perspective of the millions of workers who remain unemployed or underemployed. Moreover, the sluggish expansion has left the economy vulnerable to shocks. Indeed, last year, supply chain disruptions stemming from the earthquake in Japan, a surge in the prices of oil and other

commodities, and spillovers from the European debt crisis risked derailing the recovery. Fortunately, over the past few months, indicators of spending, production, and job market activity have shown some signs of improvement; and in economic projections just released, Federal Open Market Committee participants indicated that they expect somewhat stronger growth this year than in 2011. The outlook remains uncertain, however, and close monitoring of economic developments will remain necessary.

As is often the case, the ability and willingness of households to spend will be an important determinant of the pace at which the economy expands in coming quarters. Although real consumer spending rose moderately last quarter, households continue to face significant headwinds. Notably, real household income and wealth stagnated in 2011, and access to credit remained tight for many potential borrowers. Consumer sentiment has improved from the summer's depressed levels but remains at levels that are still quite low by historical standards.

Household spending will in turn depend heavily on developments in the labor market. Overall, the jobs situation does appear to have improved modestly over the past year: Private payroll employment increased by about 160,000 jobs per month in 2011—not counting, of course, the first month of this year; the unemployment rate fell by about 1 percentage point; and new claims for unemployment insurance declined somewhat. Nevertheless, as shown by indicators like the rate of unemployment and the ratio of employment to population, we still have a long way to go before the labor market can be said to be operating normally. Particularly troubling is the unusually high level of long-term unemployment: More than 40 percent of the unemployed have been jobless for more than 6 months, roughly double the fraction during the economic expansion of the previous decade.

Uncertain job prospects, along with tight mortgage credit conditions, continue to hold back the demand for housing. Although low interest rates on conventional mortgages and the drop in home prices in recent years have greatly improved the affordability of housing, both residential sales and construction remain depressed. A persistent excess supply of vacant homes, largely stemming from foreclosures, is keeping downward pressure on prices and limiting the demand for new construction.

In contrast to the household sector, the business sector has been a relative bright spot in the current recovery. Manufacturing production has increased 15 percent since its trough, and capital spending by businesses has expanded briskly over the past 2 years, driven in part by the need to replace aging equipment and software. Moreover, many U.S. firms, notably in manufacturing but also in services, have benefited from strong demand from foreign markets over the past few years.

More recently, the pace of growth in business investment has slowed, likely reflecting concerns about both the domestic outlook and developments in Europe. However, there are signs that these concerns are abating somewhat. If business confidence continues to improve, U.S. firms should be well positioned to increase both capital spending and hiring: Larger businesses are still able to obtain credit at historically low interest rates, and corporate balance

sheets are strong. And though many smaller businesses continue to face difficulties in obtaining credit, surveys indicate that credit conditions have begun to improve modestly for those firms as well.

Globally, economic activity appears to be slowing, restrained in part by spillovers from fiscal and financial developments in Europe. The combination of high debt levels and weak growth prospects in a number of European countries has raised significant concerns about their fiscal situations, leading to substantial increases in sovereign borrowing costs, concerns about the health of European banks, and associated reductions in confidence and the availability of credit in the euro area. Resolving these problems will require concerted action on the part of European authorities. They are working hard to address their fiscal and financial challenges. Nonetheless, risks remain that developments in Europe or elsewhere may unfold unfavorably and could worsen economic prospects here at home. We are in frequent contact with European authorities, and we will continue to monitor the situation closely and take every available step to protect the U.S. financial system and our economy.

Let me now turn to a discussion of inflation. As we had anticipated, overall consumer price inflation moderated considerably over the course of 2011. In the first half of the year, a surge in the prices of gasoline and food—along with some pass-through of these higher prices to other goods and services—had pushed consumer inflation higher. Around the same time, supply disruptions associated with the disaster in Japan put upward pressure on motor vehicle prices. As expected, however, the impetus from these influences faded in the second half of the year, leading inflation to decline from an annual rate of about 3-1/2 percent in the first half of 2011 to about 1-1/2 percent in the second half—close to its average pace for the preceding 2 years. In an environment of well-anchored inflation expectations, more stable commodity prices, and substantial slack in labor and product markets, we expect inflation to remain subdued.

Against that backdrop, the FOMC decided at its recent meeting to maintain its highly accommodative stance of monetary policy. In particular, the Committee decided to continue its program to extend the average maturity of its securities holdings, to maintain its existing policy of reinvesting principal payments on its portfolio of securities, and to keep the target range for the Federal funds rate at 0 to 1/4 percent. The Committee now anticipates that economic conditions are likely to warrant exceptionally low levels of the Federal funds rate at least through late 2014.

As part of our ongoing effort to increase the transparency and predictability of monetary policy, following its January meeting the FOMC released a statement intended to provide greater clarity about the Committee's longer-term goals and policy strategy. The statement begins by emphasizing the Federal Reserve's firm commitment to pursue its congressional mandate to foster stable prices and maximum employment. To clarify how it seeks to achieve these objectives, the FOMC stated its collective view that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate;

and it indicated that the central tendency of FOMC participants' current estimates of the longer-run normal rate of unemployment is between 5.2 and 6 percent. The statement noted that these statutory objectives are generally complementary, but when they are not, the Committee will take a balanced approach in its efforts to return both inflation and employment to their desired levels.

In the remainder of my remarks, I would like to briefly discuss the fiscal challenges facing your Committee and the country. The Federal budget deficit widened appreciably with the onset of the recent recession, and it has averaged about 9 percent of GDP over the past 3 fiscal years. This exceptional increase in the deficit has mostly reflected the automatic cyclical response of revenues and spending to a weak economy as well as the fiscal actions taken to ease the recession and aid the recovery. As the economy continues to expand and stimulus policies are phased out, the budget deficit should narrow over the next few years.

Unfortunately, even after economic conditions have returned to normal, the Nation will still face a sizable structural budget gap if current budget policies continue. Using information from the recent budget outlook by the CBO, one can construct a projection for the Federal deficit assuming that most expiring tax provisions are extended and that Medicare's physician payment rates are held at their current level. Under these assumptions, the budget deficit would be more than 4 percent of GDP in fiscal year 2017, assuming that the economy is then close to full employment. Of even greater concern is that longer-run projections, based on plausible assumptions about the evolution of the economy and the budget under current policies, show the structural budget gap increasing significantly further over time and the ratio of outstanding Federal debt to GDP rising rapidly. This dynamic is clearly unsustainable.

These structural fiscal imbalances did not emerge overnight. To a significant extent, they are the result of an aging population and, especially, fast-rising health care costs, both of which have been predicted for decades. Notably, the CBO projects that net Federal outlays for health care entitlements—which were about 5 percent of GDP in fiscal year 2011—could rise to more than 9 percent of GDP by 2035. Although we have been warned about such developments for many years, the time when projections become reality is coming closer.

Having a large and increasing level of Government debt relative to national income runs the risk of serious economic consequences. Over the longer term, the current trajectory of Federal debt threatens to crowd out private capital formation and thus reduce productivity growth. To the extent that increasing debt is financed by borrowing from abroad, a growing share of our future income would be devoted to interest payments on foreign-held Federal debt. High levels of debt also impair the ability of policymakers to respond effectively to future economic shocks and other adverse events.

Even the prospect of unsustainable deficits has costs, including an increased possibility of a sudden fiscal crisis. As we have seen in a number of countries recently, interest rates can soar quickly if investors lose confidence in the ability of a government to manage its fiscal policy. Although historical experience and economic theory do not indicate the exact threshold at which the perceived

risks associated with the U.S. public debt would increase markedly, we can be sure that, without corrective action, our fiscal trajectory will move the Nation ever closer to that point.

To achieve economic and financial stability, U.S. fiscal policy must be placed on a sustainable path that ensures that debt relative to national income is at least stable or, preferably, declining over time. Attaining this goal should be a top priority.

Even as fiscal policymakers address the urgent issue of fiscal sustainability, they should take care not to unnecessarily impede the current economic recovery. Fortunately, the two goals of achieving long-term fiscal sustainability and avoiding additional fiscal headwinds for the current recovery are fully compatible—indeed, they are mutually reinforcing. On the one hand, a more robust recovery will lead to lower deficits and debt in coming years. On the other hand, a plan that clearly and credibly puts fiscal policy on a path to sustainability could help keep longer-term interest rates low and improve household and business confidence, thereby supporting improved economic performance today.

Fiscal policymakers can also promote stronger economic performance in the medium term through the careful design of tax policies and spending programs. To the fullest extent possible, our Nation's tax and spending policies should increase incentives to work and save, encourage investments in the skills of our workforce, stimulate private capital formation, promote research and development, and provide necessary public infrastructure. Although we cannot expect our economy to grow its way out of its fiscal imbalances, a more productive economy will ease the tradeoffs that we face and increase the likelihood that we leave a healthy economy to our children and grandchildren.

Thank you, sir.

[The prepared statement of Mr. Bernanke follows:]

For release on delivery  
10:00 a.m. EST  
February 7, 2012

**The Economic Outlook and the Federal Budget Situation**

Remarks by

**Ben S. Bernanke**

**Chairman**

**Board of Governors of the Federal Reserve System**

before the

**Committee on the Budget**

**United States Senate**

**February 7, 2012**

Chairman Conrad, Ranking Member Sessions, and other members of the Committee, I appreciate this opportunity to discuss my views on the economic outlook, monetary policy, and the challenges facing federal fiscal policymakers.

**The Economic Outlook**

Over the past two and a half years, the U.S. economy has been gradually recovering from the recent deep recession. While conditions have certainly improved over this period, the pace of the recovery has been frustratingly slow, particularly from the perspective of the millions of workers who remain unemployed or underemployed. Moreover, the sluggish expansion has left the economy vulnerable to shocks. Indeed, last year, supply chain disruptions stemming from the earthquake in Japan, a surge in the prices of oil and other commodities, and spillovers from the European debt crisis risked derailing the recovery. Fortunately, over the past few months, indicators of spending, production, and job market activity have shown some signs of improvement; and, in economic projections just released, Federal Open Market Committee (FOMC) participants indicated that they expect somewhat stronger growth this year than in 2011. The outlook remains uncertain, however, and close monitoring of economic developments will remain necessary.

As is often the case, the ability and willingness of households to spend will be an important determinant of the pace at which the economy expands in coming quarters. Although real consumer spending rose moderately last quarter, households continue to face significant headwinds. Notably, real household income and wealth stagnated in 2011, and access to credit remained tight for many potential borrowers. Consumer sentiment has improved from the summer's depressed levels but remains at levels that are still quite low by historical standards.

Household spending will depend heavily on developments in the labor market. Overall, the jobs situation does appear to have improved modestly over the past year: Private payroll employment increased by about 160,000 jobs per month in 2011, the unemployment rate fell by about 1 percentage point, and new claims for unemployment insurance declined somewhat. Nevertheless, as shown by indicators like the rate of unemployment and the ratio of employment to population, we still have a long way to go before the labor market can be said to be operating normally. Particularly troubling is the unusually high level of long-term unemployment: More than 40 percent of the unemployed have been jobless for more than six months, roughly double the fraction during the economic expansion of the previous decade.

Uncertain job prospects, along with tight mortgage credit conditions, continue to hold back the demand for housing. Although low interest rates on conventional mortgages and the drop in home prices in recent years have greatly improved the affordability of housing, both residential sales and construction remain depressed. A persistent excess supply of vacant homes, largely stemming from foreclosures, is keeping downward pressure on prices and limiting the demand for new construction.

In contrast to the household sector, the business sector has been a relative bright spot in the current recovery. Manufacturing production has increased 15 percent since its trough, and capital spending by businesses has expanded briskly over the past two years, driven in part by the need to replace aging equipment and software. Moreover, many U.S. firms, notably in manufacturing but also in services, have benefited from strong demand from foreign markets over the past few years.

More recently, the pace of growth in business investment has slowed, likely reflecting concerns about both the domestic outlook and developments in Europe. However, there are

signs that these concerns are abating somewhat. If business confidence continues to improve, U.S. firms should be well positioned to increase both capital spending and hiring: Larger businesses are still able to obtain credit at historically low interest rates, and corporate balance sheets are strong. And, though many smaller businesses continue to face difficulties in obtaining credit, surveys indicate that credit conditions have begun to improve modestly for those firms as well.

Globally, economic activity appears to be slowing, restrained in part by spillovers from fiscal and financial developments in Europe. The combination of high debt levels and weak growth prospects in a number of European countries has raised significant concerns about their fiscal situations, leading to substantial increases in sovereign borrowing costs, concerns about the health of European banks, and associated reductions in confidence and the availability of credit in the euro area. Resolving these problems will require concerted action on the part of European authorities. They are working hard to address their fiscal and financial challenges. Nonetheless, risks remain that developments in Europe or elsewhere may unfold unfavorably and could worsen economic prospects here at home. We are in frequent contact with European authorities, and we will continue to monitor the situation closely and take every available step to protect the U.S. financial system and the economy.

Let me now turn to a discussion of inflation. As we had anticipated, overall consumer price inflation moderated considerably over the course of 2011. In the first half of the year, a surge in the prices of gasoline and food--along with some pass-through of these higher prices to other goods and services--had pushed consumer inflation higher. Around the same time, supply disruptions associated with the disaster in Japan put upward pressure on motor vehicle prices. As expected, however, the impetus from these influences faded in the second half of the year,

leading inflation to decline from an annual rate of about 3-1/2 percent in the first half of 2011 to about 1-1/2 percent in the second half--close to its average pace in the preceding two years. In an environment of well-anchored inflation expectations, more-stable commodity prices, and substantial slack in labor and product markets, we expect inflation to remain subdued.

Against that backdrop, the Federal Open Market Committee (FOMC) decided at its recent meeting to maintain its highly accommodative stance of monetary policy. In particular, the Committee decided to continue its program to extend the average maturity of its securities holdings, to maintain its existing policy of reinvesting principal payments on its portfolio of securities, and to keep the target range for the federal funds rate at 0 to 1/4 percent. The Committee now anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate at least through late 2014.

As part of our ongoing effort to increase the transparency and predictability of monetary policy, following its January meeting the FOMC released a statement intended to provide greater clarity about the Committee's longer-term goals and policy strategy.<sup>1</sup> The statement begins by emphasizing the Federal Reserve's firm commitment to pursue its congressional mandate to foster stable prices and maximum employment. To clarify how it seeks to achieve these objectives, the FOMC stated its collective view that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate; and it indicated that the central tendency of FOMC participants' current estimates of the longer-run normal rate of unemployment is between 5.2 and 6.0 percent. The statement noted that these statutory

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<sup>1</sup> Board of Governors of the Federal Reserve System (2012), "Federal Reserve Issues FOMC Statement of Longer-Run Goals and Policy Strategy," press release, January 25, [www.federalreserve.gov/newsevents/press/monetary/20120125c.htm](http://www.federalreserve.gov/newsevents/press/monetary/20120125c.htm).

objectives are generally complementary, but when they are not, the Committee will take a balanced approach in its efforts to return both inflation and employment to their desired levels.

#### **Fiscal Policy Challenges**

In the remainder of my remarks, I would like to briefly discuss the fiscal challenges facing your Committee and the country. The federal budget deficit widened appreciably with the onset of the recent recession, and it has averaged around 9 percent of gross domestic product (GDP) over the past three fiscal years. This exceptional increase in the deficit has mostly reflected the automatic cyclical response of revenues and spending to a weak economy as well as the fiscal actions taken to ease the recession and aid the recovery. As the economy continues to expand and stimulus policies are phased out, the budget deficit should narrow over the next few years.

Unfortunately, even after economic conditions have returned to normal, the nation will still face a sizable structural budget gap if current budget policies continue. Using information from the recent budget outlook by the Congressional Budget Office, one can construct a projection for the federal deficit assuming that most expiring tax provisions are extended and that Medicare's physician payment rates are held at their current level. Under these assumptions, the budget deficit would be more than 4 percent of GDP in fiscal year 2017, assuming that the economy is then close to full employment.<sup>2</sup> Of even greater concern is that longer-run projections, based on plausible assumptions about the evolution of the economy and budget under current policies, show the structural budget gap increasing significantly further over time

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<sup>2</sup> The Congressional Budget Office (CBO) reported an "alternative fiscal scenario" (Table 1-7, p. 22) that assumed that most expiring tax cuts and the Medicare "doc fix" would be extended and also that the automatic spending reductions required by the Budget Control Act (BCA) would not take effect; under this scenario the deficit would be about 5 percent of GDP in fiscal 2017. If the automatic spending cuts from the BCA, however, are assumed to be put in place (the effects of which are shown in Table 1-6, p. 18) then the deficit would be more than 4 percent in fiscal 2017. See Congressional Budget Office (2012), *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*. Washington: Congressional Budget Office, January, [www.cbo.gov/doc.cfm?index=12699](http://www.cbo.gov/doc.cfm?index=12699).

and the ratio of outstanding federal debt to GDP rising rapidly. This dynamic is clearly unsustainable.

These structural fiscal imbalances did not emerge overnight. To a significant extent, they are the result of an aging population and, especially, fast-rising health-care costs, both of which have been predicted for decades. Notably, the Congressional Budget Office projects that net federal outlays for health-care entitlements--which were about 5 percent of GDP in fiscal 2011--could rise to more than 9 percent of GDP by 2035.<sup>3</sup> Although we have been warned about such developments for many years, the time when projections become reality is coming closer.

Having a large and increasing level of government debt relative to national income runs the risk of serious economic consequences. Over the longer term, the current trajectory of federal debt threatens to crowd out private capital formation and thus reduce productivity growth. To the extent that increasing debt is financed by borrowing from abroad, a growing share of our future income would be devoted to interest payments on foreign-held federal debt. High levels of debt also impair the ability of policymakers to respond effectively to future economic shocks and other adverse events.

Even the prospect of unsustainable deficits has costs, including an increased possibility of a sudden fiscal crisis. As we have seen in a number of countries recently, interest rates can soar quickly if investors lose confidence in the ability of a government to manage its fiscal policy. Although historical experience and economic theory do not indicate the exact threshold at which the perceived risks associated with the U.S. public debt would increase markedly, we can be sure that, without corrective action, our fiscal trajectory will move the nation ever closer to that point.

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<sup>3</sup> This projection is under the alternative fiscal scenario developed by the Congressional Budget Office, which assumes most current policies are extended. See Congressional Budget Office (2011). *The Long-Term Budget Outlook*. Washington: Congressional Budget Office, June, [www.cbo.gov/doc.cfm?index=12212](http://www.cbo.gov/doc.cfm?index=12212).

To achieve economic and financial stability, U.S. fiscal policy must be placed on a sustainable path that ensures that debt relative to national income is at least stable or, preferably, declining over time. Attaining this goal should be a top priority.

Even as fiscal policymakers address the urgent issue of fiscal sustainability, they should take care not to unnecessarily impede the current economic recovery. Fortunately, the two goals of achieving long-term fiscal sustainability and avoiding additional fiscal headwinds for the current recovery are fully compatible--indeed, they are mutually reinforcing. On the one hand, a more robust recovery will lead to lower deficits and debt in coming years. On the other hand, a plan that clearly and credibly puts fiscal policy on a path to sustainability could help keep longer-term interest rates low and improve household and business confidence, thereby supporting improved economic performance today.

Fiscal policymakers can also promote stronger economic performance in the medium term through the careful design of tax policies and spending programs. To the fullest extent possible, our nation's tax and spending policies should increase incentives to work and save, encourage investments in the skills of our workforce, stimulate private capital formation, promote research and development, and provide necessary public infrastructure. Although we cannot expect our economy to grow its way out of our fiscal imbalances, a more productive economy will ease the tradeoffs that we face and increase the likelihood that we leave a healthy economy to our children and grandchildren.

Senator NELSON. Thank you, Chairman Bernanke.

On page 4 of your statement, you testified that the “current estimates of the longer-run normal rate of unemployment is between 5.2 and 6 percent.” How does that compare, for example, to unemployment during the go-go years of the 1990s? And do you think we are destined to have higher unemployment than in the 1990s?

Mr. BERNANKE. Well, unemployment did reach levels below that, not only in the 1990s but earlier in the 2000s as well. We are concerned that over the past few years there has been some modest increase in the sustainable long-run rate of unemployment. One of the factors contributing to that is the fact, as I mentioned in my remarks, that about 40 percent of the unemployed have been unemployed for 6 months or more; and those folks lose skills, they lose attachment to the labor force, and it is more difficult for them to find steady employment in the longer term.

I would like to emphasize that in estimating that sustainable long-run rate of unemployment, we in no way are saying that this is a desirable state of events, state of circumstances. We are only saying that monetary policy really cannot do much to bring unemployment in a sustainable way below those levels based on our current information.

However, other policies affecting workforce skills, the structure of the labor market, fiscal policy, trade, all kinds of other policies could affect and bring down that sustainable rate of unemployment, and I hope Congress will consider ways to address that problem.

Senator NELSON. We have started to see a revival of the manufacturing sector: 50,000 jobs added last month. Tell us, is there anything that you would suggest that we do to hasten the return of the manufacturing jobs?

Mr. BERNANKE. Well, the recovery of the manufacturing sector has been an encouraging development. Manufacturing has led this recovery very significantly. One reason it is doing so is that American manufacturers have become increasingly competitive on the global stage, and as emerging markets in other countries grow quickly, they represent a source of demand for our manufactured goods as well as some of our services. So, clearly, maintaining open trade with other countries and maintaining those markets is an important step.

I think another area that is important is trying to ensure that the U.S. remains a leader in advanced education, research and development, technology, and the like because many of our manufacturing firms, for example, high-tech firms, which are often clustered around universities, are producing the most sophisticated, most technologically advanced products. That is where we have a comparative advantage in the United States, and maintaining our technological leadership would certainly be a boost to our ability to export.

Senator NELSON. You know the decisions that we will have to make with regard to budgetary policy coming up, and you know that there were all these attempts to get agreement between the White House and the Congress last year that did not make it. There was one plan that a number of us were—even held a press conference, I think some 40 of us in the Senate—wanting the super

committee to go big with a \$4 trillion cut in the deficit over the next 10 years.

Would you recommend going forward, since all of that failed, steep cuts that only hit at a handful of the safety net programs? Or do you believe that we should place more on reducing future deficits over the long term in a more broad way while being fiscally conscious of the recovery efforts in the near term?

Mr. BERNANKE. Mr. Chairman, I was supportive of being aggressive last summer. A number like \$4 trillion was the CBO's estimate of what would be needed to stabilize debt-to-GDP ratios over the next decade, which is an important objective, obviously. But I would like to urge the Committee not to be solely attentive to the 10-year CBO window. Most of the problems in our fiscal path arise after the next 10 years, going out 15, 20, 30 years as our population ages, as health care costs rise, and so on.

So what I would advocate is, having a broad-based discussion, but in particular looking at sustainability over the long run. And I think that is going to take a lot of work on the part of Congress. It is really not my place to make detailed recommendations about specific components of the budget, but I do urge the Congress—and I heard many people on this Committee express the same sentiment—that we need a long-term plan to put our debt-to-GDP ratio, our overall fiscal burden on a sustainable path.

Senator NELSON. Thank you.

Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman. And Chairman Bernanke, thank you. Your remarks have been very insightful, and we all have different opinions, but I think you are pretty close to what we need to be doing, and we value that.

I would yield to Senator Grassley at this time.

Senator GRASSLEY. First of all, I want to compliment you on your movements toward transparency, and I think even the more you can do of that, and do it not just for the sake of letting people know about the economic impact of your policies so that there is not the obscurity that has existed, but to do it for the purpose of educating the public more about the important role of the Federal Reserve, is positive. You are too important for people to think that there is some conspiratorial aspect of everything the Federal Reserve does, and this comes up not often, but it comes up too often in my town meetings. I think the more you can tell people about what your role is, it is very important.

My question is based upon, first of all, if Congress fails to act on January 1, 2013, our Nation is going to see the largest tax increase in the history of the country. People do not understand this, but that is going to happen without even a vote of Congress. The Congressional Budget Office has estimated the economic impacts of this \$3.5 trillion tax increase along with a few other policies. CBO estimates that the unemployment rate at the end of 2013 could be as much as 2 percentage points higher and that the GDP growth could be as much as 3 percentage points lower.

Do you agree with CBO that the failure to prevent this tax increase will have a serious negative impact on our economy in terms of GDP growth and unemployment? And, secondly, if so, at what

point in 2012 will the uncertainty of the tax increase begin to hinder economic growth?

Mr. BERNANKE. Senator, first, thank you for your comments on transparency, and on the role of the Federal Reserve. I have agreed to give a series of lectures at George Washington University next month as part of a class, and I will be talking exactly about that issue.

I agree basically with the CBO's analysis. If no action is taken, on January 1, 2013, between expiration of tax cuts, sequestration, and a number of other measures, there will be a very sharp change in the fiscal stance of the Federal Government, which by itself with no compensating action would indeed slow the recovery. CBO predicts a 1.1-percent growth and an increase in unemployment in that year, and that is based entirely on their current law assumptions, so they are assuming that contraction will take place.

I want to be very clear that I am in no way stepping back from my strong advocacy of maintaining fiscal sustainability in the longer term. It is critically important, whatever actions are taken to mitigate the short-run impacts of some of these changes, that they be combined with a credible plan for a longer-term return to sustainability. But there is a concern there that this very sharp change in the fiscal position in a very short time might slow the recovery.

I do not know exactly when the uncertainty would become a factor, but surely as we get closer to January 1st and Congress has not given a clear road map for how it plans to proceed, that would certainly affect planning, business decisions, household decisions as they look ahead to the next year.

Senator GRASSLEY. Okay. My second question will have to be my last one. You recently announced that the Federal Open Market Committee's goal of an inflation target of 2 percent. Core inflation currently stands above the Fed's target at 2.2 percent. Separately, you also announced that the Federal funds rate will likely be held near zero through 2014. This question comes from the point of view that you said if there is a tradeoff between decision making on unemployment and on inflation, at least as I read it, unemployment would have a higher priority.

Is the Fed sending a signal that keeping inflation in check is a secondary priority to achieving full employment? And to what extent is the Fed willing to act should inflation continue to rise?

Mr. BERNANKE. Well, Senator, it is true that a 12-month backward look shows inflation a bit above 2 percent. But as we look forward and as energy price increases of early last year have not reoccurred, our projections are that inflation is going to remain very subdued, probably below our 2-percent target, going into 2012 and 2013. Because monetary policy works with a lag, we have to think about where inflation is going to be, not where it has been in the past. Inflation has averaged about 2 percent a year over my tenure as Chairman, and we expect it to be at 2 percent or below in the next couple of years. So we think that is entirely consistent with a policy of accommodative policy.

Now, I want to disabuse any notion that there is a priority for maximum employment. We say very explicitly and we take a balanced approach. Congress gave us a dual mandate. We work to

bring both sides of the mandate back towards the target. The main goal of that statement was not to announce any change in policy. The main goal was to give greater clarity about how we define these long-run objectives. But we are certainly going to be working to bring both parts of our mandate towards desired levels.

Senator GRASSLEY. I think it is good you are going to George Washington University, but if you would want to come to the grass roots of America, the University of Northern Iowa, I would help arrange it for you.

[Laughter.]

Mr. BERNANKE. Thank you. It will be streamed online, so it is open.

Senator GRASSLEY. Okay. Thank you very much.

Senator NELSON. Thank you, Senator Grassley.

Senator Wyden.

Senator WYDEN. Thank you, Chairman Nelson, and thank you, Chairman Bernanke. I want to ask you a little bit more about the shocks to the economy that you have been discussing. You talk about the pace of the recovery being slow, and particularly for the millions of people who are hurting, unemployed, underemployed, and that all of this really comes together as part of a sluggish expansion that has left the economy vulnerable to shocks. So I can see plenty of shocks: the payroll tax debate bogging down into a quagmire, talking about 2 months or another short-term effort. We mentioned Europe as another one, mentioned the question of sequestration, and, to me that alone puts a very negative spectacle out because it would mean that in a lame duck session in the 2012 Congress you would see, again, the same sort of flailing that you did after 2010.

So my first question to you on the shock issue is: Doesn't it serve to shock our economic system just to have all this delay and week after week of bickering and inability to get decisions on payroll taxes or others? Isn't that in and of itself a shock to the system in terms of what it does to business confidence and predictability and certainty?

Mr. BERNANKE. Well, policy uncertainty is certainly one of the things that businesses complain about. It makes it harder to plan. You know, we face the same issue as regulators with regulatory uncertainty, and obviously to the extent that greater clarity can be provided, it would be helpful to the economy.

Senator WYDEN. And is it fair to describe that as yet another shock to the system? Because, to me, everything I have been trying to—I am going to you about tax reform here in a minute—has been to try to figure out how to force action early, because when you do not, what you are most likely, at a time when you have this sluggish expansion, to see these shocks and a reduction in confidence and predictability and the like.

So is it fair to say that delay in this kind of climate, when it comes to getting the payroll tax issue worked out and others, that that in and of itself is a shock to the system?

Mr. BERNANKE. Well, I would cite the example of the debt ceiling debate last summer, which was clearly a shock and very probably affected consumer confidence and financial markets. More generally, loss of confidence that agreement will be reached or uncer-

tainty about what agreement will be reached is a negative for confidence.

Senator WYDEN. Let me ask you about the question—I mean, to me the antidote to economic shocks are the cushions, the kinds of cushions that start us on the road to predictable, more certain kinds of opportunities to promote economic growth, and tax reform strikes me to be right up at the top of the list. And as the super committee—we have Senator Portman here who has done very good work on this, did it in the super committee. A lot of that work has been done now. There are tough, tough political calls to be made, of course, to address tax reform, but the principles are pretty clear, much of what was done in 1986, clean out a lot of the junk, the special interest breaks, to hold down rates and keep progressivity. Wouldn't long-term predictable tax reform be the kind of cushion that would help address the shocks that you are concerned about for the economy?

Mr. BERNANKE. Predictability is good, and also a good Tax Code in itself promotes growth. I think most economists agree that a simpler, fairer, broader-base Tax Code would be constructive for growth, yes.

Senator WYDEN. And on the converse of it all, wouldn't piecemeal changes, where, again, we go through another round of temporary credits, temporary extensions, modifications to this provision, that provision, wouldn't that contribute to the uncertainty and the lack of predictability that would make it hard for us to grow?

Mr. BERNANKE. Well, Senator, as you fully appreciate, politics is complicated, and sometimes not everything is feasible from a political point of view. But from an economic point of view, obviously the more comprehensive and clean the tax reforms or spending reforms can be, the more likely they will be good, efficient from an economic point of view, and the more likely they will reduce uncertainty.

Senator WYDEN. I think your points are well taken, Mr. Chairman. My concern is, absent the kind of comprehensive reform that I think would be a stronger cushion to the shocks that you are talking about, I just hope that the country will see how important it is to steer away from yet more piecemeal kinds of changes that make this broken tax system even more dysfunctional and do not give businesses and the consumers the predictability they need to generate the growth that you are talking about.

Thank you, Mr. Chairman.

Senator NELSON. Thank you, Senator Wyden.

Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman. And, Chairman Bernanke, thanks for coming here to testify.

I do not envy your task. It seems to me that you have been given the task of trying to address fiscal mismanagement with monetary solutions, and it just does not work long term. I think we are seeing that starting to collapse in Europe as people have tried to come to the rescue of Greece, and I am just not sure how far we are behind Greece.

The argument here in terms of getting our fiscal house in order, the long-term sustainability, seems to certainly break down between how much revenue can we raise and how much do we spend.

And to me it is just clearly a spending problem. Ten years ago, we spent \$1.9 trillion. Last year, we sent \$3.6 trillion. And according to the President's budget, in 10 years he would like to spend \$5.8 trillion.

And I am concerned that we delude ourselves in thinking that we can actually increase revenue by potentially raising tax rates, or trying to get us up above the 50-year average of 18.1 percent of revenue extracted from this economy. Our long-term spending is 20.2 percent, so over the last 50 years, we have just run this 2.1 percent structural deficit.

There is an interesting article in the Wall Street Journal today about Maryland's attempt to tax millionaires. When they did that back in 2007, they estimated they would raise \$330 million by doing that. In fact, a study was just produced that said that they raised about \$120 million, about 36 percent of the raised revenue.

So I would just kind of like to get your comments on the Federal Government's ability to extract more than that 50-year 18.1-percent long-term average in revenue.

Mr. BERNANKE. Well, first, on the broad question of spending and taxes, there is a deep philosophical debate about the appropriate role of the Government, the appropriate size of Government, and you are obviously quite aware of that. And that is something Congress is going to have to work out. That is what the people elected you to do, to figure out the right role of Government in the economy.

I think it is true that beyond a certain point higher taxes impose costs on the efficiency of the economy, and those are tradeoffs that Congress has to consider. So in particular in a situation like a State where millionaires could easily cross the border and live in Virginia instead of in Maryland, it is clear that much of the gain could be lost simply by legal avoidance practices.

Senator JOHNSON. As an accountant, as a business manager, I am always looking for the root cause of problems, and I am also looking for key metrics, and you mentioned one earlier: the size of our debt in relationship to GDP. I think an even more fundamental one really speaks to the root cause of the problem, which I would argue is the size, the scope, all the control, all the intrusion of Government into our lives, all the regulation, the cost of Government. We have increased that from that 20.2 percent average over 50 years to 25 percent in 2009, and 24—it is projected, according to the Heritage Foundation, to increase to 35 percent by 2035. In the end, socialism and communism is a number, and the number is the size of Government in relationship to the economy.

Do you think 24 or 25 percent and higher as a metric of the size of Government in relationship to the economy, do you think that is a healthy metric?

Mr. BERNANKE. Senator, under the current plans, if there is no change to our entitlement programs, then the demand for spending, the amount of spending that the Government is committed to, is going to rise even beyond that level. So at some point, Congress is going to have to make a tradeoff between, what its spending programs are and what taxes it is willing to raise.

I have often said that I am in favor of the law of arithmetic. If you want a low-tax economy which has benefits from an efficiency

perspective, you have to make the tough decisions on the spending side. And vice versa, if you want to spend more, you have to figure out how to raise taxes and raise the revenues.

So I mainly try to urge Congress to make sure they are looking at both sides so that there is a balance between the two.

Senator JOHNSON. Of course, those tough decisions really do begin with Presidential leadership. I am new to this town. I have never seen anything really accomplished in Washington without very strong Presidential leadership, and I am afraid President Obama has just been phoning it in here the last couple of years in terms of our debt and deficit issue.

One question I would have is—I probably do not have a whole lot of time for it. In terms of the uncertainty caused by not—the Senate passing a budget—and I realize that in the Budget Control Act we have deemed a few numbers. But can you just speak to the last of an actual plan that makes sense to certainly business people, to consumers? Can you speak to how harmful that is in terms of economic growth?

Mr. BERNANKE. Well, Senator, I am not going to comment on parliamentary maneuverings, but Senator Wyden asked exactly the same question: Is uncertainty about the future of the Tax Code and Government programs and so on a negative for growth? I think it is because firms like to have certainty, like to be able to plan. And, again, I would take on the same responsibility as a regulator, that we need to make regulations as clear and as effective as possible.

Senator JOHNSON. Thank you.

Thank you, Mr. Chairman.

Senator NELSON. Senator Begich.

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

Thank you very much, Mr. Bernanke, for being here, and thank you for the conversation we had on the phone several weeks ago in regard to transparency. I agree that there are efforts, and I am excited to see that you are going to be out on the circuit, and I will be anxious. I might even tune in to one of those to see how they go.

Senator Johnson brought up a point. I want to make sure there is equal treatment. I am new here, too. I appreciate—I am not here to defend the President at all, but we are all to blame for this dysfunctional Washington, D.C. It is not just the President. It is Congress that is also part of the problem here. That is what I hear when I go back home. And because of that—and you kind of answered it, and I think I want to clarify or make sure I hear what you are saying. That is, because of the inability for this body to figure out and compromise and figure out pathways that have long-term certainty, it does have an impact to the consumer confidence and the business confidence of this country. Yes?

Mr. BERNANKE. Yes.

Senator BEGICH. So, what I have learned in this legislative body—but I have been an executive, I have been an assembly member, and now in this legislative body—is that legislative bodies love to blame the executive, the executive loves to blame the legislative body. But at the end of the day, on the Senate side, there are a hundred of us out of 308 million people here to make some decisions. So it is incumbent upon us, if we intend to move this country

forward, to be more certain about our long-term decisions. True? That is important, because I know as a small business person from the age of 16 that indecision does not create certainty, and this body has a great habit of indecision or push it off. So I just want to make sure—we are all equal in this. There is on one body or another. So I am kind of going through you, two comments on the other side.

Second, I heard—and I want to get your comment to make sure I am clear on this—your response to Senator Grassley in regard to the Bush tax cuts that may expire at the end of the year and what might happen. But, also, isn't there another problem to this that we did not pay for them so it had a long-term problem, which is what your opening statement alluded to, that it is good, these short-term things, but the long-term brick wall is coming. So when you have these schemes that have a tax scheme that costs \$4 trillion and you do not pay for it today, you are going to pay for it tomorrow, and you are going to pay with interest. Isn't that also a problem to this equation? As you deal with tax policy, you have to pay for it, right?

Mr. BERNANKE. Yes, Senator. I was not endorsing any particular component.

Senator BEGICH. No. I agree.

Mr. BERNANKE. I was just saying that the cumulative effect of all these different things—expiration of the payroll tax, the sequestration, expiration of the Bush tax cuts, and other things collectively—would be a fairly sharp change in the near-term fiscal position.

Senator BEGICH. Correct.

Mr. BERNANKE. I am not saying do not pay for it. I am just saying do it over a longer period of time, but do it seriously. I agree with Senator Sessions' concern, that we just push it off manana. You do not want to do that. You want to make a credible, strong plan, but one that phases in over a period so that the economy will not hit a huge pothole.

Senator BEGICH. Right, and that is why I just want to make sure that is kind of in this discussion because I was one of those that supported the \$4 trillion. I think we need to be aggressive about this. But we also have to balance against what we are trying to do today, because if you get an imbalance, you are going to have a direct impact. And there are good signs. I mean, I read your latest piece—I do not know if it was written by you or you were interviewed by Bloomberg in regard to how the economy is moving. It is going to be a slow drag on this economy for some time. But it is actually moving in certain areas. Manufacturing, as you indicated, I think has surprised a lot of people, and that is a good sign. Consumer confidence to me is a pretty important piece of the equation here because if they are not confident, they are not—I mean, it is amazing how many are still not refinancing today at 3.75 interest rate. It just boggles the mind, because I think they are just not confident yet. And part of our job is to help make them know that we have a plan at least, or something to help the confidence level.

Do you think consumer confidence is an important part to this long-term equation? Consumer and, I should say, business confidence, the combination of how they feel.

Mr. BERNANKE. Surely consumers make their spending plans and their employment plans and retirement plans, everything, based on what they see in the future, how they expect the economy to evolve and their own opportunities. If you look at the consumer confidence surveys, people are saying they do not expect to see their real incomes grow. They expect that their financial conditions are going to be flat down in the next few years, and that is not a situation that encourages people to buy a house or—

Senator BEGICH. Refinance.

Mr. BERNANKE. —start a business or anything like that.

Senator BEGICH. Right. Let me ask you one last question because my time is up. Obviously, I come from an energy State, oil and gas, and you had alluded to a couple issues that, the activities in the Middle East could have impact to our price of fuel energy here. Can you maybe just elaborate a little bit? Obviously, I am a big believer that we need to do more domestic production so we have less of those shock treatments from other sources that are out of our control. Can you give me just any additional comment on that?

Mr. BERNANKE. Well, first, as we saw in a modest way early last year, a significant increase in oil prices can be very disruptive both because it creates inflation and also because it acts like a tax on consumers, makes them less able to spend on other goods and services. A major disruption that sent oil prices up very substantially could stop the recovery.

That being said, one of the more encouraging things of the last few years is the fact that with new processes and approaches, the U.S. is becoming a much more prolific producer of fossil fuels and is also making progress on non-fossil forms of energy. So for the first time in some time, there is a chance that we can move in the right direction in terms of reducing our exposure to foreign supply disruptions.

Senator BEGICH. Thank you very much, and Alaska wants to be part of that equation, so thank you very much.

Senator WHITEHOUSE. [Presiding.] Thank you, Senator Begich.

Senator Enzi.

Senator ENZI. Thank you. Wyoming wants to be a part of that, also.

[Laughter.]

Senator ENZI. I want to thank the Chairman for all of the information you gave at the repeated appearances that you have to do before all the different committees of both the Senate and the House. It is all very helpful, and I know that everybody hangs on pretty much every word that you say, which has to be pretty daunting.

I appreciate the emphasis that you have placed on the Bowles-Simpson deficit report. I still think that if that had been broken into parts, everybody could have voted against the part they did not like, and all the parts would have passed. Then it could have come to the Senate, and I think in six parts we could have passed it, too, and averted a lot of this. But it was an austerity program, which makes it pretty tough. But to avert a fiscal catastrophe,

most of the European governments enacted austerity programs that actually reduced government spending, and recently, sovereign bond auctions by fiscally troubled eurozone countries enjoyed surprising demand, which resulted in yields well below expectations.

The New York Times suggested that these auctions are a sign that the austerity measures have comforted investors and lured them back into the eurozone bond. Despite the passage of the Budget Control Act, the U.S. Federal spending is expected to grow in 2012. Compared to the budgets of the eurozone countries, do you believe the U.S. really has entered a period of austerity, as some have suggested?

Mr. BERNANKE. Well, first, in the European case, I think that some progress in some of the troubled countries toward fiscal balance has been encouraging to investors, but there are other important factors, notably the European Central Bank's large loan to banks that has helped stabilize the financial system, and many banks in turn have used that money to buy short-term government sovereign debt from countries like Greece and Portugal and Ireland. So that is a fairly complex situation.

Senator ENZI. Well, let me ask, if they had not passed some austerity budgets, do you think there would have been this—

Mr. BERNANKE. Well, I think that countries like Greece and Portugal have really no option. They could not borrow. They are excluded from the private market. They are relying now already 100 percent on the IMF and European Union for funding, and in order to qualify for that funding, they have to show they have a plan to restore fiscal balance. So they really have no choice, and they are working to try to get to that position.

I would say in terms of the United States—I have already described my concerns about 2013. Right now I would say that overall fiscal effects on our economy are roughly neutral at this point. And, clearly, from a long-run perspective, we have not yet taken any actions to put the Government debt on a sustainable path.

Senator ENZI. Thank you.

Switching a little bit here, the Federal Reserve, like any bank, takes in deposits as liabilities and lends out those funds by purchasing Treasury securities as assets. And the Federal Reserve then remits those profits to the Treasury, and those payments are classified as Government receipts or revenues in the Federal budget. Remittances more than doubled since 2008, and CBO estimates the Federal Reserve will remit \$77 billion in 2012. I am curious as to whether that is after the Consumer Protection Bureau's 10 percent comes out or not. And they estimate that it will be \$511 billion over the next 10 years.

What are the Federal Reserve's major sources of revenue? And why have the earnings gone up since 2008?

Mr. BERNANKE. The Federal Reserve in the last 3 years has remitted about \$200 billion to the U.S. Treasury. I think that does not—I think that includes the money paid to CFPB. I will double check that for you.

Senator ENZI. Thank you.

Mr. BERNANKE. The reason that our remittances to the Treasury have gone up by so much—prior to recent years, we rarely remitted more than \$20 or \$25 billion in a year—is that as part of our mone-

tary policy, we have, as purchased Treasury securities, longer-term Treasury securities, and mortgage-backed securities, agency mortgage-backed securities. The return on those securities comes to the Fed, and then we take it and pass it back to the Treasury. So that is where the profit is coming from.

In addition, the various programs we undertook during the crisis have all turned out to be profitable, and we have put that money back to the Treasury as well.

Senator ENZI. Thank you. And switching again, how effective do you think Japanese efforts were to stimulate the economy during the 1990s? I do not think their economy has recovered, and we place all the emphasis on Europe, but I think Japan deserves some real consideration.

Mr. BERNANKE. Japan has had a difficult two decades, certainly. There are some important differences between Japan and the United States. One that I would particularly stress is that Japan has had deflation, falling prices, now for quite a long time, and combined with interest rates that cannot go below zero, that creates financial tightness in their economy, which prevents to some extent investment and growth.

Also, the Japanese were not as quick as the U.S. to recapitalize their banks as we did in 2009. They were the first into the situation. They did not have the benefit of seeing others deal with it, grapple with it. We learned from them. They continue to provide monetary policy support.

I think it is important to note that yet one other difference is that Japanese demographics are quite different from the U.S. The workforce is actually beginning to shrink because they have very low birth rates and low population growth rates, and that is certainly going to be a factor that is going to keep their growth down in the period to come.

Senator ENZI. Thank you. My time has expired.

Senator WHITEHOUSE. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and thank you for your testimony.

I wanted to start with the unemployment insurance and the conversation that is going on, and this is one of those kind of set of things that you referred to as changing on the near horizon, and the conversation is going on about whether to sustain the 79-week standard.

How do you see that piece of the puzzle fitting into the issues that would affect the economy?

Mr. BERNANKE. Well, unemployment insurance is multifaceted. On the one hand, obviously, it provides some support for people who are unemployed or who have unemployed family members, and those people in turn also will be more likely to spend, which will add to demand in the economy.

It probably on the margin leads people to wait a little longer, that the spells of unemployment may be a little bit longer because of unemployment insurance, but that, too, is a mixed blessing because in some cases the extra time allows people to find a more appropriate job with a higher wage instead of taking the very first thing that they see.

There are a lot of interesting ideas out there for redesign of unemployment insurance. Are there ways, for example, to create incentives for more training, skill building during the period of unemployment through the way in which the unemployment insurance is paid? So I think as you discuss it, it would be useful to look at the design and ask whether or not, for example, part of the payments could be used for training or for skill building.

Senator MERKLEY. Thank you. As there are many other proposals out there for redesign that may be more about stopping the continuation of unemployment insurance than actually improving the way it works, so that is a real concern in this conversation. What I gather from your point is that it plays a significant, substantial role, particularly during periods of high unemployment, in creating a foundation for demand and the workforce readjusting to the skills of the changing economy.

I think I am restating what you just said, but I wanted to make sure I read—

Mr. BERNANKE. Yes, it helps on those dimensions. It has to be said that in Europe, for example, there are some countries where unemployment insurance is so generous that it creates a permanent unemployed class, which we certainly do not want to do. So there are balances you have to strike, but those are some of the considerations.

Senator MERKLEY. Thank you. Turning to homeownership and the housing market, you have noted that an excess supply of vacant homes stemming from foreclosures depresses housing demand and has an impact on—and you have sent a white paper to Congress laying out a number of ideas, many of which my colleagues and I have been discussing over the last 2 years and made less progress on them than we had hoped. One of those concepts is proceeding to try to enable large groups of homes that are sitting vacant and driving down prices to re-enter the rental market, and I would add to that anything we can do to get homeowners back into those homes as well. But it seems like on both fronts, helping individual homeowners and, when that is not possible, getting those homes out of vacancy would be a strong strategy to stop the decline in values and start to restore the housing market.

If you want to add any comments or thoughts on that?

Mr. BERNANKE. Well, yes, I think it is an interesting direction, and we provide some analysis of it, as you say, in the background paper that we circulated. Right now we are seeing house prices still either flat or falling. They are down more than 30 percent in nominal terms. Meanwhile, there is a shortage of rental housing, apartments, rents beginning to rise, so there is an imbalance there. And to the extent we can move housing from single-family to rental, I think that is positive. The GSEs have announced a trial program, an experimental program with the details to be worked out.

The related point I think you alluded to is that there are very heavy costs to leaving homes unoccupied for long periods of time. Vandalism and neglect will cause the house value to decline significantly. It will hurt the neighborhood and so on. So efforts to maintain continuous occupation by an owner or a renter is also a positive. REO to rental programs do that, but so potentially might alternatives to foreclosure, like rent-to-own or other—short sales,

deed in lieu, other things that maintain continuous inhabitation of the house.

Senator MERKLEY. Thank you.

Senator WHITEHOUSE. Senator Cornyn.

Senator CORNYN. Mr. Chairman, good to see you. Thank you for being here.

The unemployment rate in America for the fourth quarter of 2012, according to the CBO, they project it at 8.9 percent for the fourth quarter of 2012. Do you agree with that?

Mr. BERNANKE. 2012 or 2013?

Senator CORNYN. 2012.

Mr. BERNANKE. No. Our forecasts are for unemployment to continue to decline moderately. We see growth at something close to potential, which under normal circumstances would mean that we are creating enough jobs to employ new entrants to the labor force but not making sharp improvements on the unemployment rate.

Senator CORNYN. Well, I realize the hazards of economic forecasting. I think Christina Romer, when the stimulus was first proposed, said that unemployment would be down around 6 percent the first quarter of 2012. Obviously, that was not correct. But let me just ask you some things that might affect the unemployment rate.

First of all, 8.3 percent unemployment, but what does the Federal Reserve project the real unemployment rate to be including people who have given up looking for jobs and people who are underemployed? What would that rate be?

Mr. BERNANKE. We do not make projections specifically of those, but I take your point. It is very important to look not just at the unemployment rate, which reflects only people who are actively seeking work, but there are also a lot of people who are either out of the labor force because they do not think they can find work, and that is a significant number of people. There are also a lot of people who are working but part-time, and they would like to be working full-time but they cannot find full-time work.

So the 8.3 percent no doubt understates the weakness of the labor market in some broad sense. But, on the other hand, all these various measures of unemployment have been improving, though, these broader measures are definitely higher.

Senator CORNYN. Let me ask you about what is happening in Europe. Is Europe in a recession right now?

Mr. BERNANKE. Well, certainly the southern countries, including the ones that are under a lot of fiscal pressure, have been contracting. And, generally speaking, Europe as a whole was growing essentially at a zero rate in the second half of last year. So certainly parts of Europe are in recession. Whether the whole eurozone goes into recession remains to be seen. The ECB itself has predicted a mild recession, and it has warned that this might occur. So, we think that is a possibility, but the severity and length of it remains at this point uncertain.

Senator CORNYN. And that is an important question or issue because Europe buys a lot of exports from the United States, which is an important part of our gross domestic product, correct?

Mr. BERNANKE. We have already seen some decline in exports to Europe, although exports to Europe are about 2 percent of our

GDP, and so it is not totally make or break, but it is obviously an influence.

Senator CORNYN. In addition to exports, which gives an indication of what our economic growth will be and job creation, you would also have to calculate in real consumer household income, which is actually down, I think the lowest since 1995. Is that correct, to your recollection?

Mr. BERNANKE. Well, as I mentioned in my testimony, real household income was basically flat, very close to flat over 2011, and households are quite pessimistic about their future income.

Senator CORNYN. And they have actually, because they have actually seen increased costs of goods through commodity prices, food, fuel, things like that, they have seen slight increases in taxes—if you combine State, local, and Federal taxes, they have seen higher health insurance costs. All of those things have a depressing effect on consumer spending and on the growth of GDP, don't they?

Mr. BERNANKE. Yes, that is correct, although the real income numbers I gave take into account all of those things except for the health care expenses.

Senator CORNYN. And then there is well-intentioned Government policies, and I will mention briefly the 100 percent depreciation that expires in 2011 for capital investment. Isn't it reasonable to conclude that businesses that could make that kind of capital investment would take advantage of that 100 percent depreciation, which expires at the end of this year, which would make it less likely we would see an increase in capital investment next year because businesses would have already taken advantage of that policy in 2011?

Mr. BERNANKE. We would expect to see some time shifting up, and this is one more element of this very big change in fiscal stance that takes place in 2013 that I mentioned.

Senator CORNYN. So all of those things taken together—lower capital spending, lower consumer spending growth, declining exports, and spending drag from all levels of Government—all those would tend to have a negative impact on unemployment projections. In other words, it would make it tougher for the economy to grow and create jobs rather than easier. Correct?

Mr. BERNANKE. That is why we continue to forecast a moderate recovery as opposed to one that would, quickly undo the damage of the recession.

Senator CORNYN. Thank you.

Senator WHITEHOUSE. Senator Warner is up now, and just by way of preview of coming attractions, I am going to follow the Sessions rule and save myself until the end. So it is then going to be Senator Toomey, Senator Portman, and Senator Ayotte. Is that all right?

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. And good to see you again, Chairman Bernanke. Thank you for your service.

I want to continue some of the line that my colleagues have asked, and I want to echo what Senator Enzi said, and I appreciate your support for the notion of going big and recognizing we have to have a comprehensive deficit reduction plan.

I personally believe that we should confound conventional wisdom and not punt this until after the next election cycle. I still find it—as a business guy, it would be hard for me to explain to my shareholders if my company was in dire financial traits and I said to them, “We have a plan, and I am going to get back to you in the spring of 2013,” when none of this is self-corrective in the meantime.

I guess what I would like to follow up on, though, are the comments made about Europe. I would add that—well, Senator Enzi made the point that a number of them have austerity plans. I believe every one of those countries, while they have had cutbacks, have also included increased revenues in their mix. That is correct, is it not?

Mr. BERNANKE. Yes.

Senator WARNER. But what we have seen, as somebody personally who has been very interested, for example, in what has gone on in the U.K., do you have any advice for us, lessons learned, if we were to put a plan in place, on a phasing in of whether it is revenue increases or dramatic cutbacks on spending? Are there metrics we should look at on how we phase those in? Should they be phased in over a time frame or based upon economic recovery metrics?

Mr. BERNANKE. Well, that is a judgment. I think the important thing is to recognize this is a very long term problem. It does not have to be done all today. On the other hand, gesturing towards the future without taking any concrete or credible steps is not going to be effective either. So I think the more you can demonstrate a will and commitment to sustainability over the longer term, by which I mean at least 10 years but beyond that if possible, the more flexibility there will be to address near-term concerns relating to the recovery and so on over the next 2 or 3 years. But you need both. You need both.

I think once again I agree with Senator Sessions that just simply promising, future action risks at least an adverse market reaction, adverse reaction in terms of confidence, and so on. It is the combination which I think could be effective.

Again, in the near term, we are looking still at a couple more years of recovery. But, there is nothing that stops us from very soon also laying out in some detail and with some commitment what the longer-term plan is to address the fiscal problem.

Senator WARNER. In advance of us passing that long-term plan, one thing that would be at least helpful to me, it might be easier for you to comment about what those benchmarks ought to be, regardless of whether it is revenue increases or spending cuts, when they ought to be phased in.

Let me follow up on a line Senator Cornyn raised about unemployment, and I agree we have to do more things. I think one of the interesting points we have right now, it seems like America’s rallying cry a little bit right now is, “At least we are better than the EU,” which does not exactly stand in terms of, “Give me liberty or give me death” as an American statement. But one of the things that we have by this kind of unique circumstance, even with our challenge is, obviously, enormous capital coming into our system

where we are close to zero or even negative real rates of return for that capital coming in.

Have you given any thought—one area that I think there is bipartisan consensus on is that we have been dramatically underestimating—or underinvesting in our infrastructure, broadly based, and that is, what used to be a competitive advantage is turning into a competitive disadvantage, and with private foreign capital sitting on the sidelines. Have you or your entities looked at all at any of the infrastructure bank proposals out there? We have a bipartisan one that does not create additional grants—it is not a next-generation GSE; it is more a loan support modeled after OPEC or Ex-Im—that might be able to get some of the capital that is rushing in off the sidelines into what would help on both the employment standpoint and long term.

Mr. BERNANKE. No, I have not looked at the infrastructure bank in detail, and I am, again, a little bit leery of taking positions. But I would make the following point, which is that much of the deficit discussion has been about total revenue and total spending. That is only the first cut. Beyond that, we have to ask ourselves: Is the Tax Code efficient and effective, fair, simple, et cetera? And on the spending side, are we spending in ways that are effective? You know, we do not want to build useless monuments. We want to make investments, whether it is in people or in infrastructure or whatever, that are going to pay a return.

Senator WARNER. You have to have a growth component. You cannot cut—

Mr. BERNANKE. Take it from a business perspective. You are much better off making productive investments.

Senator WHITEHOUSE. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman, and, Chairman Bernanke, thank you for being with us once again and for your time and your patience. I appreciate it.

Let me start by echoing the comments of Senator Grassley. I want to compliment you on the decision you have taken to enhance the transparency of the Fed's activity and operations. I know you have put a lot of thought into this and advocated this for a long time. I have long shared your view that it is better for our economy, it is better for everyone involved, if the Fed does operate with greater transparency. Specifically, I like the fact that you have articulated an inflation target. We could have long and interesting discussions about exactly what that should be, but the fact that you are specifying a number I think is very constructive, and so I want to thank you for that development.

I want to talk a little bit about the dual mandate that you have to contend with and then these combined simultaneous objectives of promoting full employment and maintaining price stability. You have said, I think, if I have it right, that the Fed essentially through monetary policy can control inflation over the long run but cannot control unemployment over the long run. Is that a fair characterization?

Mr. BERNANKE. Yes.

Senator TOOMEY. So the thing that I am concerned about—and I am not asking you to criticize the dual mandate. I know you are going to live with the law of the land as it applies to you, and I

fully understand that. But isn't there a real possibility that these objectives will at some point not be complementary? In other words, it seems to me very likely, for instance, that the unemployment rate is going to stay above the optimal full employment level for a number of years. And it also strikes me that at almost any time inflation could kick up above the targeted level that you have set. It has very recently. It could, as I said, at almost any time.

If that were to happen, it seems to me you have this tension between these two simultaneous objectives. You have described, quite sensibly, that you would take a balanced approach to dealing with this. But doesn't that necessarily mean that in that scenario where unemployment remains persistently high and the inflation rate kicks up above the target, wouldn't you necessarily have to back off that targeted level or pursue a policy that would tolerate higher inflation than your own target?

Mr. BERNANKE. So, again, this, is a dual mandate-oriented approach, as you understand, and we thought the main benefit of being clear was to provide more information about what our long-run objectives were, to get more quantitative information about that. The situation you are describing, just to be clear, is hypothetical. It is not currently the situation. Inflation looks to be at or near the target going forward.

Senator TOOMEY. At this precise moment, yes.

Mr. BERNANKE. Let me be clear about one thing. We are not going to seek higher inflation in order to advance employment. It is possible that because we do not control in the short run perfectly, obviously, inflation and employment, that you could have shocks that would drive both objectives away from their target, in which case in a very symmetrical way we would be returning both parts of the mandate toward the target, but we would have to take account of the other part of the mandate. So, it could affect the speed at which we return inflation to target. But by the same token, if inflation is high, it could affect the speed at which we return employment to the target. There has to be some interaction of those two things, and it is fully balanced and symmetrical in that respect.

Senator TOOMEY. That is roughly what I thought you would have to say. Let me try a different approach. It seems unlikely, to me anyway, that the Fed would pursue such an extremely accommodative monetary policy as it has been pursuing and is pursuing if it were not for the employment mandate. I am concerned about some of the unintended consequences of maintaining zero interest rates, negative real interest rates, and I wonder if you would comment on some of these. I just think about some of the implications. Savers are being punished for this at least twice: once by virtue of the fact that after sacrificing their whole life to accumulate savings, they get no return; and then the very real possibility that the value of those savings will be eroded. Secondly, we are encouraging excessive risk taking. Thirdly, it seems to me this drives a misallocation, certainly has the potential to drive a misallocation of investment and, I would argue, the risk of creating bubbles. In fact, it is hard not to see the U.S. Treasury market as a bubble right now. And, lastly, doesn't this enable the excessive deficits that we are running

here, in part because they are funded at artificially low interest rates?

So these are some of the concerns that I have from this policy, and I wonder if you would just comment on them.

Mr. BERNANKE. I do not know if I can cover all of them. Let me just first say that our single mandate, central banks like the Bank of England and the ECB, which have policies very similar to the Fed, given that inflation is close to target, I do not think we would be doing radically different things if we had a single mandate at this particular in time. We are quite aware of these costs and risks. I have talked about them in speeches, and it is one of the reasons that we discussed the efficacy and the risks associated with the policies as part of the overall discussion.

With respect to, say, savers, it is true that low interest rates reduce the return that savers get on their saving, but I would make the general point that savers just do not necessarily hold, say, Treasury bonds. They also hold corporate debt and stocks and a variety of other securities, and the returns on those securities depend very importantly on the strength of the economy. So by trying to strengthen the economy, we are helping to improve the returns to savers.

To some extent, on risk taking, part of the reason for the policy is to move people away from very conservative liquid positions slightly more into riskier positions that involve investment and lending and so on that would help promote and strengthen the economy. We do not want to go too far, and we are very attentive to that. And we have greatly expanded our ability to monitor the financial system and to watch out for problems and to try to address them. And I have been in many conversations with insurance companies, pension funds, and so on.

On misallocation, we are trying to get the economy back to a more full employment situation. When you are this far away from full employment, it is not obvious that the investments that are being made are the right investments. They may be insufficient, for example, because there is not enough demand for product.

You asked me before about deficits, and I understand that concern. But I think that the effects of Fed policy, independent of all the other factors, on Treasury rates is modest, and in any case, rates will rise eventually. And if investors were to lose confidence in U.S. Federal fiscal policy, there is nothing the Fed could do to prevent those rates from rising.

So I trust that Congress will understand that, independent of the Fed's policy here, which is aimed at strengthening the economy, which also helps deficits, that it is extremely important to be looking ahead and making appropriate plans for stabilizing the deficit. I would be happy to talk with you at some other time more at length if you would like.

Senator WHITEHOUSE. Senator Portman.

Senator PORTMAN. Thank you, Mr. Chairman, and to Chairman Bernanke, thanks for your insights today. As usual, I want to join my colleagues in commending you on the increasing openness and transparency at the Fed. In that spirit, I am going to ask for your openness and transparency on some questions on the economy.

You talked a little about the fact that you see some signs of improvement, especially in manufacturing. Those are certainly welcome. But you also cited a number of troubling aspects. You talked about the long-term unemployed and said that over 40 percent of people have now been unemployed for more than 6 months, which is twice what it was in the last recovery. I would add to that that this recovery is not like any previous recoveries, certainly going back to the Depression, which you are student of, in the sense that the jobs are not coming back the way they have. We are over 5 million jobs down still 48 months after the recession. At this time, after the 1981 recession, which was the deepest recession in recent times, we had 6 million jobs that had been created as compared to over 5 million down. And even in the so-called jobless recovery of 2001, as at this point, 48 months out, we were up at least 350,000 jobs. Something is going on that is very different.

I also think that the labor participation rate issue is a key issue, and it is part of your mandate. You did not talk about that in depth, but my understanding is you said earlier the 8.3 percent is understating unemployment. But if the participation rate were simply where it was prior to the recession, which makes it about 66 percent participation versus 64 percent, our unemployment number would be over 10 percent. And so I think we have a more serious structural problem than perhaps just another business cycle. And if you agree with me on that, then I would love to hear what you think about what we should do in terms of structural changes. I would add to that, by the way, what you cited on the fiscal side. You in essence said that we are at an increased probability of a fiscal crisis, as I read your testimony, because of crowding out higher debt payments, but also the possibility of, as what has happened in southern Europe, a sudden spike in interest rates.

So my question to you is, on the tax side, on the regulatory side, on the health care side, on the energy side, as you talked about briefly, in the area of health care costs, worker retraining, don't we need sort of a reset of the economy and a more aggressive structural change to our economy? And if so, if you agree with that, along what lines would you suggest?

Mr. BERNANKE. Well, first of all, I think that there is still a substantial cyclical component in what is happening. Our estimate of long-run unemployment of 5.2 to 6 percent is still quite far below 8.3, of course. So it remains important to try to continue to support the recovery. There are a number of forces that are slowing the recovery, and I talked about housing and financial markets and credit markets in my testimony.

All that being said, good policy is good policy anytime. There are lots of things where the U.S. would benefit from structural reforms. I have talked frequently about the Tax Code. I know you are very interested in budgeting and Tax Code issues. That would be very constructive. We have very important needs on education and workforce skills. R&D continues to need support. Health care is a major, major issue both because of the Federal fiscal situation—this is the major force driving the long-run deficits, or a major force—but also because these high costs are bad for the efficiency and the living standards of the economy in general.

So those are all areas that, when you and I were colleagues in the previous administration, we talked about some of those issues. You have worked on trade, which is also an area where I think progress can still be made. So all of these structural reforms should not be put on the shelf just because we are still recovering from a deep recession.

Senator PORTMAN. I would just suggest that, back in those days you talked about, I was OMB Director in 2007, as and we had 4.5 percent unemployment. We had a debt that was 1.2 percent of GDP. Things seemed like they were going pretty well. Obviously, they were not. There were some underlying problems in the economy. But the fact is I think we need more of a sense of urgency, and I think from your position and one of credibility and respect on the monetary side but also on the fiscal side, I think that sense of urgency is needed. I really believe that we are looking at something different this time, and I think if we do not begin to make these serious changes, we are going to be in trouble.

You mentioned tax reform as an example. In the last two decades every one of our OECD partners, meaning the developed countries in the world, have reformed their tax code to attract investment and capital. You talked about the need for us to change our Tax Code to encourage working, to encourage savings and investment and capital formation. Everyone has done it except us, and we continue to fall behind as a result, in my view. And this I think can be played out in these other areas we talked about, certainly including on the regulatory side and health care, as you said, and as you say, health care will bankrupt the country unless we do something about it.

So I thank you for your testimony today, and I look forward to your continued advice on the structural changes we need in our economy to truly deal with the second part of your mandate and to get this economy and jobs back on track.

Mr. BERNANKE. Thank you, Senator.

Senator WHITEHOUSE. Senator Ayotte.

Senator AYOTTE. Thank you, Mr. Chairman.

Chairman Bernanke, I appreciate your hard work. I wanted to ask you in a follow-up to what Senator Portman framed in terms of the concerns about the fiscal outlook of this country and where we are obviously with over \$15 trillion in debt, rising health care costs, a situation where if you are relying on entitlements like Medicare, the trustees have said that will go bankrupt in 2024, and then looking farther out, Social Security in 2036.

What is it, when you think about the fiscal state of this country and your responsibilities as the Chairman of the Reserve, that keeps you up at night?

Mr. BERNANKE. Well, I have tried to stay away from individual programs and taxes, but I feel it is within my remit to talk to Congress about the overall fiscal situation. I think it is very clear—and I am sure Doug Elmendorf made a very clear presentation—that on current reasonable expectations about policy, the U.S. Federal deficit will become unsustainable within 15 or 20 years at the most, and that possibly some of those effects will be even brought forward by markets, for example.

So we clearly need some major changes in our fiscal planning, in our fiscal path going forward, and I would want to emphasize these are concerns which are not just about our children 20 years from now, but they could have effects much sooner if markets began to lose confidence in our Nation's ability to stabilize our debt burden.

Senator AYOTTE. And in follow-up to what Senator Portman said, do you believe that here in the Congress we need a greater urgency in addressing these issues, these structural issues?

Mr. BERNANKE. Certainly you do. In fairness to the hardworking people here, I would say there is a lack of clarity to some extent among the general public. I think people have conflicting views about, what they want, and everyone wants a lower deficit, but nobody wants to lose their own program or their own tax cut. So it is difficult, I understand, but absolutely, I think we would all benefit from action to credibly and strongly articulate a plan that would bring our fiscal situation into sustainability over the next couple of decades.

Senator AYOTTE. And does that need to happen immediately, in the next year or two?

Mr. BERNANKE. As soon as possible, certainly.

Senator AYOTTE. Thank you.

I wanted to follow up on questions that Senator Toomey had asked you about some of the risks that we see with our monetary policy right now. Yesterday, Charles Schwab wrote a piece in the Wall Street Journal. I do not know if you had a chance to look at that piece, but in addition to the issue that you already addressed to Senator Toomey, which was the issue of the risk of keeping interest rates low with respect to savers, he also noted that there is also a concern that—he described it this way: We have also seen “a destructive run of capital out of Europe and into safe U.S. assets such as Treasury bonds, reflecting a worldwide aversion to risk.” And, “New business formation is at record lows....There is still insufficient confidence among business people and consumers to spark an investment and growth boom.”

“In short,” he says, “the Fed's actions, rather than helping, are having the perverse effect of destroying the confidence of businesses and individuals to invest and the willingness of banks to loan to anyone but those whose credit is so strong they do not need loans.”

Can you respond to that?

Mr. BERNANKE. I disagree with that completely. I think, first of all, one of the goals of our asset purchase program is to take safe Treasuries out of circulation and push investors into situations which are appropriately risky, that is, making loans, buying corporate debt, and taking actions, hiring, investing that will expand the economy. So obviously beyond a certain point you do not want to create excessive risk, but going from a situation where people are very hunkered down to a slightly riskier position is positive for the economy.

Moreover, when banks and others are making decisions about whether to lend, they have to ask what is the alternative. The alternative now is very low yielding Treasury securities. So making only 2 percent on a 10-year Treasury, that is a very low bar for making a 10-year loan to a new business, and that encourages

lending rather than discourages lending. So our policy is strengthening the economy, and that reduces uncertainty and increases the willingness of firms to hire and invest.

Senator AYOTTE. Thank you. I know that my time is up. I would also see the risk as well in terms of the booming of interest rates to our debt and having to address that issue right away.

Thank you.

Senator WHITEHOUSE. Next is Senator Thune.

Senator THUNE. Thank you, Mr. Chairman, and thank you for calling the hearing to talk about monetary policy and fiscal policy, both of which impact our economy. The economy is the issue that is on the forefront of the minds of the American people, and I want to thank you, Mr. Chairman, for making time to be with us today to talk about your views on that.

I am sure this has probably been asked in some form today, but I want to get at the level of exposure that the U.S. banking system has to eurozone banks. My understanding is that overall exposure has come down. I am concerned that there is significant derivatives exposure that remains, and if the situation of the eurozone were to deteriorate, we could see a crisis on a par with what we saw in 2008 and 2009 in this country. I am wondering if the Federal Reserve keeps records of total exposure that our U.S. banks have to the European banking system.

Mr. BERNANKE. Well, we do. As supervisors, we ask banks to provide the information to help us analyze their exposures. They are, particularly to the direct sovereign debts of the weaker countries, much reduced. The banks still are exposed, of course, to their European counterparts, but they have also reduced that exposure and hedged it to some extent.

I would like to point out that we also look at the quality of the hedges. A credit default swap is no better than the bank or the counterparty who wrote it, and so we have been looking at that as well. So we think banks have made progress in protecting themselves against problems in European sovereign or bank debt, but I would agree with your final observation, which is that if there is a very substantial crisis or similar problem in Europe, because there are so many channels in which that would flow through the financial system, I think our banks would still be and our whole financial system would still be significantly affected.

Senator THUNE. But you do have a way of calculating or quantifying that exposure, and you are confident that risk is being reduced by banks in this country to a level that you would say is sufficient?

Mr. BERNANKE. Well, it is being reduced. It is, of course, difficult to ask banks to completely eliminate their exposure to a major part of the world economy, which is Europe, but, yes, there has been progress made both by banks and by money market mutual funds in reducing exposures and improving hedging. But, again, I do not want this to be interpreted as a complacent statement. I think that if there were a major problem in Europe, the risk aversion, the volatility, the uncertainty, all those things would have a powerful impact on our financial system.

Senator THUNE. Broadly speaking, is the United States currently in a fiscal position to withstand another economic crisis?

Mr. BERNANKE. That is an interesting question. Ironically, the U.S. dollar strengthened and U.S. interest rates went down during the worst parts of the crisis because the U.S. is viewed as a safe haven and it is where a lot of investors want to go, when the rest of the world is uncertain. So in that respect, that actually helps us.

On the other hand, if we were to have a significant further downturn in the economy that reduced down tax revenues and greatly increased deficits, that would certainly increase the stress on an already stressed situation.

Senator THUNE. And with regard to that, one of the responsibilities of the Federal Reserve Board is to have regular contact with the President's Council of Economic Advisers and other key economic officials. As Chairman, you also meet from time to time with the President. In those discussions, in your contact with the President and his advisers, have you underscored the necessity of entitlement reform in order to get the country back on a sustainable fiscal path?

Mr. BERNANKE. That issue is well recognized and I have certainly talked about it, yes.

Senator THUNE. Okay. One of the concerns that many of us have had is that there has not been—in the President's budget submissions, at least, and we are going to get another one here this next week—any real focus on those issues and a willingness to confront what we think are very serious fiscal challenges with regard to these unsustainable costs driven primarily by the big three, if you will, Medicare and Medicaid and Social Security. I assume that you agree entitlement reform cannot wait. That is something that we need to be focused on.

Mr. BERNANKE. I think, inevitably, that is going to be part of broad fiscal reform. It does not mean that the system has to change tomorrow, because, after all, people who are already receiving those benefits deserve, not to be shocked by radical changes in their benefits, and I think most people would agree with that. But one could take action now to propose longer-term changes.

I think it is interesting that the Commission that looked at Social Security in the early 1980s and proposed a phase-in of the retirement age, that phase-in is still going on today—

Senator THUNE. Right.

Mr. BERNANKE. —30 years later. So doing things well in advance actually makes it politically and economically much easier to adjust to.

Senator THUNE. Okay. I see my time has expired. Thank you, Mr. Chairman.

Senator WHITEHOUSE. And we saved the best for the last, the Ranking Member, Senator Sessions.

Senator SESSIONS. Well, thank you, Mr. Chairman, for your patience and sharing your views on the economy with us. I would just add that there are dangers out there. We cannot always predict what they are, and I believe we are running a debt at a level so high that it could cause problems that we cannot foresee.

Charles Schwab is not an insignificant figure in American economics, and he is not totally happy with the Fed. I would say if we asked you in 2006, did you agree with Nouriel Roubini, you

probably would have disagreed. But sometimes dark prognostications, unfortunately, come true. I am worried about our future.

You have talked about the dangers our entitlements impose. Do you have any concerns that the size of our debt presents a threat to our economy, both as some sort of financial crisis that Erskine Bowles predicted and as drag on current economics growth.

Mr. BERNANKE. Well, Senator, you just pointed out that it is very hard to forecast, and then you asked me to forecast.

[Laughter.]

Senator SESSIONS. You have basically said you do not foresee any danger in the next few years—

Mr. BERNANKE. No, I did not say that. I think—

Senator SESSIONS. Well, what would you say the dangers are in the next few years?

Mr. BERNANKE. I would say the following, which is that my sense—and it is just my sense—of markets is that they are not reacting to the current level of debt. What they are attentive to is the process. In other words, if you think about the S&P downgrade of U.S. debt last summer, they cited what they felt was the inability of Congress to actively work together to achieve meaningful reductions in the debt profile.

So my sense is, and, of course, I do not know for sure, but my sense is that a strong demonstration by Congress and the administration that they understand these issues and that they have a plan for attacking them, I suspect, would go a long way to maintain confidence in the bond market. But that is just my judgment.

Senator SESSIONS. It is an uncertain world.

Mr. BERNANKE. Of course.

Senator SESSIONS. Do you agree with the idea Rogoff and Reinhart developed in their book that when a nation's debt reaches 90 percent of GDP, that it could pull down growth from one to two percent? Do you think that is a sound theory or do you reject that?

Mr. BERNANKE. I do not think there is a fixed number. But I did say in my testimony that as debt gets higher, particularly as the economy gets to full employment, it will tend to raise interest rates and crowd out investment and affect productivity growth. So it is certainly a negative. I do not think that was even in their book. I think that was in some separate work that they did.

Senator SESSIONS. That is—

Mr. BERNANKE. But in any case, I do not think there is a magic number. But certainly, the higher the debt-to-GDP ratio—

Senator SESSIONS. What would you consider to be the debt-to-GDP ratio today? What is the valid—

Mr. BERNANKE. What is it today? Well, the Federal debt held by the public relative to GDP is somewhere around 70 percent. If you add State and local obligations, it might be closer to 90 percent. Then you have to ask, how do you deal with unfunded liabilities way out in the future.

Senator SESSIONS. You are talking about Social Security and Medicare.

Mr. BERNANKE. Social Security and Medicaid that is unfunded, and that would put you over 100 percent. So there are different ways of looking at it. Certainly, the main concern I have, again, is not the level at a given moment in time but just the fact that we

are on a path that is not going to be sustainable, where the amount of debt will cause higher interest rates, which will cause higher deficits and will continue to move into the stratosphere and that has to be addressed before it happens, obviously.

Senator SESSIONS. At a coffee shop in Davos last week, Mr. Rogoff was quoted in the Financial Times. The interviewer said when a State's debt exceeds 90 percent of GDP, it will reduce the economic potential for that country. And then the reporter said, I suggested that the United States is still comfortably short of that level, but I am swiftly corrected. If you count the Federal, State debts crucially and add in unfunded debts and the Social Security system, the matters you just mentioned, the Rogoff thinks America's debt level is well over 120 percent of GDP. And their paper is based on exhaustive study of financial crises.

Thank you for sharing with us. I do believe you are correct to advise us that we should move forward with reform on all fronts sooner rather than later. We disagree about exactly when we ought to start some of the reductions in spending. I believe that we should not go a day with inefficient, wasteful government spending. Every bit of that should be eliminated sooner rather than later.

Thank you, Chairman Bernanke, and thank you, Mr. Chairman, for your courtesy. I hope our permanent Chairman feels better soon, or our quasi-permanent Chairman.

Senator WHITEHOUSE. We wish Senator Conrad well, who is beleaguered with an infection today.

Mr. Chairman, I would like to review a discussion we had in our earlier meeting because I think it is helpful to put the spotlight on the issue, and it is the question of health care, which is the most significant part of the discussion about so-called entitlements.

I would begin with the observation that we have very significant Medicare liabilities out into the future, but we also have very significant Medicaid liabilities that are going up. We have private health insurance whose costs are going up at least as fast if not faster. It is a little hard to judge because they take away benefits to offset costs. But it appears to be going up faster, in my view. You have the Veterans Administration and the defense budget both suffering from increases in health care costs. Indeed, Secretary Gates said, "Health care costs are eating my budget alive," talking about the defense budget.

When you stack all of those different elements of the American health care system together, we burn 18 percent of our Gross Domestic Product on health care costs. Our nearest, our most inefficient, our least efficient industrialized competitor is at about 12 percent, which puts us 50 percent worse than the least efficient country in the world on health care delivery among our industrialized competitors. And very responsible views about what the savings are per year are as high as a trillion dollars a year, which is a big deal for the economy.

And sitting on this Budget Committee, I have the recurring frustration that there is a tendency to overlook the solution to that health care problem, which is actually very well underway in the private sector already in places like Geisinger and Gunderson Lutheran and Kaiser and Mayo and Intermountain and others, which is to, to quote the Ranking Member, turn our system, our health

care system, from one that is—he used this in a different context, but inefficient and wasteful to something that is healthy, lean, and productive.

And because that is a cultural transformation, because it requires turning a few corners, because it requires an element, as Atul Gawande said, of experimentation and innovation, it is not something that lends itself to scoring, and scoring is always the coin of the realm in these budget discussions.

So what I urged you in our off-the-record meeting and what I would urge you again here today is that as you are discussing this problem, please do not overlook that element of a potential solution, which would not only help with Medicare and Medicaid costs into the future, but help with health care costs across the board which are burdening our export industries, which are burdening our families, which are just a huge burden on the entire American economy.

That is my worry. Because you cannot score it, because it is a reform of a systemic nature, we tend not to talk about it. Simpson and Bowles came here. They agreed. Yes, absolutely critical. You are right. We did not talk about it because you cannot score it. Rivlin and Domenici came here. Yes, you are right. This is critically important. We did not talk about it because you cannot score it. Please do not let the Fed be a place in which this message gets lost simply because you cannot score it. Chairman.

Mr. BERNANKE. Well, Senator, I actually spoke about health care costs as a major factor in my testimony today and I agree with everything you said. We have a system which is excellent in some dimensions and is less than excellent in others, but certainly costs an awful lot. And finding ways to control those costs is absolutely essential, not just for the Federal budget, although it is critical for the Federal budget, but as you say, for the broader economy.

We have had a number of meetings at the Fed where we brought in health economists to talk to them about various approaches, and, of course, there are not any, simple approaches. But I guess one principle worth might set the stage for discussion. One way of looking at our system today is we have a fee-for-service system and third party pay. So there is really, in some sense, nobody who is making the economic decision about the effectiveness of care and that is an essential element, I think, of an effective system. There are many ways to address that, but that is one of the issues.

Senator WHITEHOUSE. Thank you. I appreciate your coming in today. I know you have a hard stop at noon and we are now two minutes over, so we will let you go, but—

Senator SESSIONS. Could I have two minutes more?

Senator WHITEHOUSE. Absolutely.

Senator SESSIONS. I would like to show some numbers that go back two administrations. The numbers indicate that even though the unemployment rate looks like it is moving down, we still have fewer people working today than in 2001 and that is pretty significant since the population of the working age has increased. I think all of us need to ask ourselves, how can we have more growth in productivity and job creation in the country.

Mr. BERNANKE. I could not agree more.

Senator SESSIONS. And then the other chart is the labor participation rate, which is looking at the percentage of people in the working age cohort who are working, and that is a steady downward trend. All of us need to be thinking about that.

I think one factor we have talked about is debt. It may be crowding out growth. But if we can think of ways to increase productivity without increasing our debt, would you not agree that would help. If these trends continue, it would indicate that the United States is weakening as a nation economically.

Mr. BERNANKE. Well, some of these trends are demographically related one way or another, but clearly, if we increase opportunity, more people will want to come back out of being out of the labor force and come back into employment.

Senator SESSIONS. But the number of people who have dropped out is significant, and these figures show that. That number right there is based—considers the demographic and age factors. It says, within the cohort of people that should be within the working age, we have fewer working, and all of us need to focus on that. I think it is one reason the middle class is feeling a lot of pain right now.

Mr. BERNANKE. Well, let us do reflect on the fact that although there is a long way left to go, we have gone from an economy that was losing over 700,000 jobs a month when the administration took office to one that gained nearly a quarter-million in the last report. So there is a lot left to do, but we are adding jobs, not losing them.

Senator SESSIONS. Well, I like adding some jobs.

Mr. BERNANKE. Thank you.

Senator SESSIONS. How many jobs does the economy need to create to okeep up with population growth.

Mr. BERNANKE. Oh—

Senator SESSIONS. The number—

Mr. BERNANKE. Normally, you need to grow two to two-and-a-half percent, somewhere around 100,000, 110,000 jobs a month just to keep stable in terms of the unemployment rate. So at least the last numbers—

Senator SESSIONS. We are above that—

Mr. BERNANKE. —the 240,000—

Senator SESSIONS. We are above that—

Mr. BERNANKE. —is above that.

Senator WHITEHOUSE. Thank you very much, Chairman. We appreciate your testimony.

Mr. BERNANKE. Thank you.

Senator WHITEHOUSE. The hearing is adjourned.

[Whereupon, at 12:06 p.m., the committee was adjourned.]

**Question for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Whitehouse:**

**Question:** Last week, I introduced legislation that would require the highest-earning Americans to pay an effective federal tax rate of at least 30%. This minimum would be phased in between \$1 million and \$2 million of adjusted gross income. As you may know, only about 0.1% of taxpayers earn over \$1 million, so 99.9% would not be affected by my bill - the Paying a Fair Share Act (S. 2059). We are awaiting an official revenue estimate from JCT, but outside groups have estimated the bill would generate tens of billions of dollars a year in revenue. If that is correct, would you expect it to have a significant impact on our deficits and borrowing costs? I expect many of my Republican colleagues will oppose the bill reasoning it would hinder job creation by taxing "job creators." Is there any evidence to support the theory that requiring those at the very top to pay a 30% tax rate would lead them to behave in a way that would create fewer jobs? Is there any evidence that increases in the top marginal tax rate during the 1990s hindered job creation?

**Answer:** I believe that it is appropriate for me to leave it to the Congress and the President to make the judgments about what specific actions are most appropriate in regard to tax and budget policies. However, it is clear that the decisions made about the size and the structure of the federal tax system have important consequences on the performance of the economy, fairness, and the size of government. These decisions entail balancing many factors to implement policies that reflect our values and priorities as a nation. In regard to economic performance, a basic principle of public finance is that the economic efficiency of a tax system can usually be enhanced if tax rates can be kept as low as possible while at the same time making the tax base as broad as is feasible in order to raise the necessary amount of revenue. Tax reforms that lower effective tax rates could provide tangible economic benefits by improving incentives to work, save, hire, and invest.

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

1. We can both agree on the importance of reducing the federal deficit. The GAO reported in 2011 that by replacing the \$1 note with a \$1 coin, the government could save at least \$5.5 billion over 30 years. Using Federal Reserve methodology in its 1990, 1993, and 1995 Reports, GAO calculated annual savings of \$318 million, \$395 million and \$456 million.

In addition, in 2000 GAO estimated savings of \$522 million per year, which projects to nearly \$16 billion in savings over 30 years. GAO also noted in a 1995 report that Federal Reserve Board of Governor Edward W. Kelley, Jr. testified before the House Banking and Financial Services Committee that the Reserve Model estimated \$460 - \$467 million per year in government savings by replacing \$1 notes with \$1 coins. In its latest, March 2011 Report, GAO stated: "We have previously recommended to the Congress replacement of the \$1 note with a \$1 coin and, in view of the ongoing significant estimated federal deficit, continue to support this prior recommendation." Do you support the GAO's recommendation that we move from a one dollar note to a one dollar coin?

The GAO has produced two recent reports on the issue of replacing \$1 notes with \$1 coins. The first report was published in March 2011 and the second in February 2012. Both rely on similar data, with the second report incorporating data on important efficiency improvements in the processing of notes. Most importantly, the second report clearly separates the GAO's estimates of the real resource costs of replacing \$1 notes with \$1 coins from estimates of the seigniorage revenue that might flow to the government from mandating use of the \$1 coin.<sup>1</sup>

Overall, the GAO found that the real resource costs of producing sufficient \$1 coins to replace all \$1 notes are never fully recovered during the 30-year period of analysis in its studies and that the net benefits to the government are attributable to increased seigniorage revenue from mandating use of the \$1 coin. This result flows from the fact that although coins are expected to last longer than notes, the coins are estimated to cost six times more to produce. In addition, the GAO's estimate of increased seigniorage from use of the \$1 coin flows from an assumption that coins would need to replace notes at a ratio of greater than 1-to-1. This replacement ratio, based on the experiences of Canada and the United Kingdom in the 1980s, presumably results from characteristics of coins such as weight and bulk that make holding and carrying coins a less efficient payment option for some purposes and leads consumers and businesses to store unwanted coins in informal inventories. Analytically, the closer the replacement ratio is to 1-to-1, the lower the amount of seigniorage revenue available to offset the real resource costs of producing the coins. Since seigniorage is crucial to these calculations, it is also important to recognize that the use of electronic payments has been growing rapidly and creates significant uncertainty about the long-term estimates of seigniorage. Other important issues involve

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<sup>1</sup> A 2004 GAO report clarified that seigniorage from coins is not counted in tallies of the U.S. budget deficit or surplus, and is not counted or scored by the Congressional Budget Office or the Office of Management and Budget for purposes of determining the budgetary effects of legislation.

changes in processing \$1 notes since the 1990s that have substantially increased their average life as well as concerns that counterfeiting \$1 coins could increase if they are in widespread use.<sup>2</sup>

**2. I am told that the Federal Reserve Board acknowledged the existence of an analysis by Board staff entitled “One Dollar Note vs. One Dollar Coin: A Cost-Benefit Analysis”, conducted in late 2008 or early 2009. It is my understanding that the report estimated annual savings of \$800 million to \$900 million from using \$1 coins instead of \$1 notes – which in turn projects out to as much as \$27 billion in savings over 30 years. I believe that study, as written in 2008/2009, would be very helpful to this committee as we look for ways to reduce the federal deficit, and would be particularly helpful in concert with the five GAO reports on this issue. Will you please share a copy of the study with me?**

In the latter half of 2008 and early 2009, the Board staff began a research study of the broader societal costs and benefits of changing the use of \$1 notes and \$1 coins. Initial work was undertaken by junior staff. However, because of other pressing matters at the time, that initial work was not reviewed, refined, or approved by senior management. As a consequence, no final study or analysis resulted from that effort.

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<sup>2</sup> For example, the United Kingdom is faced with a counterfeit £1 coin that the public is largely unable to authenticate.



**Questions for the Record  
Senator Sessions  
The Honorable Ben S. Bernanke  
The Outlook for U.S. Monetary and Fiscal Policy  
Tuesday, February 7, 2012  
Senate Budget Committee**

**Questions:**

Over the last three years, the Federal Reserve has lent out trillions of dollars at fixed interest rates that won't be paid back for long periods of time. At the same time the Fed borrows money at changing interest rates over short periods of time.

1. What will happen if interest rates go up?
2. Won't the Fed lose money?

**Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Sessions:**

**Over the last three years, the Federal Reserve has lent out trillions of dollars at fixed interest rates won't be paid back for long periods of time. At the same time the Fed borrows money at changing interest rates over short periods of time.**

**1. What will happen if interest rates go up?**

See response to question 2.

**2. Won't the Fed lose money?**

In response to the financial crisis that emerged in the summer of 2007, the Federal Reserve implemented a number of lending programs designed to support the liquidity of financial institutions and foster improved conditions in financial markets. After conditions in financial markets improved, however, these programs were wound down, and almost all of the loans have been repaid. Thus, Federal Reserve lending is unlikely to be a source of concern of income in coming years.

Beginning in late 2008, the Federal Reserve has purchased longer-termed securities in an effort to ease overall financial conditions and to support a stronger economic recovery. These purchases have resulted in an increase in the quantity of reserve balances in the banking sector. (When the Federal Reserve purchases a security, it credits the account of the bank of the entity from whom it purchased the security, thus increasing reserve balances.) Because the rate earned on the Federal Reserve's securities holdings is above the rate the Federal Reserve pays on reserves, Federal Reserve income has increased significantly as its securities holdings have increased. After covering its costs and making adjustments to capital, the Federal Reserve remits its income to the Treasury. Over the 2009-11 period, such remittances totaled more than \$200 billion, well above the usual level of remittances prior to the financial crisis.

As discussed in the minutes of the June 2011 FOMC meeting, at the appropriate time, the Federal Reserve will begin to remove policy accommodation and normalize the size and composition of its balance sheet. As part of this process, the Federal Reserve will likely raise the rate it pays on reserves to put upward pressure on short-term interest rates and also sell securities at a gradual pace over time. As short-term interest rates move higher, the Federal Reserve's interest expense on reserve balances will rise and the possibility of some realized losses on sales of securities could lead to lower Federal Reserve net income. Nonetheless, the odds are strong that the Fed's asset purchase programs, both through their net interest earnings and by strengthening the overall economy, will help reduce rather than increase the federal deficit and debt.

## ASSESSING INEQUALITY, MOBILITY, AND OPPORTUNITY

THURSDAY, FEBRUARY 9, 2012

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, Nelson, Whitehouse, Merkley, Sessions, 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.

First of all, thanks, everyone, for being here today. Really an outstanding panel of witnesses and colleagues who will be joining us. As this is the Thursday before a long weekend, and there is a great deal of other Senate business transpiring today, so we will have colleagues coming and going throughout the hearing. We apologize to the witnesses for that, but we hope you understand that on a Thursday before a long weekend there are many competing demands on the time of Senators.

Today's hearing will focus on income inequality, economic mobility, and opportunity in our country. We have five really distinguished witnesses: Dr. Jared Bernstein, a senior fellow at the Center on Budget and Policy Priorities; Dr. Heather Boushey, senior economist at the Center for American Progress. Am I pronouncing that correctly?

Ms. BOUSHEY. It is "Boo-shay."

Chairman CONRAD. I apologize. Heather Boushey, senior economist at the Center for American Progress; Ms. Sarah Anderson, Global Economy Project director at the Institute for Policy Studies; Dr. Scott Winship, fellow at the Center on Children and Families at the Brookings Institution; and Dr. Mark Warshawsky, a member of the Social Security Advisory Board.

Dr. Warshawsky, am I pronouncing that correctly?

Mr. WARSHAWSKY. Yes.

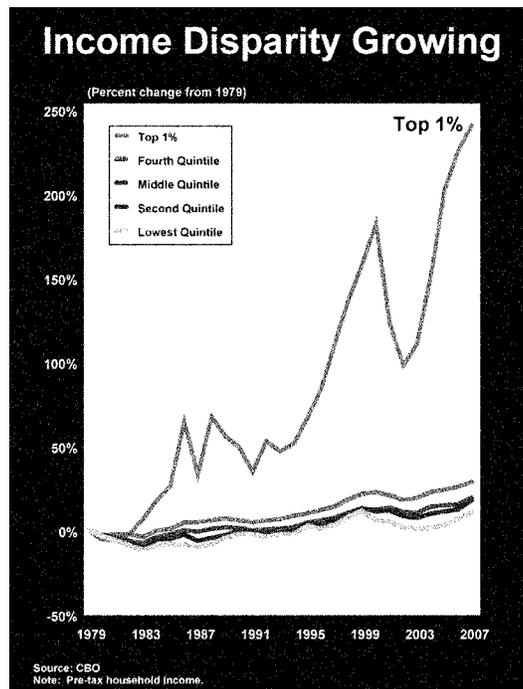
Chairman CONRAD. Thank you. Thanks to all of you for being here. You all have really come here highly recommended.

It is clear that income inequality, coupled with a lack of economic mobility and opportunity, is a significant challenge for our country. We have seen the rich getting much richer. Nothing wrong with

that. We applaud success in this country. But we are concerned when we see the middle class have their incomes stagnate. It has become increasingly difficult for middle- and lower-income Americans to move to the next rung on the ladder.

The growing gap between the very wealthy and everyone else has serious ramifications for the country. It hinders economic growth, it undermines confidence in our institutions, and it goes against one of the core ideals of this country that if you work hard and play by the rules, you can succeed and leave a better future for your kids and your grandkids.

This first chart shows the growing income disparity between the wealthiest 1 percent and everyone else. This chart is really very dramatic. Going back to 1979, you can see what has happened. If you look at the 80 percent who are at the lowest income levels of our society, their incomes have gone up only modestly. They have largely stagnated. The top 1 percent have skyrocketed during that period.



To help put these income levels in perspective, here is a breakdown of U.S. taxpayers by income group. You can see the average pre-tax household income in 2011 for the top 1 percent was \$1.5

million. In comparison, the average income for the middle quintile was \$45,000.

<b>Breakdown of U.S. Taxpayers</b>	
	<u>Average Income in 2011</u>
<b>Top 1 Percent</b>	<b>\$1.5 M</b>
<b>Top Quintile</b>	<b>\$252,000</b>
<b>Fourth Quintile</b>	<b>\$80,000</b>
<b>Middle Quintile</b>	<b>\$45,000</b>
<b>Second Quintile</b>	<b>\$25,000</b>
<b>Lowest Quintile</b>	<b>\$9,000</b>

Source: Tax Policy Center  
Note: Pre-tax household income.

Now, when my staff showed me this chart, I challenged it because I remember seeing repeatedly that the top 1 percent starts at about \$370,000 a year. And that is true. That is where the top 1 percent starts. But if you look at their average income for the top 1 percent, in 2011 it was \$1.5 million.

We also have an economic mobility challenge in this country. This is a recent article that appeared on the front page of the New York Times. It is titled, "Harder for Americans to rise from economy's lower rungs." The article notes that Americans enjoy less economic mobility than their counterparts in Canada and much of Western Europe.

# The New York Times

THURSDAY, JANUARY 5, 2012

## Harder for Americans to Rise From Economy's Lower Rungs

By JASON DePARLE

WASHINGTON — Benjamin Franklin did it. Henry Ford did it. And American life is built on the faith that others can do it, too: rise from humble origins to economic heights. “Movin’ on up,” George Jefferson-style, is not only a sitcom song but a civil religion.

But many researchers have reached a conclusion that turns conventional wisdom on its head: Americans enjoy less economic mobility than their peers in Canada and much of Western Europe. The mobility gap has been widely discussed in academic circles, but a sour season of mass unemployment and street protests has moved the discussion toward center stage.

Former Senator Rick Santorum of Pennsylvania, a Republican candidate for president, warned this fall that movement “up into the middle income is actually greater, the mobility in Europe, than it is in America.” Na-

tional Review, a conservative thought leader, wrote that “most Western European and English-speaking nations have higher rates of mobility.” Even Representative Paul D. Ryan, a Wisconsin Republican who argues that overall mobility remains high, recently wrote that “mobility from the very bottom up” is “where the United States lags behind.”

Liberal commentators have long emphasized class, but the attention on the right is largely new.

“It’s becoming conventional wisdom that the U.S. does not have as much mobility as most other advanced countries,” said Isabel V. Sawhill, an economist at the Brookings Institution. “I don’t think you’ll find too many people who will argue with that.”

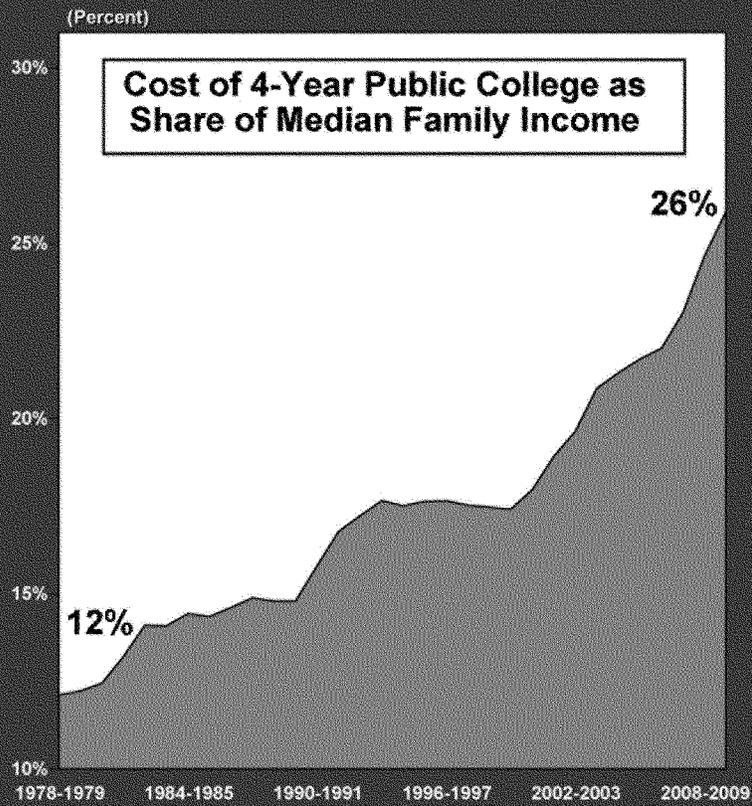
One reason for the mobility gap may be the depth of American poverty, which leaves poor

*Continued on Page A12*

One of the most significant factors blocking economic mobility is the rising cost of education. We have seen the cost of college education soaring. All of us who are grandparents know this. I compare what it cost for me to go to school and what it cost for my daughter to go to school and what it is costing for our grandson to go to school, and it really is dramatic. And this is having an enormous effect on families across the country.

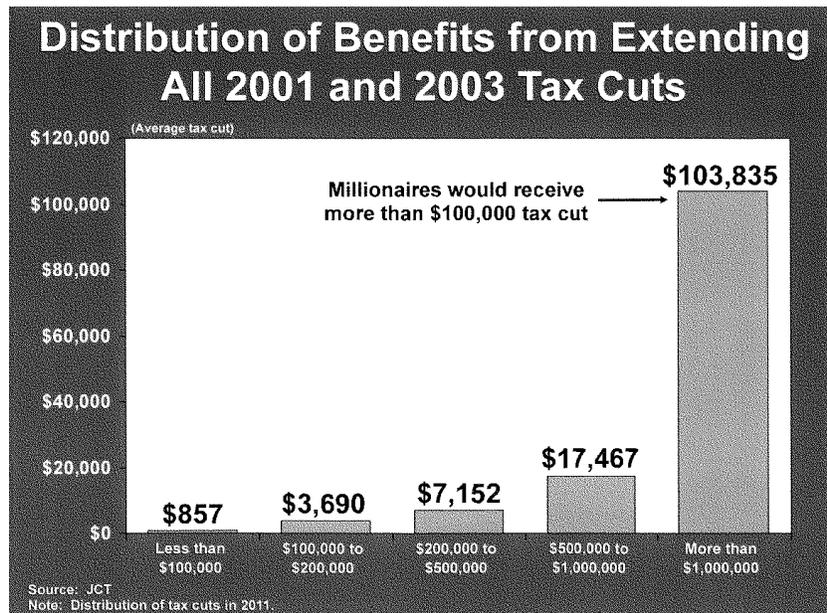
The cost to attend a 4-year public college has risen from 12 percent of median family income in 1979 to 26 percent of median family income in 2009. So that is a doubling in the share of median family income going to pay for a typical 4-year public school. Higher education is simply getting too expensive for many middle- and lower-income families to afford. I think we are hearing that from families all across the country. I am certainly hearing it from my constituents.

# Cost of College Education Soaring



Source: SBC calculations using data from National Center for Education Statistics and Census Bureau, U.S. Department of Commerce

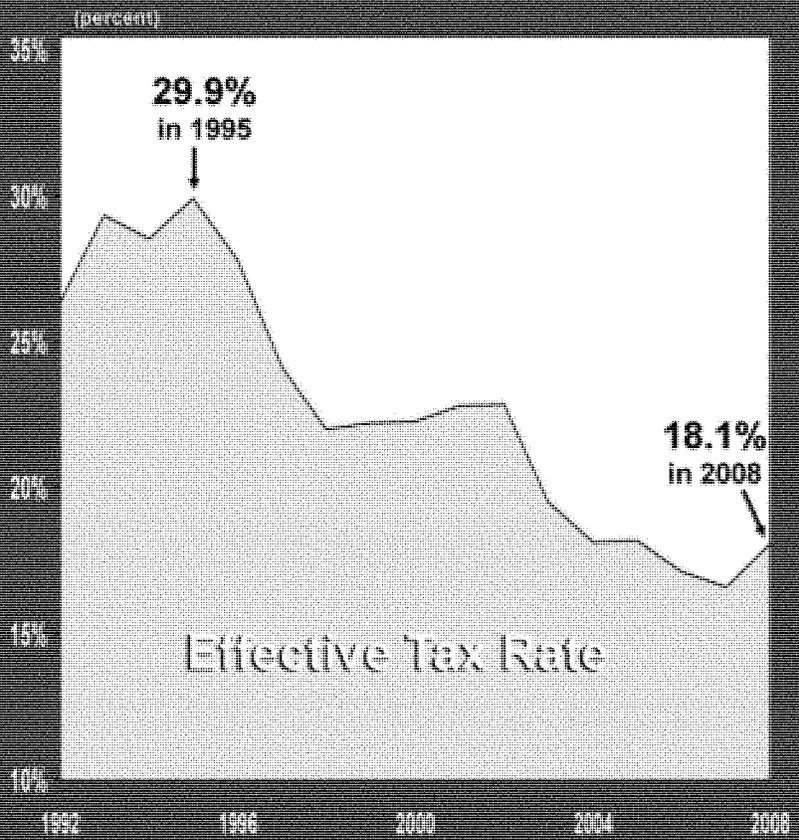
Unfortunately, our tax system is contributing to income inequality. The Bush era tax cuts in 2001 and 2003 were particularly notable for how much they were tilted to benefit those who are the most fortunate among us. If we look at who would benefit from extending all of the 2001 and 2003 tax cuts, we can see that millionaires would receive an average tax cut of about \$100,000. Meanwhile, those making less than \$100,000, constituting the vast majority of taxpayers, would receive an average tax cut of about \$850.



Those earning over \$1 million, average tax cut about \$100,000; those making less than \$100,000, constituting the vast majority of taxpayers, would receive an average tax cut of about \$850.

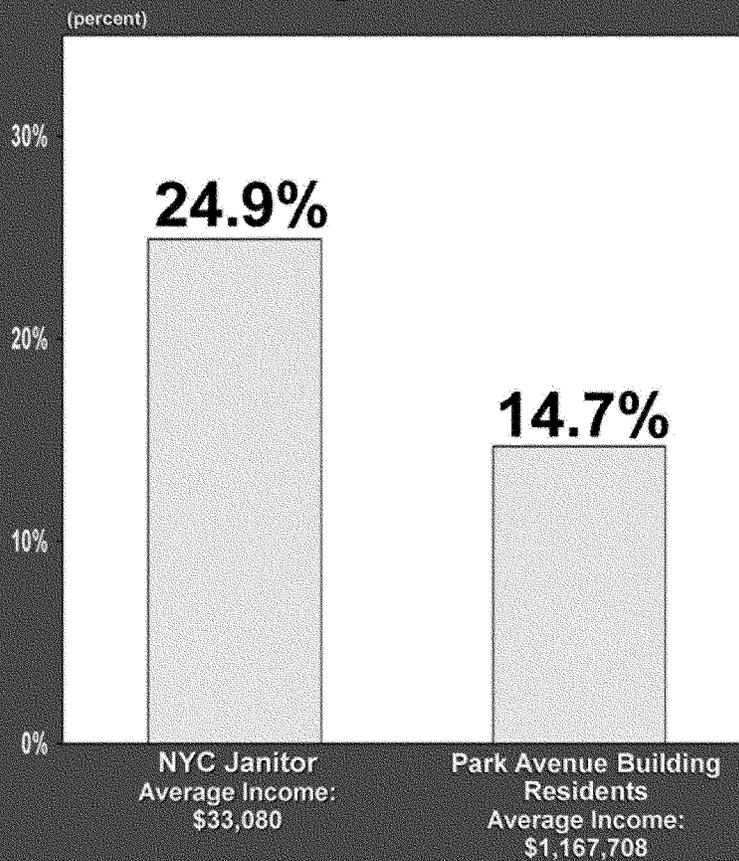
The effective tax rate for the wealthiest in this country, the rate actually paid after factoring in exclusions, deductions, credits, and other preferential treatment, has fallen dramatically. In fact, the effective tax rate for the 400 wealthiest taxpayers fell from almost 30 percent in 1985 to 18.1 percent in 2008. This trend was highlighted in an article in Tax Notes last year. The article used IRS data to compare the average effective tax rates for the residents of 1 Park Avenue building in New York City where the average income is more than \$1.1 million a year to the average effective tax rate for a typical New York City janitor, their average income about \$33,000. The data shows the average effective tax rate for the building residents was 14.7 percent. The rate for the janitor was 24.9 percent. That is just not right.

# Effective Tax Rate for 400 Wealthiest Taxpayers



Source: IRS

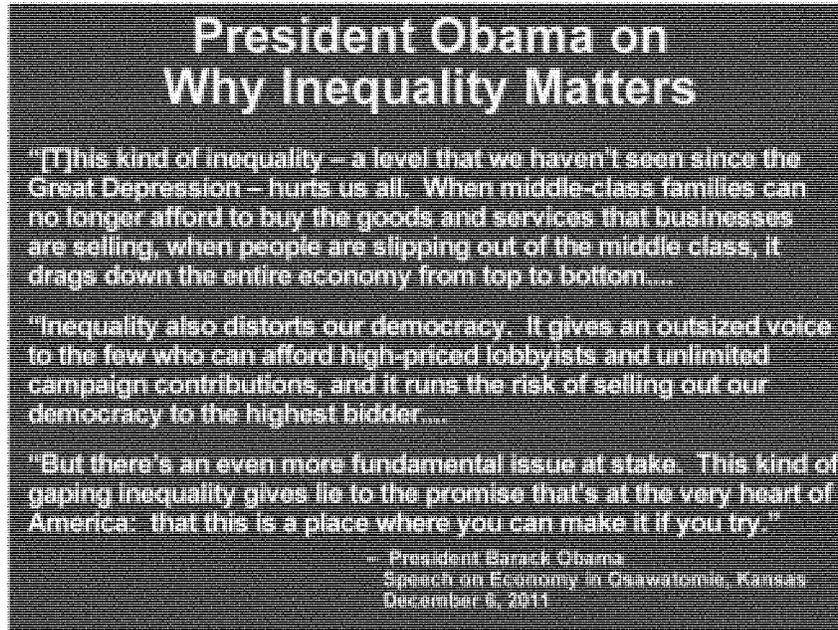
## Effective Tax Rate of NYC Janitor vs. Park Avenue Building Residents



Source: IRS

Note: As cited in Tax Notes, by Martin Sullivan, February 22, 2011.

In a speech in Kansas late last year, President Obama summed it up well in talking about the reasons for income inequality. He said, and I quote: “This kind of inequality”—excuse me just a minute. I am still recovering from this—whatever Senator Sessions gave me.



Senator SESSIONS. I know you have it, but we are glad you are back.

Chairman CONRAD. I am glad to be back, but the doctors tell me I am no longer infectious. I did not want to impose this on others. I stayed away.

The President said in his speech, “This kind of inequality, a level we have not seen since the Great Depression, hurts us all. When middle-class families can no longer afford to buy the goods and services that businesses are selling, when people are slipping out of the middle class, it drags down the entire economy. Inequality also distorts our democracy. It gives an outsized voice to the few who can afford high-priced lobbyists and unlimited campaign contributions, and it runs the risk of selling out our democracy to the highest bidder. But there is an even more fundamental issue at stake. This kind of gaping inequality gives lie to the promise that is at the very heart of America: that this is a place where you can make it if you try.”

I think the President has it about right. We need a society where everyone rises and falls based on their own hard work, skills, and ingenuity, not as a result of their family or the class that they were born into. We need to do a better job of removing barriers to economic mobility, such as the high cost of education. And we need to reform our Tax Code to make it fairer and less skewed to benefit the most well off.

With that, we will turn to Senator Sessions for his comments, and then we will turn to our distinguished panel of witnesses.

#### OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Mr. Chairman, this issue of income inequality is important. We need to talk about it. I have talked about it a good bit in my speeches. I am concerned about it. But I think we will hear from our panel today that some of the numbers that have been floated out there are distorted, and the best thing we can do to help those in middle and lower incomes in America is create growth, create more jobs, so businesses have to pay more to get better workers and more workers.

I would also say that Monday is the day the President is scheduled to submit a budget for the United States of America. As Mr. Bernanke told us yesterday, we have too much uncertainty. When asked should we have a Senate budget plan, he said about uncertainty—"Is uncertainty negative for growth? I think it is."

So we will have this hearing today, but the most important thing the Budget Committee needs to be doing is to be figuring out how to develop a long-term plan for America that will create growth to benefit all Americans. And some say we cannot begin to cut spending now, but I believe that the debt itself is a detriment to growth. According to the Rogoff-Reinhart study, we may already be seeing a decline in growth based on the fact that the gross debt is equal to 100 percent of GDP—above their number.

I was at a luncheon yesterday with the German, French, and Spanish ambassadors. The French ambassador, when asked, "Well, can you cut spending in France now that the economy is fragile in France?" His immediate answer: "We have no choice. We had no choice. We have to cut spending." He said, "What we are doing is focusing on growth. You are familiar," he said, "with the French bureaucracy. It would take months to start a business. We have started 600,000 new businesses in France, and now you can register a business online in 15 minutes."

The German ambassador said this: "You cannot fight a debt crisis with more debt." So I think that is the message this country is ready to hear, and they need to see a plan from the President that helps us get there.

Now, with regard to the hearing today, the Bush tax cuts shifted more of the tax burden to the rich than existed before those tax cuts occurred. The rich are paying a larger percentage of the total tax burden after the tax cuts than before. Senator Johnson, Senator Toomey, and others have indicated they are openly and aggressively willing to eliminate loopholes and things that allow people to avoid the taxes they ought to be paying.

The tax rate you showed of 24 percent, we have to remember that you are counting in that tax rate the pension payments workers make for their Social Security retirement plan that will benefit them the rest of their lives, and for the lower-income workers it is a particularly healthy pension plan and a disability insurance plan also. And I think that we need to focus on how to get the economy growing.

A couple of things I would mention. When measured by narrow definitions of household annual income, there is little disagreement

that the gap between the wealthy and poor has increased. But it is a narrow definition. According to a recent CBO report, the growth in income inequality has been driven largely by the gains, some surging gains, in the top 1 percent of people in America. And there are some things that give false impressions of inequality, making it look worse than it may be, and we will hear Dr. Winship and Dr. Warshawsky talk on some of the other factors that are at work here.

But significant changes in tax law have fundamentally altered what is reported as income, artificially making income inequality appear larger than it is. Growth in the tax-favored, tax-protected savings plans such as 401(k)s removed income that people were showing on their tax returns as taxable income, and now does not show up in the numbers.

We do not properly consider in these numbers mobility. The defining characteristic of the U.S. economy is upward mobility. Comparing snapshots of income distribution at points in time misses this important dimension and, therefore, can be somewhat misleading. Research shows that the distribution of lifetime income is more equal than what a one-time snapshot would show, Mr. Chairman. Research has generally found that about one-half of those in the bottom quintile—one-half in the bottom quintile—moved to a higher quintile in 10 years.

A study by an economist at the Federal Reserve Bank of Minneapolis found that nearly half of the families in the lowest-income quintile in 2001 had moved up, lowest fifth, had moved up within 6 years. Over the same period, more than a third of those in the highest quintile had moved down. A lot of the people that are making high incomes, those are one time or good years that often can turn sour in a hurry.

Research conducted by the Pew Economic Mobility Project on intergenerational mobility showed that two-thirds of 40-year-old Americans live in households with larger incomes than their parents had at the same age, even adjusted for higher prices and inflation.

A separate Pew study showed that four out of five adults today are better off than their parents were at the same age. We would like to have them all better off, and I am worried about some of the things that are happening. But we need to look at the numbers honestly.

Overlooked in the 2011 CBO report on income inequality is the acknowledgment that incomes rose for all groups over the study period: an 18-percent increase for households in the lowest quintile, 20 percent; an average of a 60-percent increase for households in the 21st through the 80th percentiles; and 65-percent increases for those in the 81st through the 99th percentile. That top 1 percent had greater growth. Just look at the bonuses football players and baseball players get.

Evidence shows that immobility among one segment of the population, men at the bottom fifth of earners, is especially intractable. Low education and unwed motherhood tend to exacerbate poverty in this demographic, which is particularly acute among racial minorities.

Executive pay has risen, but correlation is not causation, especially when the number of highly compensated CEOs is small in number and cannot explain the differences, mathematically.

Health insurance represents a significant and growing portion of worker compensation, including Government transfer payments like Medicare, Medicaid, CHIP. Because health insurance provided by an outside entity allows households to consume more health care without giving up income, without impacting their income, it is appropriate to include that in household income. But as the 2011 CBO report points out, many analyses of household income omit the benefit of health insurance. And Mr. Warshawsky concludes in a report that over half of the lag in wage growth among low-income workers is attributable to the rapid increase in the cost of employer-provided health insurance. A 2011 CBO report agrees that if you consider health care, Medicare, Medicaid, CHIP, the inequality distribution would not be as great.

So, Mr. Chairman, this is an important issue. I think we should air it out. I am really worried about our financial future. This Committee needs a budget. I know you believe in having a budget. But I am aware that the Majority Leader said we are not going to have one this year. The President apparently said just a day or two ago, maybe yesterday, that he was not going to ask the Senate to move forward with one. So I assume we will not move forward.

We need a financial plan for America that creates a framework for growth, prosperity, higher wages, and more jobs, and we need to consider some things like immigration and how a large flow of workers illegally in our country can indeed pull down the wages of American workers.

Thank you. I look forward to the hearing.

Chairman CONRAD. I thank the Senator, and I would like to just address for a moment the last issue that you raised because we do have a difference of opinion on this. We do have a budget. The Budget Control Act passed in August of last year, an overwhelming bipartisan vote in the Senate, passed the House, signed by the President into law, that established the budget for this year and next, set 10 years of spending caps. That is, I think, unprecedented in the time I have been in the Senate, 10 years of spending caps. It set up a procedure to give a special committee the ability to deal with revenue and entitlements, which, unfortunately, they were unable to agree on.

But with respect to the question of whether we have a budget, we do. In fact, the appropriators have been told to proceed to write their appropriations bills to the spending levels provided for in the Budget Control Act.

Where I would agree with the Senator is I think it would also be useful to have a longer-term plan. I believe we really need a 10-year plan. That is a place where we have agreement because we do have to act on this debt threat, and we need a longer-term plan to do it. That is where we have agreement.

Senator SESSIONS. Beyond 10 years, too. Is that what you are saying?

Chairman CONRAD. I actually—

Senator SESSIONS. Mr. Bernanke yesterday said the 10-year window is artificial. It would help our economy if we could show that in the long term we are on a sound path.

Chairman CONRAD. I agree with that entirely. In fact, I told my staff after the session we had separately with Chairman Bernanke, all of the members of the Budget Committee, he said to us repeatedly, Do not be a slave to the CBO 10-year budget window. Our problem, of course, in writing a longer-term plan is there is no scoring, there is no independent scoring of what the savings would be. But I think we really do need to think how could we write not only a 10-year plan but a longer-term plan.

Now, there is an additional place—I think we have to be brutally honest with each other. We have a difference on the short term. You believe we need to take austerity measures right now. I believe we need to take austerity measures right now but that do not kick in until the economy is somewhat stronger. In other words, I believe we need to write a 10-year plan and a plan beyond that would fundamentally reform our tax system, reform our entitlements, also take on other aspects of spending, and a credible plan to reduce deficits and debt. In fact, I would like to balance the budget in 10 years.

Short term, we have a disagreement because virtually every expert that has come before us has said do no harm. The Chairman of the Federal Reserve said be careful about tax increases and spending cuts right now when the economy is weak. Put them off. Do them, but do them when the economy is stronger. I believe that is good advice. This is where we have a difference.

Senator SESSIONS. Well, as I told Mr. Bernanke yesterday—he shared thoughts of that nature—we could work with that. I am willing to acknowledge that if we could get a 10-year improvement in our debt course, perhaps it would be better—and it would be better insofar as we can—to ensure that it occurs over a period of time. But I just would quote to you what the German ambassador said when they were confronting it, and they basically got their budget in balance: “You cannot fight a debt crisis with more debt.” So we need to begin to alter that soon.

Secondly, we are going to look at the President’s budget Monday, and we are going to ask, “Does he have a change in the debt course over 10 years?” The Joint Select Committee did not reach an agreement that touched the entitlement programs, which Mr. Bernanke and every witness has told us have to be dealt with.

Will the President propose a realistic solution to that, or is he afraid to do so because he wants to go into the election attacking those who have the gumption to stand up and say changes have to occur? That is the real challenge. You have been willing to say we have to make changes. Let us see what the budget that gets proposed Monday. Last year it did not do that. I do not believe we are going to be able to pass anything historic that the President does not support. And apparently he would rather attack the rich throughout this campaign and thinks he can win by proposing to take more money from the rich, and that is somehow going to create jobs and wealth and prosperity for working Americans. I doubt it will. That is not my vision of where we should heading with America.

So this is a big, big matter. I think this is an important issue we are dealing with today. This is a good panel, and I am glad you are feeling better, and I will try to hush for a while and hear from our panel.

Chairman CONRAD. Well, let me just say to my colleague, I believe the President has had it about right. I believe absent the steps the Federal Government took to climb out of the deep ditch that this President inherited—this economy was cratering when he came into office. We were losing 800,000 jobs a month. Now we are gaining 200,000 jobs a month. That is a dramatic turnaround. And I think the policies that he pursued are largely to be credited, and, by the way, it was not just this President. It was at the end of the previous President that we started with the TARP, that we started with stimulus. I think those steps were absolutely essential, and it is not just my opinion, but we have the work of Mark Zandi, who was one of the top economic advisers in the McCain campaign, and the work of the former Vice Chairman of the Federal Reserve, who concluded that the Federal actions that were taken prevented a second Great Depression, and that if those steps had not been taken, we would have had 16-percent unemployment today, 8 to 10 million more people unemployed.

So I think the President will get quite high marks for what he has done so far. The question that is fairly raised is: Where do we go from here? The place where you and I have an agreement is the need for a longer-term plan to get us back on track. That is what I hope that we are able to take up in this Committee. And I know the difficulties. I absolutely understand Senator Reid saying, look, we have a budget. Why would we spend time taking another budget to the floor when there is so little prospect of succeeding given the great divide both in this body and the divide between this body and the House? I understand that. I really do. I understand we have very few days available for floor activity on these issues, and so what are the prospects of getting another budget passed that really succeeds at taking on this long-term debt threat.

To me, it is worth the effort, but we have to be able to demonstrate here that we can find agreement because, otherwise, a waste of time to go to the floor.

I would just say this to you: I am committed personally to try to find a way if we can reach across the aisle in this Committee and put together a longer-term plan. But it would have to be a compromise. Neither one of us would get our own way, that is for sure. It would take an ability to find a way to come together. And, I must say I am not talking about the two of us now, but I am talking about the larger body. It has been hard to find a way forward. I was on the Fiscal Commission; 11 of the 18 of us there did agree, 5 Democrats, 5 Republicans, 1 Independent. The Group of Six, I have spent hundreds and hundreds of hours there. We did reach a framework agreement there. We have to show, if we really want to convince our leaderships that it is worth floor time, that we can come together. And I hope we do.

Senator SESSIONS. Well, I would just say that the Budget Control Act caps on numbers was done by a secret committee, and it was half what every witness told us we needed to reduce the debt by, \$2.1 trillion. They said it should be at least 4 trillion. Most people

think we should do much more because we are going to add \$13 trillion to the debt in the next 10 years. A \$2 trillion reduction to \$11 trillion in debt is not enough. It is just not enough. And so I am worried about that.

I will just say this: I would just say that if I have the opportunity and I think the Republican leadership has the opportunity a year from now to write a budget, we are going to write a budget. It is going to be a budget that the House and the Senate agree to. It is going to change the debt course of this country, and it is not going to continue this cloud over our future that, as Mr. Erskine Bowles said, is leading us—and as you have said, as we have all said, leads us to the most predictable debt crisis in America's history.

Thank you, Mr. Chairman.

Chairman CONRAD. Let me just say this is a place where we do agree. I tried to convince the Fiscal Commission to do a \$6 trillion plan. I tried very hard to convince them. I tried pretty hard to convince the Group of Six to do a \$5.6 trillion plan.

Senator SESSIONS. Which is hard.

Chairman CONRAD. It is hard. But it is doable.

Senator SESSIONS. It is doable.

Chairman CONRAD. It is doable. Well, let us go to our witnesses. We apologize to you, but this is an important discussion. We have to have it. We have to be honest with each other. And I think Senator Sessions and I have been honest with each other.

Dr. Bernstein, welcome. Please proceed.

#### **STATEMENT OF JARED BERNSTEIN, SENIOR FELLOW, CENTER ON BUDGET AND POLICY PRIORITIES**

Mr. BERNSTEIN. Thank you, Chairman Conrad and Ranking Member Sessions. I am honored to testify before you today.

My testimony focuses on the urgent importance of the issues at hand, but first, let me lay out the facts as they are widely agreed upon by most analysts. I have tried to use the most comprehensive income sources, ones that include the value of employer-provided health care, income and near-income transfers, realized capital gains, as well as sources that make adjustments for factors like changing household sizes over time, all of the factors, Senator Sessions, that you raised in your concerns. All of these adjustments are made, actually, by the Congressional Budget Office in their income series. My Figure 1 happened to be the same as your Figure 1, so I do not need to show it.

Senator SESSIONS. But some of the numbers that have been cited publicly do not consider all those factors.

Mr. BERNSTEIN. Agreed. Agreed. But in my testimony, I focus on the ones that do.

One reason the incomes of the wealthiest households have surpassed the rest is because of the concentration of non-wage income, like capital gains and dividends. Figure 3 from my testimony shows the concentration of capital income by income class. Eighty-six percent of all capital incomes accrue to the richest fifth of households. A subset of that 38 percent goes to the 120,000 households at the very tippy-top of the income scale, the top one-tenth of one percent.

The fact that this income receives extremely favorable treatment through our tax code—it is currently subject to a top rate of 15 percent instead of the 35 percent top rate on ordinary income—is one reason for its prominent role in the national inequality debate underway right now, a discussion motivated by the comparatively low rate of taxation on some prominent persons of phenomenal wealth.

So how does this play out in our inequality trends? Figure 5 from my testimony shows that the percent change in a measure of income concentration, again, using the comprehensive CBO data, comparing market or pre-tax income with incomes after taxes, shows that the increase in inequality was ten percentage points higher—higher—when taxes and transfers are included. So let me underscore this point. Income inequality, according to the CBO, rose ten percentage points more quickly after taxes than it did before.

I now turn to linkages between the topics of today's hearing, inequality, opportunity, and mobility. Senators, I am deeply concerned that too many American families, particularly the poorest among us, are stuck in a vicious cycle where high levels of inequality are preventing economic growth from reaching them as it did decades ago. And, Senator Sessions, I refer that point to your comments because growth in a climate of such inequality is not enough if it is not reaching middle-and lower-income families.

It is not just income growth, however, that they are missing out on. It is opportunity. Reduced opportunity, say less educational access for children from lower-income families, both reinforces high levels of inequality and diminishes economic mobility, making it harder for poor families to climb up to the middle class. This negative feedback loop is particularly likely to occur when inequality diverts overall growth from low-income families, leading to high and persistent child poverty. Causally, this chain of events is likely to operate through everything from diminished access to quality education, starting with preschool, to inferior public services, like poor quality libraries and parks, to lack of health care, inadequate housing in underserved communities, and even a polluted physical environment.

My testimony cites numerous studies that strongly suggest this negative loop is already underway, particularly as regards the impact of poverty in early childhood. I can think of nothing sadder and more wasteful than the inability of children to realize their potential, yet that is the threat of this reinforcing negative loop, from higher inequality to diminished opportunity to immobility.

Let me suggest the policy implications of the evidence I have presented. I am well aware of and support this committee's and its Chairman's commitment to putting this nation on a sustainable budget path. But in the interest of avoiding further damage to the ability of disadvantaged families to escape the vicious cycle I elaborated, we must not seek to get on that path by spending cuts alone. Spending cuts will be part of the mix. Thus far, they have been the only ingredient in the mix.

In this regard, I urge policy makers to be guided by principles put forth by both the Bowles-Simpson Commission and the Gang of Six. These deficit reduction efforts recognize that key Federal programs, like Food Stamps, now called SNAP, and the EITC

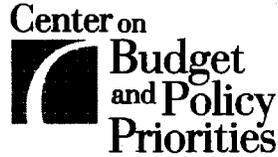
would increase poverty and hardship and both decisively ruled out such cuts. In fact, discretionary programs that serve low-and moderate-income families, programs like Pell Grants that play a role in the upward ladders against stagnant income mobility, have already been the target of budget cuts. Head Start, Title I, and job training, programs that can also help families overcome mobility barriers, these, too, are at risk. In the spirit of breaking the cycle of inequality, diminished opportunity, and immobility, Congress should avoid these cuts.

Turning very briefly to tax reform, allowing the high-end Bush tax cuts to expire at the end of this year as President Obama has proposed is consistent with the balanced approach I advocate above and the reduction of after-tax inequality. Ending the preferential treatment of income from capital gains and dividends is also consistent with the goals of both deficit reduction and moderating inequality.

In closing, I reiterate two points. First, by protecting those parts of the budget that offset poverty and promote opportunity, members can push back on the negative cycle I described in my testimony.

Second, through expiration of the high-end Bush tax cuts and ending preferential treatment of capital incomes, members of this committee can return progressivity to a tax code that has become considerably less effective as a levee against rising inequality. Thank you.

[The prepared statement of Mr. Bernstein follows:]



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February 9, 2012

**TESTIMONY OF JARED BERNSTEIN**  
**Senior Fellow, Center on Budget and Policy Priorities**

**Before the**  
**Senate Budget Committee**  
**United States Congress**

**Hearing on "Assessing Inequality, Mobility and Opportunity"**

Chairman Conrad, Ranking Member Sessions, I'm honored to testify before you today and I very much applaud your interest in the issues of income inequality, mobility, and opportunity. I can hardly think of any set of issues more pressing in the economic lives of American families.

As this committee well appreciates, even with recent improvements in the job market, the American economy still faces significant challenges, particularly the historically high levels of income and wealth inequality, the squeeze on middle-class incomes, and elevated rates of poverty.

The main findings of this testimony are:

- It is important to examine trends in income inequality through the lenses of various different data sources, as each has its own strengths and limitations. The fact that all of these series show similar trends toward increased dispersion of incomes is itself good evidence of the validity of their findings.
- A key factor driving the ups and downs in the inequality trend in recent decades is capital incomes, particularly capital gains; the fact that such income is given preferential treatment in our tax code relative to ordinary income from wages is thus a relevant issue for both inequality and tax reform.
- Some analysts and policy makers cite income mobility—movements by persons and families up and down the income scale over the course of their lifetimes, or from one generation to the next—as a reason why policy makers should be less concerned about historically high levels of inequality. However, a key finding here is that the rate of income mobility has not accelerated in recent decades; if anything, it may have slowed. Therefore, it is incorrect to argue that income mobility has offset the greater distance between income classes over time—i.e., higher inequality. It is also notable that there is considerably less mobility in the US than in most other advanced economies, including those with far lower levels of income inequality. This finding suggests that higher inequality may be blocking key opportunities, such as educational attainment, that would reduce inequality and enhance mobility.

- The potential interactions between our major economic and fiscal challenges remain a challenge for policy makers. Along with inequality, there is the related squeeze on low- and middle- class incomes, high rates of poverty, and the high, though declining, rate of unemployment. And, of course, a central concern of this committee is our bleak fiscal outlook. Addressing one of these problems could potentially exacerbate another.

For example, recent Congressional Budget Office analysis predicts that full and sudden expiration of the 2001 and 2003 tax cuts in 2013 would push unemployment higher.<sup>1</sup> Similarly, cuts to programs that are supporting low and moderate income families, like nutritional assistance, the Earned Income Tax Credit or the Child Tax Credit, could worsen poverty and inequality.<sup>2</sup> This worsening would further exacerbate inequality if we were to then turn around and use some of these savings to lower taxes on the wealthiest households.

While this may sound fanciful, it is not. In fact, the 2011 budget proposed by House Republicans does precisely this. As analysis from the Center on Budget and Policy Priorities shows, almost two-thirds of that budget's spending cuts over ten years — \$2.9 trillion—come from programs targeted at households with low and moderate incomes.<sup>3</sup> And those budget savings are used to support tax cuts for the wealthiest households.

With this in mind, a central question of this testimony is how policymakers can address these three problems—inequality, economic slack, and the fiscal path—without solving one problem at the expense of exacerbating another problem. Most pointedly, revenue and spending policies designed to put the nation on a sustainable budget path must not exacerbate inequality, poverty, or the ongoing middle-class squeeze.

### **Inequality, Opportunity, and Mobility**

#### *Inequality*

Based on a number of different data sources, each with their own strengths and limitations, inequality analysts have found the following:

- Low, middle, and high family incomes generally grew at similar rates from the late 1940s to the late 1970s, when they began to diverge.<sup>4</sup>

<sup>1</sup> See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012-2022*, January 2012, Table 2-2, [http://cbo.gov/ftpdocs/126xx/doc12699/01-31-2012\\_Outlook.pdf](http://cbo.gov/ftpdocs/126xx/doc12699/01-31-2012_Outlook.pdf).

<sup>2</sup> See for example Arloc Sherman, *Poverty and Financial Distress Would Have Been Substantially Worse in 2010 Without Government Action, New Census Data Show*, Center on Budget and Policy Priorities, November 7, 2011, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3610>.

<sup>3</sup> Robert Greenstein, *Chairman Ryan Gets Nearly Two-Thirds of His Huge Budget Cuts from Programs for Lower-Income Americans*, Center on Budget and Policy Priorities, April 20, 2011, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3451>.

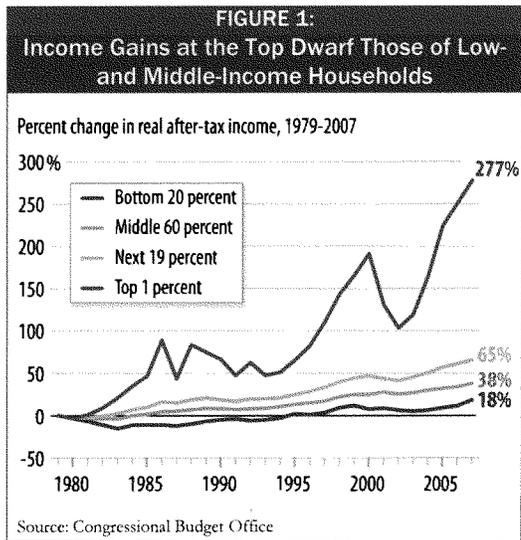
<sup>4</sup> See Chad Stone, Hannah Shaw, Danilo Trisi and Arloc Sherman, *A Guide to Statistics on Historical Trends in Income Inequality*, Center on Budget and Policy Priorities, Figure 1, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3629>.

- Since the latter 1970s, income grew much more quickly at the top of the income scale than at the middle or the bottom, as can be seen in Figure 1.

This time period coincides with various developments that analysts have identified as associated with higher levels of wage, income, and wealth inequality:

- increased globalization, particularly import penetration from low-wage producers;<sup>5</sup>
- diminished unionization, as unions are associated with a more equitable distribution of earnings;<sup>6</sup>
- higher unemployment, which like less unionization, reduces the bargaining power of many in the workforce;<sup>7</sup>
- ongoing technological change, which increases the relative demand for more highly educated workers;<sup>8</sup>
- the decline in the real value of the minimum wage;<sup>9</sup>
- regressive changes in the tax code, particularly tax cuts to high marginal income tax rates and rates on non-labor income;<sup>10</sup>
- financial deregulation and “innovation” and the increased “financialization” of industry: the increase of the financial sector as a share of economic activity and the associated growth of income sources, such as capital gains, that are concentrated at the top of the income scale.

Many of these are, of course, related. Increased globalization has contributed to industry shifts, e.g., a smaller manufacturing share and larger financial share of both employment and output, which



<sup>5</sup> See David Autor, David Dorn, and Gordon H. Hanson, *The China Syndrome: Local Labor Market Effects of Import Competition in the United States*, MIT Working Paper, August 2011, <http://econ-www.mit.edu/files/6613>.

<sup>6</sup> See Jared Bernstein, Lawrence Mishel and Heidi Shierholz, *The State of Working America 2009/2009*, April 2009, pp. 198-209.

<sup>7</sup> See Jared Bernstein, “Slack Attack,” *On the Economy*, June 22, 2011, <http://jaredbernsteinblog.com/slack-attack/>.

<sup>8</sup> Claudia Goldin and Lawrence F. Katz, *The Race Between Education and Technology*, June 2008.

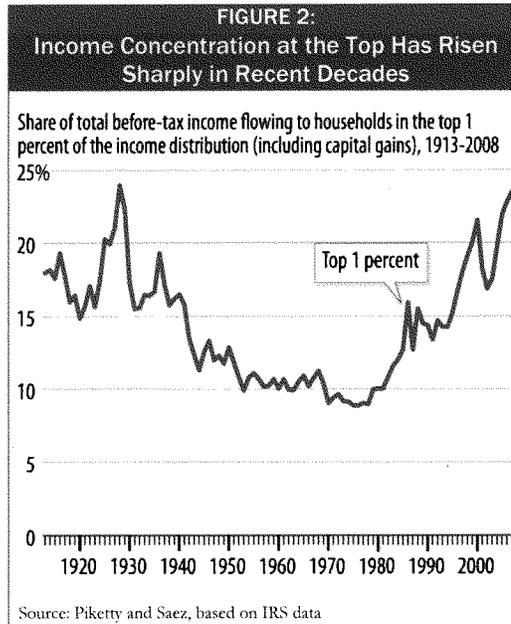
<sup>9</sup> See David S. Lee, “Wage Inequality in the United States During the 1980s: Rising Dispersion or Falling Minimum Wage?,” *The Quarterly Journal of Economics*, August 1999, <http://piketty.pse.ens.fr/fichiers/Lee1999.pdf>.

<sup>10</sup> See Piketty et al, 2011.

have both raised non-employment for affected workers (particularly non-college-educated men) and led to less unionization (as employment declined in more heavily unionized sectors).

Changes in the tax code favoring non-labor income combined with deregulation of financial markets gave rise to far more aggressive uses of methods like securitization, “shadow banking” (off-balance sheet holdings), and income shifting to favorably treated income sources like capital gains, which is associated with higher inequality.

A much even longer term view is provided by research that looks at the share of national income held by the top 1 percent of households, this time including realized capital gains. Prior to the great recession, when asset losses reduced the share of income accumulating at the top of the scale, the top 1 percent of households held 23.5 percent of national income, the highest share since 1928, another business cycle that didn’t end well, to say the least. (See Figure 2)



Inequality data tend to be available with a lag, but we can gain some insight into where inequality stands right now through looking at profit and compensation shares of national income. As noted, capital incomes took a hit in the recent recession (note the 2008 downturn in the top 1 percent share at the end of the series in Figure 2). But since then profits, which correlate positively with the top 1 percent share, have more than recovered, and in fact, the most recent data (from the third quarter of 2011) show corporate profits as a share of national income to be at their highest level in the history of these data, going back to 1947. Compensation as a share of national income, conversely, is at its lowest level since the mid-1960s.<sup>11</sup>

While the benefits of corporate profits of course reach well beyond the top 1 percent, these findings suggest that after contracting in the great recession, income concentration is again on the rise.

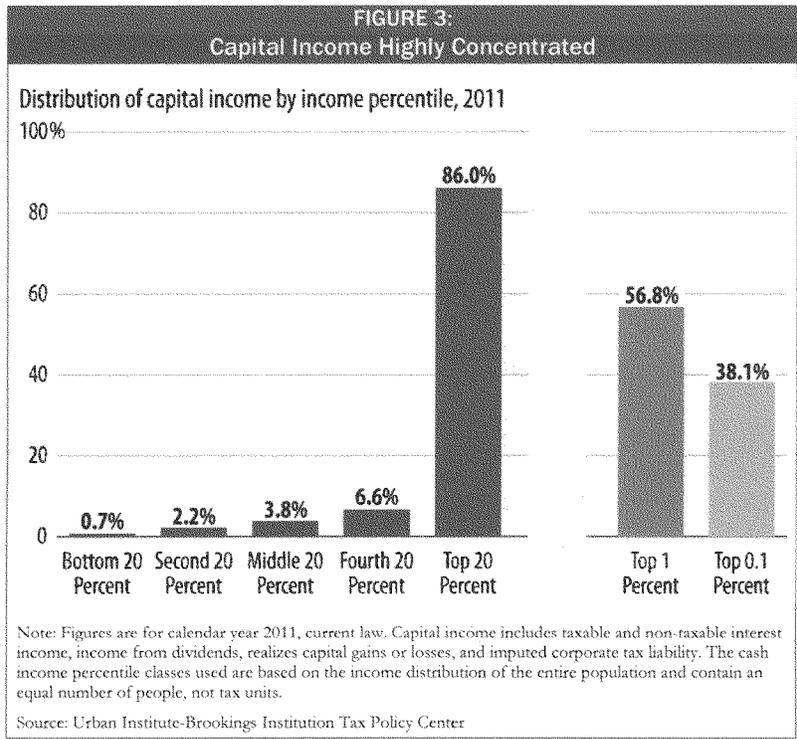
#### *The Role of Capital Incomes*

The relationship between profitability and inequality raises the role of capital incomes, particularly realized capital gains. In fact, in recent decades, capital gains, dividends, and other sources of non-

<sup>11</sup> See National Income and Product Accounts, table 1.12, <http://www.bea.gov/national/nipaweb/index.asp>.

wage income have become an increasingly determinant source of changes in inequality, especially in measures that break out the top 1 percent, where such income is concentrated.

Figure 3, using data from the Tax Policy Center, shows the concentration of capital income by income class. Note that 86 percent of all capital income accrues to the richest fifth of households, 57 percent goes to the top 1 percent, and 38 percent goes to the 120,000 households in the very top 0.1 percent of the income scale, whose average income was about \$7 million last year.



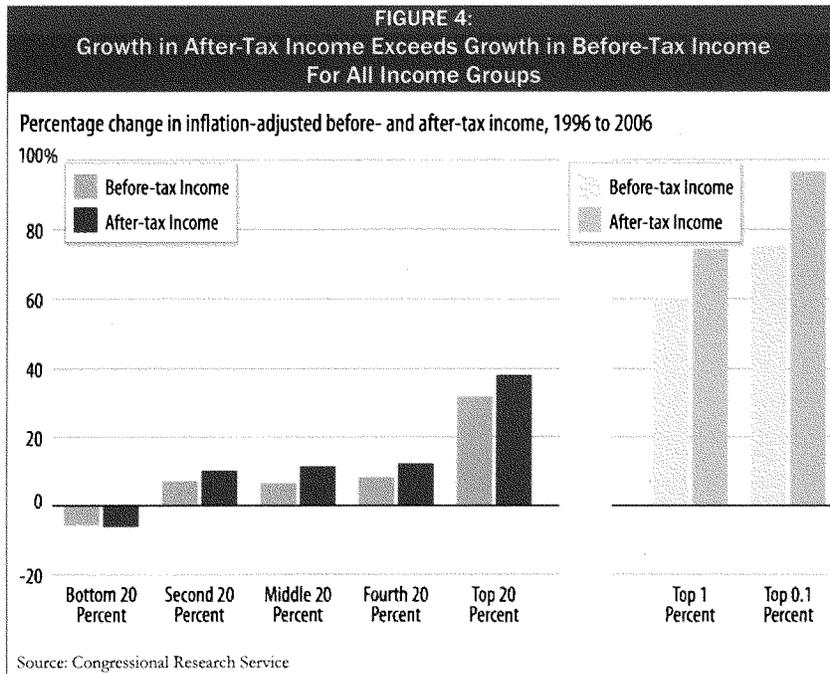
A recent study by the Congressional Research Service, using high-quality data on tax filers, provides more insight on this connection between capital income and inequality.<sup>12</sup>

- The share of income from dividends and capital gains grew from 10 percent to 14 percent among all tax filers and from 31 percent to 38 percent among the top 1 percent; since this

<sup>12</sup> Thomas L. Hungerford, *Changes in the Distribution of Income Among Tax Filers Between 1996 and 2006: The Role of Labor Income, Capital Income, and Tax Policy*, Congressional Research Service, December 29, 2011, <http://taxprof.typepad.com/files/crs-1.pdf>

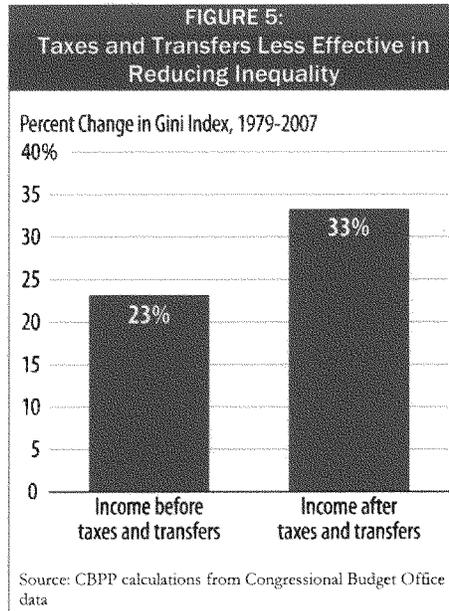
type of income is much more concentrated at the top to begin with, its increasing share is one explanation for inequality's growth.

- The wage and salary share, on the other hand, fell sharply, and this too boosted inequality, since its distribution is much less skewed than capital incomes
- Figure 4, using the CRS data, shows the familiar pattern of inequality's growth, in this case from 1996-2006, both pre- and post-tax income. The patterns of growth here reveal numerous important points:
  - Due to tax cuts over these years, the growth in after tax income was greater than that of pretax for all income groups.
  - However, since tax cuts, including the much-reduced tax on capital gains and dividends, were most generous to those with the highest incomes, after-tax income inequality grew slightly more quickly than pretax income. In other words, while the system of federal taxation is still progressive, it became less so over these years, and thus did less to offset the growth of pretax income inequality.



- A recent CBO study of income inequality covering more years—1979-2007—finds this same result: “The equalizing effect of transfers and taxes on household income was smaller in 2007 than it had been in 1979.”<sup>13</sup>
- One consequence of the combination of sharp growth in capital incomes along with regressive changes in taxes and transfers is the decline in the effective tax rates—their federal tax liability divided by their incomes—of those at the very top of the income scale. For the richest 400 taxpayers, the effective federal tax rate on their income fell from about 26 percent in the early 1990s to 18 percent in 2008, a period when their annual incomes increased 700 percent.<sup>14</sup>

These findings raise a central point of my testimony. I strongly urge policy makers, particularly those with oversight over federal tax and transfer policy, to avoid what economist Alan Blinder has labeled, in a metaphor germane to events of last weekend, “unnecessary roughness,” i.e., exacerbating market-driven inequality with regressive changes to taxes and transfers. Figure 5 shows the percent change in the Gini index—a measure of income concentration—from the CBO data comparing market, or pretax, incomes with after tax and transfer income. Note the increase in inequality was ten percentage points higher when taxes and transfers are included.



#### *Mobility and Opportunity*

There is little disagreement in the trends above: income inequality is historically very high. But some policy makers and analysts cite economic mobility—the movement of persons and families up and down the income scale over their lifetimes and across generations—as a reason for less concern about elevated levels of inequality. Their argument is essentially this: sure, there’s greater distance

<sup>13</sup> Congressional Budget Office, *Trends in the Distribution of Household Income Between 1979 and 2007*, October 2011 <http://cbo.gov/ftpdocs/124xx/doc12485/10-25-HouseholdIncome.pdf>. Note that CBO income data also include transfer income, an omitted income source in the CRS data.

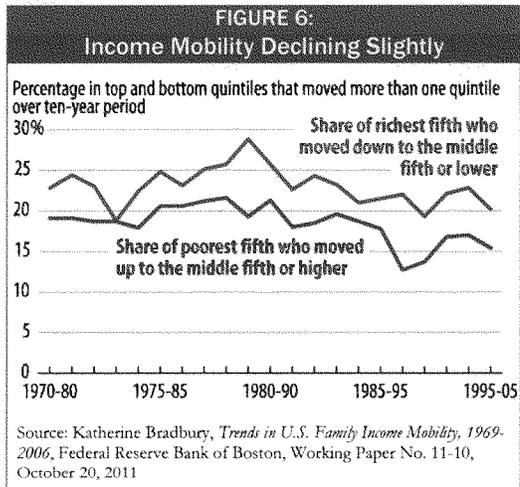
<sup>14</sup> See Chuck Marr, “5 Reasons Why the ‘Supercommittee’ Must Consider Tax Increases,” *Off the Charts*, Center on Budget and Policy Priorities, August 3, 2011, <http://www.offthechartsblog.org/5-reasons-why-the-%E2%80%9Csupercommittee%E2%80%9D-must-consider-tax-increases/>.

between income classes than there used to be. But since people move relatively freely between these income classes, that greater distance is not problematic.

A moment's reflection reveals the fatal flaw in this argument. It's not enough to cite the *existence* of mobility to offset sharply *increased* inequality. That explanation depends on accelerated mobility. That is, the rate at which households switch places in the income distribution—some move up while others move down—must increase if we are to be convinced the mobility is offsetting greater inequality.

In fact, there is no evidence that the rate of mobility has increased, and there's some evidence to the contrary. A recent paper by Boston Federal Reserve economist Katharine Bradbury documents a statistically significant decline in the rate of mobility. The slowdown isn't dramatic; Bradbury accurately labels it "slight."

Figure 6 uses two measures from Bradley's analysis to disprove the claim that faster mobility has offset higher levels of inequality. The lines in the figure represent mobility over ten-year spans. They show the share of families in the richest fifth who move down the income scale to the middle or lower fifths and the share of families in the poorest fifth who move up to the middle or higher. The lines basically drift down starting in the late 1970s, meaning there's less movement between the rungs on the income ladder. Bradbury found that the downshift over time was statistically significant.



Another important insight regarding income mobility relates to international differences. Here, recent comparative work has found less mobility in the United States compared to almost every other advanced economy.<sup>15</sup> This may strike some listeners as surprising, given the supposed linkage between our more free market approach to economic policy compared to that of countries like those of Scandinavia, for example, which have considerably higher levels of mobility. Yet, the data clearly show this to be the case.

This raises the question as to whether there is a causal relationship between higher inequality and lower mobility. While such causal linkages are notoriously hard to prove, research has suggested potentially convincing linkages. In a recent presentation on inequality, Council of Economic Adviser's Chairman Alan Krueger showed that, in fact, countries with higher levels of inequality

<sup>15</sup> See Bernstein, Mishel and Shierholz, Chapter 2.

tend to have less intergenerational mobility (i.e., the economic status of adult children was positively correlated with that of their parents).<sup>16</sup>

Access to opportunity, or lack thereof, may play an important in these relationships, a point I return to below.

### Why Do Inequality and Mobility Matter?

Often, results like those above on the evolution of inequality and mobility trends have been discussed exclusively in terms of fairness. That is an important criterion, especially to national policy makers. The concept of fairness is a deeply embedded and widely accepted principle of American society in the sense that those who work hard and “play by the rules” will achieve improving living standards and better opportunities for themselves and especially for their children. To the extent that high inequality and stagnant (or declining) mobility blocks such outcomes, the “American dream” is threatened.

Note that this explanation of fairness is based on opportunity, not outcomes. This is important distinction as some critics of those of us concerned about these inequality issues argue that our policy goal is equality of outcomes. It is not. It is equality of opportunity.

But fairness is not the only critique of the impact of the inequality and mobility results presented above. We should also be mindful of their impact on growth and the macroeconomy. Here again, some of these findings were summarized by Alan Krueger in the recent speech noted above:

- **Less robust (or debt-financed) consumption.** Seventy percent of the US economy is accounted for by consumer spending, so if that part of GDP lags, economic growth slows. It is also the case that the propensity to consume out of current income is higher among lower-income households (i.e., compared to wealthier households, they’re more likely to spend than save their income).

Based on an estimate of these relative propensities and the large shift in the share of national income that accrued to the top 1 percent over the past few decades, Krueger calculates that aggregate consumption could be 5 percent higher in the absence of such large income shifts. Applying “rules of thumb” on the relationship between aggregate growth and jobs, and assuming both economic slack and that this income was not simply replacing demand elsewhere in the economy, this extra consumption growth could reduce unemployment by 1.75 percentage points, implying about 2.6 million more people with jobs.

Krueger cites an important caveat about this type of calculation. In the face of stagnant earnings in the 2000s, many in the middle class borrowed to make up—or more than make up—the difference, in which case middle-class consumption did not fall as much as it would have absent this leverage. To point out that this method of improving middle class living standards is both unsustainable and extremely risky is an obvious understatement.

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<sup>16</sup> See Alan Krueger, *The Rise and Consequences of Inequality*, address at the Center for American Progress, January 12, 2012, <http://www.americanprogress.org/events/2012/01/krueger.html>.

- ***Inequality and longer term growth.*** Krueger also points to recent research showing that “in a society where income inequality is greater, political decisions are likely to result in policies that lead to less growth.” Economist Mancur Olson also hypothesized about this relationship decades ago.

As more income, wealth, and power is concentrated at the top of the income scale, narrow coalitions will form to influence policy decisions in ways less likely to promote overall, or middle-class, well-being, and more likely to favor those with disproportionate power and resources. In the current economics debate, we clearly see these dynamics in a tax code that bestows preferential treatment on those with large amounts of assets, like capital gains and stock dividends, relative to wage earners.

### **Inequality, Opportunity, and Mobility**

Putting together the findings suggests a hypothetical causal chain or even a negative feedback loop: from higher inequality, to reduced opportunity, to diminished mobility. Reduced opportunity — say, less educational access for children from lower income families — both reinforces high levels of inequality and further diminishes mobility. As in research I note below, this loop is particularly likely to occur when inequality diverts overall growth from low-income families, leading to high and persistent child poverty. Causally, this chain of events is likely to operate through everything from diminished access to quality education, starting with pre-school (early educational interventions have been shown to have lasting positive impacts on later earnings and mobility<sup>17</sup>), to inferior public services, like poor quality libraries and parks, to lack of health care, inadequate housing in underserved communities, and even a polluted physical environment.

To the extent that higher inequality and less mobility lead more children to be exposed to these risk factors, we may well find that as society grows ever more unequal, those falling behind are losing access to the ladders that used to help them climb over the mobility barriers they faced.

In fact, research on the impact of poverty in early childhood has found some of these connections to be operative.

- Duncan and Magnuson (2011) find that the future earnings and hours worked of children from low-income families (incomes below \$25,000) was significantly more responsive to extra income than those outcomes for children from higher income families.<sup>18</sup>
- Ratcliffe and McKernan (2011) find worse adult outcomes, including less educational attainment, premarital births, and worse employment histories for children who experienced multiple years of poverty compared to those who did not.<sup>19</sup>

<sup>17</sup> See James Heckman, *Letter to Joint Select Committee on Deficit Reduction*, University of Chicago, September 21, 2011, <http://www.heckmanequation.org/content/resource/letter-joint-select-committee-deficit-reduction>.

<sup>18</sup> Greg J. Duncan and Katherine Magnuson, “The Long Reach of Early Childhood Poverty,” *Pathways*, Stanford Center on Poverty and Inequality, Winter 2011, [http://www.stanford.edu/group/scspi/\\_media/pdf/pathways/winter\\_2011/PathwaysWinter11\\_Duncan.pdf](http://www.stanford.edu/group/scspi/_media/pdf/pathways/winter_2011/PathwaysWinter11_Duncan.pdf).

<sup>19</sup> Caroline Ratcliffe and Signe-Mary McKernan, *Childhood Poverty Persistence: Facts and Consequences*, Urban Institute, June 30, 2010, <http://www.urban.org/publications/412126.html>.

- Bailey and Dynarski (2011) find growing gaps between children from low- and higher income families in college entry and graduation. For example, they note that “rates of college completion increased by only four percentage points for low-income cohorts born around 1980 relative to cohorts born in the early 1960s, but by 18 percentage points for corresponding cohorts who grew up in high-income families.”<sup>20</sup>
- Various studies find that severely disadvantaged neighborhoods are associated with negative outcomes for children and youth, including reduced cognitive development, less education attainment, and worse health outcomes.<sup>21</sup>

Consider the role of inequality in this opportunity framework. Turning back to Figure 4 from the CRS, it can be seen that will average, pretax income grew by 20%, 1996-2006, but that of the poorest families actually fell 6% in real terms while that of low-income families in the second income fifth grew by 7% (well under 1% per year). Had these families’ income grown at the average rate, their average income would have, in fact, been about \$3,000 higher than it was in 2006. That extra income, according to the research cited above, could have made a real difference in the lives of the children in these families when they grow to adult.

### The Policy Agenda Implied by These Developments

This committee has been in the forefront of some of the most important policy developments in areas that directly and indirectly effect inequality and mobility, particularly tax and transfer policies. As stressed in my introduction, we are at a unique historical moment where policy makers must engage in a delicate balancing act. The fiscal imperative to achieve a sustainable budget path in the long run must be balanced with the need for continued stimulus in the short run, such as the full year extensions of the payroll tax holiday and UI benefits. And as shown in Figure 5, changes in taxes and transfers over the past decade have already led them to be less effective as a levee against increased inequality. Legislators must be careful to avoid exacerbating this problem, or better, to begin to correct it.

**Tax Reform:** This has broad implications for tax reform. Allowing the high-end Bush tax cuts to expire at the end of this year, as President Obama has proposed, is consistent with this approach. Because high-income households are not liquidity constrained in their after-tax income, tax increases on them are not expected to create “fiscal drag” and this part of the tax cuts alone is expected to generate about \$850 billion in savings over ten years, including interest.

<sup>20</sup> Martha J. Bailey and Susan M. Dynarski, *Gains and Gaps: Changing Inequality in U.S. College Entry and Completion*, Working Paper, December 2011, [http://www-personal.umich.edu/~baileymi/Bailey\\_Dynarski.pdf](http://www-personal.umich.edu/~baileymi/Bailey_Dynarski.pdf).

<sup>21</sup> See for example Nancy O. Andrews with Christopher Kramer, “Coming Out as a Human Capitalist: Community Development at the Nexus of People and Place,” *Community Development Investment Review*, Federal Reserve Bank of San Francisco, Volume 5, Issue 3, 2009; Julia Burdick-Will et. al., “Converging Evidence for Neighborhood Effects on Children’s Test Scores: An Experimental, Quasi-experimental, and Observational Comparison,” *Project on Social Inequality and Educational Disadvantage*, Brookings Institution, March 2, 2010; Jens Ludwig et. al., “Neighborhoods, Obesity, and Diabetes: A Randomized Social Experiment,” *The New England Journal of Medicine*, October 20, 2011, <http://www.nejm.org/doi/full/10.1056/NEJMsa1103216>; Margery Austin Turner et. al., *Helping Poor Families Gain and Sustain Access to High-Opportunity Neighborhoods*, Urban Institute, October 2011, <http://www.urban.org/publications/412455.html>.

The above discussion of capital incomes should also be considered in this context. Recent revelations about the comparatively low effective tax rates paid by prominent wealthy individuals, like investor Warren Buffet or former Massachusetts Governor Mitt Romney, have also amplified these issues. Low effective rates of certain very high-income individuals are clearly a function of significant shares of their income coming from source with favorable treatment through the tax code, such as the current 15% on certain capital gains and dividends.

Ending the favorable treatment of these income sources is consistent with the goals of both deficit reduction and moderating inequality. According to the Joint Committee on Taxation, for example, the cost of the tax benefits of the current preferential treatment of long-term capital gains and dividends is \$450 billion, 2011-2015.<sup>22</sup>

Though a full analysis of the response to rate changes is beyond the scope of this testimony, policy makers do, of course, need to be mindful of behavioral responses to tax changes. Summarizing a robust literature, the main response to tax changes among high income or high wealth households appears largely unrelated to “supply-side” effects, like greater capital investment leading to higher productivity, wage, or job growth. Instead, beneficiaries of these tax cuts are more likely, to rearrange their taxable income in ways to avoid taxation, such as the strategic timing of realization of capital gains.

In this regard, recent research looks at the relationship between top marginal tax rates, income inequality, and growth.<sup>23</sup> Comparing these variables across time and various countries, this research generates the figures shown in the appendix. The top panel finds a significant negative relationship between changes in top marginal rates and the change in the share of pretax income accruing to the top 1% (e.g., lowering high-end tax rates is correlated with growth in the share of income at the very top of the scale); the bottom panel shows no relationship between these high-end tax cuts and average income growth. The authors conclude that much higher tax rates on the compensation of the highest earners would be consistent with greater revenue collection and less inequality, while not injurious to growth.

**Spending Cuts:** Unless we are prepared to reduce government spending to the point where essential functions would be inoperable, it should be clear that the nation cannot get on a sustainable budget path on the back of spending cuts alone. It is, however, equally clear that spending cuts will be part of the mix. In fact, thus far, they have been the *only* ingredient in the mix.

In this regard, I urge policy makers to be guided by principles put forth by both the Bowles-Simpson Fiscal Commission and the Gang of Six. Both of these deficit reduction efforts recognized that cuts in key federal programs like SNAP and the EITC would increase poverty and hardship, and both decisively ruled such cuts out.

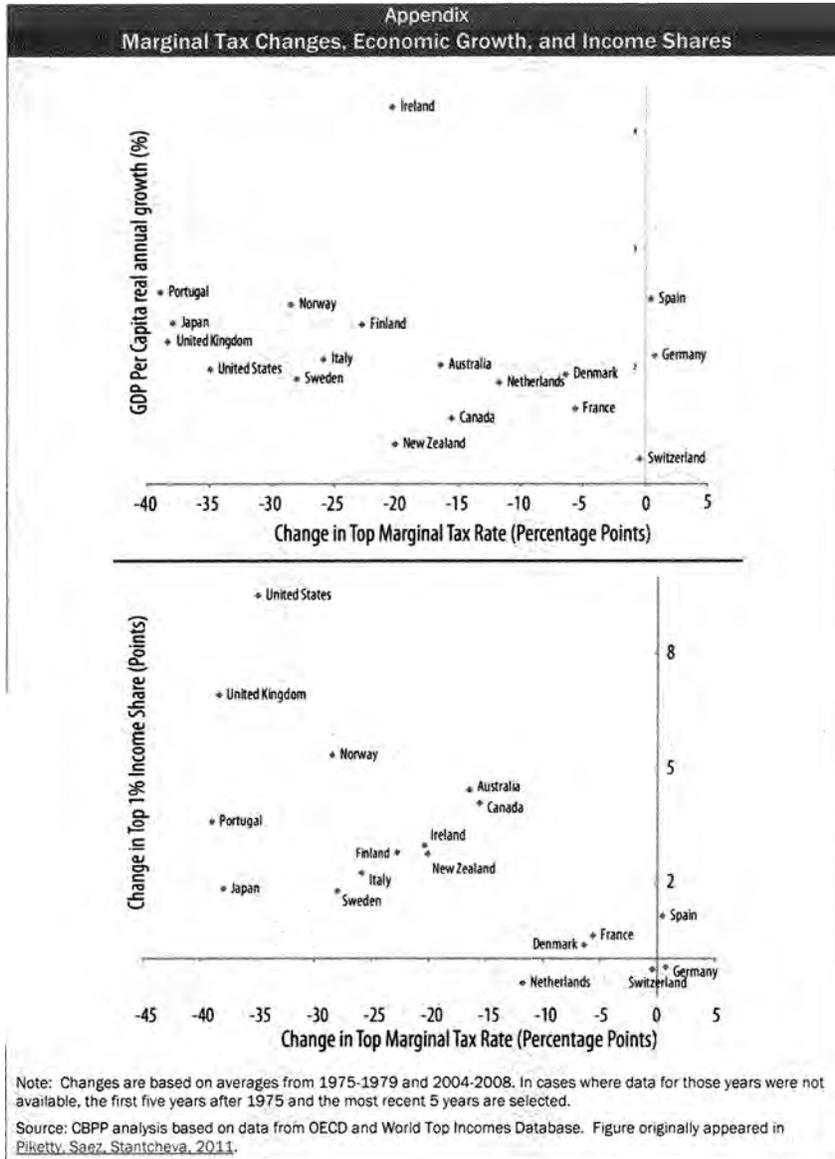
Both groups—Bowles and Simpson and the Gang of Six—highlighted as a basic guiding principle that deficit reduction should be achieved in ways that do not increase poverty. Those plans avoided

<sup>22</sup> The Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2011-2015*, January 17, 2012, <http://www.jct.gov/publications.html?func=startdown&id=4386>.

<sup>23</sup> Thomas Piketty, Emmanuel Saez, and Stefanie Stantcheva, *Optimal Taxation of Top Labor Incomes: A Tale of Three Elasticities*, National Bureau of Economic Research Working Paper 17616, November 2011: [http://www.nber.org/papers/w17616.pdf?new\\_window=1](http://www.nber.org/papers/w17616.pdf?new_window=1)

cuts in means-tested assistance programs other than Medicaid. The Gang of Six also instructed the Agriculture Committees not to meet their deficit-reduction target by substituting food stamp cuts for some or all of the savings those committees would be directed to produce in agriculture programs, and barred the tax-writing committees from cutting the EITC or Child Tax Credit to achieve the savings they were asked to produce through tax reform.

In fact, many discretionary programs that serve low- and moderate-income families have already been the target of budget cuts. For example, LIHEAP – which helps low-income families with their heating and cooling bills – saw its funding dramatically decreased in 2011. Other cuts to discretionary spending, like the recent eligibility cuts to Pell Grants in 2012, are particularly dangerous in that they have the potential to further reduce the mobility prospects of young adults and children. Congress should avoid additional cuts to programs that help families overcome mobility barriers, programs like Head Start, Title I, and job training.



Center on  
Budget  
and Policy  
Priorities

**“Assessing Inequality, Mobility  
and Opportunity”**

Testimony before the  
Senate Budget Committee

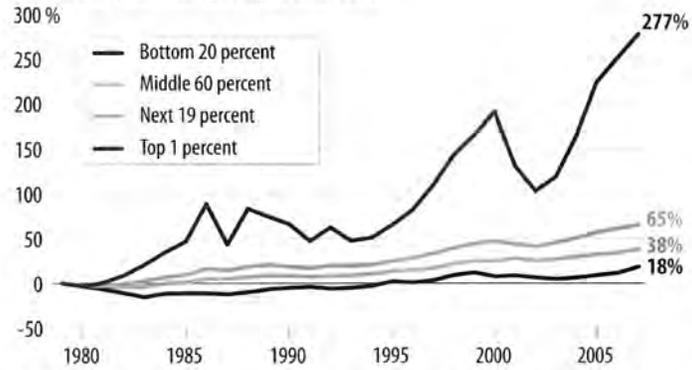
Jared Bernstein, Senior Fellow  
Center on Budget and Policy Priorities

February 9, 2012

[www.cbpp.org](http://www.cbpp.org)

**Income Gains at the Top Dwarf Those of  
Low- and Middle-Income Households**

Percent change in after-tax income since 1979



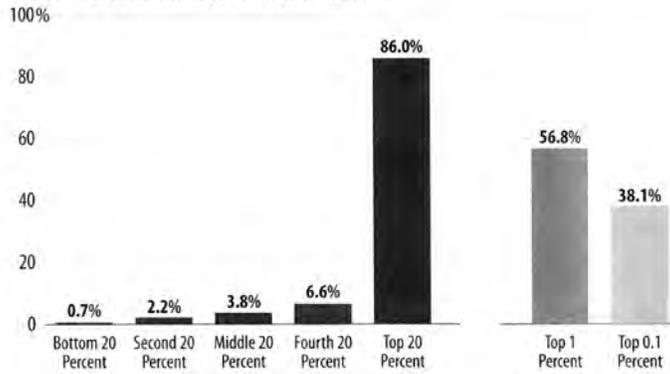
Source: Congressional Budget Office

www.cbpp.org



### Capital Income is Highly Concentrated

Distribution of capital income by income percentile, 2011

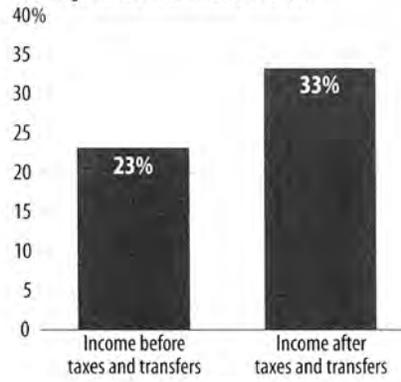


Source: Urban Institute-Brookings Institution Tax Policy Center

[www.cbpp.org](http://www.cbpp.org)

### Taxes and Transfers Less Effective in Reducing Inequality

Percentage increase in Gini index, 1979-2007



Source: CBPP calculations from Congressional Budget Office data

[www.cbpp.org](http://www.cbpp.org)

Chairman CONRAD. Thank you, Dr. Bernstein.  
Dr. BOUSHEY.

**STATEMENT OF HEATHER BOUSHEY, SENIOR ECONOMIST,  
CENTER FOR AMERICAN PROGRESS**

Ms. BOUSHEY. Thank you. Thank you, Chairman Conrad and Ranking Member Sessions and members of the committee, for inviting me here to testify today.

A strong middle class is a necessary condition to establishing a vibrant, competitive, and stable economy. My colleagues here on this panel will discuss how high inequality in the United States has become and how the rungs on the ladder upwards have become farther apart. In my brief comments, I want to lay out how a strong middle class actually encourages and supports improved productivity and investment as well as the kinds of institutions that lead to broad-based economic growth.

Lower inequality is associated with sustained economic growth, which is, as we have certainly learned in recent years, critical for sustaining economic opportunities for millions of American families. In short, to support economic growth, I encourage you to focus on the policies that support the middle class.

First, high inequality means that everyone does not get a fair shot, which drags down our nation's economic productivity. A strong middle class is positioned to make investments in education and incubate the next generation of high-skilled workers, inventors, and entrepreneurs, which pushes up long-term economic growth.

However, the data is increasingly showing that we are a country where your parents' earnings, not a child's skills or merit, are paramount in determining their children's future earnings. And new research is bringing to light the importance of the years before a child even enters schools for their future earnings.

A strong middle class creates the capacity of ordinary people to become entrepreneurs or to follow up on an invention or an innovative idea. More than 70 percent of U.S. entrepreneurs come from the middle class. A strong middle class also encourages firms to make productivity-enhancing investments and fosters the kind of trust that improves workplace productivity.

Second, a strong middle class is a source of stable demand, which creates the incentive to invest. Having a deep market with demonstrated demand from a strong middle class is how businesses receive signals as to profitable opportunities for investment. A successful business owner, Nick Hanauer, explained in Bloomberg Businessweek, quote, "Only consumers can set in motion a virtuous cycle that allows companies to survive and thrive and business owners to hire."

The lack of such signals continues to plague the U.S. economy at present. Yet, growing inequality affected demand even before the economic crisis. Families borrowed to make ends meet, to cover health care costs, to put a child through college, and to purchase a home in a neighborhood with good schools. The financial sector was only too happy to oblige. Increasingly unencumbered by regulation and flush with cash, Wall Street created a variety of new ways to extend credit. Yet, as we have learned over the past few

years, this economy was unsustainable and the crash was devastating to millions of families.

Third, high inequality does damage to our nation's institutions, which hinders economic performance. There is evidence that higher campaign contributions from the financial services industry have been associated with an increased likelihood of voting for legislation that transfers wealth from taxpayers to that industry. Further, as finance has grown in its importance to the U.S. economy, economic policy has shifted to meet the needs of Wall Street rather than Main Street. For example, maintaining an uncompetitive dollar and a large U.S. trade deficit hurts U.S. manufacturing and U.S. workers but benefits the financial sector, while trade agreements have often pushed new rights for financial investors over domestic manufacturing industries.

Inequality has also been shown to affect the ability of people to find common ground in governance and to take action on pressing policy issues that benefit the majority. As American society has become wealthier, a larger segment can opt out of public goods, such as public education, Social Security, public parks, or even municipal policing. On the other hand, greater immigration and incarceration mean that larger shares of lower-income groups are outside the electorate. The increased polarization has curtailed new legislation with dramatic effects on social and tax policy, such as falling real minimum wages and less progressive taxation.

The middle class is the engine of growth, but it is threatened by dwindling public investments, a tax system increasingly rigged to the benefit of the wealthy, a fraying safety net, and assaults on what should be the bedrock guarantees of Medicare, Medicaid, and Social Security. The budget should boost critical investments and take steps toward rebalancing the tax code so that everyone pays their fair share.

The United States remains one of the wealthiest nations on the planet. The notion that we cannot afford to fix our economy is, quite simply rubbish. We can if we have the political will. Thank you.

[The prepared statement of Ms. Boushey follows:]

## Center for American Progress Action Fund



Testimony before  
the U.S. Senate Committee on the Budget  
on “Assessing Inequality, Mobility, and Opportunity.”

Heather Boushey  
Senior Economist, Center for American Progress Action Fund  
February 9, 2012

Thank you Chairman Conrad and Sen. Sessions for inviting me here to testify today. My name is Heather Boushey and I'm a Senior Economist with the Center for American Progress Action Fund.

A robust and expanding middle class was the engine that transformed the United States into the strongest economy in the world. Our middle class is today threatened by mounting income inequality and a tax code rigged to favor the rich. In my brief comments I will lay out how focusing on building a strong middle class is a necessary condition to establishing a vibrant, competitive, and stable economy.

My colleagues will discuss how high inequality has become in the United States and how the rungs on the economic-mobility ladder have become farther apart. This kind of inequality is not only bad for the 99 percent who've been left behind; it is actually responsible for some of the biggest problems facing Americans today—high home foreclosures, high unemployment, a low pace of business investment, and an inability to get ahead.

The analysis I will describe to you today is based on an in-depth, ongoing project at the Center for American Progress, where we are bringing together the economic evidence showing how a strong middle class and inequality at levels below what we currently have in the United States will enable everyone to have a fair shot, while encouraging and supporting the competitiveness of our firms and the strength of our economy.

Economists typically measure economic success by profits, the creation of good jobs, a growing GDP, and a falling unemployment rate. The economy grows when firms are either more productive or when they invest more capital and hire more labor.

A strong middle class supports improved productivity and investment, while high inequality can have real, pernicious effects on both. High inequality also makes the economy less stable, which can, as we've seen in the past few years, have devastating effects on the opportunity for millions of American families.

**Inequality means everyone doesn't get a fair shot, which drags down our nation's economic productivity**

A strong middle class is positioned to make investments in education and incubate the next generation of high skilled workers, inventors, and entrepreneurs, which pushes up long-term economic growth primarily (though not exclusively) through their effects on productivity.

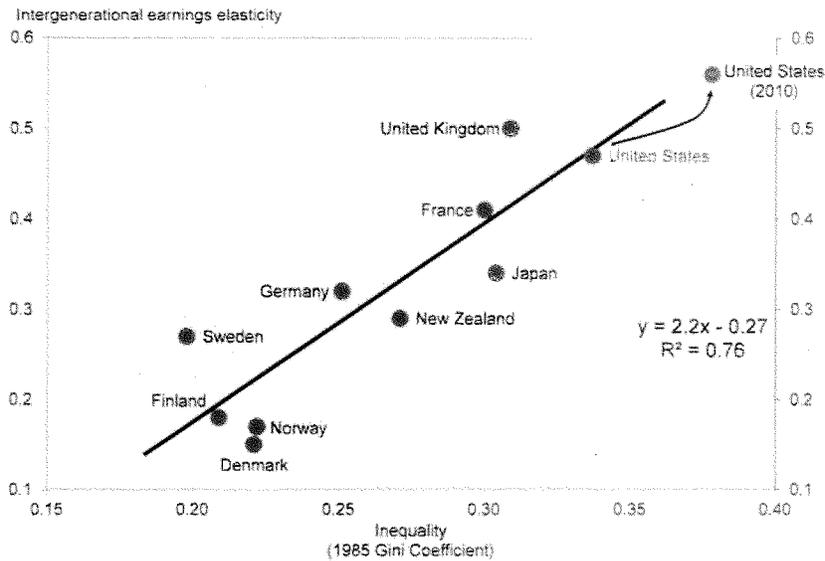
Economists agree that education is a key piece of the productivity puzzle. High-quality public education enables children from all backgrounds to achieve. A new paper by Stanford economist Peter Klenow and his colleagues shows just how big that kind of economic effect can be. They find that between 1960 and 2008, 17 to 20 percent of U.S. economic growth was due to gains from women and people of color entering professional occupations and able to make use of their talent.<sup>1</sup>

Increasingly, however, the data shows that we are a country where parents' earnings are paramount in determining their children's future earnings. As economists Flavio Cunha and James Heckman put it, "The best documented market failure in the life cycle of skill formation in contemporary American society is the inability of children to buy their parents or the lifetime resources that parents provide."<sup>2</sup>

This sort of class-stratified society is exactly what most of us think America is not (or at least should not be).<sup>3</sup> Plus, this kind of class calcification is also bad for economic growth.

The relationship between today's inequality and tomorrow's economic mobility—and the importance of a fair shot for everyone—was a key theme of a speech by Alan Krueger, chair of the President's Council of Economic Advisers, at the Center for American Progress last month. To show how class has become calcified in America, he showed this chart, which he called the "Great Gatsby Curve":

## The Great Gatsby Curve



Source: Krueger, Alan. 2012. "The Rise and Consequences of Inequality." Speech at the Center for American Progress, Washington, DC, January 12.

In the chart, the Gini coefficient, one of the most commonly used measures of income inequality, is on the x-axis. The higher the Gini, the more unequal a nation is. Notably, for 1985, the United States was more unequal than any of the other nine advanced economies shown. A measure of economic mobility is on the y-axis. This measure, the "intergeneration earnings elasticity," measures how important a parent's earnings are to predicting their child's future earnings (in this chart, only looking at fathers and sons).<sup>4</sup>

Imagine two American fathers, Middle-Class Dad and Rich Dad, standing together with their adult sons. Rich Dad earned 100 percent more than Middle-Class Dad when the boys were young. This chart shows that Rich Dad's son will earn about 50 percent more than Middle-Class Dad's son.

When a parent's economic status has too big an impact on his children's economic status, it has a pernicious impact on the economy. Today, somewhere in America, there's a young toddler who may be the next Bill Gates or Steve Jobs (or just a really terrific worker who boosts productivity at her firm). But if she's not Rich Dad's little girl, our economy may never benefit from her talents and that would be a loss for everyone.

Yet this is the kind of country we have become. Today, the probability that a top-scoring low-income student attends college is at about the same as that of a low-scoring high-income student.<sup>5</sup>

The shrinking middle class also creates a vicious cycle as middle-class families typically support the kinds of investments in public education that give everyone a fair shot. In new work, my colleague David Madland finds that communities with less inequality tend to make greater investments in public education and tend to have better education outcomes.<sup>6</sup>

And new research is bringing to light the importance of the years before a child even enters school for long-term educational achievement and future earnings. Effective parenting is critically important to giving children a good start on the road to social and economic mobility. At the same time upward mobility is associated with stable family income, which is more common among those with two working parents—increasingly the norm in our society.<sup>7</sup>

Yet the ability of parents to be good workers and effective parents is sharply curtailed by workplaces that haven't adapted to this reality. Parents, especially those in low- and middle-wage jobs, are too often forced to choose between a day's pay and perhaps losing their job if they have to take care of a sick child. These Americans have little to no flexibility to create schedules that can help address—or at the very least not exacerbate—work-family conflict.

There is another, more immediate, impediment to upward mobility, which also threatens our future productivity: Young men are not attending college at the same rate as women. One could conclude that men don't understand that investing in a college degree pays off handsomely. But there is another interpretation. Many college-educated men are finding they have been sold a bill of goods, because one in five earns less than the typical high-school graduate.<sup>8</sup>

America's future productivity will be hampered if young men invest in their human capital yet end up with a historically high pile of student debt and are no better off than those that entered the labor market right out of high school. Improving our higher education system is yet another way to close the distance between the rungs on the economic ladder. Providing opportunity is imperative for our economic future.

Inequality limits the capacity of ordinary people to become entrepreneurs or follow up on an invention or innovative idea. Research by the Kauffman Foundation demonstrates that more than 70 percent of entrepreneurs in the United States come from the middle class.<sup>9</sup> Yet a hollowed-out middle class means that families have less access to resources that could float an entrepreneur while her vision takes shape. Many entrepreneurs start their businesses using home-equity loans or credit cards, which may be unavailable to the poor or middle class.<sup>10</sup>

A strong middle class also encourages firms to make productivity-enhancing investments and fosters the kind of trust that improves workplace productivity. Higher wages encourage firms to invest in capital to improve productivity, while falling or slow-growing wages discourage these kinds of investment. For example, higher wages encourage firms to make investments that reduce their reliance on labor, such as building a more efficient factory.

#### **Inequality skews demand and limits incentives for investment**

A strong middle class is a source of stable demand, which creates the incentive to invest. But don't believe me. Here's how Nick Hanauer, a ground-floor investor in Amazon who now runs a venture-capital firm, Second Avenue Partners, explained this in *Bloomberg Businessweek*: “[O]nly consumers can set in motion a virtuous cycle that allows companies to survive and thrive and business owners to

hire. An ordinary middle-class consumer is far more of a job creator than I ever have been or ever will be.”<sup>11</sup>

Placing the middle class at the core of what makes an economy grow is not a new idea. When Henry Ford began paying his workers the then-princely sum of \$5 a day, this was not charity; it was a business strategy designed to lower costs and make production more efficient.<sup>12</sup>

Demand remains the most challenging issue facing businesses in the wake of the Great Recession. The National Federation of Independent Businesses conducts a monthly survey of its members and for over three years has reported that “sales”—another way of saying “demand”—are the single-most important problem for its members—more of a problem than regulations, taxes, inflation, or the cost of labor.<sup>13</sup>

Having a deep market with demonstrated demand from a strong middle class is how businesses receive signals as to profitable opportunities to invest. Yet the lack of such signals continues to plague the U.S. economy at present, although hopefully that is starting to change.

Growing inequality affected demand before the economic crisis. As Harvard Law School professor Elizabeth Warren (with her daughter Amelia Warren Tyagi) documented, Americans’ debts are the result of a financially strapped middle class. Families borrowed to make ends meet, to cover health care costs, to put a child through college, and to purchase a home in a neighborhood with good schools.<sup>14</sup>

The financial sector was only too happy to oblige. Increasingly unencumbered by regulation and flush with cash, Wall Street created a variety of new ways to extend credit. Basically, America didn’t get a raise and the financial sector said, “Don’t worry, buddy, we’ll loan you the money to pay the bills.” Of course, the whole thing was unsustainable.

Recent research by IMF economists shows that investors were recycling their higher incomes into loans.<sup>15</sup> As demand dries up because of stagnating incomes, those at the top have great incentives to expand credit to keep up purchasing power. If incomes do not recover, however, this, as we have seen, is an unstable and unsustainable game.

Thus came the Great Recession and the struggle ever since among everyday Americans to make ends meet. The U.S. case does not appear to be an outlier. New research across 174 countries finds that the more equal the country, the longer it was able to sustain economic growth.<sup>16</sup>

#### **Inequality does damage to our nation’s institutions, which hinders economic performance**

There is evidence that Wall Street has used its burgeoning wealth to benefit their industry, not the nation as a whole. Higher campaign contributions from the financial services industry have been associated with an increased likelihood of voting for legislation that transfers wealth from taxpayers to that industry.<sup>17</sup>

Sky-high incomes for those in finance allowed them to sell loans to the 99 percent and buy legislation that transfers wealth from taxpayers to themselves. And on top of all this, these same sky-high incomes increasingly encouraged the best and the brightest young people to enter finance instead of engineering, medicine, or teaching, all of which enhance our economy’s productivity.<sup>18</sup>

Further, as finance has grown in its importance to the U.S. economy, economic policy has shifted to meet the needs of Wall Street rather than Main Street. Maintaining an uncompetitive dollar and a large U.S. trade deficit hurts U.S. manufacturing (and U.S. workers) by making U.S. goods more expensive overseas, but benefits the financial sector through keeping a lid on inflation through a wider array of cheap imports, reducing costs to acquire assets (and hire workers) overseas, and financing the trade deficit.<sup>19</sup> Further, trade agreements pursued new rights for financial investors over domestic manufacturing industries.

Growing inequality and the bias towards Wall Street and away from U.S. manufacturing also lowers overall economic productivity as low-productivity, service-sector jobs replace high-productivity manufacturing jobs.<sup>20</sup>

Inequality has also been shown to affect the ability of people to find common ground in governance and take action on pressing policy issues that benefit the majority. As American society has become wealthier, a larger segment can opt out of public goods, such as public education, Social Security, public parks, or even municipal policing. On the other hand, greater immigration and incarceration means that larger shares of lower-income groups are outside the electorate. The increased polarization has curtailed new legislation, with dramatic effects on social and tax policy, such as falling real minimum wages and less progressive taxation.<sup>21</sup>

What happens to 99 percent of Americans should be the focus of our nation's economic policy.

The budget for fiscal year 2013 should lay out a responsible course for rebuilding the economy so that it works for everyone, not just the privileged few. The American middle class is the engine of economic growth. But it is threatened by dwindling public investments, a tax system increasingly rigged to benefit the wealthy, a fraying safety net, and assaults on what should be the bedrock guarantees of Medicare, Medicaid, and Social Security.

The budget plan should protect those guarantees, boosts critical investments, and takes steps toward rebalancing the tax code so that all pay their fair share. And it does this a fiscally responsible way, charting a path that nurtures the economic recovery while reducing the deficit—without asking the middle class to shoulder a disproportionate share of the burden.

We can reverse inequality. The United States remains one of the wealthiest nations on the planet. The notion that we cannot afford to fix our economy is, quite simply, rubbish. We can if we have the political will.

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- <sup>17</sup> Atif Mian, Amir Sufi, and Francesco Trebbi, "The Political Economy of the U.S. Mortgage Default Crisis," *American Economic Review* 100, (5 2010): 1967-98.
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Chairman CONRAD. Thank you.

Ms. ANDERSON. Ms. Anderson, I should repeat, is Global Economy Project Director at the Institute for Policy Studies. Welcome.

**STATEMENT OF SARAH ANDERSON, GLOBAL ECONOMY  
PROJECT DIRECTOR, INSTITUTE FOR POLICY STUDIES**

Ms. ANDERSON. Thank you, Chairman. Thank you so much for this opportunity.

I do believe that inequality is the pressing issue of our time and I really applaud the committee for giving it this level of attention. And I want to begin by emphasizing what I see as the good news, which is that we have tackled this problem before. A century ago, we had very high levels of inequality comparable to those we are seeing today, and yet over several decades, policy makers were able to use fair taxation and effective social programs and build the world's biggest middle class, and I think we have a lot to learn from that experience.

At the Institute for Policy Studies, we have particular expertise in one of the key drivers of inequality that has not been mentioned yet today and that is executive compensation. For nearly 20 years, we have been tracking the upward spiral of CEO pay and I have a lot of indicators in my written testimony, but let me just point out that, for example, the ratio between CEO and worker pay has gone up from 42-to-one in 1980 to about 325-to-one in 2010, and the average pay for S&P 500 CEOs now is about \$11 million a year.

Beyond contributing to inequality, excessive executive compensation is a problem because the chance of hitting these massive jackpots gives executives an incentive to do behaviors that might bump up their short-term profits and expand their own paychecks, but undermine our nation's long-term economic health.

In our Annual Executive Excess Reports, we have looked at corporate behaviors, like tax dodging, like massive layoffs, like risky financial activities, like offshoring jobs. All of these appear to boost CEO pay. But, of course, they have delivered a body blow to the American middle class.

Policy makers should also be concerned about excessive executive pay because extreme inequality within firms is simply bad for business. It is well documented now that when you have extreme gaps between top and bottom earners that it hurts worker morale and productivity and can increase turnover rates.

Now, Congress has recently taken some steps to address CEO pay and I want to highlight a couple of them. The first is the provision in the Dodd-Frank law that requires companies to now report their CEO-to-worker pay ratios within their companies. I think this could help encourage corporate boards to narrow these gaps. Unfortunately, there has been a very intense backlash by lobby groups representing CEOs and the SEC has delayed implementation of this transparency measure.

The second executive pay reform I wanted to mention is a rather little known provision in the TARP legislation that set a cap on the tax deductibility of executive pay at \$500,000. There is a similar provision in the health care reform bill just applying to health insurance companies. And I think if we could extend that kind of tax

deductibility cap across all corporations, we could get rid of a loophole that now encourages excessive executive pay, because as it is now, the more companies pay their CEOs, the more they can deduct.

Beyond the issue of executive pay, we clearly need a broader agenda to tackle extreme inequality, and I think if you look back at the previous era, it is clear that progressive taxation was one of their most important tools. In my written testimony, I have three charts that look back over the past century and they show that the decades when we had the highest top marginal tax rates were also the decades that had the lowest levels of inequality and the highest levels of economic growth.

I end with seven reforms that I think could help get us back to a healthier level of inequality and I would like to highlight just one that I do not think has gotten enough attention here on Capitol Hill and that is the idea of putting a very small levy on each trade of stocks and derivatives and other financial instruments. A financial transactions tax like that could generate massive revenues while also discouraging the short-term speculation that has been driving up pay in the financial sector but adding little to the real economy.

And so in conclusion, I want to acknowledge that this is going to be a long-term challenge for this country, but we have transformed a highly divided nation into a more stable and equitable one before and we can certainly do it again. Thank you.

[The prepared statement of Ms. Anderson follows:]



**Testimony of Sarah Anderson  
Global Economy Project Director  
Institute for Policy Studies**

**Before the Committee on Budget  
United States Senate**

**"Assessing Inequality, Mobility, and Opportunity"**

February 9, 2012

I would like to thank Chairman Conrad, Ranking Member Sessions, and the other members of the Committee for inviting me to contribute to this discussion. I believe inequality is the pressing issue of our time, and I applaud the committee for giving our nation's grand divide this level of attention.

Let me begin with the good news. Our nation has tackled this problem before — and successfully so. A century ago, during the original "Gilded Age," we experienced extremely high levels of inequality, levels comparable to those we are seeing today. Over the span of several decades, policymakers, backed by strong labor unions and other social movements, turned that inequality around. Through fair taxation and effective social programs and standards, we had achieved much lower levels of inequality by the middle of the twentieth century. We had laid the foundation for a strong and stable economy and put in place a middle class that was broader than any the world had ever seen. There is much to learn from that experience.

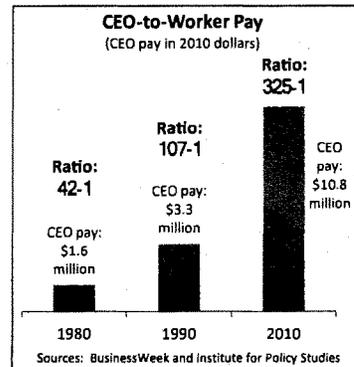
#### **Executive compensation as a key driver of inequality**

The Institute for Policy Studies has particular expertise in one aspect of our nation's drift into deep and extreme inequality: executive compensation.

For nearly 20 years, we at IPS have been publishing an annual analysis of the upward spiral in CEO pay. Our *Executive Excess* series has helped track and explain this trend, which has contributed significantly to the rising share of national income that flows to our nation's top 1 percent. Increases in executive compensation do not tell the whole story behind our growing economic divide, but they do offer an important lens into the broader problem.

Some select indicators of just how disproportionately large rewards for executives have become:

- The ratio between CEO and worker pay has risen from 42-to-1 in 1980 to 107-to-1 in 1990 to 325-to-1 in 2010.<sup>1</sup>



- Average compensation for S&P 500 CEOs reached \$10.8 million in 2010, more than six times the level for large company CEOs in 1980, after taking inflation into account, and triple the level in 1990.<sup>2</sup>
- Executives and financial professionals account for 70 percent of the increase in the share of national income going to the top 0.1 percent between 1979 and 2005.<sup>3</sup>
- Combined compensation for the top five executives by corporate enterprise increased as an average percentage of corporate profits from 5 percent in the period 1993-1995 to nearly 10 percent in the period 2001-2003.<sup>4</sup>

### **Why should policymakers be concerned about excessive executive compensation?**

#### **1. Excessive compensation encourages executive behavior that harms the broader economy**

Over nearly two decades, my colleagues and I at the Institute for Policy Studies have examined how extremely high levels of compensation affect executive behavior. Such massive jackpots, we've found, give executives incentives to behave in ways that may boost short-term profits and expand their own paychecks at the expense of our nation's long-term economic health.

Among our research findings:

- In last year's annual *Executive Excess* report, we looked at the intersection between executive compensation and tax dodging. We found that among the top 100 highest-paid CEOs in 2010, 25 had made more in personal compensation than their companies had paid in federal income taxes.<sup>5</sup>
- In 2010, we found that CEOs of the 50 firms that had laid off the most workers since the onset of the economic crisis had made nearly \$12 million on average, 42 percent more than the CEO pay average at S&P 500 firms as a whole.<sup>6</sup>
- In 2009, we found that the top five executives at the 20 banks that had accepted the most federal bailout dollars had averaged \$32 million each in personal compensation during the three years leading up to the 2008 meltdown.<sup>7</sup>
- In 2004, we found that CEOs at companies which had outsourced the most U.S. jobs to other countries were rewarded with bigger paychecks than their peers. Average CEO compensation at the 50 firms that had outsourced the most service jobs increased by 46 percent in 2003, compared to a 9 percent average increase for all large company CEOs. Top outsourcers earned an average of \$10.4 million, 28 percent more than the average CEO compensation of \$8.1 million.<sup>8</sup>
- In 2002, we found that top executives at 23 companies under government investigation for their accounting practices had earned far more during the preceding three years than average CEOs. CEOs at the firms under investigation had earned an average of \$60.1 million during 1999-2001, 65 percent more than the average of \$36.5 million for all leading executives for that period.<sup>9</sup>

Tax dodging, mass layoffs, reckless financial deals, offshoring jobs, "creative accounting"—all of these appear to boost CEO pay. But they have dealt one body blow after another to the American middle class, leaving a deeply skewed distribution of income and wealth.

## 2. Extreme CEO-worker pay gaps undermine business enterprise effectiveness

Our nation's long-term economic health depends to a great extent on the effectiveness of our U.S. enterprises. A growing body of research indicates that extreme inequality within firms leaves enterprises less productive and effective.

A Stanford University review of several studies found that organizations with highly differentiated pay between top and bottom earners tended to experience a decline in employee morale and job satisfaction.<sup>10</sup> Another study showed that in corporations with relatively narrow pay gaps, employees tended to produce higher quality products.<sup>11</sup> Additional research indicates that wide pay gaps lead to higher employee turnover rates.<sup>12</sup>

John Mackey, CEO of Whole Foods, limits his cash compensation to no more than 19 times the average for workers at his firm. In the *Harvard Business Review*, he wrote "Because of the yawning gap between the leaders and the led, employee morale is suffering, talented performers' loyalty is evaporating, and strategy and execution is suffering at American companies."<sup>13</sup>

Peter Drucker, the father of modern management theory, pointed out in the early 1980s that in any hierarchy, every level of bureaucracy must be compensated at a higher rate than the level below. The more levels, the higher the pay at the top. This gives CEOs a personal interest in maintaining rigid hierarchies that are disempowering for workers. Drucker's solution was to limit executive pay to no more than 20 times the compensation of their employees.<sup>14</sup> A landmark Brookings Institution report by David Levine supported this general view, stating "large differences in status can inhibit participation."<sup>15</sup>

Jim Collins, the author of several best-selling books on management science, spent five years trying to determine "what it takes" to turn an average company into a "great" one. He eventually identified 11 firms that had successfully generated off-the-charts stock returns over 15 years. Not a single one had a high-paid CEO. A celebrity CEO, Collins wrote, turns a company into "one genius with 1,000 helpers."<sup>16</sup>

### Recent reforms to address excessive executive compensation

Executive pay is not just an issue for shareholders. As the Wall Street meltdown made vividly clear, excessive pay packages contribute to a reckless corporate culture that endangers the well-being of the broader public. Responsible action is needed to encourage more rational pay practices.

**Dodd-Frank Pay Reforms:** In the wake of the 2008 crash, Congress did include a number of modest executive compensation provisions in the Dodd-Frank financial reform bill. One of the most innovative of these provisions, Section 953b, requires all U.S. corporations to compute and report the ratio between CEO and median employee pay. This disclosure requirement will improve information available for shareholders and the public on a metric fundamental to enterprise success. Hopefully, it will also encourage corporate boards to narrow this gap by raising median worker pay and/or reducing pay at the top.<sup>17</sup>

However, in the face of an intense backlash from corporate lobby groups, the SEC has delayed implementation of this new law. Regulators are facing strong pressure to water down several additional Dodd-Frank pay provisions, including Section 956, which would give regulators the power to prohibit pay packages for financial executives that encourage inappropriate risks.

**Limits on the Tax Deductibility of Executive Pay:** Congress also set an important precedent in the Troubled Asset Relief Program by establishing a \$500,000 cap on the tax deductibility of executive

compensation at bailout firms. A similar provision was included in the 2010 health care reform legislation with regard to health insurance companies. These provisions took an important step towards filling a loophole in the tax code that encourages excessive pay.

Currently, there are no meaningful limits on how much corporations can deduct from their taxes for the expense of executive compensation. The more they pay their CEO, the more they can deduct from their taxes. Other taxpayers bear the brunt of this loophole, either through the increased taxes needed to fill the revenue gaps or through cutbacks in public spending. A tax deductibility cap on executive compensation should be established for all corporations. Ideally, it would deny all firms tax deductions on any executive pay that runs over 25 times the pay of a firm's lowest-paid employee or \$500,000, whichever is higher.

#### **A broader agenda to reverse extreme inequality**

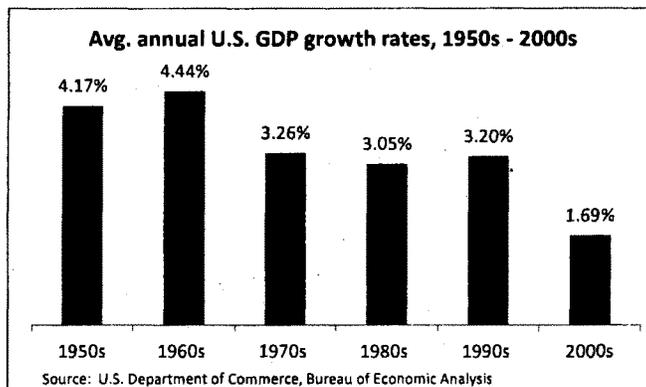
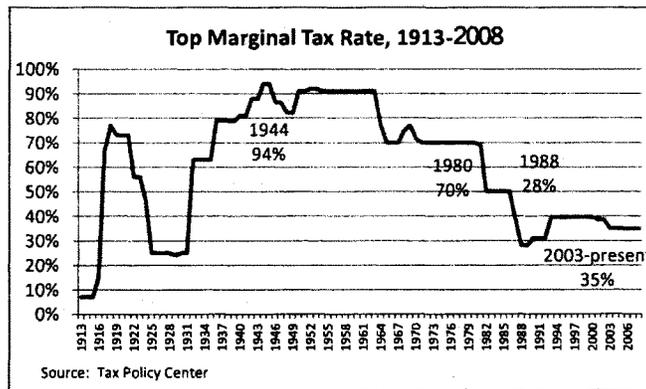
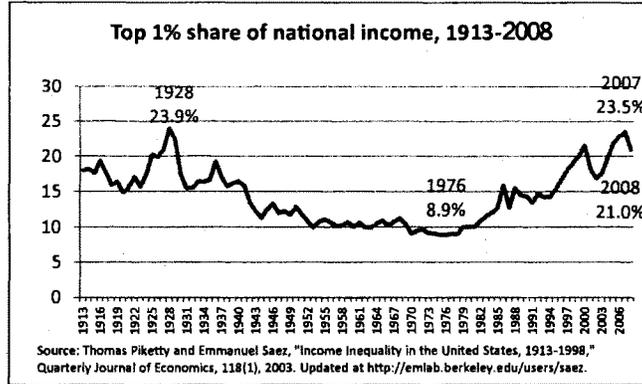
While Congress has made some small steps forward in recent years, much more needs to be done to rein in executive pay, as part of a broader effort to reverse extreme inequality. This broad agenda will need to include initiatives to lift up the bottom through living wages and more accessible high-quality health care and education, as well as efforts to address corporate concentration, campaign finance laws, and other obstacles to shared prosperity. But a look back at the previous era's efforts to tackle inequality reveals that one of those reformers most important tools was progressive taxation.

In the middle of the last century, the U.S. tax system did a great deal to offset maldistributions of income and wealth. A major reason corporate boards did not compensate executives at such exorbitant levels during that period was that the bulk of that excessive pay would have simply been taxed away.

During the 1950s and early 1960s, the top marginal tax rate on income over \$400,000 a year (the equivalent of less than \$3 million today) faced a tax rate just over 90 percent. During that time, the share of the nation's total pre-tax income going to the top 1% hovered around 10 percent, according to one academic study.<sup>18</sup> As taxes on the wealthy have declined over the past 50 years, we've seen a steady increase in wealth and income concentration at the top. Today, with a top marginal rate of only 35 percent, the top 1% enjoy more than 20 percent of the nation's income.<sup>19</sup> Not only did the "high-tax" decades coincide with lower inequality rates, they were also marked by relatively high GDP growth rates. (See details in charts on following page).

A recent report by the Congressional Budget Office found similar trends towards rising inequality in after-tax income during the period 1979-2007. According to their calculations, the top 1 percent of the population with the highest income saw an increase in their average real after-tax household income of 275 percent during this period, compared to only 65 percent for the rest of the highest quintile (the 81<sup>st</sup> through 99<sup>th</sup> percentiles); 37 percent for the population in the middle of the income scale (the 21<sup>st</sup> through 80<sup>th</sup> percentiles); and 18 percent for the lowest quintile.<sup>20</sup>

Preferential treatment and loopholes have allowed the richest Americans to pay far less than the statutory tax rates. The richest 400 U.S. taxpayers have seen their effective tax rate decline from over 40 percent of their income in 1961 to just 18.1 percent in 2010.<sup>21</sup> In 2009, the most recent data available, 1,500 millionaires paid no income taxes, largely because they made use of off-shore tax schemes, according to the Internal Revenue Service.<sup>22</sup>



### Key elements of tax reform to reverse extreme inequality

This section draws heavily from the forthcoming book by my Institute for Policy Studies colleague Chuck Collins, *99 to 1: How Wealth Inequality is Wrecking the World and What We Can Do About It* (Berrett-Koehler, March 2012).

**New income tax brackets for the 1 percent.** Under our current tax rate structure, households with incomes over \$350,000 pay the same top income tax rate as households with incomes over \$10 million. In the 1950s, there were 16 additional tax rates over the highest rate (35 percent) that we have today.

**A tax on financial speculation.** The richest 1 percent of Americans contributed to the 2008 economic meltdown by moving vast amounts of wealth into the speculative shadow banking system. Our society is still paying the mammoth social costs of this meltdown — through home foreclosures, unemployment, and the destruction of personal savings. A modest federal tax on every transaction that involves the buying and selling of stocks and other financial products would both generate substantial revenue and dampen short-term speculation. For ordinary investors, the cost would be negligible. A financial speculation tax would amount to a tiny insurance fee to protect against financial instability.

**A higher tax rate on income from wealth.** Giving tax advantages to income from wealth also encourages short-term speculation. With carefully structured rate reform, we can end this preferential treatment for capital gains and dividends and, as Warren Buffett and other analysts have noted, encourage long-term investing.

**A progressive estate tax on the fortunes of the 1 percent.** The wealthiest Americans have all benefited from generations of investments in public goods that have left the United States with an infrastructure — in everything from education and roads to dispute resolution — that enables wealth creation. Our wealthy have a responsibility to give back to the society that has given them so much. The current estate tax on inherited wealth stands at 35 percent and only applies to estates over \$5 million (\$10 million for a couple). Congress could raise additional revenue from those with the greatest capacity to pay by establishing a progressive estate tax with graduated rates and a 10 percent surtax on the value of an estate above \$500 million, or \$1 billion for a couple.

**An end to tax haven abuse.** By one estimate, the use of tax havens by corporations and wealthy individuals costs the federal treasury \$100 billion a year.<sup>23</sup> These havens are transferring wealth out of local communities into the foreign bank accounts of the world's wealthiest and most powerful.<sup>24</sup> Tax havens, or more accurately "secrecy jurisdictions," can also facilitate criminal activity, from drug money laundering to the financing of terrorist networks.

**A wealth tax on the top 1 percent.** A "net worth tax" could be levied on household assets, including real estate, cash, investment funds, savings in insurance and pension plans, and personal trusts. Such a tax could be calibrated to tax wealth only above a certain threshold. For example, France's solidarity tax on wealth only kicks in on asset value in excess of \$1.1 million.

**The elimination on the cap on social security withholding taxes.** Extending the payroll tax to cover all wages, not just wage income up to \$110,100, would be an important step. Some of our richest Americans are done paying withholding taxes in January, while ordinary working people pay all year.

### Conclusion

Our current levels of extreme inequality did not suddenly appear. They have grown steadily over the past 30 years. Reversing this inequality trend will be a long-term challenge. But we have transformed a highly divided nation into a more stable and equitable society before. We can certainly do it again.

## NOTES

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Chairman CONRAD. Thank you very much.  
 We will go to Dr. Winship. Again, Dr. Winship, thank you very much for being here to testify and please proceed.

**STATEMENT OF SCOTT WINSHIP, FELLOW, CENTER ON  
 CHILDREN AND FAMILIES, BROOKINGS INSTITUTE**

Mr. WINSHIP. Chairman Conrad and Ranking Member Sessions, it is a pleasure and a privilege for me to testify before you today on the important issues of inequality, mobility, and opportunity.

I want to note at the outset that while I am a fellow at the Brookings Institution, my testimony today is solely on my own behalf. Brookings does not normally take policy positions as an institution.

Let me first briefly summarize the facts around income mobility in the United States. I would characterize mobility in America as alive as well, but would emphasize an important caveat. We have too little upward mobility out of poverty.

To start with, the evidence on trends in mobility points to very small changes since the mid-20th century, small enough that we do not have the technical requisites to detect them confidently or consistently. The exception to this pattern is that upward mobility in the absolute sense of being better off than one's parents almost surely has risen. That is, even though the ability of poor and middle-class children to end up more highly ranked on income than their parents were, even though that has not improved, successive generations of poor and middle-class kids have ended up better off in absolute terms.

The U.S. tends to have less mobility than other industrialized nations when aggregate measures are used. However, evidence suggests that we are unique in a very specific way. We have no more downward mobility from the middle than other nations, no less upward mobility from the middle, and no less downward mobility from the top, nor do we have less upward mobility from—

Chairman CONRAD. Can I stop you there and just have you repeat that, because I think you are saying some very important things there, and if you repeat it—I want to make sure I get into my head what you are saying there.

Mr. WINSHIP. Sure. So again, when we look at aggregate measures of mobility, the U.S. tends to come out looking worse than other nations do, but research that has dug behind these aggregate measures tends to show that the way that the U.S. is unique is not that we have less upward mobility from the middle or more downward mobility from the middle or that we have less downward mobility from the top. It is specifically that we have less upward mobility from the bottom. And even more specifically, that is specific to men. So we do—

Chairman CONRAD. Can I ask you, when you say the bottom, are you talking about the bottom 20 percent?

Mr. WINSHIP. That is right. That is right. The bottom 20 percent, the bottom quarter. So interestingly, though, if you look just at women, we tend to do just as well at moving women from the bottom 20 percent out of it.

Chairman CONRAD. So it is largely the place where we do not do as well is on the male side.

Mr. WINSHIP. That is right.

Chairman CONRAD. And we have two women here testifying.

[Laughter.]

Chairman CONRAD. We have three men. Perhaps we should have had another woman testify?

Mr. WINSHIP. So long as I was not the one bumped out—

[Laughter.]

Mr. WINSHIP. So the last basic way of assessing the extent of mobility in America is to use the criterion of former Supreme Court Justice Potter Stewart, who said of a very different sort of problem, “I know it when I see it.” That is, apart from the question of whether things are getting worse or how we compare to other countries, we may just feel like there is not enough mobility in the U.S. That is a difficult case to make if the question is one of sufficient absolute mobility, being better off than your parents were. It turns out, as Ranking Member Sessions noted, 80 percent of 40-year-olds, before the recession, anyway, were better off than their parents were at the same age.

However, the picture, I would argue, changes if we consider the sufficiency of upward mobility in terms of where one ranks. Research conducted by my Brookings colleagues Julia Isaacs, Isabel Sawhill, and Ron Haskins for my former colleagues at the Pew Economic Mobility Project shows that children starting out in the bottom fifth of incomes have only about a 17 percent chance of ending up in the top two-fifths, what I would call the upper middle class and where I suspect most of us have ended up or will by mid-life.

To be sure, even failure to reach the top two-fifths may still translate into significantly higher living standards if economic growth is significant. But poor children face long odds if they want to be able to grow up to be whatever they want to be, to use an expressed aspiration that many of us, I suspect, heard from our own parents.

Many on the political left have argued that the opportunities of middle class and poor Americans have been hurt by rising inequality. However, the evidence of such an impact is exceedingly thin, I would argue. In part, that is because only one kind of inequality has risen markedly. If you look within the 99 percent, inequality has grown only modestly, if at all, as I describe in my written testimony. Inequality between the 99 percent and the top one percent, on the other hand, has risen a lot, but there is very little evidence to suggest that the gains at the top have come at the expense of other Americans.

Economist Stephen Kaplan has shown that income concentration at the top fell quite a bit during the Great Recession. But if that translated into gains for everybody else, it is, shall we say, not obvious. Why, then, should increases in income concentration necessarily translate into losses for everyone else?

Consider that Mark Zuckerberg, founder of Facebook, stands to make \$5 billion cashing out stock options this year. How would the typical American end up better off if Zuckerberg could not exercise those options? Will a typical worker be better off in 2013 because Zuckerberg will not realize the windfall he did in 2012?

American inequality levels are viscerally bracing, but one still has to make the case that they are undesirable. Consider two men,

one of whom makes 200 times the other. Should we be concerned about the poorer man? Well, if I told you that the two men in this example are Zuckerberg and Mitt Romney, who made just \$22 million in 2010, would that change your answer? Romney, to be clear, made over 400 times the typical American household in 2010. Should we be concerned about that household? What really matters for answering this question is how the poor and middle-class are doing and how much opportunity they have.

Income growth has slowed, but as I indicate in my testimony, the poor and middle-class are quite a bit better off than they were 30 years ago, when the numbers are analyzed correctly. That does not mean that the living standards of the poor are comfortable, but if their circumstances are problematic, that is a problem of poverty rather than inequality.

I will close just by saying policies to promote opportunity must recognize the differences between good and bad mobility and between good and bad inequality. Some upward immobility reflects behaviors we want to discourage and some downward immobility behaviors we want to encourage. Some degree of inequality is vital for rewarding hard work and risk.

So I would argue, in closing, that we ought to be focused on economic growth as the best anti-poverty policy we have, the best path to a prosperous middle class. I would agree with Ranking Member Sessions and Chairman Conrad that that is going to involve reducing deficits in the longer term. I would also agree that we want to get to that soon, but not jeopardize the fragile recovery that we have. And I would also argue that we should not forget the limited upward mobility that we have at the bottom, a point that Governor Mitch Daniels has made, calling upward mobility, "the crux of the American promise."

Thank you for this opportunity to testify this morning.

[The prepared statement of Mr. Winship follows:]

**Testimony Before the Senate Budget Committee, February 9, 2012**

Scott Winship, Fellow, Center on Children and Families, The Brookings Institution

Thank you for the opportunity to testify today on the important issues of inequality, mobility, and opportunity. I want to note at the outset that while I am a Fellow at the Brookings Institution, my testimony today is solely on my own behalf. Brookings does not normally take policy positions as an institution.

The facts of income inequality and mobility are nonpartisan. They are incomplete and subject to revision. But in order to guide policy, facts must be as accurately understood and conveyed as possible. Doing so is often difficult not only because the world is complicated, but because new evidence routinely appears to muddy the picture we previously managed to discern.

The facts also leave room for interpretation as to how problematic they are, but often times neutral facts are asserted as problems. Other facts are wrongly thought to be problematic only if they exhibit deterioration. But for something to be a problem, it does not have to be getting worse. On the other hand, just because something claimed to be a problem is growing more common over time does not demonstrate that it is really a problem. With these considerations in mind, let me briefly summarize the facts around income mobility and inequality in the United States.

Broadly speaking, there are three ways to think about intergenerational income mobility.<sup>1</sup> We can ask whether members of one generation end up ranked similarly to the way their parents' income ranked them. If parents are in the bottom fifth of households, ranked by income, how likely is it that their children will also be in the bottom fifth when they are the same age? Note that the "bottom fifth" might be a better-off group in the future than it is today. Another way to assess mobility is to see whether children tend to end up better off than their parents in absolute terms—whether they have higher incomes than their parents (after taking into account increases in the cost of living), regardless of where they or their parents ranked against their peers. Households can experience upward mobility in this sense even if their rank is no higher than that of their parents. Finally, we can consider the extent of mobility by asking how far apart children end up given how far apart their parents were. If one parent has twice the income of another, by what factor will their children's incomes differ? This last way to approach the question of mobility combines concerns about rank and absolute income gains.

The extent of mobility—in any of these senses—may be assessed in three different ways. First, we can ask whether things have gotten worse. The Administration and others on the political left have argued that income mobility has diminished over time.<sup>2</sup> However, the evidence points to very small changes since the mid-twentieth century—small enough that we do not have the technical requisites to detect

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<sup>1</sup> For an earlier summary of economic mobility in America, see my essay, "Mobility Impaired," *National Review*, November 14, 2011 ([http://www.brookings.edu/articles/2011/1109\\_economic\\_mobility\\_winship.aspx#\\_ftn10](http://www.brookings.edu/articles/2011/1109_economic_mobility_winship.aspx#_ftn10)).

<sup>2</sup> See, for instance, President Obama's December 6, 2011 speech in Osawatomie, Kansas (<http://www.whitehouse.gov/the-press-office/2011/12/06/remarks-president-economy-osawatomie-kansas>).

them confidently or consistently.<sup>3</sup> My own estimates suggest that upward mobility from poverty to the middle class among today's late twentysomethings is about what it was for the previous generation. Roughly 50 to 55 percent of those who started out poor reached the middle class by age twenty-seven.<sup>4</sup> The exception to this pattern of minimal change in mobility is that upward mobility in the absolute sense of being better off than one's parents has risen. For instance, I estimate that 47 percent of late twentysomethings today have already outpaced the incomes their parents had when the kids were 15 years old. In the previous generation, just 41 percent did. In short, if the benchmark against which we judge our mobility is past levels, we do not appear to have much of a problem.

A second way to assess our current mobility levels is to compare ourselves with other nations. In the sense of how much parental income gaps translate into future child gaps, the U.S. tends to have less mobility than most European countries and other English-speaking nations. A comparison to Canada is illustrative. Consider a man who earns twice what his neighbor earns. In Canada, that man's son can be expected to earn 25 percent more than the neighbor's son. In the U.S., the figure is 60 percent.<sup>5</sup>

However, evidence on *earnings* mobility in the sense of where parents and children rank suggests that our uniqueness lies in how ineffective we are at lifting up men who were poor as children. In other words, we have no more downward mobility from the middle than other nations, no less upward mobility from the middle, and no less downward mobility from the top. Nor do we have less upward mobility from the bottom among women. Only in terms of low upward mobility from the bottom among men does the U.S. stand out.<sup>6</sup> This distinctive pattern presents complications for accounts that explain American immobility by pointing to our policies or our economic system. Further muddying the picture is the complete lack of evidence on cross-national differences in the extent to which children outpace parents in absolute terms.

As a third way of assessing the extent of mobility in America, we can use the criterion of former Supreme Court Justice Potter Stewart, who said of a very different sort of problem, "I know it when I see it." That is, apart from the question of whether things are getting worse or how we compare to other countries, we may just believe that there is not enough mobility. That is a difficult case to make if the

<sup>3</sup> I summarize the evidence in my critique of the president's speech—see "The President's Suspect Statistics," National Review Online, January 2, 2012 (<http://www.nationalreview.com/articles/286874/president-s-suspect-statistics-scott-winslip?pg=1>).

<sup>4</sup> The estimate depends on whether people who report household incomes less than or equal to \$0 are included. "Poor" in these analyses means being in the bottom tenth of incomes; "middle class" means an income of at least half the median. Parental income is assessed at age 14 to 16, and the incomes of adult children are assessed twelve years later, at ages 26 to 28.

<sup>5</sup> See Miles Corak (2010), "Chasing the Same Dream, Climbing Different Ladders," Pew Economic Mobility Project ([http://www.economicmobility.org/assets/pdfs/PEW\\_EMP\\_US-CANADA.pdf](http://www.economicmobility.org/assets/pdfs/PEW_EMP_US-CANADA.pdf)).

<sup>6</sup> See Markus Jantti et al. (2006), "American Exceptionalism in a New Light," Institute for the Study of Labor (IZA) Discussion Paper No. 1938 (<http://ftp.iza.org/dp1938.pdf>).

question is one of sufficient absolute mobility; eighty percent of forty-year-olds before the recession were better off than their parents were at the same age.<sup>7</sup>

However, the picture, I would argue, changes if we consider the sufficiency of upward mobility in terms of where one ranks. Research conducted by my Brookings colleagues, Julia Isaacs, Isabel Sawhill, and Ron Haskins for my former colleagues at the Pew Economic Mobility Project shows that a child starting out in the bottom fifth of incomes has only a one-in-three chance of being solidly middle class (escaping the bottom two-fifths) as an adult.<sup>8</sup> She has only a 17 percent chance of ending up in the upper middle class (the top two fifths). To be sure, even failure to reach the “middle” so defined may still translate into higher living standards than the middle enjoyed in the past if there is sufficient absolute mobility. But poor children face long odds and limited opportunity if they want to be able to “grow up to be whatever they want,” to use an expressed aspiration many of us, I suspect, heard from our parents.

What about income inequality? Many on the political left, including the president’s Council of Economic Advisors chair, have argued that rising inequality has hurt the middle class and poor.<sup>9</sup> The evidence of such an impact is exceedingly thin.<sup>10</sup> In part, that is because only one kind of inequality has risen markedly. Within “the 99 percent”, inequality has grown only modestly, if at all. According to research by Richard Burkhauser and his colleagues, after taking into account the value of employer-sponsored and federally provided health insurance, the person at the 90<sup>th</sup> percentile (richer than 90 percent of Americans) has about six times the household income of the person at the 10<sup>th</sup> percentile (poorer than 90 percent of Americans).<sup>11</sup> In concrete terms, it is roughly the difference between having \$80,000 and having \$12,000 to \$15,000. The six-to-one ratio held in the early 1990s, and it was probably not much lower in the mid-1980s. It is almost certainly the case that in the late 1960s the ratio was no lower than four, and it was probably closer to five.<sup>12</sup> Furthermore, these figures do not attempt to make adjustments for the research finding that the cost of living has risen less for the poor and middle class than for upper-income households, which would make the increase in “90/10” inequality even smaller.<sup>13</sup>

<sup>7</sup> See Julia Isaacs, Isabel Sawhill, and Ron Haskins (2008), “Getting Ahead or Losing Ground,” Brookings Institution for the Pew Economic Mobility Project ([http://www.economicmobility.org/assets/pdfs/PEW\\_EMP\\_GETTING\\_AHEAD\\_FULL.pdf](http://www.economicmobility.org/assets/pdfs/PEW_EMP_GETTING_AHEAD_FULL.pdf)).

<sup>8</sup> Ibid.

<sup>9</sup> See Alan Krueger’s January 12, 2012 speech at the Center for American Progress (<http://americanprogress.org/events/2012/01/pdf/krueger.pdf>).

<sup>10</sup> See my critique of Krueger’s claims—“Closing Arguments in the Great Gatsby Curve Wonk Fight of 2012,” originally published at Reihan Salam’s blog, The Agenda, on National Review Online’s website ([http://www.brookings.edu/opinions/2012/0120\\_mobility\\_winsip.aspx](http://www.brookings.edu/opinions/2012/0120_mobility_winsip.aspx)).

<sup>11</sup> These conclusions are based on two papers coauthored by Burkhauser, one with Kosali Simon (2010), “Measuring the Impact of Health Insurance on Levels and Trends in Inequality,” National Bureau of Economic Research Working Paper 15811 (<http://www.nber.org/papers/w15811>) and one with Shuaizang Feng and Stephen P. Jenkins (2009), “Using the P90/P10 Index to Measure U.S. Inequality Trends With Current Population Survey Data,” *Review of Income and Wealth* 55(1): 166-185.

<sup>12</sup> Ibid and Jencks et al. (2010), “How Has Rising Economic Inequality Affected Children’s Educational Outcomes?” Working Paper.

<sup>13</sup> Christian Broda and John Romalis (2009), “The Welfare Implications of Rising Price Dispersion,” Working Paper.

Unlike inequality within the 99 percent, inequality between the 99 percent and the top 1 percent has risen a lot (though not just in the United States).<sup>14</sup> The top 1 percent received 24 percent of all income in 2007 compared with 10 percent in 1980. But there is very little evidence to suggest that the gains at the top have come at the expense of other Americans. Income concentration at the top fell quite a bit between 2007 and 2009, dropping down to 18 percent of all income received, but that hardly translated into gains for everyone else.<sup>15</sup> Why should increases in income concentration necessarily translate into losses for everyone else? The size of the economic pie can grow in such a way that everyone gets a bigger slice despite the top getting a bigger share of the pie.

Consider that Mark Zuckerberg, founder of Facebook, stands to make five billion dollars cashing out stock options this year.<sup>16</sup> How would the typical American end up better off if the Facebook IPO were to fall through so that Zuckerberg could not exercise his options? Or if the IPO does go through, will the typical worker be better off in 2013, because Zuckerberg will not realize the windfall he did in 2012?

American inequality levels are viscerally bracing, but one still has to make the case that they are undesirable. Consider two men, one of whom makes over 200 times the other. Should we be concerned about the poorer man? What if I told you that the two men in this example are Zuckerberg and poor Mitt Romney (who made just \$22 million in 2010)?<sup>17</sup> Romney made over 400 times the typical American household in 2010.<sup>18</sup> Should we be concerned about that household?

What really matters is how the poor and middle class are doing and how much opportunity they have. Income growth has slowed, but research by Burkhauser and his colleagues and by Bruce Meyer and James Sullivan has shown that median household income still rose by as much as 35 or even 55 percent over the last 30 years.<sup>19</sup> There were even small gains during the “lost decade” of the 2000s, prior to the Great Recession. While the gains since 2000 have more or less evaporated, that the typical household is—at worst—at the same level as in the boom years of the late 1990s is disappointing but hardly alarming. Meyer and Sullivan’s research also shows that incomes at the bottom have increased robustly over the past 30 years, contrary to what official income trends show. By 2009, the household income at the 10th percentile—the household poorer than 90 percent of the others—was only about a third lower than that of the median household in 1980, after adjusting for inflation.

<sup>14</sup> See the World Top Incomes Database at <http://g-mond.parisschoolofeconomics.eu/topincomes/>.

<sup>15</sup> See the data compiled by Stephen Kaplan, building on the work of Thomas Piketty and Emmanuel Saez, at <https://s3.amazonaws.com/s3-documentcloud.org/documents/274723/kaplan-full.pdf>.

<sup>16</sup> Richard Waters, “Facebook chief faces tax bill of \$1.5bn,” *Financial Times*, February 3, 2012 (<http://www.ft.com/cms/s/2/6dbfbce-4e8b-11e1-ada2-00144feabdc0.html#axzz1ljinTCNj>).

<sup>17</sup> Richard Rubin and Jesse Drucker, “Romney’s 13.9% Tax Rate Shows Power of Investment Tax Preference,” Bloomberg, January 25, 2012 (<http://www.bloomberg.com/news/2012-01-24/romney-paid-13-9-percent-tax-rate-on-21-6-million-2010-income.html>).

<sup>18</sup> Median household income in 2010 was \$49,445. See [http://www.census.gov/newsroom/releases/archives/income\\_wealth/cb11-157.html](http://www.census.gov/newsroom/releases/archives/income_wealth/cb11-157.html).

<sup>19</sup> Burkhauser, Larrimore, and Simon (2011), “A ‘Second Opinion’ on the Health of the American Middle Class,” National Bureau of Economic Research Working Paper 17164 (<http://www.nber.org/papers/w17164>) and Meyer and Sullivan (2011), “The Material Well-Being of the Poor and the Middle Class Since 1980,” AEI Working Paper 2011-04 (<http://www.aei.org/files/2011/10/25/Material-Well-Being-Poor-Middle-Class.pdf>).

Just because living standards have improved does not mean that the lives of the poor are comfortable. Meyer and Sullivan find (roughly) that the household at the 10th percentile gets by on \$20,000 a year, or under \$1,700 a month. That is hardly luxurious. For a good working definition of "insecurity," consider the one in five household heads who reported that sometime in 2010 they worried about whether they would run out of food before they could afford to buy more.<sup>20</sup> But if the circumstances of the poor are problematic that is because of poverty, not because of inequality.

The problem with most discussions of income mobility and inequality is that they do not distinguish between good and bad mobility or between good and bad inequality. A world of perfect mobility, as the researcher/writer Reihan Salam has noted, is "one in which no matter how hard you work to provide your children with every advantage in life, they're just as likely to sink to the bottom of the heap as to rise to the top."<sup>21</sup> No one should find that ideal attractive; some immobility reflects behaviors we want to encourage or discourage. Similarly, in a world of perfect equality, there would be no rewards for hard work or risk. That would cripple economic growth and hurt everyone.

The issue of economic growth points to the central importance of absolute mobility—of ensuring that children do at least as well as their parents, and ideally much better. Economic growth is the best antipoverty policy we have and the best path to a prosperous middle class, as evidenced by the broad gains of the postwar boom years, to say nothing of the late 1990s. High-end inequality was flat during the former period but rising during the latter.

In the short run, the hard reality is that American consumers are wary of spending, banks wary of lending, and businesses wary of hiring. With the bursting of the housing bubble, a significant minority of the population is in the red, and their weak position is inhibiting the national confidence we need to return to pre-recession growth levels. If we had weathered a normal recession, fiscal stimulus in the form of spending or tax cuts might have been sufficient to dig out of our hole. But recessions preceded by financial crises are different. The amount of stimulus it would take to swiftly restore growth is inconceivable given the historically high deficits we face.

Thankfully, we appear to be turning a corner, so the question increasingly appears to be how to speed up the recovery rather than how to avoid a double-dip recession. The way to do so, in my view, is to facilitate private efforts to put overleveraged homeowners back in the black. That would restore consumer demand, detoxify the problematic mortgage-backed assets lingering on the books of banks, and rejuvenate lending. Importantly, it could be done in a way that did not undermine personal responsibility on the part of borrowers.

<sup>20</sup> Coleman-Jensen et al. (2011), "Statistical Supplement to Household Food Security in the United States in 2010," United States Department of Agriculture Economic Research Service (<http://www.ers.usda.gov/Publications/AP/AP057/>).

<sup>21</sup> Reihan Salam, "Going Nowhere," *The Daily*, November 29, 2011 (<http://www.thedaily.com/page/2011/11/29/112911-opinions-column-mobility-salam-1-2/>).

A second easy way to promote short-term growth is not to talk down the economy. Political scientist Dan Wood and his colleagues found that the degree of optimism or pessimism in presidential speeches between 1978 and 2002 had a detectable effect on consumers' sentiment about the economy and unemployment, which in turn affected economic growth.<sup>22</sup> I worry that the interest from one side in framing this year's presidential and senate campaigns around overdrawn themes of inequality and diminished opportunity for the middle class will affect perceptions of the economy's strength.

In the longer term, economic growth will require that we get projected deficits under control. That means containing the growth of entitlement spending, through policies like the Wyden-Ryan Medicare reform proposal. It also means policies to promote innovation, entrepreneurship, and international competitiveness.

For some, it may be tempting to focus policy solely on economic growth to the exclusion of addressing limited upward mobility in terms of rank. But keep in mind all those kids who are unlikely to grow up to be whatever they want. Economic growth alone cannot be expected to increase upward mobility out of the bottom, which Indiana governor Mitch Daniels has called, "the crux of the American promise." Many children face challenging barriers to mobility. Two thirds of African American children experience neighborhood poverty rates the level of which only six percent of white children see.<sup>23</sup> It is certainly true that many parents do a poor job promoting opportunity for their children, but children do not choose their parents. As children age, they must increasingly take responsibility for decisions that limit their future opportunities. Yet who among us remembers our adolescent years as a period of peak rationality?

Policies to promote upward mobility from the bottom could take the form of investments in education, coupled with reforms to school governance and incentives to promote accountability. They might include reforms to safety net programs to encourage independence, work, marriage, and savings. More ambitiously, child savings accounts could be seeded and family contributions matched on condition that any federal contribution must be used for higher education or a wedding, available only to young adults who avoid run-ins with the law and teen parenthood, or else forfeited back to the Treasury. Senator Sessions has supported a version of child savings accounts in the past; I believe that done well, the strategy could transform the expectations and aspirations of poor children and their parents, easily paying for itself over the long run.

Once again, thank you for the opportunity to testify this morning. I look forward to answering any questions you may have.

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<sup>22</sup> B. Dan Wood, Chris T. Owens, and Brandy M. Durham (2005), "Presidential Rhetoric and the Economy," *Journal of Politics* 67(3): 627-645.

<sup>23</sup> Patrick Sharkey (2009), "Neighborhoods and the Black-White Mobility Gap," Pew Economic Mobility Project ([http://www.economicmobility.org/assets/pdfs/PEW\\_NEIGHBORHOODS.pdf](http://www.economicmobility.org/assets/pdfs/PEW_NEIGHBORHOODS.pdf)).

Chairman CONRAD. Thank you, Dr. Winship.

We will now go to Dr. Warshawsky, a member, again, of the Social Security Advisory Board. Welcome, and please proceed with your testimony, sir.

**STATEMENT OF MARK J. WARSHAWSKY, MEMBER, SOCIAL SECURITY ADVISORY BOARD**

Mr. WARSHAWSKY. Thank you very much. Chairman Conrad, Ranking Member Sessions, and members of the committee, I appreciate the opportunity to share my research findings and other information with you on recent trends and causes of earnings inequality.

There is a large misunderstanding in the public on the difference between earnings and compensation. A major theme reflected in recent government policies and politics and media coverage is a great concern with the perceived increased inequality of the distribution of resources in the United States over the last few decades. This phenomenon is usually measured in terms of household income or worker earnings. By these measures, inequality appears to have increased.

This limited view of the data has launched any number of redistributionist policies and proposals, especially focused on tax and entitlement programs. What many analyses ignore or downplay, however, are the insidious effects on earnings of rapidly growing costs of health care benefits.

Using standard economic assumptions, if the cost of employer-provided health benefits are growing at a faster rate than total compensation, then take-home earnings, which is compensation less the cost of health and other benefits, must grow slower for those at the lowest levels of compensation than for those at the highest levels.

Chairman CONRAD. Can I stop you right there—

Mr. WARSHAWSKY. Sure.

Chairman CONRAD. —and have you repeat that sentence, because that is very important and it is a little complicated to grasp just hearing it once. So I think it is a very important—

Mr. WARSHAWSKY. I will be glad to. If the costs of employer-provided health benefits are growing at a faster rate than total compensation, then take-home earnings, which is compensation less the costs of those benefits, must grow slower for those at the lowest levels of compensation than for those at the highest levels.

This simple math means that the inequality of earnings would increase with fast-growing health care costs. This will be true even while the overall distribution of compensation and inequality measured according to compensation remains essentially unchanged.

Data in studies support the hypothesis that rapid growth in health care costs lead to an increase in earnings inequality with no change in compensation inequality. I had access to data from SSA and from the BLS that supports this view.

From 1999 to 2006, the average hourly earnings increased about 29 percent. But hourly compensation, which also includes the costs of benefits, increased more quickly, about a 32 percent increase. This growth differential is explained mainly by the fact that the

cost of benefits increased at a much faster pace than compensation. Health insurance in particular increased almost 74 percent.

And I would note a study a BLS economist that found no change between 1997 and 2007 in the fraction of jobs for which the employer made some contribution toward their employees' health insurance coverage. That there was little change in employee access to health benefits makes sense because of nondiscrimination requirements in the tax code that prevent an employer from favoring the higher paid. Also, employers desire to avoid adverse selection in the health plans and therefore want to encourage younger, healthier workers, who are generally lower paid, to enroll.

As a share of compensation on average across all workers, health insurance rose from 5.8 to 7.6 percent of compensation. Looking across the earnings distribution, according to the Bureau of Labor Statistics, the share of compensation going to health benefits increased notably for those in the lower-and middle-class percentiles. The growth in share was highest for those in the 30th percentile, from 6.5 percent to 12 percent, and was also higher for the 60th percentile, middle-income workers, from almost seven percent to 11 percent. But at the top percentile, the share in compensation going to health care only increased slightly.

The cost of health care essentially drove an ever-widening wedge between the growth of take-home earnings and compensation, and we find this exactly and precisely in the data. Earnings grew about 27 percent for those in the 30th to 60th percentiles, about 30 percent in the 80th the 90th percentiles, and about 35 percent in the 95th to 99th percentiles. But compensation growth at 35 percent was essentially evenly distributed across earnings levels. In fact, it grew the fastest at the lowest decile, at 41 percent.

Because the rapid increase in the cost of health insurance is a prominent long-run feature of our economic environment over the last 50 years, it has likely played an important role in the longer-term trends in earnings inequality, as well, and indeed, several studies have found this link over longer time periods.

There are important policy implications of these research findings. Because total compensation growth has been essentially the same across earnings groups, the hand-wringing over inequality has been largely shooting at the wrong target. Either we were satisfied that we were getting value for the rapid increase in spending on health care and there is no inequality problem because compensation is growing evenly, or we are concerned that we are not getting value and the poor and middle-class workers are particularly bearing the deadweight loss of health care, of inefficient health care.

In the latter case, this suggests that the most effective policy tool to address perceived inequality would be to slow the growth of health care costs in the economy. In this regard, it is my judgment that the Affordable Care Act is likely on net to make matters worse. Slowing the growth in health care costs is admittedly a challenging structural and political problem, but that just argues for more policy effort and political courage there. Just treating the symptoms of the inequality problem with tax and entitlement policies will have harmful side effects on overall economic growth and

lose the opportunity to control budget deficits by lowering health care costs.

Members of the committee, thank you for your time and attention.

[The prepared statement of Mr. Warshawsky follows:]

Statement of the Honorable Mark J. Warshawsky, Ph.D. to the Senate Budget Committee,  
Hearing on "Assessing Inequality, Mobility and Opportunity" February 9, 2012

"What's Really Driving Inequality"

Chairman Conrad, Ranking Member Sessions, and Members of the Committee, I appreciate the opportunity to share my research findings and other information with you on the recent trends and causes of earnings inequality. I formerly was Assistant Secretary for Economic Policy at the Treasury Department where, among other activities, I followed developments in the labor market. I am currently a Member of the Social Security Advisory Board, and it was through this position that I gained access to unpublished detailed data from the Social Security Administration (SSA) and the Bureau of Labor Statistics (BLS) on the distribution of earnings and employee benefits. I used this data to conduct the research which is the content of my statement today. The research was published in an article appearing this past week in the Bloomberg BNA Pensions and Benefits Daily Reporter; I attach a copy of that article to this testimony.<sup>1</sup> I am not today representing the Advisory Board or any other government or private organization; rather I am only stating the research findings in the article and my own understanding of their analytical significance and policy relevance.

*There is a large misunderstanding in the public on the difference between earnings and compensation.*

A major theme reflected in recent government policies and politics and media coverage is a great concern with the perceived increased inequality of the distribution of resources in the United States over the last few decades. This phenomenon is usually measured in terms of household income or worker earnings. By these measures, inequality appears to have increased.

This limited view of the data has launched any number of redistributionist policies and proposals, especially focused on tax and the entitlement programs. Here I argue that there has been a fundamental misdiagnosis and inaccurate measurement of the problem. What many analyses ignore or downplay are the insidious effects on earnings of rapidly growing costs of health care benefits.

Using some standard economic assumptions, if the costs of employer-provided health benefits are growing at a faster rate than total compensation, then take-home earnings – compensation less the cost of health and other benefits – must grow slower for those at the lowest levels of compensation than for those at the highest levels. This simple math means that the inequality

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<sup>1</sup> Mark J. Warshawsky, "Can the Rapid Growth in the Cost of Employer-Provided Health Benefits Explain the Observed Increase in Earnings Inequality?" Bloomberg BNA Pensions and Benefits Daily, 22, February 3, 2012, pp. 1 –9; reproduced with permission from the Bureau of National Affairs.

of earnings would increase with fast-growing health care costs. This would be true even while the overall distribution of compensation and inequality measured according to compensation remains essentially unchanged.

The rapid growth in the cost of health care in the United States is widely noted. It is correctly said to cause burgeoning government spending and deficits, slower overall growth in worker earnings (wages), and later retirements. Less noted and understood is the tie of growth in health care costs to an increase in earnings inequality. The simple logic is as follows. Let's say that compensation (which is made up of earnings and benefits) grows at a certain common rate across workers over time at all compensation levels owing to, say, overall labor productivity improvements and that the market for labor services is competitive.

Let's also posit that health care benefit costs are the same dollar amount per worker at any point in time regardless of the worker's level of compensation and are evenly and widely provided to workers, or at least the distribution of prevalence and cost by compensation level has not changed much over time. But let's also say that health benefit costs are growing at a faster rate than compensation. Then earnings (which equal compensation less the cost of health and other benefits) must grow slower for those at the lowest levels of compensation than for those at the highest levels of compensation.

*Data and studies support the hypothesis that the rapid increase in health costs leads to an increase in earnings inequality but no change in compensation inequality.*

Statistics from the SSA and BLS strongly support this view. From 1999 to 2006, average hourly earnings increased about 29 percent. But hourly compensation, which also includes the cost of benefits, increased more quickly, about a 32 percent increase. This growth differential is explained mainly by the fact that the cost of benefits increased at a much faster pace than compensation—health insurance in particular increased almost 74 percent! And a study by a BLS economist found no change between 1997 and 2007 in the fraction of jobs (.789) with positive health insurance costs to the employer, that is, jobs for which the employer made some contribution toward employees' health insurance coverage.

That there was little change in employee access despite the large increase in employer cost makes sense because nondiscrimination rules in the tax code prevent an employer from favoring the higher-paid group in its workforce with tax-advantaged benefits. Also employers desire to avoid adverse selection in their health plans and, therefore, want to encourage younger, healthier workers (who generally are lower paid) to enroll. Currently the average employer cost of family health insurance coverage for workers is over \$10,000 a year, a truly large amount of money.

As a share of compensation, on average across all workers, health insurance rose from 5.8 to 7.6 percent. Looking across the earnings distribution, according to the BLS data, the share of compensation going to health benefits increased notably from 1999 to 2006 especially for those in the lower and middle earnings percentiles. The growth in share was highest for the 30<sup>th</sup> percentile (low-earning full-time workers), from 6.5% to 12.2%, and was also high for the 60<sup>th</sup> percentile (middle-income workers), from 6.8% to 11.1%. At the 99<sup>th</sup> percentile (high income workers), by contrast, the health share in compensation moved only from 4% to 4.3%.

The cost of health care essentially drove an ever widening wedge between the growth of take home earnings and compensation. That is indeed exactly found in the data—earnings grew over 1999-2006 around 27 percent in the 30<sup>th</sup> to 60<sup>th</sup> percentiles, about 30 percent in the 80<sup>th</sup> to 90<sup>th</sup> percentiles, and about 35 percent in the 95<sup>th</sup> and 99<sup>th</sup> percentiles. But compensation growth, at around 35 percent, was essentially evenly distributed across all earnings levels; in fact, it grew the fastest in the lowest decile, at 41 percent, and at the same average rate in the highest percentile, at 36 percent.

Moving from dry statistics to perhaps more understandable job categories, consider the following results from the BLS on how the cost of health insurance may impact middle-income workers to a greater extent than upper-income workers. In 2006, workers in public elementary and secondary schools were paid \$29.80 per hour and their health insurance cost \$4.37 per hour, or 11.3 percent of compensation, while management workers in private industry were paid \$41.43 per hour and their health insurance cost \$3.05 per hour, or 6.1 percent of compensation. Even if the rate of growth in compensation was equal across these different job types and earnings levels, a higher rate of health care cost growth would mean that the higher-paid worker, the manager in private industry, would have more rapid growth in earnings than the middle-income worker, the schoolteacher. Indeed, according to a 2008 study by the Kaiser Foundation using BLS data, the percentage increases in the health insurance cost share from 1999 to 2005 were larger for low-compensation occupations than for high-compensation jobs.

Because the rapid increase in the cost of health insurance is a prominent long-run feature of the economic environment for the last fifty years, it likely has played an important role in the longer-term trends in earnings inequality as well. Several other studies indeed find this link over longer time periods.

*There are important policy implications of these research findings.*

Because total compensation growth has been essentially the same across earnings groups, the handwringing over inequality has largely been shooting at the wrong target. Either we are satisfied that we are getting value for the rapid increase in spending on health care, and there is no inequality problem because compensation is growing evenly, or we are concerned that we

are not getting value, and the poor and middle-class workers are particularly bearing the dead-weight loss. In the latter case, this suggests that the most effective policy tool to address perceived inequality would be to slow the rate of growth of health care costs in the economy. In this regard, the Affordable Care Act is likely, on net, to make matters worse.

There are several recent examples in which rising earnings and income inequality have influenced policy proposals and legislative outcomes. In the 2010 budget document presented in February 2009 by the then-incoming Obama administration, the increasing income share of the top percentile of earners from 1980 through 2008 was shown prominently as a graph. The budget document ascribes the cause of increasing inequality to "technological advances and growing global competition."

Acting on the view that public policy needs to overcome this trend, the administration has consistently proposed letting the 2003 tax cuts for upper-income earners (defined as \$200,000 for single taxpayers and \$250,000 for joint filers) expire, and to limit the deductions and credits that may be taken by these earners. These proposals have not been enacted. In the health care reform legislation of 2010, however, an extra 0.9 percent payroll tax was placed on earnings in excess of \$200,000/\$250,000 of the taxpaying unit, and unearned income became subject to an extra 3.8 percent tax. These earnings triggers are not indexed for inflation and are being used to finance the expansion of health care subsidies mainly to lower-income workers. The overall mechanism is clearly intended to lessen income inequality.

Another area of public policy in which the issue of income inequality enters is Social Security reform. In 2010, two bipartisan deficit reduction commissions recommended, along with other provisions reducing scheduled benefits, that the maximum level of earnings taxable at the Social Security payroll tax rate (12.4 percent) be raised from \$106,800 currently (in 2011) to about \$200,000 (in today's dollars) ultimately.

The motivation for the proposal is to have Social Security be financed by 90 percent of total wages; this has been deemed a policy goal, presumably on fairness grounds. As my testimony in 2011 to the House Ways and Means Subcommittee on Social Security showed, this increase would mean that about 99 percent of workers would have all of their wages taxed by Social Security, as opposed to the historical norm of 94 percent of workers. Moreover, according to SSA statistics, the workers in the earnings range of \$106,800 to \$200,000 in 2009 actually saw their share of total wages decline slightly from 1990, while workers in the top fractiles got big increases in earnings over that time period. Even over the shorter period 1999 to 2006, workers with earnings above the 95th percentile but below the 99th percentile threshold got relatively small increases in earnings shares compared with the top percentile and fractiles.

In any case, this and the other proposals and legislated policies apparently do not consider a more relevant measure of well-being and economic capacity—total compensation and the trends pertaining thereto. As discussed earlier, this measure of inequality has not worsened. Even assuming that earnings, and not compensation, inequality is the most relevant policy and political measure, the empirical results in my paper indicate that the most effective policy tool to use in response would be to slow the rate of growth of health care costs in the economy.

Slowing the growth in health care costs is admittedly a challenging structural and political problem but that just argues for still more policy effort and political courage there. Just treating the symptoms of the inequality problem with tax and entitlement policies will have harmful side effects on overall economic growth and lose the opportunity to control budget deficits by lowering health care costs.

Members of the Committee, thank you for your kind attention to my statement. I am now glad to answer your questions.

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### Can the Rapid Growth in the Cost of Employer-Provided Health Benefits Explain the Observed Increase in Earnings Inequality?



By MARK J. WARSHAWSKY

**N**ewly available data on earnings from the Social Security Administration indicates that earnings growth for lower-earning workers lagged that of higher-earning workers from 1999 through 2006. Most of this lag can be attributed, however, to the rapid increase in the cost of health insurance benefits provided to workers by employers, according to calculations using unpublished data provided by the Bureau of Labor Statistics. This finding is broadly supported by other studies in this area covering longer periods. The consistent growth of compensation across earnings percen-

tiles up to the highest fractiles, in contrast to earnings growth, may be a particularly important empirical result for recent policy debates and legislation on health, entitlement, and tax reform.

The rapid growth in the cost of health care in the United States is widely noted. It is correctly said to cause burgeoning government spending and deficits, slower overall growth in worker earnings (wages), and later retirements. Less noted and understood is a possible tie of growth in health care costs to an increase in earnings inequality. The logic is based on simple arithmetic. Let's say that compensation (which is made up of earnings and benefits) grows at a certain common rate across workers over time at all compensation levels owing to, say, overall labor productivity improvements and that the market for labor services is competitive.

Let's also posit that health care benefit costs are the same dollar amount per worker at any point in time regardless of the worker's level of compensation and are evenly and widely provided to workers, or at least the distribution of prevalence and cost by compensation level has not changed much. But let's also say that health benefit costs are growing at a faster rate than compensation. Then earnings (which equal compensation less the cost of health and other benefits) must grow slower for those at the lowest levels of compensation than for those at the highest levels of compensation.

It is rare to observe the total compensation of individual workers directly in surveys or in administrative records, but it is common to observe and measure individual and household earnings (and income, which includes capital returns). The logic just expressed would say that measured earnings inequality would increase with health care costs even while the overall distribution of compensation and actual compensation inequality remain essentially unchanged.

This short article examines this hypothesis with some unique data sources and a review of a few underappreciated studies from the professional literature. First, new and detailed unpublished data from the Social Security Administration (SSA) on changes in the distribution of earnings in recent years is presented. Data from national surveys of employers on overall trends in average compensation and the cost of health benefits is also reviewed. Four recent papers in the professional literature that have addressed directly the question of the tie of earnings inequality to the growing cost of health care

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are summarized. Unpublished data from the Bureau of Labor Statistics on the distribution of earnings and the cost of health benefits by earnings levels are then examined to explore any connection to the increase in earnings inequality. The paper concludes with a brief discussion of the implications of this analysis for public and corporate policies and proposals on compensation, health care benefits, taxes, and entitlement spending.

### I. The Distribution of Earnings

The increase in earnings and income inequality in the United States over the last three or four decades is fairly well documented. For example, Piketty and Saez (2003, web updated in 2010) find that the share of total wages going to the top decile of income taxpayers increased from 25.67 percent in 1970 to 29.09 percent in 1983 to 35.18 percent in 1999, remaining at 35.06 percent in 2006. As shown in Table 1, this increase in share is largely concentrated at the top of the decile—the 90th to the 95th percentiles had almost no increase, the 95th to 99th percentiles only a relatively small increase, but there were large increases at the top percentile and upper fractiles from 1970. Notable is the recent stability in wage shares across the board from 1999 through 2006 in this data set.

Using Social Security records for workers ages 25 to 60 in commerce and industry earning at least a quarter of the annual minimum wage, Kopczuk, Saez, and Song (2010) also find that wage inequality has increased over time. In particular, they calculate that the wage share of the top percentile (earnings above \$236,000 in 2004) increased from 6.45 percent in 1978 to 7.53 percent in 1983, 12.42 percent in 1999, and 12.99 percent in 2000, before falling back to 12.38 percent in 2004, the last year in their analysis.

For some time, the SSA has published annual statistics on the distribution of wages based on its records of payroll taxes paid. More recently, it has created data tables for tax years 1999 through 2009 for earnings, including wages and self-employment income, for all workers, with fine granularity at the upper fractiles of the earnings distribution.<sup>1</sup> This data includes workers of all ages, from those earning less than \$100 annually to those earning more than \$50 million annually. Three sets of tables are provided: the number of workers with “HI-taxable” earnings by level of annual earnings, the total amounts of HI-taxable earnings by level of annual earnings, and the average amount of HI-taxable earnings by level of earnings. The levels of annual earnings, fixed in nominal terms, are generally given in \$5,000 nominal increments, except for finer increments below \$5,000, and somewhat grosser increments for those earning above \$500,000 (\$10,000 increments through \$1 million, \$100,000 through \$5 million, \$250,000 through \$10 million, \$1 million through \$20 million, and \$10 million increments thereafter).

“HI-taxable” earnings refer to taxable payrolls for the Health Insurance program segment of Medicare. Since 1994, there has been no cap on the taxable amount of earnings for HI, unlike Social Security, and moreover, a larger proportion of federal, state, and local government employees and all railroad workers are

covered by Medicare, again different than Social Security. Therefore, these data are likely to be good estimates of the extent and distribution of earnings across the entire working population.<sup>2</sup>

The data for each year reflect all earnings on SSA’s Master Earnings File (MEF) as of specific dates. The 1999-2008 data include all earnings that were posted to the MEF through April 2010; the 2009 data include all earnings that were posted to the MEF through January 2011. SSA estimates that the 2008-2009 data are about 98 percent complete relative to the expected ultimate amount, but inspection of the data indicates that even in 2007, there was a significant level of incomplete records, especially for self-employment income at higher earnings levels.

Hence, this analysis focuses on a comparison of 1999 and 2006, for which the data sets seem to be complete and represent similar points in the economic cycle. The latter consideration is particularly important for the purposes of this article because it is well known that the earnings of those at the upper tails of the distribution expand by disproportionately larger amounts when the economy is expanding, and decline disproportionately when the economy is in recession.

Table 2 shows the results of the summary and analysis of the SSA earnings statistics, focusing on the examination of recent trends in inequality. The top panel shows some relevant aggregate statistics. Total wages and self-employment income grew from about \$4.6 to \$6.2 trillion, nominally, or 34.6 percent, from 1999 through 2006. Price inflation over this period was 21 percent, as measured by the CPI-U. The number of workers with reported earnings increased from about 153.6 to 162.4 million, 5.7 percent growth over the period. Mean earnings grew from \$29,775 to \$37,905, or 27.3 percent. The average wage index, based just on wages, and used in the Social Security benefit formula, grew at a similar pace, while the maximum level of earnings subject to Social Security taxes and included in the benefits formula grew at a bit faster pace, that is, almost 30 percent, as it is based on wage data lagged two years.

The lower bottom panel of Table 2 shows estimates of the actual earnings at various percentiles in the distribution of earnings. I start at the 30th percentile because workers earning less than the dollar amount indicated presumably include many young workers still attached to their parents’ homes or in college; older workers already largely, but not completely, retired; part-time workers whose spouses work full time; workers largely dependent on government welfare and other benefit programs; and so on. Starting from the 30th percentile, the 65th percentile represents the “median,” and, as shown, fine detail is provided about the upper parts of the distribution.

Also shown are the share of aggregate earnings attributed to those workers in the indicated percentile or fractile and below, and the ratio of the indicated level of earnings to the “median,” and growth from 1999 through 2006. These measures are all used as indicators of changes in the distribution, that is, increasing or decreasing earnings inequality.

<sup>1</sup> Memo from Drew Sawyer to Stephen Goss, Feb. 4, 2011, “Distribution of Workers by Level of Annual HI-Taxable Earnings.”

<sup>2</sup> There may be some tax evasion, however, and hence underreporting of earnings; this is likely to be more prominent in self-employed income than in wages, but the impact on measures of inequality is unlikely to be biased.

The rate of earnings growth over the period increases as one climbs the earnings percentiles from the 30th to the 99.95th percentile. For example, earnings grew 23.2 percent at the 30th percentile, 23.8 percent at the 50th percentile, 24.4 percent at the 65th, 26.0 percent at the 80th, 29.9 percent at the 95th, 32.5 percent at the 99.5th, and 35.3 percent at the 99.95th. At still higher percentiles, the growth rate falls, to 23.9 percent at the 99.9975th percentile, before it increases again, to a pace of 38.9 percent at the 99.9995th percentile, the very top of the distribution. These statistics, overall, are a confirmation of the inequality in earnings increasing in a consistent manner from 1999 to 2006.

Another measure, the ratio to the "median," also shows increasing inequality over this period. For example, in 1999, the 40th percentile had earnings at a ratio of .509 to the median. In 2006, however, the ratio at that percentile had fallen, slightly, to .506. By contrast, at the upper percentiles and fractiles, the ratio to "median" rose significantly. For example, at the 99.5th percentile, in 1999, the ratio was 8.895, whereas in 2006, it was 9.478. The increased inequality according to this measure is particularly apparent at the top of the distribution.<sup>3</sup>

Similarly, according to the earnings share measure, inequality increased across the distribution. For example, in 1999, 0.22165 of aggregate earnings went to workers in the 60th percentile and below, while in 2006, the earnings share was a percentage point less, 0.21165. The differential remains as we move up the earnings percentiles; for example, in 1999, the earning share below the 99.8th percentile was 0.92904, while in 2006, it was 0.92602—a decline of about 0.3 percentage points.

**Earnings Inequality, 1999 and 2006.** Another way of looking at the share data is to make it comparable to that reported in Table 1, drawn from Picketty and Saez (2003, updated). That is done in Table 3, where, unlike the finding by Picketty and Saez, it is shown that earnings inequality continues to increase in recent years. For the top decile, the earnings share increased by 1 percentage point, but most of that is represented by the top percentile, at about 0.6 percent; even that increase occurs mostly in the top half percentile. (For 2006, the top earnings percentile started at \$230,579, and the top half percentile started at \$340,514.)

In summary, the earnings measures derived from SSA data show that inequality continued to increase in recent years, across the business cycle. But what about total compensation paid to workers, including the value of employee benefits—has inequality increased there, too? The more comprehensive *compensation* measure of the return to labor and of well-being should be the relevant one for analysts and policymakers as they consider trends in the levels and in the inequality of well-being derived from work effort.

## II. Trends in Average Compensation, Earnings, and Health Insurance Costs to Employers

Before questions about compensation inequality are answered more directly, the trend data that is available

<sup>3</sup> Yet another related measure is the ratio of the average to the median; it increased from 1.50 in 1999 to 1.53 in 2006, another indication of some increasing inequality in earnings.

about broad, economywide trends in labor compensation and, in particular, the employer cost of health care benefits, should first be reviewed. This article reports on data published by the Bureau of Labor Statistics (BLS) from its employer survey on jobs' financial characteristics, the Employer Cost of Employee Compensation (ECEC), and by the Kaiser Foundation from its employer survey on Employer Health Benefits.

As seen in Table 4, hourly earnings reported by the BLS, composed of wages, paid leave and supplemental pay, increased, on average, across the entire economy, from \$16.57 in 1999 to \$21.37 in 2006, a 29 percent increase, similar to the increase reported by Social Security (see Table 2). But hourly compensation, which also includes the cost of benefits, increased more quickly, from \$20.29 in 1999 to \$26.86 in 2006, a 32 percent increase. This growth differential is explained mainly by the fact that the cost of benefits increased at a faster pace than compensation—health insurance in particular increased from \$1.18 an hour to \$2.05 an hour, or almost 74 percent. Seen as a share of compensation, health insurance rose from 5.8 to 7.6 percent, a noticeable increase. Retirement costs also increased more rapidly than wages, but this increase was temporary as it was caused by defined benefit plans in the private sector responding to funding losses and required and discretionary employer contributions therefore increasing.

Data from the Kaiser Foundation for this same time period show an even faster rate of growth in employer costs for health insurance. As seen in Table 5, the average employer (both private and public) annual cost of health insurance for workers increased from \$1,878 in 1999 to \$3,615 in 2006 for single coverage, a 92.5 percent rate of growth. The cost of family coverage grew even faster, over 100 percent.

From 1999 through 2006, access to (and provision of) health insurance to workers did not change much. According to the Kaiser Foundation in 1999, 79 percent of private industry workers had access to health insurance (and 62 percent chose to be covered). In 2006, 78 percent of private-sector workers had access (and 59 percent chose to be covered). Pierce (2008), using BLS ECEC data, found no change between 1997 and 2007 in the fraction of jobs (.789) with positive health insurance costs to the employer, that is, jobs for which the employer made some contribution toward employees' health insurance coverage.

That there was little change in access despite the large increase in employer cost makes sense because nondiscrimination rules in the tax code prevent an employer from favoring the higher-paid group in its workforce with tax-advantaged benefits. Also employers desire to avoid adverse selection in their health plans and, therefore, want to encourage younger, healthier workers (who generally are lower paid) to enroll.

To anticipate some of the later results in the paper, consider the worker at the 50th percentile in Table 2, earning \$19,846 in 1999 and \$24,570 in 2006—for her, earnings growth was only 24 percent. If the average cost of health insurance coverage for single workers were added to earnings for these workers, total compensation would be \$21,724 in 1999 and \$28,185 in 2006, an increase of almost 30 percent. This rate of increase clearly is much closer to the rate of earnings growth of much higher-percentile workers (e.g. at the 95th, 97th, and 98th percentiles) and would go a long

way to explaining the increase in observed earnings inequality from 1999 to 2006.

Consider another, more direct, illustration from the BLS data of how the cost of health insurance may impact middle-income workers to a greater extent than upper-income workers. In 2006, workers in public elementary and secondary schools were paid \$29.80 per hour and their health insurance cost \$4.37 per hour, or 11.3 percent of compensation, while management workers in private industry were paid \$41.43 per hour and their health insurance cost \$3.05 per hour, or 6.1 percent of compensation. Even if the rate of growth in compensation was equal across these different job types and earnings levels, a higher rate of health care cost growth would mean that the higher-paid worker, the manager in private industry, would have more rapid growth in earnings than the middle-income worker, the schoolteacher.<sup>4</sup>

### III. Literature Review

In 2008, I presented in a research paper a simple model of the distribution of compensation, earnings, and the cost of health insurance across workers. I fit the model parameters to actual experience and data on growth and inequality in wages and on the growth in health insurance costs from 1998 to 2007. My research found that the increase in health insurance costs could explain the entire increase in earnings inequality over the period.

Nyce and Schieber (2011) examine this hypothesis more carefully, using data from the Current Population Survey (CPS) from 1980 through 2009 on full-time worker's pay and benefit plan coverage. They find that for the 1980s and 1990s, wages grew considerably faster at the top earnings deciles than at lower earnings levels. For 2000-2009, the lowest deciles had faster wage growth than the middle deciles, but had increases that were comparable to the top deciles, a result not entirely consistent with the Social Security data reported earlier. When Nyce and Schieber add the cost of benefit plans (both retirement and health), they find that compensation growth was higher overall and smoother across earning deciles and across time periods, except for in the 1980s, when the upper deciles still had much bigger increases, and in the 1990s, when the top decile had a big increase.

Decomposing the benefits segments, Nyce and Schieber discovered that social insurance costs increased disproportionately for the upper deciles in the 1980s and 1990s, as payroll tax rates and bases were then raised. Increases in retirement costs hit all deciles in 2000-2009, but funding holidays and restrictions subtracted more from the lower-paid in earlier decades. Increases in health care costs added considerably to compensation growth for lower-paid workers in the 1990s, but less so for upper-income workers; it added most to the middle of the earnings distribution in the 1980s and to the middle and upper end of the distribution in 2000-2009. So the evidence produced by Nyce and Schieber is mixed but somewhat supportive of the hypothesis of

<sup>4</sup> According to a study by the Kaiser Foundation (2008) using BLS data, the percentage increases in the health insurance cost share from 1999 to 2005 were larger for low-compensation occupations than for high-compensation jobs; see Figure 8 there.

this paper, namely that the rapid growth in health care costs is the underlying cause of the increase in earnings inequality.<sup>5</sup>

Pierce (2008) uses BLS data from the ECEC to look at trends in compensation inequality more directly, at the job, but not worker, level. (The ECEC is a survey of employers about civilian, nonfederal job positions, both part time and full time, rather than a survey of actual workers.) In particular, Pierce compares the wage distribution to the distribution of employer costs, including the costs of health and retirement plans and paid leave, from 1987 to 2007. He found that wage compression occurred in the bottom half of the wage distribution, especially over the 1987-1997 decade, while wage growth was highest in the upper percentiles during this entire period. Health insurance costs rose substantially, especially over the 1997-2007 period, and especially in jobs with wages near the median. Pierce ascribes the lack of growth of health insurance costs in the lower percentiles to a decline in worker enrollment, perhaps as public sources of insurance coverage expanded, rather than to a decline in employer offer rates. By contrast, rising pension costs in the last decade, which, as we noted above, are temporary, added to compensation in above-median wage jobs.

So the evidence in Pierce, both on wages and health insurance costs, is broadly consistent with this paper's data and hypothesis. (As further supportive evidence from the structure of compensation, Pierce finds that in any year, the health share in compensation increases through the 35th percentile of the compensation distribution, presumably reflecting movement from part-time to full-time jobs; stays flat from the 35th to the 60th percentiles; and then declines—rapidly after the 90th percentile.)

Burkhauser and Simon (2010) use CPS data for 1995 through 2008 to investigate the impact of the value of health insurance received by households on the level and distribution of economic well-being. They include both employer- and government-provided health insurance values in their calculations for individuals in households of various ages and income levels.<sup>6</sup> Using traditional measures of income, Burkhauser and Simon find that inflation-adjusted growth was fairly even across deciles from 1995 to 2008, except for the lowest decile, in which growth lagged behind the others. When the value of health insurance is added, however, the bottom three income deciles actually show higher growth than the other deciles.

Focusing on working-age individuals (25 to 61), the same result is found, but even more starkly. Whereas inflation-adjusted income grew 1.9 percent for the first decile and 10.5 percent for the top decile, when the value of health insurance is added, it grew 12.3 percent for the first decile and 11.7 percent for the top decile.

<sup>5</sup> Nyce and Schieber had to make many assumptions and imputations of benefit costs across the earnings distribution and removed the top 1 percent of workers, so the evidence produced is suggestive but still not direct.

<sup>6</sup> Like Nyce and Schieber, Burkhauser and Simon make imputations of the value of employer-provided health insurance from a source other than the CPS itself; Burkhauser and Simon's data source, the Medical Expenditure Panel Survey Insurance Component, however, is quite disaggregated, including state and employer size that is then matched with the CPS.

**Table 1. Wage Shares of Tax-Paying Units, 1970-2006**  
In Percent

Percentiles	90-100	90-95	95-99	99-100	99.5-100	99.9-100
1970	25.67	10.03	10.51	5.13	3.21	1.06
1983	29.09	10.59	11.54	6.96	4.66	1.08
1999	35.18	10.63	12.89	11.67	8.73	4.68
2006	35.06	10.50	12.84	11.73	8.77	4.66

Source: Table B2, Top Wage Income Shares, 1927-2006, web update of Thomas Pridemore and Emmanuel Saez, "Income inequality in the United States, 1913-1998," *The Quarterly Journal of Economics*, Vol. 118(1), February 2003, pp. 1-39.

A BNA Graphic/per2006gt

Burkhauser and Simon also calculate the Gini coefficients, a measure of inequality in a distribution, where 0 means complete equality and 1 means complete inequality. From 1999 to 2006, the Gini coefficient increased from 0.4267 to 0.4380 for the simple income measure, but increased at half that rate, from 0.4147 to 0.4205, for the total income measure, which includes the value of health insurance coverage. In regression analysis, Burkhauser and Simon find a positive trend in income inequality when the value of health insurance is not considered, but a reversal of that trend when the value of health insurance is included.<sup>7</sup>

The Congressional Budget Office (CBO) (2011) has recently completed an analysis of income inequality at the household level over the period 1979 to 2007. Its main sources of data on household income (after taxes and after transfers, on an inflation-adjusted basis) were a sample of individual income tax returns, matched to the CPS. The CBO finds that income grew by 275 percent for the top percentile, by 65 percent for the 81st through 99th percentiles, by 40 percent for 21st through 80th percentiles, and by 18 percent for the bottom quintile. In terms of income shares, the top percentile increased from 8 percent in 1979 to 17 percent in 2007, the top quintile increased from 43 to 53 percent, and the other quintiles lost 2 to 3 percentage points.

The CBO attributes this increased concentration to all sources of income, including labor and business income—income sources comparable to those tallied by SSA. The CBO also examines the impact of rising health care costs on rising inequality and finds that the direction of influence is the same as is seen in this paper. The CBO uses data from the Census Bureau, which matched the CPS to some old (1977) survey data on health care spending and coverage, and indeed finds that including health insurance in income reduces measured income inequality and the measured increase in inequality between 1979 and 2007. It noted that employer-sponsored health insurance especially lifted proportionately the income of the middle of the income distribution. CBO did not report, however, the impact of the cost of health insurance on measured income growth, as this paper will do below.

<sup>7</sup> Gokhale (2010, pp. 175-6) gives an alternative explanation of the historical increase in earnings inequality—the impact of the aging of the baby boom generation, that is, the transition of the baby boom generation into the ages of highest life cycle earnings during the 1970s, 1980s, and 1990s.

#### IV. Changes in Earnings, Compensation, Health Insurance by Earnings Percentiles

BLS provided this author with unpublished data on benefit costs by earnings percentiles from the March 1999 and March 2006 ECEC. The data included hourly earnings, paid leave, and employer costs of insurance and retirement and savings by selected earnings percentiles. The statistics are summarized in Table 6, highlighting the cost of health insurance as a share of compensation. The distribution begins at the 30th percentile, as in the reporting of the SSA statistics, to exclude part-time, young or semi-retired workers.

In 1999, looking across the earnings distribution, the health share was highest at the 40th earnings percentiles, at 8 percent, and remained in the range of 7 percent before it fell at the 90th percentile and beyond. In 2006, the health share increased notably, with a doubling of the cost of health insurance, for all earnings percentiles except the highest (99th). The share was highest at the 30th earnings percentile, at 12.2 percent, and was also high at the 60th percentile, at 11.1 percent, but then fell steadily to 7 percent at the 95th percentile.

As explained above, this characteristic—high rates of growth in a significant component of compensation that is also fairly evenly distributed—will lead naturally to differential rates of growth in earnings (which excludes the cost of health insurance) but much closer and more consistent rates of growth in compensation (which includes the cost of health insurance) across the distribution of earnings. That is indeed exactly found in the BLS data—earnings growth over 1999-2006 increases from around 27 percent in the 30th to 60th percentiles to as high as 35 percent in the 99th percentile (a quite similar pattern is found in the SSA data), but compensation growth is much more evenly distributed, with some bumps across earnings percentiles, at around 35 percent.

This is strong evidence, particularly when combined with the statistics and studies cited in the prior sections of this paper, for the hypothesis that much of the observed recent increase in earnings inequality can be explained by the rapid increase in the cost of health insurance employee benefits, and that there, therefore, has not been a significant increase, if any, in compensation inequality. Moreover, because the rapid increase in the cost of health insurance is a prominent long-run feature of the economic environment for the past 50 years, it

likely has played an important role in the longer-term trends in earnings inequality as well.

### V. Discussion and Implications

Inequality in the distribution of income and earnings currently plays an important role in political discussions, policy formulation, and public attitudes. In the United States, although generally the focus has been on equality of economic opportunities rather than on equality of outcomes, the latter becomes more salient in troubled, slow-growth times. In the academic literature, for example, in Piketty and Saez (2003), there is a narrative focus on the rising pay of corporate executives, rather than on the rising incomes of stars such as athletes and actors, and of professionals, such as surgeons and litigators. This focus may relate to the thought that pay within large economic organizations should have some internal equity; it also may be caused simply by the availability of publicly disclosed information about corporate compensation packages.

In any case, there are several recent examples in which rising earnings and income inequality have influenced policy proposals and legislative outcomes. In the 2010 budget document presented in February 2009 by the then-incoming Obama administration, the increasing income share of the top percentile of earners from 1980 through 2008 was shown prominently as a graph, attributed to Piketty and Saez. The budget document ascribes the cause of increasing inequality to "technological advances and growing global competition," and then says, "Yet, instead of using the tax code to lessen these increasing wage disparities, changes in the tax code over the past eight years exacerbated them." (2010 Budget of the Obama Administration, p.9.)

Therefore, acting on this view, the administration has consistently proposed letting the 2003 tax cuts for upper-income earners (defined as \$200,000 for single taxpayers and \$250,000 for joint filers) expire, and to limit the deductions and credits that may be taken by these earners. These proposals have not been enacted. In the health care reform legislation of 2010, however, an extra 0.9 percent payroll tax was placed on earnings in excess of \$200,000/\$250,000 of the taxpaying unit, and unearned income became subject to an extra 3.8 percent tax. These earnings triggers are not indexed for inflation and are being used to finance the expansion of health care subsidies mainly to lower-income workers. The overall mechanism is clearly intended to lessen income inequality.

Indeed, as I predicted in my 2008 paper, the essence of health care reform legislation itself may be considered a reaction to the observed increases in earnings inequality. Among the major features of the new law are new health insurance premium subsidies to low- and middle-income workers not covered by employer plans, and expanded eligibility for Medicaid. Burkhauser and Simon (2010) estimate that including the expansionary health insurance policies in their measures will increase full income in 2008 dollars by 8.3 percent in the lowest decile, 4.3 percent in the second decile, 3.08 percent in the third decile, 1.51 percent in the fourth decile, and 0.75 percent in the fifth decile, but by negligible amounts above that. The Gini coefficient value would be reduced from .3982 to .3918, at 2008 levels. This reduction is about half of the increase in inequality in observed income from 1995 to 2008.

Another area of public policy in which the issue of income inequality enters is Social Security reform. In 2010, two bipartisan deficit reduction commissions recommended, along with other provisions reducing scheduled benefits, that the maximum level of earnings taxable at the Social Security payroll tax rate (12.4 percent) be raised from \$106,800 currently (in 2011) to about \$200,000 (in today's dollars) ultimately.

The motivation for the proposal is to have Social Security be financed by 90 percent of total wages; this has been deemed a policy goal, presumably on fairness grounds. As my testimony in 2011 to the House Ways and Means Subcommittee on Social Security showed, this increase would mean that about 99 percent of workers would have all of their wages taxed by Social Security, as opposed to the historical norm of 94 percent of workers. Moreover, according to SSA statistics, the workers in the earnings range of \$106,800 to \$200,000 in 2009 actually saw their share of total wages decline slightly from 1990, while workers in the top fractiles got big increases in earnings over that time period. Even over the shorter period 1999 to 2006 shown in tables 2 and 3, workers with earnings above the 95th percentile but below the 99th percentile threshold got relatively small increases in earnings shares compared with the top percentile and fractiles.

In any case, this and the other proposals and legislated policies apparently do not consider a more relevant measure of well-being and economic capacity—total compensation and the trends pertaining thereto. As discussed earlier, this measure of inequality has not worsened. Even assuming that earnings, and not compensation, inequality is the most relevant policy measure, the empirical results in this paper indicate that the most effective policy tool to use in response would be to slow the rate of growth of health care costs in the economy. Slowing the growth in health care costs is admittedly a challenging structural problem, but that just argues for still more analysis, experiments, and effort there, as opposed to just treating the symptoms of the problem. This is particularly so if some of the symptom treatments, such as tax increases and entitlement boosts, have negative consequences, such as discouraging work effort and lowering economic growth.

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	1999		2006		1999-2006 Growth		
Total Wages & SEI	\$4.573T		\$6.156T		34.60%		
CPI-U	166.6		201.6		21.00%		
N	153.583M		162.404M		5.70%		
Mean Earnings	\$29,775		\$37,905		27.30%		
AWI	\$30,470		\$38,651		26.80%		
Tax Max	\$72,600		\$94,200		29.80%		
Earning Percentiles	Estimated Annual Earnings Thresholds	Earnings Share	Ratio to "Median"	Estimated Annual Earnings Thresholds	Earnings Share	Ratio to "Median"	1999-2006 Earnings Growth
30%	\$9,936	0.04175	0.344	\$12,244	0.04167	0.341	23.20%
40%	14,713	0.08306	0.509	18,173	0.08054	0.506	23.50%
50%	19,846	0.14089	0.687	24,570	0.13607	0.684	23.80%
60%	25,611	0.22165	0.887	31,837	0.21165	0.886	24.30%
65%	28,882	0.26278	1.000	35,926	0.25691	1.000	24.40%
70%	32,574	0.31500	1.128	40,564	0.30724	1.129	24.50%
75%	36,807	0.37347	1.274	46,062	0.36337	1.282	25.10%
80%	41,959	0.43873	1.453	52,883	0.42713	1.472	26.00%
85%	48,738	0.51328	1.687	62,015	0.49797	1.726	27.20%
90%	58,972	0.60270	2.042	75,668	0.59261	2.106	28.30%
95%	79,778	0.71622	2.762	103,619	0.70730	2.884	29.90%
97%	100,666	0.77603	3.485	130,915	0.76824	3.644	30.10%
97.50%	109,700	0.79345	3.798	142,912	0.78617	3.978	30.30%
98%	122,734	0.81292	4.249	159,611	0.80602	4.443	30.10%
98.50%	142,459	0.83501	4.932	185,362	0.82868	5.160	30.10%
99%	176,362	0.86147	6.106	230,579	0.85579	6.418	30.70%
99.50%	256,902	0.89662	8.895	340,514	0.89211	9.478	32.50%
99.60%	290,822	0.90577	10.069	386,470	0.90166	10.757	32.90%
99.70%	340,841	0.91631	11.801	454,234	0.91267	12.644	33.30%
99.80%	426,402	0.92904	14.764	569,288	0.92602	15.846	33.50%
99.85%	500,524	0.93678	17.330	670,423	0.93414	18.661	33.90%
99.90%	628,860	0.94613	21.773	847,154	0.94402	23.581	34.70%
99.95%	948,601	0.95886	32.844	1,283,174	0.95751	35.717	35.30%
99.975%	1,470,990	0.96858	50.931	1,972,183	0.96780	54.896	34.10%
99.980%	1,703,933	0.97125	58.996	2,260,243	0.97058	62.914	32.60%
99.990%	2,706,921	0.97831	93.723	3,493,709	0.97782	97.247	29.10%
99.9950%	4,336,335	0.98396	150.140	5,427,563	0.98345	151.076	25.20%
99.9975%	6,661,059	0.98841	230.630	8,252,253	0.98780	229.701	23.90%
99.9990%	10,671,910	0.99268	369.500	14,483,685	0.99202	403.153	35.70%
99.9995%	15,788,635	0.99479	546.660	21,933,011	0.99448	610.505	38.90%

Source: Mark J. Warshawsky - calculations based on unpublished Social Security Administration data. A BNA Graphic/per2015g

Percentiles	90-100	90-95	95-99	99-100	99.5-100	99.9-100
<b>1999</b>	<b>39.730</b>	<b>11.352</b>	<b>14.525</b>	<b>13.853</b>	<b>10.338</b>	<b>5.387</b>
<b>2006</b>	<b>40.739</b>	<b>11.469</b>	<b>14.849</b>	<b>14.421</b>	<b>10.789</b>	<b>5.598</b>

Source: Mark J. Warshawsky - calculations based on unpublished Social Security Administration data. A BNA Graphic/per2015g

Picketty, Thomas, and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," *Quarterly Journal of Economics*, February 2003, pp. 1-39.

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**Table 4. Average Compensation per Hour for all Civilian Workers, 1999 and 2006**  
Dollar Value and Share of Compensation in Percent

	March 1999		March 2006	
	Dollar Value	Share of Compensation	Dollar Value	Share of Compensation
<b>Earnings</b>	\$16.57	81.6%	\$21.37	79.6%
Wages	14.72	72.5%	18.82	70.1%
Paid Leave	1.34	6.6%	1.88	7.0%
Supplemental Pay	0.51	2.5%	0.67	2.5%
<b>Benefits</b>	\$3.73	18.4%	\$5.50	20.4%
Health Insurance	1.18	5.8%	2.05	7.6%
Retirement	0.76	3.7%	1.15	4.3%
Legally Required*	1.65	8.1%	2.16	8.0%
Other**	0.14	0.7%	0.14	0.5%
<b>Total Compensation</b>	<b>\$20.29</b>	<b>100%</b>	<b>\$26.86</b>	<b>100%</b>

\*Employer payments to Social Security, Medicare, unemployment insurance and worker's compensation insurance.

\*\*Life and disability insurance

Source: Bureau of Labor Statistics, Survey of Employer Cost of Employee Compensation.

A BNA Graphic/per205g4

**Table 5. Average Employer Cost of Health Insurance Coverage for Workers**

	Single	Family
<b>1999</b>	<b>\$1,878</b>	<b>\$4,247</b>
<b>2006</b>	<b>\$3,615</b>	<b>\$8,508</b>
<b>Growth Rate</b>	<b>92.5%</b>	<b>100.3%</b>

Source: Kaiser Foundation Employer Health Benefits Annual Surveys.

A BNA Graphic/per205g5

Warsawsky, Mark, "The Effects of Rising Health Cost on Salaries and Income Inequality," *Watson Wyatt Insider*, May 2008.

Warsawsky, Mark, "An Evaluation of the Proposal to Raise the Social Security Taxable Maximum," Testi-

mony presented to the House Committee on Ways and Means, Subcommittee on Social Security, June 23, 2011.

**Table 6. Employer Costs per Hour Worked for Employee Compensation, Selected Components: Civilian Workers by Selected Earnings Percentiles, March 1999 and March 2006**

Earnings <sup>1</sup> Percentile	1999				2006				1999-2006	
	Total Earnings <sup>2</sup>	Total Compensation <sup>3</sup>	Health Insurance	Health Share of Compensation	Total Earnings	Total Compensation	Health Insurance	Health Share of Compensation	Earnings Growth	Compensation Growth
30	\$9.14	\$10.07	\$0.62	6.16%	\$11.67	\$14.21	\$1.73	12.17%	27.70%	41.10%
40	\$10.87	\$12.33	\$0.99	8.03%	\$13.64	\$15.78	\$1.56	9.89%	25.50%	28.00%
50	\$12.82	\$14.34	\$1.03	7.18%	\$16.31	\$19.15	\$2.00	10.44%	27.20%	33.50%
60	\$15.32	\$17.13	\$1.16	6.77%	\$19.49	\$23.21	\$2.57	11.07%	27.20%	35.50%
70	\$18.67	\$21.32	\$1.56	7.32%	\$23.92	\$28.50	\$2.74	9.61%	28.10%	33.70%
80	\$23.09	\$26.27	\$1.78	6.78%	\$30.12	\$35.61	\$3.01	8.45%	30.40%	35.60%
90	\$30.14	\$34.58	\$2.25	6.51%	\$39.35	\$46.07	\$3.36	7.29%	30.60%	33.20%
95	\$37.54	\$42.47	\$2.34	5.51%	\$50.15	\$58.40	\$4.15	7.11%	33.60%	37.50%
99	\$54.26	\$59.51	\$2.39	4.02%	\$73.03	\$80.82	\$3.44	4.26%	34.60%	35.80%

<sup>1</sup> Percentiles based on wages and salaries plus supplemental pay (overtime and premium pay, shift differentials and nonproduction bonuses).

<sup>2</sup> Includes wages and salaries plus supplemental pay with paid leave added.

<sup>3</sup> Includes all insurance (health, life, disability) and retirement and savings; legally required benefits excluded.

Source: Mark J. Warshawsky - calculations based on unpublished Bureau of Labor Statistics data, National Compensation Survey.

A BNA Graphic/per2006

Chairman CONRAD. Thank you, sir.

We are going to go to Senator Whitehouse first for questioning. Senator Whitehouse has been especially diligent with respect to these issues and especially diligent with respect to health care and how that affects these issues. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman, and let me just express my appreciation to both you and to the Ranking Member for the courtesy you have shown all of your members by reserving your questions towards the end and letting your members go ahead of you, as you have just done for me today.

Two questions. The first is for Ms. Anderson. As you have recognized, the Wall Street reform bill requires members of a compensation committee to be so-called independent directors, and I think that was a fairly good step. I had also proposed that, in addition to the compensation committee members being independent, that the compensation consultants on whom the directors rely meet some kind of an independence standard. It strikes me that there is a circularity in which compensation consultants are paid a lot of money to tell CEOs that they should be paid a lot of money and that is a loop that does not have a lot of light shone on it.

Let me ask you first, as somebody who looks at this, anecdotally, have you ever heard of a compensation consultant recommending lower CEO pay? You laughed when I said that.

Ms. ANDERSON. No. What they tend to do is recommend that they should be paid above the average among their peer group, and what this contributes to is the Lake Wobegon theory, everyone is above average, and it just ratchets up pay. And as you mentioned, some of these consultants are hoping to get other kinds of work for the company and so, of course, they are not going to deliver a report that would upset the CEO, and so there may be a conflict of interest there.

Senator WHITEHOUSE. You agree that it is an inherently biased system and that some independence requirement on the part of the compensation consultants would be a step in the right direction?

Ms. ANDERSON. It would definitely be a step in the right direction, and you could go further by requiring more independence on corporate boards, for example, taking some of the lessons from Europe where they have worker representatives sitting on corporate boards, and that is pointed to as a factor in why CEO levels are lower in Europe than in the United States.

Senator WHITEHOUSE. Franklin Roosevelt said once that, "We have always known that heedless self-interest was bad morals; we know now that it is bad economics." Let me ask each of you, starting with Dr. Bernstein: On the bad morals part, I think that has been widely known. Go back to "Tale of Two Cities" where there is the unforgettable scene of the French marquis running down the child in his carriage and throwing the gold coin out the window because, after all, it was only a child and not nobility that mattered and they had gold coins to spare. That was sort of emblematic of the bad morals part of President Roosevelt's equation.

Can you tick off specific ways in which income inequality is, in fact, bad economics and what the trigger points are at which it becomes bad economics to the extent that the scientific study of this supports that?

Mr. BERNSTEIN. Sure, Senator. Let me start with an observation that the Chair of the Council of Economic Advisers who spoke about this recently made on this very point, suggesting that if income inequality had not risen as much as it did, middle-class families would have higher incomes. In my testimony I show that if instead of incomes growing so quickly at the top and stagnating at the middle and bottom, if they grew on average across, middle-class families would have about \$3,000 more say this year than would otherwise be the case.

Now, those families have a higher propensity to consume. We are 70-percent consumption economy. The economy would grow more quickly—and this was one of Dr. Boushey's points—if income were more broadly distributed and less concentrated at the top.

And then I want to tick off four things very quickly, and here I am in disagreement with Dr. Winship, who argued that there was not good evidence on the relationship between inequality and diminished opportunity.

In my testimony I cite four—well, actually, I cite about eight studies that contradict that, particularly regarding low-income kids. Future earnings and hours of children from low-income families are significantly more responsive to extra income than children from higher-income families. Worse adult outcomes, less educational attainment, premarital births, worse employment histories occur for children who experience multiple years of poverty compared to those who did not.

Another study finds growing gaps between children from lower- and higher-income families in college entry and graduation. And there are neighborhood effects as well associated with negative outcomes for kids and youth, including reduced cognitive development, less education, less educational attainment, and worse health outcomes.

All of those are associated with higher levels of inequality, less growth reaching poor people, more persistent child poverty.

Senator WHITEHOUSE. So in a nutshell, if you have a family earning \$30,000 a year and a family earning \$30 million a year, the last dollar that the family earning \$30,000 a year earns is going to have a lot more impact on their children's success, education, and upbringing than the last dollar of the \$30 million that the other family earned?

Mr. BERNSTEIN. Correct.

Senator WHITEHOUSE. Okay. Dr. Boushey, did you want to add to that? I am afraid I am going to run out of time.

Ms. BOUSHEY. Yes, certainly, just a few quick things.

I think there is a growing body of economic evidence that shows that the kind of high inequality that we have here in the United States today is actually having a negative effect on economic growth and will continue to through some of the things that Dr. Bernstein talked about. Our future productivity depends on kids today having access to education that makes them high-skilled workers and can, push our economy forward. Because of today's high inequality, millions of children are being prohibited from getting the kind of education or having access to the kind of resources where they could be an entrepreneur or move forward. Then that will have a long-term downward effect on our productivity.

One example—

Senator WHITEHOUSE. Let me jump in and ask you a very specific example of this, which is the minimum tax, the so-called Buffett Rule. We actually had Mr. Buffett speak to us last night, and he laughed out loud. He said, “In all my experience I have never had anybody turn away from a good deal that will make them money because their taxes would be a little higher on it. It is either a good deal or it is not,” he said, “and that is the end of the equation.”

So from his point of view, it does not have an effect. From your point of view, if you applied the Buffett Rule so that income over \$1 million were taxed at a rate equivalent to what plumbers and police captains might pay, is there evidence that that would depress economic activity and that hedge fund folks would no longer allocate capital or do what they do and that that would drive the economy downward?

Ms. BOUSHEY. I do not think so. Let us look at the past 10, 15 years. We saw an economy where we cut tax rates for the wealthiest, and that led to a decade where we saw the lowest rate of employment growth, income growth, and investment growth in the 2000s of any economic recovery in the post-World War II era. So we economists like to look for the natural experiments, right? So we cut taxes on the wealthy. The logic was that that would lead to a strong and vibrant economy, and it did not. That is the evidence in front of us. And, in fact, not only did it not lead to strong growth or strong investment growth, but it actually set up the conditions that led to the economic crisis which put our economy in the mess that we have now and leading us to have these very serious conversations about the debt that we have to repay because of the steps that we took many years ago.

So I think, we do not have to look that far to see strong evidence that that is not going to pull our economy down, and then we could go back to the 1960s and 1950s and say, hey, we had higher tax rates on those at the very top and we had stronger economic growth over time than we do today.

There is also evidence from other countries that those countries that have less inequality have more sustained and stable economic. Again, economic crises are devastating to our economy and to our families, and so making that connection I think should be a critical piece of policymaking.

Senator WHITEHOUSE. Thank you. My time has expired. Thank you, Chairman, and I thank the Ranking Member.

Chairman CONRAD. Thank you.

Senator Sessions.

Senator SESSIONS. Mr. Chairman, I would yield to Senator Thune. I am glad he was able to join us. I know he is busy, part of our leadership.

Senator THUNE. Thank you, Mr. Chairman, and thank you, Senator Sessions, for yielding, and thank you for calling the hearing and the opportunity to ask some questions. Thank you to our panelists for being here today.

Dr. Warshawsky, your research indicates that growing earnings inequality is largely a function of the rising cost of employer-sponsored health insurance, that higher health care costs impede

growth in the wage component of employee compensation. So it would seem to me that we should be focusing on slowing the rate of growth in health care costs, and yet the Congressional Budget Office tells us that the President's Affordable Care Act does not bend the cost curve at all. And, in fact, President Obama stated repeatedly that under the Affordable Care Act you can keep what you have, but the only way that this is possible is if employers continue to offer pricey health insurance to their employees, which, according to your research, will further suppress wage growth and exacerbate income inequality. And since the President supports raising taxes to help reduce the income inequality and provide health insurance for all, doesn't that policy combination merely create sort of a vicious cycle of rising inequality and higher taxes?

Mr. WARSHAWSKY. I think there is very strong logic and agreement for what you are indicating. It is my view on the Affordable Care Act that there will be a very large increase in health care demand that comes from the act but very little increase in supply, at least initially. And, therefore, in 2014 and 2015 there will be a very large increase in health care costs because of the act, which will lead exactly to the cycle that you have indicated.

Senator THUNE. And in terms of just how that bears on the whole issue of income inequality, the assumption that I made would you consider that to be an accurate one, that if you have rising health care costs because you are trying to cover everybody, you have, higher taxes going into effect of on a lot of income earners in this country, that that would further this trend toward inequality and, frankly, at the same time impose higher taxes on the very people that you are hoping are going to create the private sector opportunities that will provide good-paying jobs for people in this country?

Mr. WARSHAWSKY. Senator, I think that what people fail to recognize is how expensive health insurance is although sometimes people talk about these numbers, but I do not think they really have assimilated them. An average employer-provided a health insurance policy for a family, in terms of the employer cost, is \$10,000. So when you are talking about an income of \$30,000, that is a very, very substantial cost, and it has to be covered out of the compensation budget of the employer. And when you look at it at a national level, the percent of GDP that is going to health care in this country is approaching 18, 19 percent. So it has to affect income—the numbers that are that large and rates of growth that are as rapid as what we have seen over the last 15, 20 years have to have enormous consequences for a lot of relationships and certainly to have consequences for inequality.

Senator THUNE. And you talked about the costs of health care, rate of growth in health care costs going up. Have you modeled exactly how much you see that going up year over year, at least in the early stages you said when the demand will outstrip the supply?

Mr. WARSHAWSKY. I have not done formal modeling of that, but it is really a simple, logical impression that the health care reform act, while massive and complicated, will in its essence provide insurance to about 30 million people who currently do not have insurance. We know that people who do not have insurance spend

about 50 percent less on health care, so we are going to increase by those numbers health care demand when they are provided insurance. And, again, we are not increasing supply; therefore, there is going to be an immediate increase in costs because of the increase in demand.

There are some provisions in the act that claim that they will lower costs way out in the future, but I think there have been a lot of studies recently that show the difficulty of doing so. The Congressional Budget Office indicated that those type of experiments and those type of policy changes, nine out of ten, have not succeeded.

So I think what we have in the health care act is certain increase in demand and increase in costs and a very, very speculative, way out in the future, decline in cost.

Senator THUNE. Okay. Dr. Boushey, you had mentioned in your remarks, that the rich ought to pay their fair share, so my question would be: What are the criteria in practical terms of a fair share? How do you know when a fair share has been reached? I hear that term used a lot please translate that for me.

Ms. BOUSHEY. Well, so a couple of things come to mind. A few things come to mind.

First and foremost, as actually Dr. Bernstein talked about in his testimony and shows some charts on, we should be taxing capital gains income at the same rate that we tax regular income. It does not make sense that you have this gap—that we privilege certain kinds of income in the Tax Code in the way that we have when all of that income typically goes to folks at the very top of the income distribution.

Second, we should be making sure that those folks that—the hedge fund guys that currently are not paying the same rate of tax as everybody else are paying the same personal income tax rates.

But I think a bigger question is, over the past few decades we have seen this long-term decline in the tax rates at the very top of the income distribution, and yet we have not seen commensurate with that the kind of increase in economic growth or employment growth or creation of good jobs that folks were promised when we started going down this path of reducing tax rates at the top.

Many decades ago, the line was, supply-side economics was that if you limit tax rates for those on the top, the economy will grow better, we will see a stronger middle class, and this will benefit all of us; it will trickle down. We now have decades of evidence that shows that that is not the economy we have become. We have become an economy that is increasingly unequal. We have become an economy where the middle class is being squeezed. So I think going back to a time where we used to have higher taxes at the top and the economy performed better, I think going—that to me would be the threshold.

Senator THUNE. And if you had to make a suggestion about how we could reform the Tax Code today, you mentioned taxing capital gains and dividend income at the ordinary income rate and doing away with carried interest. Is that what you recommend?—

Ms. BOUSHEY. Right.

Senator THUNE. You did not say it that way, but what would you suggest in terms of a rate structure in a Tax Code then?

Ms. BOUSHEY. I do not have the exact rate structure in my head at this time, but I am happy to follow up with some written remarks on that.

Senator THUNE. Okay. Well, I just think that doing this under any circumstance is difficult. I was a staffer here 25 years ago when the last tax reform bill was debated and voted upon, and there was a significant amount of economic growth coming out of that. And, in fact, when the capital gains tax rate was lowered in 2003, there was a tremendous amount of growth in the amount of tax revenue that came in from that tax at the time, too, because people were taking realizations, they were paying taxes, and they were reinvesting. There is an incentive toward investment, I think, and there is certainly a rationale, an economic rationale, for why you would take investment income differently.

But, anyway, I appreciate your response and—I see my time has expired. Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

Let me just say I personally believe that if we had fundamental tax reform, we could enhance economic growth. I think the previous tax reform, as the Senator asserted, did help us do that. And if there was ever a wealth of opportunity, it is in the current Tax Code, because I believe if somebody were to design a Tax Code today, in light of global competition, you would never write the Tax Code we have. This Tax Code was written and designed at a time we did not have to worry about global competition. The United States was completely ascendant, completely dominant when this Tax Code was written. And you did not have to worry about our competitive position when this Tax Code was written, in large measure. Now, there have been lots of tax changes since, but honestly—I am a former tax commissioner. I used to be chairman, before I came to the Senate, of the Multi-State Tax Commission, and I have spent a lot of time dealing with the reality of the Tax Code. And, honestly, I cannot imagine one that is more complicated, more anticompetitive than the one that we currently have.

So I think there is a wealth of opportunity to broaden the base, actually lower rates, especially on the corporate side, to help America be more competitive, and to raise some additional revenue to help on the deficit. I think there is a wealth of opportunity.

Let me just ask—I go back to this chart, which to me is so incredibly striking. This chart shows at 20-percent increments, the bottom 20 percent are in orange; the next 20 percent are in purple; the next 20 percent are in green; the next 20 percent are in blue. So that is 80 percent of the population has shown basically very little growth from 1979 to 2007. But look at what has happened to the top 1 percent.

Look, I have nothing against the top 1 percent. My family is in the top 1 percent. So, I am in a very fortunate situation. But I really do not know how anybody can look at that and say this is a healthy development. I just do not know how anybody can conclude this is a healthy development.

Let me just go down the line and ask, Dr. Bernstein, what is your reaction to this chart? What does it tell you? And do you think it is a concern?

Mr. BERNSTEIN. Well, I very much think it is a concern, but I think it is a concern largely for—and I am not contradicting you at all—that clump of lines below the top 1 percent. The problem that we face is if you look at the increase in median family income, if you look at the increase in the income of the lowest-income families, it is not that it has gone down. You would not expect that in an economy where productivity has grown 70 percent over the period that you just showed. I think it sometimes is a canard to say everything is okay because some of these families got some income growth over 30 years. Of course they did. The question is: In an economy with that level of productivity growth, how have families done relative to average growth? And that is the problem. It connects that clump of lines at the bottom to the one that shoots up at the top. If growth were more equally distributed, the middle class would not be facing the kinds of economic constraints I mentioned, particularly germane for the poor.

One final point about that graph. It is a little hard to see in those numbers—and Dr. Boushey emphasized this point as well—if you actually look at the 2000s, there is where you see a particularly sharp increase—you see that line is just rising asymptotically for the top 1 percent.

Chairman CONRAD. “Asymptotically,” that is a good one.

Mr. BERNSTEIN. It is just going straight up.

[Laughter.]

Chairman CONRAD. Okay.

Mr. BERNSTEIN. It is rocketing straight up.

Chairman CONRAD. I thought I knew what you meant, but I was not sure.

Mr. BERNSTEIN. Sorry.

Chairman CONRAD. I love that word, though—“asymptotically.”

Mr. BERNSTEIN. But, anyway, if you actually look at what median incomes or low incomes did in the most recent period, they were quite flat. What you can also kind of see in that clump is in the 1990s it was quite different. There you had a tight job market that delivered some of the benefits of productivity growth to middle-and lower-income families, not nearly as much as the top 1 percent, but I think it is the combination of the soaring at the top and the far less growth at the lower rungs that I get from that picture.

Chairman CONRAD. Well, it is interesting that you say that because if you study that chart clearly, the bottom 40 percent during that period from 2000 to about 2006 actually went down.

Mr. BERNSTEIN. And I would also stress that this includes Dr. Warshawsky’s caveat there. This includes the value of employer-provided health coverage.

Chairman CONRAD. Dr. Boushey.

Ms. BOUSHEY. Well, this is quite a stunning chart, and I think that, one of the things that we have been thinking a lot at the Center for American Progress about is what does it mean for the economy. You know, clearly it has implications for families, for whether or not there is economic opportunity for those families at the bottom. But how does that actually affect how our economy works? And there is just some really fascinating and a growing body of research out there.

For example, there is an economist at the IMF named Michael Kumhof who has been doing some modeling looking at this, showing that, as those families at the very top get wealthier and wealthier, they had to have something to do with that money, which was recycled, of course, into the loans that we saw increasing during the 2000s, the increase in the subprime mortgages and the expansion of debt. That money came from somewhere. It came primarily from—there is a connection between this high inequality and the kind of debt-driven economy that we had over the 2000s. Not only did those families in the middle not see their incomes rise very fast and so they took on a lot of debt to sort of make ends meet and to keep their standard of living, but there was a lot of surplus funds available to make those loans possible. And that, of course, is a very unstable system. This is the kind of thing that we typically have seen happen in other countries, not the United States.

So that is just one of the—and my testimony goes through a ton of new evidence of the pernicious effects that inequality has on our economy and our economic stability, so that there are real problems with having this vast pulling apart for the overall economy.

The second thing—and then I will pause—are, of course, the effects that economists have been looking into on our institutions and our political process. These economists at the Chicago Booth School of Management—I think I am mangling the name a little bit—were looking into, okay, well, what happens at the top when you have this growth in the financial sector? What happens? And they found that actually, those folks in finance had been taking more and more funds and putting them into politics, and that has, of course, happened alongside with the deregulation of the financial industry, which, of course, was related—the Financial Crisis Inquiry Commission found was a key factor in the economic crisis that we had in the 2000s. So making those connections between inequality and its effects on demand and consumption and economic stability is something that we also need to be thinking about alongside whether or not those children at the bottom, poor families, are able to make ends meet and to move up the ladder.

Chairman CONRAD. Ms. Anderson?

Ms. ANDERSON. Yes, I do not think we would be having this conversation today if people felt like the individuals represented by that red line there, the top 1 percent, had gotten where they were purely on the basis of their hard work and their talent. I think there is the widespread sense that many of them got there because they rigged the rules. And I would like to go back to that chart that Chairman Conrad raised before about the decline in the effective tax rate. People feel like the 1 percent has exploded because of the tax preferences for wealthy because many of them are hiding money in tax havens, because they have made a killing off of risky financial activities that have harmed the rest of the economy. I think that is what is driving right now the concern about inequality and why it is so critical that we reform our Tax Code to bring it back to a fair level.

Chairman CONRAD. Let me just say, my time has expired, but we will have a chance to come back—

Senator WHITEHOUSE. Mr. Chairman?

Chairman CONRAD. Yes?

Senator WHITEHOUSE. May I ask you a question about the graph that is up behind you?

Chairman CONRAD. Yes, just briefly.

Senator WHITEHOUSE. I am sorry. Just the bottom lines that represent the lower 80 percent, does that include the cost of health care in that?

Chairman CONRAD. Yes.

Senator WHITEHOUSE. It does. So that is built in. It is embedded.

Chairman CONRAD. It is embedded. This looks at all elements of income in the period 1979–2007. By the way, these trends continue. We have not got them on the chart, but we did look to 2011, and the data is very much the same pattern.

Senator SESSIONS.

Senator SESSIONS. Well, I am not sure that health care was included in there. The CBO report says that incomes for all groups rose during the period and an increase of 18 percent in the lowest 20 percent. So I do not know what you are including in there, and there was an increase of 60 percent for those in the 21st through the 80th percentiles. So I do not know, that chart, how accurate it is.

Also, it does not, I assume, include the income taxes that the higher-income people pay. I know it says “pre-tax.” And I would say it rose just as fast during the 1990s. It plummeted during the recession of early 2000s and went back up. If you drew the line from the peak before the recession, then it would be pretty much—actually slowing down a little bit in the last couple of years.

Let me see. Dr. Winship—

Chairman CONRAD. Can I just respond on that point?

Senator SESSIONS. All right.

Chairman CONRAD. I have from CBO what they included, and they say this very clearly: “In the main analysis of this study, CBO counted the full value of health insurance premiums paid by employers as income.”

Senator SESSIONS. Okay. Well, all I am saying is CBO showed that it was not flat earnings growth, like that chart shows. They said it was 18 percent for the bottom quintile and 60 percent for the next three quintiles. So somehow that chart does not properly reflect everything, it seems to me.

Dr. Winship, one of the things that it seems to me we ought to focus on is the inequality that exists—and that is not a pejorative term; it is just an inequality, some people making more than others—does not mean there is no mobility, does it? And that the gains at the top do not subtract from the bottom? Would you agree with those principles? I think that is sort of what you said in some of your statement.

Mr. WINSHIP. So let me address your second point first, which is whether gains at the top come at the expense of others, and I think, pretty much everything that Dr. Bernstein just said in response to Senator Whitehouse kind of elides that question, right. So poverty causes disadvantages. I would not dispute that at all. The question is whether the poor would be richer if the rich were less rich, and I think that is where I guess we disagree and that I feel like there is essentially no evidence that shows that.

The two big periods of growth in the U.S., we can think of the golden age of the post-war period when inequality was low and not increasing, but also in the late 1990s when inequality was rising. There is just no evidence across countries. Dr. Boushey cited one study that argued that there was a link between how fast countries recovered from the recession and their inequality levels. There is other research. Christopher Jencks at Harvard University has looked at the association across countries between their rates of economic growth and their inequality levels and found basically no relationship.

So I think the key question here underlying whether we ought to be worried about this very striking chart has just sort of been assumed away by a lot of folks. So I do not think that the evidence is there to say that if Mark Zuckerberg somehow did not cash out his stock options this year, that somehow that \$5 billion would go to other people. So what has happened is that investors, from around the world, by the way, are interested in investing in Facebook and he has been exercising these options which were arranged years ago.

If that opportunity for Mr. Zuckerberg went away, it is just completely unclear to me where that \$5 billion goes and how does it end up in the pockets of people in the middle or people at the bottom. I just think no one has told a convincing story about that.

Senator SESSIONS. Dr. Warshawsky, you have listened to all of this. Do you have any comments to add?

Mr. WARSHAWSKY. Yes. I appreciate the opportunity to respond to a couple of items which have been raised.

With regard to the chart that was discussed, it is a little hard for me to see the footnotes, but if it is what I think it is from the CBO study. I did have a conversation with the CBO analyst about the reflection of health care costs in their study. They used some very old data from the Commerce Department which I argued with the analyst that really was not the best methodology. The data that I use is much more recent from the Bureau of Labor Statistics which tells a different story, what can I say, and that the earnings inequality is there, but if you reflect it in terms of compensation, it is not there, and that is largely a story of health care costs. Now, that was over a shorter period of time. It was over 1999 to 2006, but I think that is in that chart, as well. So I simply can say it looks like there is a disagreement and I prefer the BLS data as more accurate and comprehensive.

I did want to respond to something else which Dr. Boushey has mentioned. I think in economics, causality is very difficult to ascertain, and my opinion is that the causality goes in a very different direction from what she has indicated. If the growth, the real strong economic growth that we saw in the 1950s and 1960s—and that was when health care costs were much lower and much less significant than they are now—that is what led to the earnings growth for all across the earnings distribution, because when labor markets are tight, unemployment is low, of course, people who are workers are going to get bigger wage increases, and that is what we experienced in the Golden Age in the 1950s and 1960s. And so, really, in addition to the health care cost issue, I think economic growth is the best solution for earnings inequality.

Senator SESSIONS. I could not agree more. One reason that low-skilled men are not doing as well and realizing the growth in their wages that I would like to see them receive is because we have had a massive inflow of illegal immigrants, of people who take those jobs and pull down those wages. Now, some can try to dispute that, but I think it is indisputable. You bring in large amounts of low-skilled labor, it will reduce wages just like more cotton imported into America will pull down the price of cotton, and that is a factor.

Another factor is—I guess my time is running out, but I would just say another factor is we are, indeed, more technologically advanced and there is less repetitive work out there. So that is a systemic problem that I worry about. I want the average, honest, hard-working American to have their incomes increase. I think we need to defend them on the world stage trade-wise. Ms. Anderson, I think you mentioned that, or Ms. Boushey.

I think we are not adequately defending legitimate manufacturing in America from unfair trade practices and that is impacting our workers. The CEO in the Wall Street suites moves his plant to China and he thinks, fine, there is not a problem here. He is utterly unconcerned about the number of people that may have lost their job as long as he can make the same profit margin, maybe more.

I think there are some things that we can talk about, but raising capital gains taxes will clearly reduce the number of transactions that occur. And when transactions are reduced, less capital gain taxes are paid. And experience shows that when the tax rate was cut, you actually had an increase in revenue. I do not think that would be sustained forever, but you are not going to get a great deal of income increase, in my opinion, by raising capital gains taxes to the income tax rate.

I see you have the hammer out. I had better hush.

[Laughter.]

Senator SESSIONS. Senator Wyden, thank you for coming, and I yield.

Chairman CONRAD. Let me just go back to this chart for a minute because I do not want to leave a misunderstanding. This chart is directly from CBO. This is their chart. It is not my chart. It is their chart.

I think the difference between what you are seeing is a matter of scale. That is, there are increases here in the bottom 80 percent of the population. You know, if you look from 1979 to 2007, there is an increase there. The thing that is so striking is the difference between the income increase for the 80 percent of the population that is at the lower end and the top one percent. That is what is so stunning. So—

Senator SESSIONS. But CBO says in their report, the number in their report is that the three mid quintiles showed 60 percent increase, and that—

Mr. BERNSTEIN. Could I make a comment about that, Senator?

Chairman CONRAD. Yes.

Mr. BERNSTEIN. I actually—in my Figure 1, I have exactly the numbers that I believe you are citing, because you said the 18 percent for the bottom. For the next three quintiles, it increased 38 percent, not 60 percent, just to be clear.

Senator SESSIONS. Okay. Well, that is better than that chart—

Mr. BERNSTEIN. But that is not zero. I agree with you.

Chairman CONRAD. No, it is not, but it does not take away from the relationship. The relationship that is in the CBO chart that is in Dr. Bernstein's chart—I do not know if you got that from CBO, as well—

Mr. BERNSTEIN. Yes, it is the same—

Chairman CONRAD. It is the same chart. It is the disparity that is so striking.

Senator WYDEN.

Senator WYDEN. Thank you, Mr. Chairman. It has been an excellent hearing.

I want to talk for a minute about one way in my view that our country can address this income inequality issue and do it in a way that Democrats and Republicans will support, that we can actually see some real coming together around, and I want to start with you, Dr. Bernstein. I know you are one of the advisors to somebody who is part of my little cross-section of economists, Mark Thoma at the University of Oregon. Let me start with you, if I could.

One of the fastest growing parts of the Federal Government are the tax expenditures. We are upwards of a trillion dollars today. And what is clear—you see it with progressive folks, you see it on the conservative pages of the Wall Street Journal—is that, disproportionately, tax expenditures go to the folks who are best off in America.

So it seems to me that if you clean out these tax expenditures that Democrats and Republicans now correctly have concluded disproportionately benefit the folks that are best off and use those very same dollars to broaden the base of the tax system, we would be in a position in our country to help grow the economy, create good-paying jobs—that is what happened after progressive Democrats and Ronald Reagan came together in the middle 1980s—we would be in a position to grow the economy and make a real dent in terms of income inequality. I mean, you could almost legislate what amounts to a pay hike for middle-class folks because you would be broadening the base and putting them in a better position to keep up with costs, and they have not had a pay raise for a decade.

Dr. Bernstein, any quarrels with that kind of analysis?

Mr. BERNSTEIN. I very much agree with the broad architecture of your thinking there, and I do view this as somewhat of a holy grail for tax reform and I think that is fairly widely agreed upon by folks on both sides of the aisle. Now, the devil is in the details, and when you start going after people's tax expenditures, they get a little sensitive. But one that I mentioned in my discussion today, and I even cited a tax expenditure cost from the Joint

Committee on Taxation, was the benefits we provide in that part of the code to capital gains and dividends, which amount to \$450 billion in terms of its cost to the Treasury over five years.

But I would say this, two things. One, the distribution of expenditures is skewed, as you suggested. Not that many go to the middle class. The main one is the mortgage interest deduction, and that is not trivial, but that, again, largely benefits those in the top few—in the upper percentiles.

I would also say that where there is also some important tax expenditures that I had argued in my testimony

that this Committee on the Budget should protect are refundable credits that help to support the income, and I would argue the opportunities, of our lowest-income families. Two particularly important ones, because they were expanded in the Recovery Act and have been, I think, smartly, renewed at the end of 2010, was the refundable credit on the Earned Income Tax Credit and the Child Tax Credit. Those are tax expenditures that I think actually are very consistent with improving the opportunity and dampening, moderating the inequality that we have talked about so far.

Senator WYDEN. I want to let your colleagues get into it. I just wanted to, again, highlight the prospects, and your response to my question, I think, reaffirms this, the opportunity for bipartisanship in this area. For example, Senator Coats and I have introduced the first bipartisan approach really in 25 years, since the Reagan proposal. Senator Coats, to his credit, keeps the refundable credits that you are talking about, so we retain those.

And then with respect to capital gains and essentially investment income, we put that on a progressive scale, as well, so as to really, again, try to bring this base-broadening approach to essentially the entire economy. I mean, there is no reason why it cannot be applied to investment income, as well. Essentially, under our approach, we put a certain amount off limits and then everything above that we put on a progressive scale. So, yes, somebody who makes all their income just on investment will pay a bit more, but we have talked to people who work in that area and they say they can live with that.

And we broaden the base so as to bring a whole lot of additional people—

Mr. BERNSTEIN. Can I make one more quick point about this, sir—

Senator WYDEN. Of course. Certainly.

Mr. BERNSTEIN. —is it is very important not to view—I fully support everything you just said, but I think it is very important not to view this as solely revenue neutral, as if you would want to essentially return all of the tax expenditures that you get back from broadening the base in lower rates. Some of it needs to be reserved to reduce the deficit and to offset some of the deep spending cuts, particularly the ones that threaten opportunity and mobility.

Senator WYDEN. It is not fair if I respond to everything that you have said. I want to get everybody into

it. Our bill was actually scored by the Joint Committee on Taxation. They essentially give informal analyses as generating revenue. And then, of course, again, on both sides of the political spectrum, Brookings folks who have been on the progressive side, Heritage folks on the other side, also highlight the fact that this kind of pro-growth approach to tax reform, whether it will produce exactly what we had in the 1980s, the principles are still the same, and given the fact that we have this growing income inequality in the United States and all sides, all across the political spectrum, people say tax expenditures have played a role in it, this is a chance to bring, I think, Democrats and Republicans together and we are going to go prosecute the case.

Would any of you other four who have been very patient like to add anything on the question of tax expenditures and income inequality? You are not required to.

Ms. BOUSHEY. Well, if nobody else is going to, I wanted to add one thing on the issue of taxes and the potential for some sort of alliance. There was a new poll that just came out from the Small Business Majority that asked small business owners about whether or not millionaires are paying their fair share in taxes and it has some really interesting new findings, so I would encourage you to look at it because it is connected to that logic. A majority of small business owners favor letting the Bush tax cuts lapse for those making more than \$250,000 a year. So I think there is some opening there to at least talk about the folks at the high end.

Senator WYDEN. Any others?

Mr. WINSHIP. Yes. Thank you for the opportunity, Senator Wyden. I would not disagree with some of the principles that you have articulated. I think it is not completely clear to me that it would have a big impact on the sort of striking charts that we were just looking at. I think, and maybe Dr. Bernstein will correct me if I am wrong, the difference between his chart and the chart in the back is that his is after tax and I think the one that has been presented up front was before tax. So I am not sure that it will have the direct visual impact on these charts.

What I do think is unfortunate about the tax expenditures is because the benefits do tend to flow to folks who have already accumulated assets, it tends to subsidize asset purchases that would have been made anyway, which is inefficient but which also has the effect of bidding up the price of these assets and so it puts things like home ownership—

Senator WYDEN. Take a look, and Chairman Conrad has been good enough to let me just wrap up with this point. Take a look at some of the increases in income that middle-class people would have under what Senator Coats and I are proposing. I mean, I am not here speaking for him. He is a conservative Republican. But, for example, we triple the standard deduction. That means for a middle-class family that is making \$10,000 a year in income, that means \$30,000, they make \$50,000, \$60,000 is put off limits. So we are talking about putting thousands of dollars into the pockets of middle-class folks by broadening the base, doing it in a bipartisan way, by getting out this tax expenditure issue which is so tilted, according to all philosophies, and giving people that relief permanently. So take a look at those numbers and I would be interested in your thoughts.

Mr. Chairman, thank you for the extra time.

Chairman CONRAD. Yes. I apologize to colleagues.

Senator MERKLEY.

Senator MERKLEY. Thank you, Mr. Chair, and thank you all for your testimony.

I wanted to start—Mr. Winship, in your testimony, you note that the way to speed up the recovery is to facilitate efforts to put over-leveraged homeowners back in the black, to restore consumer demand, detoxify problematic mortgage-backed assets, rejuvenate lending, and to do so in a way that does not undermine personal

responsibility on the part of the borrowers. As you write those words, what is the policy strategy that you are thinking about?

Mr. WINSHIP. Thank you, Senator. The specific strategy I have in mind is one that has been advocated, I think, both on the left and the right, which is shared equity mortgages. So this has been championed by Ben Bernanke, by Ken Rogoff, who I think was mentioned earlier, and I believe by Larry Summers in the current administration. But the idea would essentially be to facilitate through mostly regulatory efforts, I believe, the refinancing of mortgages that are currently troubled in such a way that lenders would essentially be able to get a portion of the capital gains that accrue when the seller eventually sells. And so the idea is—

Senator MERKLEY. I am going to stop you there. I am well familiar with it, and what you called shared equity is often called shared appreciation mortgages. So I just—there are a number of possibilities and that is one of them and one that I have cosponsored a bill on.

I am also very interested in the challenge of folks who are not—their loans, almost through the luck of the draw, if you will, whose loans are not insured already by Fannie and Freddie and therefore do not benefit from the HARP 2 program, a similar ability to refinance to lower interest rates. It seems like just something is fundamentally wrong when we can do massive bailouts for large financial institutions and extend very low-cost credit in unbelievable levels, but we cannot enable people to refinance because they happen to have a non-Fannie or Freddie rather than a Fannie or Freddie loan.

I will just leave that there and say I think measures that should have been taken two to three years ago, we are still arguing about the perfect way to do it. There is no perfect way. But what seems very clear is the recovery is going to be modest, at best, if we do not address this huge debt overhang that you identify in your testimony.

I wanted to switch, Dr. Bernstein, to your thoughts about how unequal access, the political process, can worsen income inequality, certainly, a huge issue that folks back home already knew about through the Citizens United decision is now becoming—if they did not know about that, now it resonates as the super PAC problem. In short, the money from the one percent, if you will, drowns out the voice of the people.

There was a political cartoon recently that had a picture of the Supreme Court, and instead of “We, the people,” it said, “We, the powerful.” Indeed, it is a fundamentally different notion about what we envision our nation to be when the voice of the people is drowned out.

And so I thought I just might ask you to comment, your thoughts about this issue, the disproportion of power and resources and what we need to do to address it.

Mr. BERNSTEIN. Thank you, Senator. I actually do not have a lot to add to the way you put it. I thought that was exactly the right dynamic.

I would suggest—I thought Dr. Winship made a good point when he said if someone has a very, does a great IPO and comes away with billions of dollars, that does not hurt middle-or poor-income

people. That just helps them. And as a first order proposition, I think that is true. But when you then think about the political influence that those kinds of resources buy, I am extremely struck by the national amnesia on these issues regarding the meltdown that occurred in 2007–2008. You mentioned the housing bust and its role there. Economists since Adam Smith recognize that financial markets are inherently unstable and we have always had to regulate them.

I think where you really see the distortionary traction of the dynamics that you raised in your question is around this issue of financial re-regulation, and Ms. Anderson was talking about this, as well. Money in politics is trying to de-fang, as we speak, financial reform in such a way that will assuredly get us right back here again with another financial bust. And if that IPO or dollars flow back into the power dynamics that we have described, it is very much going to boost inequality and diminish the opportunity of the lowest-income families, as I presented in my testimony.

Senator WYDEN. Thank you very, very much. It is certainly a concern to me, as the chart that the Chair put up a short while ago, and I think a similar chart was in your testimony, a slightly different way of framing the statistics. It does say to the American people that the economy is working very well for the very few and very poorly for everyone else. My colleagues talked a few moments ago about the fact that immigration affects the labor supply within the economy and has an impact.

I would also point out that when we extend the framework of our economy, it has a huge impact. And indeed, what we did from World War II through the mid-1990s is we incorporated other developing nations—or, excuse me, developed nations—into our economic circle, if you will, and what we have done recently is to create a circle for our economy that involves billions of folks who live at a very much lower level, standard of living, and who operate under rules that are very different for the labor force and for the environment. And that, too, has an enormous impact on lowering the standards for what Americans can be paid within our economy.

It is particularly a large factor because China has a three-tiered industrial policy. The first is related to paying low wages and low environmental enforcement. And the second level of this policy really is about pegging its currency that creates a tariff on our products and a subsidy to theirs. And the third is related to direct subsidies, and recently we had 200 postings by our Trade Representative that outlined subsidies within the Chinese economy for things that are being exported. And it showed a famous brand strategy, a renewable energy strategy, a paper strategy, and then miscellaneous other. And if I might add a fourth, it is not extending the rule of law to involve things that involve the theft of intellectual property.

We, therefore, do not have, if you will, a level playing field within this new economy, economic structure we have created, and we are getting taken to the cleaners. We have lost five million middle-income jobs in factories over the last ten years. And it is happening parallel to why that chart is showing enormous growth, and the distinction between these circumstances of working Americans and those who are at the top.

So I throw that out there as a major factor that we must wrestle with as a nation if we are going to have middle-class Americans able to have living wages. Does anyone wish to comment on this? Yes, Ms. Anderson.

Ms. ANDERSON. I agree with your comments. I just wanted to add another point that is part of China's strategy, which is denying basic labor rights. I see that also as an issue with the immigration situation in the U.S. That is one reason why people might bring down labor standards is because they do not feel like they have basic rights. And so I think that focusing on how do we strengthen and protect basic rights to organizing independent unions and other basic labor rights needs to be part of that discussion.

Senator MERKLEY. Okay. I see I am over my time, so I will defer to the Chair as to whether I should ask anyone else if they have comments.

Chairman CONRAD. I need to end the hearing. I have been called to another committee hearing. I apologize for that, but that has actually begun already and I absolutely have to go to it.

I want to thank all of the witnesses, all of our colleagues who have participated. I think it has been a very useful hearing. Thanks to all of the witnesses.

The hearing is adjourned.

[Whereupon, at 12:04 p.m., the committee was adjourned.]

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The Honorable John R. Thune  
United States Senate SD-511  
Washington, DC 20510

February 10, 2012

Dear Senator Thune,

It was an honor to participate in the Senate Budget Committee Hearing on February 9, 2012 on the topic of addressing inequality, mobility, and opportunity. I am following up to provide a more thorough response to your question at the hearing asking me for suggestions on what to set individual tax rates at.

In answer to your question, I am attaching a copy of testimony given before the Joint Economic Committee on November 17, 2011 by my colleague, Seth Hanlon, who is Director of Fiscal Reform at the Center for American Progress and an expert on tax policy issues. In this testimony, Mr. Hanlon concludes:

In sum, there is little reason to believe that the expiration of the Bush-era marginal income tax rates on high-incomes will have a negative impact on economic growth or job creation. Rather, they will strengthen our economy's long-term prospects by contributing substantially to debt reduction. The expiration of the top two marginal rates is an important first step toward a fair and fiscally responsible tax code.

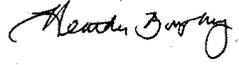
I will add two points. First, while getting individual tax rates right is a key component of tax reform, it is also important that we take further steps to introduce more equity into the tax code. Ending the preferential treatment of income from investment over income from wages, closing unproductive loopholes that allow individuals and businesses to avoid paying their fair share of taxes, and broadening the base of the tax code by ending subsidies such as those to oil and gas companies would be excellent first steps in this process.

Second, the most critical issue facing the United States continues to be a paucity of jobs. With the share of Americans with a job at lows not seen in 29 years, Congress should be focused above all else on boosting demand, reducing unemployment, and putting our economy back on a path toward healthy economic growth.

Progress Through Action

If you have any further questions on this matter, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "Heather Boushey". The signature is written in a cursive style with a large initial 'H' and a long, sweeping tail.

Heather Boushey  
Senior Economist  
Center for American Progress Action Fund

Center for American Progress Action Fund



**Testimony before the Joint Economic Committee hearing,  
“Could Tax Reform Boost Business Investment and Job Creation?”**

**Seth Hanlon,  
Director of Fiscal Reform, Center for American Progress Action Fund  
November 17, 2011**

Thank you, Chairman Casey, Vice-Chairman Brady, and the members of the committee for the chance to appear today to discuss tax reform and the economy.

There is wide agreement that the tax code is long overdue for reform. Our current tax code is inefficient, overly complex, and unfair in myriad ways. Our tax code is also failing at its most fundamental purpose, which is to raise sufficient revenue to meet our needs as a country in an equitable way. Fundamental tax reform—a reform that broadens the tax base and eliminates economic distortions—is important for promoting long-term economic growth.

That said, tax reform simply cannot address the central economic challenge facing the United States right now—the severe and prolonged jobs crisis, which is a product of the lack of demand in the economy. At a time of 9 percent unemployment and vast unused resources, Congress should be focused above all else on boosting demand, reducing unemployment, and putting our economy back on a path toward healthy economic growth.

And so my testimony today will summarize briefly the reasons why I believe that fundamental tax reform is an important priority, but one that should not derail immediate and fast-acting measures to address our most pressing challenge—putting people back to work. My testimony will then discuss some of the critical issues and principles in tax reform, including:

- The fiscal context for tax reform
- The need to avoid tax policies that would shift a greater share of the tax burden on middle-class families
- The need for business tax reform that encourages investment and job growth in the United States, levels the playing field among competing businesses, and ensures that companies pay their fair share

\* \* \*

### I. The immediate economic challenge

The most immediate and fundamental challenge facing the economy today is the jobs crisis. More specifically, it is the \$1 trillion hole in aggregate demand caused by the collapse of the housing bubble, the financial crisis, and continued mass unemployment.<sup>1</sup> The Great Recession is still taking its toll on the economy. The output gap—the difference between the economy’s actual output and its capacity to produce at full employment—is still at about 6.7 percent of potential GDP, or nearly \$1 trillion per year.<sup>2</sup> That gap has closed somewhat since the low point of the Great Recession, thanks in part to the American Recovery and Reinvestment Act and other policies, but the Congressional Budget Office projects it to remain at 5 percent below potential GDP through 2011, with an output gap persisting for several years to come and inflicting continued pain on workers.

The economy needs more aggregate demand to close the output gap and return people to work. CBO predicts that if we stay on the current policy path “a large amount of labor and capital resources [will] be unused for some time.”<sup>3</sup> The fact that the economy is not performing at its potential is shown most dramatically and tragically in the fact that 14 million people remain unemployed, and long-term unemployment stands at record levels. The prolonged output gap means that business investments are not being made and worker skills are atrophying, which hurts our national economic competitiveness.

With excess capacity, businesses will be hesitant to hire and invest until they are confident there will be demand for their products and services. The most urgent problem is not a lack of capital, at least not for large businesses. The corporate sector has been enjoying strong profits and is flush with cash: Nonfinancial companies are holding more than \$2 trillion in cash and liquid assets in the United States, according to the Federal Reserve.<sup>4</sup> The tax code is now strongly incentivizing business investment, with 100 percent expensing (full write-offs) of investments made this year. And despite the claims, “regulatory uncertainty” is not a real explanation for the lack of hiring.<sup>5</sup> Both the economic data and business owners themselves point to a lack of demand as the major obstacle to job creation and economic growth.<sup>6</sup>

Though it is not the subject of my testimony today, my colleagues at the Center for American Progress have identified the most promising ways to boost consumer and business demand and create private-sector jobs while investing in the future. They include: investing in infrastructure, aiding the housing market by reducing the flood of foreclosed homes, providing aid to the states to prevent further public sector layoffs, and supporting the energy-efficient retrofitting of homes and businesses.<sup>7</sup> Congress also cannot afford to *worsen* consumer demand by allowing the temporary payroll tax reductions and long-term unemployment assistance to expire. These ideas and others are encapsulated in the president’s American Jobs Act, which many independent forecasters predict will create as many as 1.3-1.9 million jobs.<sup>8</sup>

In sum, tax reform is a worthy goal. Done right, it can improve long-term economic growth, especially if it is part of a long-term growth strategy that also makes important public investments and strengthens the middle class.<sup>9</sup> But it is not a response to the immediate and ongoing jobs crisis. And therefore discussions of tax reform should not be to the exclusion of immediate job creation measures like the American Jobs Act.

## II. The context for tax reform: long-term fiscal challenges and growing inequality

### a. The existing tax code does not raise adequate revenue to meet national needs under any realistic fiscal scenario

Any tax reform effort will have to be considered against the backdrop of the long-term fiscal challenges facing the United States. Those challenges are undeniable. The United States was running deficits even at the peak of the business cycle in the mid-2000s. Since 2008, the recession and Congress's policy responses caused a sharp fall-off in revenues. The short-term fiscal situation has improved, with deficits as a share of GDP declining for fiscal year 2012 and projected to decline further over the next several years. However, the more serious challenges are in 2021 and beyond, as an aging population, rising health care costs (even if the rate of growth slows), responsibilities to the millions of new Iraq and Afghanistan veterans, a decaying infrastructure in need of rebuilding, and other ongoing national needs exert pressures on the budget. The United States will also have to pay a growing amount of interest on the debts incurred from the wars, the 2001-03 tax cuts, and the larger deficits caused by the recession.

The fact is that our current tax policies do not raise nearly enough revenue to stop the accumulation of debt, even in scenarios with draconian spending cuts. If we maintain our current tax policies, revenues will only reach 18.1 percent of GDP in 2021 and will average just 17.7 percent over the next decade.<sup>10</sup> That is not nearly enough to prevent continued deficits even under the House-passed budget, under which federal spending would decline to about 20 percent by the end of the decade. That budget would dramatically reduce public investments in education, infrastructure, and scientific research while tearing at the social safety net, including turning Medicare into an inadequate voucher program and slashing Medicaid.

In light of these realities, every major bipartisan effort to propose solutions for the nation's long-term fiscal challenges has found it necessary to rely on both spending reductions and substantial revenue increases that boost revenues to at least 20 percent of GDP, or significantly higher.<sup>11</sup> It should be noted that federal revenues averaged about 20 percent of GDP over the four-year period from FY 1998-FY 2001, when the budget was last in balance—and spending needs were much less then, with a smaller pre-9/11 military budget, a younger population, and lower health-care costs per capita.

The fact that our current tax code is inadequate to fund our national needs without accumulating more debt means that tax reform must contribute to solving our long-term fiscal challenges. In other words, it must be revenue-positive. If our tax code cannot be reformed to raise additional revenue, the resulting deficits will drive debt-to-GDP ratios to unsustainable levels, with negative repercussions for the United States economy over the long term.

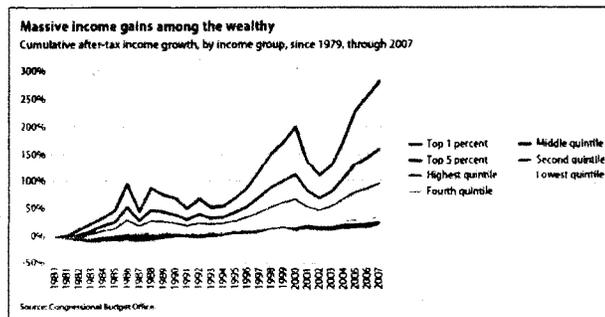
Many hold up the last major tax overhaul, the Tax Reform Act of 1986, as a model for today. TRA86 was ostensibly revenue neutral, achieving significant reductions in both corporate and individual tax rates in exchange for reductions in tax expenditures and loopholes. But today, our long-term budget challenges are much more severe than they were in 1986. And the large budget

deficits that persisted after 1986 were closed only through further deficit reduction efforts, including increases in the top marginal rates in 1990 and 1993.

The good news is that unlike some European countries that also have long-term fiscal imbalances, the United States is a low-tax country. Federal receipts as a share of GDP were under 15 percent for the last three years—the lowest since 1950. The United States also raises comparatively little revenue by international standards: Total revenues in the United States were 26.9 percent of GDP from 2004-2008, nearly 25 percent lower than the average OECD country. Within the OECD, only Mexico, Chile, Turkey, and South Korea had lower taxes as a share of their economies. By comparison, revenues total 33 percent of GDP in Canada and 36 percent in Britain. The bottom line is that there is ample room to increase revenues. We are a low-tax country now and will remain a relatively low-tax country even if we balance the federal budget entirely with new revenue.

**b. Tax reform must not exacerbate growing income inequality by shifting a greater share of the tax burden onto low-income Americans and the middle class**

Another important part of the context for tax reform is that income inequality has dramatically widened in recent decades. Top income earners, most dramatically the top 1 percent, have pulled apart from those in the middle and at the bottom. In recent years, the share of income accruing to the top 1 percent reached levels not seen since the 1920s.<sup>12</sup> At the same time, real incomes for the middle class have barely grown.

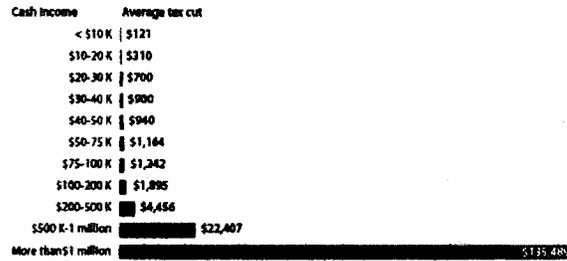


As income inequality has continued to grow, and while middle-class incomes have stagnated, the tax rates paid by the well-off have plunged. Millionaires are now paying about one-quarter less in federal taxes as a share of their income as they were as recently as the mid-1990s.<sup>13</sup> The top 1 percent of Americans has experienced a similar reduction in taxes.<sup>14</sup> A principal cause of the lighter tax burden on the wealthy was the tax rate cuts enacted under President George W. Bush in 2001 and 2003: The average millionaire (whose incomes average \$2.9 million) will pay \$135,000 less this year because the 2001-03 tax cuts are still in effect, according to the

nonpartisan Tax Policy Center.<sup>15</sup> The wealthy have also benefited greatly from historically low rates on income from capital gains and dividends.<sup>16</sup>

**Who is benefitting from the Bush tax cuts?**

Millionaires and high-income households continue to receive the largest tax cuts in 2011



Source: Urban-Brookings Tax Policy Center table T11-013.

The end result is a federal income tax code that is generally progressive, but less progressive than it used to be, and one in which many very wealthy people pay lower effective rates than people below them on the income scale. And of course the federal income tax is only one component of a larger tax system; other kinds of taxes, including payroll taxes and consumption taxes (e.g., excise taxes, state and local sales taxes) fall harder on those at the bottom than those at the top. Families in the middle of the income spectrum pay 9.4 percent of their incomes in federal payroll taxes on average, while the top 1 percent pays only 1.6 percent.<sup>17</sup> This is because the largest portion of federal payroll taxes only applies to a worker's first \$106,800 in wages, and not to wages in excess of that amount or to investment income.

President Obama has said that one of the principles underlying tax reform should be the "Buffett rule." The "Buffett rule" is not a specific tax code rule, but the general principle that no millionaires should be paying lower taxes as a share of their income than middle-class families. The current tax code often violates this principle. For example, there are nearly 100,000 millionaires (about one in four) who pay a tax rate of less than 26.5 percent—more than 10.4 million Americans earning less than \$100,000 pay.<sup>18</sup> Statistics like these undermine the sense of basic fairness that should undergird the tax code.

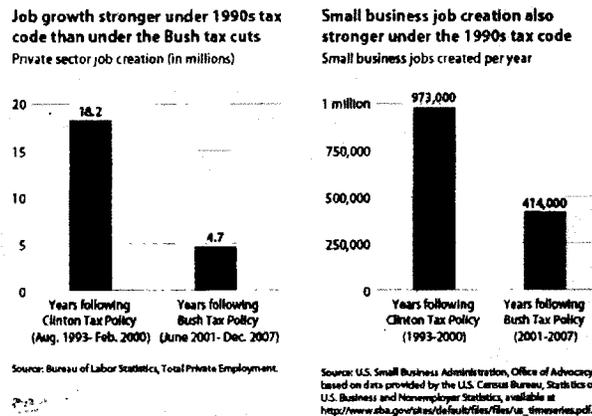
So in sum, we need additional revenues. And the group of Americans whose incomes have skyrocketed are now paying lower taxes than they were just a short time ago. These factors point toward allowing the Bush tax cuts on top-incomes to expire. Doing so would reduce the deficit over 10 years by about \$800 billion—two-thirds of the way toward the amount of deficit reduction that the Joint Select Committee on Deficit Reduction is charged with finding.

It is often claimed that allowing the high-end Bush tax cuts to expire—which would simply reinstitute the top marginal tax rates that were in effect during the 1990s economic expansion—would stifle job creation and harm small businesses. It is even said that the very prospect that tax

rates on the rich will return to 1990s levels—with the 33 percent bracket going to 36 percent and the 35 percent bracket going to 39.6 percent—is holding back hiring and business investment. Neither of these claims is true. Three facts underscore why.

The first is recent history. The expiration of the two top brackets would simply revert the top marginal tax rates to levels that were in effect from 1993-2001. The same claims about economic growth and the negative impact on small business were made in 1993, when the top marginal rate was raised from 31 percent to 39.6 percent, a much larger percent increase than is contemplated now. What followed, however, was a period of very strong economic growth and job growth, among both large and small employers. And the federal budget was balanced for the last four fiscal years the 1990s tax rates were in effect.

With higher tax rates on both ordinary income and capital gains in effect, business investment was stronger in the 1990s than in the period since the 2001-03 tax cuts.<sup>19</sup> Millions of jobs were created and real incomes grew across the income spectrum. About 18.2 million private-sector jobs were created in the six years after the top tax rate was raised to 39.6 percent in 1993, compared to only 4.7 million private-sector jobs created in the corresponding period after the 2001 Bush tax cuts, which does not even include job losses from the Great Recession.<sup>20</sup> Small businesses created jobs at a much faster rate when the Clinton-era tax code was in effect. Between 1993 and 2000 small businesses (those with fewer than 500 employees) added nearly a million jobs per year on average (973,000). But in the period after the Bush tax cuts were enacted in 2001 until the onset of the recession in 2007, small business job growth was less than twice as rapid (414,000 per year).<sup>21</sup>



Also undermining the claim that small businesses will be harmed if the high-end Bush tax cuts expire on schedule is that only a very small percentage of small businesses owners are in the highest tax brackets. Only about 3 percent of small business owners are in the top two tax brackets.<sup>22</sup>

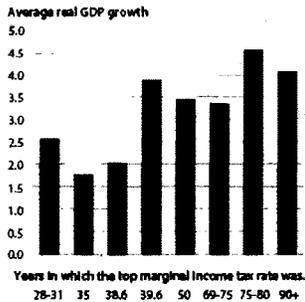
And finally, the portion of the benefit of extending the high-end tax cuts going to small business employers is very small. A new Treasury report reveals that fully 92 percent of the tax benefit would go to corporate executives, investors, highly paid professionals, athletes, and other people who are not small business employers.<sup>23</sup>

Two other points should be emphasized. First, even those in the 33 and 35 percent brackets would continue to benefit by about \$6,500 per year from extensions of the current *lower bracket* rates, which President Obama has proposed in each of his budgets. And they would only pay incrementally higher tax rates on dollars of income earned above the cutoffs for the top two brackets. A married business owner with \$300,000 in total income and \$250,000 in taxable income, for example, would pay only \$243 more under the rate structure in the president's budget proposal than she is now—or less than 0.1 percent of her total income. A business owner with \$600,000 in total income and \$500,000 in taxable income would pay only about \$10,000 more—or only 1.5 percent of his total income. It is difficult to believe that a business owner would respond to these modestly higher personal tax bills by cutting payroll or foregoing promising investments. It is even more difficult to believe that the very prospect of such modest tax increases taking effect in 2013 would be chilling business investment today. It should also be emphasized that because labor costs are deductible, the marginal personal tax rate of the owners of a business has no impact on the business's incentive to hire workers.

Top bracket rates of 36 and 39.6 percent are much lower than the top rates that existed for most of the history of the income tax, including the United States's strongest periods of economic growth. The historical evidence shows that marginal rates higher than current rates are perfectly consistent with robust economic growth. As my colleague Michael Linden has found, the United States has experienced stronger economic growth and faster job creation in periods when top marginal tax rates were much higher than the current 35 percent.<sup>24</sup>

**Top tax rates and GDP growth**

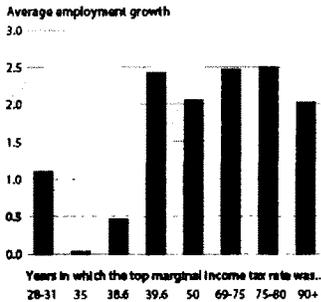
Average annual growth in real gross domestic product, by top marginal income tax rate, 1950-2010



Source: Bureau of Economic Analysis and Tax Policy Center.

**Top tax rates and job growth**

Average annual percent growth in total payroll employment, by top marginal income tax rate, 1950-2010



Source: Bureau of Labor Statistics and Tax Policy Center.

In sum, there is little reason to believe that the expiration of the Bush-era marginal income tax rates on high-incomes will have a negative impact on economic growth or job creation. Rather, they will strengthen our economy's long-term prospects by contributing substantially to debt reduction. The expiration of the top two marginal rates is an important first step toward a fair and fiscally responsible tax code.

### **III. Corporate and business tax reform**

Finally, I would like to address the corporate and business tax reform—in particular the need for tax reform that encourages rather than discourages job growth in the United States, levels the playing field among competing businesses, and ensures that U.S. companies pay their fair share.

The corporate tax is an important component of our tax system. It is the third largest federal revenue source, behind individual income and payroll taxes. It also provides a needed backstop to the individual income tax, preventing tax sheltering in corporations and helping to maintain the progressivity of the income tax. However, the corporate tax is in need of reform. In President Obama's words, "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."

The president is right that the corporate tax code favors some industries over others, distorting investment and thereby impeding economic growth over the long-term. The corporate tax code is ripe for reform.

#### **a. The corporate tax burden in context**

As with individual taxes, the discussion of corporate tax reform must take into account the fiscal challenges facing the United States. Corporate taxes once contributed about 30 percent of federal revenues in the 1950s, but they have steadily declined and in recent years have averaged only about 10 percent of federal revenues. Corporate taxes represent a smaller portion of GDP in the United States than in other major economies.<sup>25</sup> With the diminishing corporate tax, the United States has relied more heavily on other taxes, in particular payroll taxes on wages. Payroll taxes, which were about 12 percent of federal revenues during the 1950s, have reached 40 percent of revenues.<sup>26</sup> The increasing share of business activity being conducted via "passthrough" entities, including S corporations and LLCs is partly responsible for the decline in corporate tax revenues. But also responsible is the fact that corporations are paying lower tax rates on their profits than they did in the recent past.<sup>27</sup>

This is the case despite the fact that the United States's 35 percent statutory tax rate—the rate on the books—has not been lowered in 25 years and is now the second highest in the OECD. But solely focusing on the statutory rate leads to misperceptions about the overall tax rate actually paid by corporations, because it ignores the wide variety of tax preferences and loopholes that exist in the code. Corporate "tax expenditures," the special exemptions, deductions, and credits that companies use to reduce their tax bill, total roughly \$1.2 trillion over 10 years.<sup>28</sup> And not all

features of the tax code reducing corporate effective rates appear on the official tax expenditure lists.

The better measure of the actual tax paid by corporations is their effective rates. And corporate effective rates are much lower than the statutory 35 percent rate. Recent studies have found that the effective rates of large U.S. corporations are in line with or actually lower than their foreign counterparts.

- In 2007, a Treasury Department survey found that by one measure, the average tax rate paid by U.S. corporations from 2000-2005 was 13.4 percent—below the OECD average of 16.1 percent.<sup>29</sup> As the Treasury report summarized, “The contrast between [the United States’s] high statutory corporate income tax rate and low average corporate tax rate implies a relatively narrow corporate tax base, due to accelerated depreciation allowances, corporate tax preferences, and tax-planning incentives created by [the] high statutory rate.”<sup>30</sup>
- A recent analysis of public company financial statements by Citizens for Tax Justice and the Institute for Taxation and Economic Policy, or CTJ/ITEP, found that 280 of the largest U.S. corporations paid an average effective tax rate of 18.5 percent over 2008-2010—just over half of the statutory rate.<sup>31</sup>
- A recent study of the effective tax rate paid by the largest 100 U.S. companies and 100 largest European Union companies over the last decade found that the American companies paid lower income tax rates, on average, than their European rivals.<sup>32</sup>
- Other studies have found that corporate effective rates are closely in line with those in other large countries.<sup>33</sup>

Because their success is bound to the success of the overall U.S. economy, U.S. corporations have a strong stake in our country’s fiscal sustainability and growth. They benefit greatly from U.S. government services, from law enforcement to product safety, to patent protection, to education and workforce development. Given these realities, the corporate sector should not be exempted from the process of deficit reduction. To take the corporate income tax off the deficit reduction table means that critical government services and public investments would face even deeper cuts, or that middle-class Americans would face a larger share of the tax burden. Neither alternative is desirable. The narrowness of the U.S. corporate tax base means that U.S. corporations can, on the whole, contribute a greater share of revenues. Accordingly, corporate tax reform should be at least revenue-neutral. Given the potential savings from broadening the corporate tax base, it should be possible to achieve deficit reduction from the corporate tax while still lowering the statutory rate.

#### **b. International tax reform**

The corporate tax code is replete with explicit subsidies and other preferences that cause economic distortions. One of the most significant distortions in the corporate code is its fundamental bias toward foreign investment over investment in the United States.

The debate over international taxes is often framed as a choice between “worldwide” and “territorial” tax systems. I would maintain that these labels obscure the more fundamental issues of whether our tax system encourages investment and job creation in the United States and whether it protects our revenue base.

Despite the fact that the United States nominally has a “worldwide” tax system, foreign profits are taxed very differently than domestic profits. Because of the feature known as “deferral,” U.S. multinationals can delay paying U.S. taxes on overseas profits indefinitely; whereas they pay taxes on domestic profits in the year they are earned. Overseas profits are taxed only when and if they are returned to the United States, as when they are paid out as dividends from overseas subsidiaries to U.S. parents. At that point corporations do not pay the U.S. corporate rate, but rather the difference between the U.S. corporate rate and the effective rate of foreign taxes they have paid. (This is because corporations are entitled to a credit for foreign taxes.)

Our current deferral system provides tax incentives for overseas investments. In fact, it encourages U.S. companies to make job-creating investments offshore even if similar investments in the United States (absent tax considerations) would be more profitable. As a result of “deferral” and other aspects of the U.S. international tax system, U.S. multinational corporations pay much lower tax rates on foreign investments than on domestic investments: In 2008, the Government Accountability Office, or GAO, found that corporations pay a 16.1 percent rate on foreign-source income (combining both the source country tax and the residual U.S. tax), and a 25.2 percent rate on U.S. source income.<sup>34</sup> In recent years, companies have become more adept at lowering the effective rate on foreign investments, and thus their overall effective tax rates, through complex tax strategies enabled by U.S. policy changes.<sup>35</sup> These strategies are only available to large multinationals.

The tax differential between foreign and domestic income not only puts a thumb on the scale in favor of offshore investment; it also creates enormous incentives for companies to use complex legal and accounting techniques to move income-producing assets to low-tax countries or tax havens, especially assets like valuable intellectual property that exist only on paper.<sup>36</sup> U.S. companies report their largest profits in small countries like the Netherlands, Luxembourg, and Bermuda—even though that is clearly not where the most real economic activity is taking place.<sup>37</sup> The U.S. Treasury, the Government Accountability Office, the Joint Committee on Taxation, and numerous independent researchers have published studies pointing to strong evidence of tax-motivated income shifting.<sup>38</sup> The resulting phenomenon has been called “stateless income”—profits that migrate to low-tax or no-tax jurisdictions, eroding the tax bases of the countries where the income is actually generated (*i.e.*, where the R&D is performed, the business decisions are made, where the customers are, and so on).

Corporate income shifting decimates the corporate revenue base, draining the United States of tens of billions of dollars in revenue every year. By one estimate, the U.S. government lost about \$90 billion in revenue in 2008 from corporate income shifting—up from \$60 billion in 2004.<sup>39</sup> To put that figure in perspective, the corporate income tax only raised an average of \$300 billion per year during the 2004-08 timespan.

These two problems—the bias toward overseas investment and the erosion of the tax base due to income shifting—could be made worse if the United States moves in the direction of a “territorial” tax system without more fundamental reforms. Under a territorial system, overseas profits would be tax-exempt, not just tax-deferred. The only remaining backstop against profit shifting, the tax upon repatriation, would be removed.

It is often said that the United States must move to a territorial system to maintain competitiveness with other countries that have adopted territorial taxation. But there is little evidence that U.S. firms’ global competitiveness is actually being undermined by the existing deferral system, which (because of the combination of deferral and other aspects of the tax code) often allows them to pay lower taxes than they would under a properly functioning territorial system.<sup>40</sup> Of course, the competitiveness of a company is determined mostly by nontax factors; but to the extent taxes matter, the key figure is the company’s relative effective tax rate. The most recent comprehensive survey of the effective tax rate paid by the largest 100 U.S. companies and 100 largest European Union companies over the last decade found that the American companies paid about the same or lower effective tax rates, on average, than their European rivals.<sup>41</sup>

As one of the authors of that study notes, the reason that EU companies have the same or higher effective rates is that EU countries have a broader tax base. Specifically, those countries have stronger antiabuse rules that deter the shifting of profits into tax havens.<sup>42</sup> Rather than moving headlong toward territoriality, the United States should address income shifting directly. A good place to start would be to enact a rule requiring current U.S. taxation of income reported in low-tax countries or tax-havens. Many countries with “territorial” tax systems already have such rules.<sup>43</sup>

**c. Leveling the playing field among business investment by reducing inefficient tax code subsidies**

Finally, corporate tax reform provides an opportunity to level the playing field between businesses and reduce the economic distortions caused by special tax preferences. The tax code contains some \$130 billion in annual tax expenditures benefitting businesses.<sup>44</sup> The approximately \$100 billion for corporations represents a significant share (one-quarter to one-half) of all corporate tax revenues.

The relative generosity of these types of subsidies helps lead to vast differentials in the relative tax burdens of various industrial sectors. For example, according to financial statement research by New York University professor Aswath Damodaran, drug and biotechnology firms paid a small fraction of the statutory rate (effective rates of 4.5 and 5.6 percent, respectively); while heavy construction and trucking firms paid close to 35 percent (33.8 percent and 30.9 percent, respectively). Financial services firms paid 16.5 percent, while petroleum producers paid 11.3 percent.<sup>45</sup> The recent CTJ/ITEP analysis of corporate effective rates also found that corporate effective tax rates vary widely by industry: Financial firms, for example, paid 15.5 percent effective rates; miscellaneous manufacturing paid 23.1 percent; and engineering and construction paid 27.4 percent. CTJ/ITEP found that 56 percent of total tax subsidies went to four industries: financial; utilities; telecommunications; and oil, gas, and pipelines.<sup>46</sup>

By reducing unjustified preferences, Congress can level the playing field for competing investments. Removing tax-caused distortions can improve long-term economic growth; it can also reduce the deficit and potentially help pay for a corporate rate reduction.

To be sure, however, some business tax expenditures have economic justifications. The low-income housing tax credit, for example, helps address the dearth of affordable housing in many communities and cannot simply be eliminated. There is also a strong theoretical justification for the research tax credit, in that one firm's research and experimentation expenses may lead to innovations that benefit other firms and the broader economy. Congress should, however, conduct ongoing reviews of the credit's effectiveness in increasing innovative research above the levels that would exist in its absence. In general, Congress should apply the same level of scrutiny to these kinds of special tax breaks as it does to programs that spend taxpayer dollars directly. After all, as economists across the ideological spectrum recognize, tax "expenditures" are the economic equivalent of spending programs.<sup>47</sup>

In reviewing the tax expenditure budget, the critical question is not whether the sectors that receive special tax breaks support jobs or economic activity—of course they do—but whether there is a strong enough public policy reason to give them taxpayer subsidies not available to other businesses. A useful framework for evaluating special tax provisions is whether, if they were structured as direct-spending programs, they would make economic sense or represent the best use of taxpayer dollars.

The need to scrutinize the effectiveness of business tax expenditures highlights one final point: Tax reform is hard. Fiscally responsible reforms to corporate taxes are probably not possible without reforms to other aspects of the tax code, potentially affecting individuals and noncorporate businesses. Reform is extremely complex, and must be done right, which will take time.

\* \* \*

That brings me back to my central point, which is that while tax reform has the potential to enhance our economy's growth prospects over the long-term, it should not distract Congress from the urgent jobs crisis facing America today.

Thank you once again for the opportunity to appear today.

- <sup>1</sup> See Adam Hersh, *Misery is not an option: Economy needs more demand*, MarketWatch, July 29, 2011, [http://www.marketwatch.com/story/misery-is-not-an-option-economy-needs-more-demand-2011-07-29?link=MW\\_story\\_latest\\_news](http://www.marketwatch.com/story/misery-is-not-an-option-economy-needs-more-demand-2011-07-29?link=MW_story_latest_news).
- <sup>2</sup> Congressional Budget Office, Detailed Economic Projections, CY 2011-2021; Actual Data, 1950-2009, <http://cbo.gov/doc.cfm?index=12316>.
- <sup>3</sup> Statement of Congressional Budget Office Director Douglas Elmendorf, "Confronting the Nation's Fiscal Policy Challenges," before the Joint Select Committee on Deficit Reduction, Sept. 13, 2011, <http://www.cbo.gov/ftpdocs/124xx/doc12413/09-13-FiscalPolicyChallenges.pdf>.
- <sup>4</sup> Ben Casselman & Justin Lahart, *Companies Shun Investment, Hoard Cash*, Wall St. Journal, Sept. 17, 2011.
- <sup>5</sup> See Lawrence Mishel, *Regulatory Uncertainty: A Phony Explanation for Our Jobs Problem*, (Washington: Economic Policy Institute, Sept. 27, 2011); Kristina Costa & Michael Linden, *Five Canards About Job-Killing Regulations*, (Washington: Center for American Progress, Oct. 21, 2011, [http://www.americanprogress.org/issues/2011/10/regulation\\_canards.html](http://www.americanprogress.org/issues/2011/10/regulation_canards.html)).
- <sup>6</sup> Small business owners have identified "poor sales" as the single most important problem facing their businesses in recent surveys of small business owners conducted by the National Federation of Independent Businesses (NFIB). See Mishel, *Regulatory Uncertainty*, pp. 6-8.
- <sup>7</sup> Michael Ettlinger et al, *Spurring Job Creation in the Private Sector*, (Washington: Center for American Progress, Aug. 26, 2011), [http://www.americanprogressaction.org/issues/2011/08/private\\_sector\\_jobs.html](http://www.americanprogressaction.org/issues/2011/08/private_sector_jobs.html).
- <sup>8</sup> See Mark Zandi, *An Analysis of the Obama Jobs Plan*, Moody's Analytics, Sept. 9, 2011, [http://www.economy.com/dismal/article\\_free.asp?cid=224641](http://www.economy.com/dismal/article_free.asp?cid=224641); Macroeconomic Advisers, *American Jobs Act: A Significant Boost to GDP and Employment*, Sept. 8, 2011, <http://macroadvisers.blogspot.com/2011/09/american-jobs-act-significant-boost-to.html>.
- <sup>9</sup> The Center for American Progress recently proposed a comprehensive plan for balancing the budget, reforming the tax code, and promoting long-term growth. See Michael Ettlinger, Michael Linden & Seth Hanlon, *Budgeting for Growth and Prosperity* (Washington: Center for American Progress, May 2011), [http://www.americanprogress.org/issues/2011/05/budgeting\\_for\\_growth.html](http://www.americanprogress.org/issues/2011/05/budgeting_for_growth.html). The plan was developed as part of the Solutions Initiative convened by the Peter G. Peterson Foundation.
- <sup>10</sup> This scenario would extend all of the 2001-03 tax cuts, "patch" the AMT, and maintain all current "tax extenders." The current payroll tax holiday is not extended under this scenario.
- <sup>11</sup> The co-chairs of the President's Commission on Fiscal Responsibility and Reform ("Bowles-Simpson") proposed to increase revenues to 20.5 percent of GDP by 2021; the Bipartisan Policy Center's Debt Reduction Task Force ("Rivlin-Domenici") raised revenues to 21.4 percent of GDP by 2021; and the rough outline from the Senate's "Gang of Six" would raise revenues to 19.9 percent of GDP by 2021. See Michael Linden, *Obama Plan Lighter on Taxes than Bipartisan Plans*, (Washington: Center for American Progress, Sept. 26, 2011), [http://www.americanprogress.org/issues/2011/09/obama\\_plan\\_revenue.html](http://www.americanprogress.org/issues/2011/09/obama_plan_revenue.html).
- <sup>12</sup> Thomas Picketty & Emmanuel Saez, *Income Inequality in the United States, 1913-1998*, Quarterly Journal of Economics, 118(1), 2003, 1-39 (and 2008 update), available at <http://elsa.berkeley.edu/~saez/>.
- <sup>13</sup> Seth Hanlon, *Making More, Contributing Less* (Washington: Center for American Progress, Aug. 4, 2011), [http://www.americanprogress.org/issues/2011/08/millionaire\\_tax\\_rates.html](http://www.americanprogress.org/issues/2011/08/millionaire_tax_rates.html).
- <sup>14</sup> Congressional Budget Office, *Average Federal Taxes by Income Group* (June 2010).
- <sup>15</sup> Tax Policy Center, Table T11-0207. "Millionaires" are households with more than \$1,000,000 in cash income.
- <sup>16</sup> At 15 percent, the tax rate on long-term capital gains is the lowest since the 1930s; the 15 percent rate on qualified dividends is the lowest ever.
- <sup>17</sup> Congressional Budget Office, *Average Federal Taxes by Income Group* (June 2010) (2007 figures). CBO attributes employer-side payroll taxes to workers.
- <sup>18</sup> These figures include all federal taxes. See Thomas L. Hungerford, *An Analysis of the "Buffett Rule"* (Congressional Research Service, October 7, 2011); Sarah Ayres, *The Three Things You Need to Know About Millionaire Tax Rates* (Washington, Center for American Progress, Oct. 14, 2011), [http://www.americanprogress.org/issues/2011/09/millionaire\\_fast\\_facts.html](http://www.americanprogress.org/issues/2011/09/millionaire_fast_facts.html).
- <sup>19</sup> See Michael Ettlinger & John Irons, *Take a Walk on the Supply Side* (Washington, Center for American Progress, Sept. 12, 2008), [http://www.americanprogress.org/issues/2008/09/supply\\_side.html](http://www.americanprogress.org/issues/2008/09/supply_side.html).

- <sup>20</sup> Bureau of Labor Statistics, Total Private Employment (comparing August 1993 – February 2000; June 2001 – December 2007).
- <sup>21</sup> U.S. Small Business Administration, Office of Advocacy, based on data provided by the U.S. Census Bureau, Statistics of U.S. Business and Nonemployer Statistics, available at [http://www.sba.gov/sites/default/files/files/us\\_timeseries.pdf](http://www.sba.gov/sites/default/files/files/us_timeseries.pdf).
- <sup>22</sup> See Joint Committee on Taxation, *President Law and the President's Fiscal Year 2011 Budget Proposals Related to Selected Individual Income Tax Provisions Scheduled to Expire under the Sunset Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001* (JCT 36-10, July 14, 2010), p. 10; Urban-Brookings Tax Policy Center, Table T10-0186 (finding that only 2.5 percent of tax units reporting business income of any kind, and 3.2 percent of those reporting positive business income, would have fallen into the top two tax brackets in 2011 under President Obama's proposal to allow the 2001-03 tax cuts to expire for top earners).
- <sup>23</sup> This figure was derived by economist Martin A. Sullivan (Tax Notes, Sept. 12, 2011) from recent Treasury data in Knittel et al, *Methodology to Identify Small Businesses and Their Owners*, Office of Tax Analysis, Technical Paper 4, Aug. 2011.
- <sup>24</sup> Michael Linden, *The Myth of the Lower Marginal Rates* (Washington: Center for American Progress, June 20, 2011), [http://www.americanprogress.org/issues/2011/06/marginal\\_tax\\_charticle.html](http://www.americanprogress.org/issues/2011/06/marginal_tax_charticle.html); Linden, *Rich People's Taxes Have Little to Do with Job Creation* (Washington: Center for American Progress, June 27, 2011), [http://www.americanprogress.org/issues/2011/06/marginal\\_tax\\_employment\\_charticle.html](http://www.americanprogress.org/issues/2011/06/marginal_tax_employment_charticle.html).
- <sup>25</sup> U.S. Dep't of Treasury, *Treasury Conference on Business Taxation and Global Competitiveness, Background Paper* (July 23, 2007), table 5.3, <http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf>.
- <sup>26</sup> OMB Historical Tables, table 2.2.
- <sup>27</sup> Citizens for Tax Justice and the Institute for Taxation and Economic Policy have been analyzing the financial statements of the largest U.S. corporations since the early 1980s. The corporations included in their study paid an average effective tax rate of 14.1 percent in 1981-83, which rose to 26.5 percent shortly after the Tax Reform Act of 1986. In 1996-98 the average effective rate fell to 21.7 percent; and in 2002-03 it had fallen to 17.2 percent. The latest study, based on 280 profitable companies over the years 2008-10, found that the corporations paid an average effective rate of 18.5 percent. See Citizens for Tax Justice and the Institute for Taxation and Economic Policy, *Corporate Taxpayers & Corporate Tax Dodgers, 2008-10*, <http://ctj.org/corporatetaxdodgers/>, p. 9.
- <sup>28</sup> See U.S. Dep't of Treasury, *Treasury Conference on Business Taxation and Global Competitiveness, Background Paper* (July 23, 2007), table 2.1, <http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf>.
- <sup>29</sup> U.S. Dep't of Treasury, *Treasury Conference on Business Taxation and Global Competitiveness, Background Paper* (July 23, 2007), table 5.3, <http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf>.
- Using OECD data, the Treasury study divides corporate operating surplus by corporate remittances to derive a measure of average tax rates in each country.
- <sup>30</sup> *Treasury Background Paper* (2007), p. 43.
- <sup>31</sup> The CTJ/ITEP analysis only included companies that reported profits in all three years.
- <sup>32</sup> Reuven Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest U.S. and E.U. Multinationals* (draft of Oct. 24, 2011), available at <http://ssrn.com/abstract=1949226>.
- <sup>33</sup> A summary of such studies is found in Jane Gravelle, *International Corporate Tax Rate Comparisons and Policy Implications* (Washington: Congressional Research Service, Mar. 31, 2011).
- <sup>34</sup> Government Accountability Office, *U.S. Multinational Corporations: Effective Tax Rates Are Correlated with Where Income Is Reported* (GAO-08-950, Aug. 2008), <http://www.gao.gov/new.items/d08950.pdf>.
- <sup>35</sup> Roseanne Altshuler & Harry Grubert, *The Three Parties in the Race to the Bottom: Host Governments, Home Governments, and Multinational Companies*, 7 Fla. Tax Rev. 154 (2005) (attributing the decline to tax planning strategies developed after the introduction of the U.S. Treasury's "check the box" regulations in 1997); Edward D. Kleinbard, *Stateless Income*, 11 Fla. Tax Rev. \_\_\_ (2011) (forthcoming), pp. 33-57 (also discussing the enactment of IRC section 954(c)(6) in 2004).
- <sup>36</sup> Several illustrative (anonymous) examples of these techniques are described in Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCT 37-10, July 20, 2010).
- <sup>37</sup> See Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, Tax Notes (March 30, 2011).
- <sup>38</sup> Dep't of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (Nov. 2007); GAO (2008); Joint Committee on Taxation, *Present Law and Background Related to Possible*

*Income Shifting and Transfer Pricing* (JCX 37-10); Michael McDonald, *Income Shifting from Transfer Pricing: Further Evidence from Tax Return Data* (Dep't of Treasury, Office of Tax Analysis Technical Working Paper 2, July 2008); Statement of Martin A. Sullivan, "Transfer Pricing Issues in the Global Economy," before the Committee on Ways and Means, U.S. House of Representatives, July 22, 2010; Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, Tax Notes (Mar. 28, 2011).

<sup>39</sup> Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, Tax Notes (March 30, 2011). Martin Sullivan cites \$28 billion annually as a "lower bound" estimate. Sullivan, 7/22/10 testimony.

<sup>40</sup> J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 Emory L.J.79 (2009).

<sup>41</sup> Reuven Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest U.S. and E.U. Multinationals* (draft of Oct. 24, 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1949226](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1949226).

<sup>42</sup> Avi-Yonah & Lahav, p. 7.

<sup>43</sup> Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income* (JCX 33-11, May 20, 2011).

<sup>44</sup> President's Economic Recovery Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation* (Aug. 2010).

<sup>45</sup> Professor Damodaran's complete chart is available at <http://www.stern.nyu.edu/~adamodar/pc/archives/dbtfund09.xls>

<sup>46</sup> See Citizens for Tax Justice and the Institute for Taxation and Economic Policy, *Corporate Taxpayers & Corporate Tax Dodgers, 2008-10*, <http://ctj.org/corporatetaxdodgers/>, p. 8.

<sup>47</sup> Several economists and tax experts emphasized this point at a recent Senate Finance Committee hearing. Former Federal Reserve Board Chairman Alan Greenspan said: "Cuts in tax expenditures can be alternatively structured, and viewed, as cuts in outlays rather than a reduction in revenues. The deduction for interest on home mortgages, for example, could just as easily have been reconstituted as a subsidy payment to homeowners. Similarly, oil and gas depletion allowances could be restructured as subsidies to producers." President Ronald Reagan's chief economic advisor, Martin Feldstein, testified that when tax expenditures are reduced, "the economic effect is the same as any other reduction in government outlays." Edward Kleinbard, former director of Congress's Joint Committee on Taxation, explained that "deliberate Congressional subsidy programs baked into the tax code ... are a form of government spending, not tax reductions." Senate Finance Committee Hearing, "Examining Whether There is a Role for Tax Reform in Comprehensive Deficit Reduction and U.S. Fiscal Policy," Sept. 13, 2011.

# THE PRESIDENT'S FISCAL YEAR 2013 BUDGET PROPOSAL

TUESDAY, FEBRUARY 14, 2012

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, Murray, Nelson, Stabenow, Cardin, Whitehouse, Warner, Begich, Sessions, Grassley, Enzi, Crapo, Graham, Thune, Portman, Toomey, Johnson, and Ayotte.

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

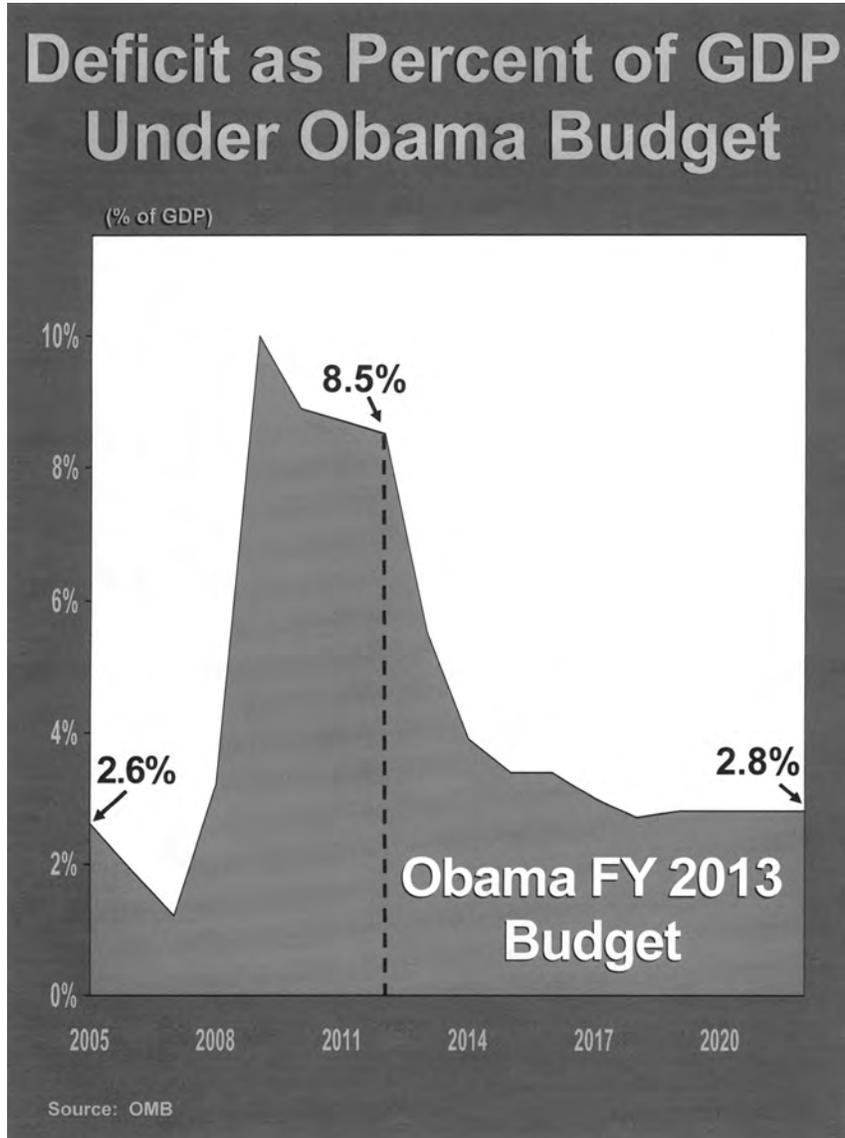
## OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I want to welcome Acting Director Zients back to the Budget Committee. Director Zients testified before the Budget Committee's Task Force on Government Performance in 2009 in a hearing chaired by Senator Warner. He was there in his role as the administration's Chief Performance Officer, so we want to welcome you back.

Today we will be examining the President's Fiscal Year 2013 Budget Proposal, which was sent to Congress yesterday. I believe the President's budget would continue to move the Nation in the right direction.

According to the administration, under the President's budget, the deficit as a share of the economy would fall from 8.5 percent of GDP in 2012 to 2.8 percent in 2022. That represents real progress.



It is important to remember the economic crisis that the President inherited. I think all of us remember back to 2008 and 2009 when we experienced the worst recession since the Great Depression. The economy actually contracted, it shrank, at a rate of almost 9 percent in the fourth quarter of 2008. We lost 800,000 private sector jobs in January of 2009 alone, and unemployment was surging. Those are the conditions the President inherited. They were not of his making. He was asked to come in as the cleanup crew.

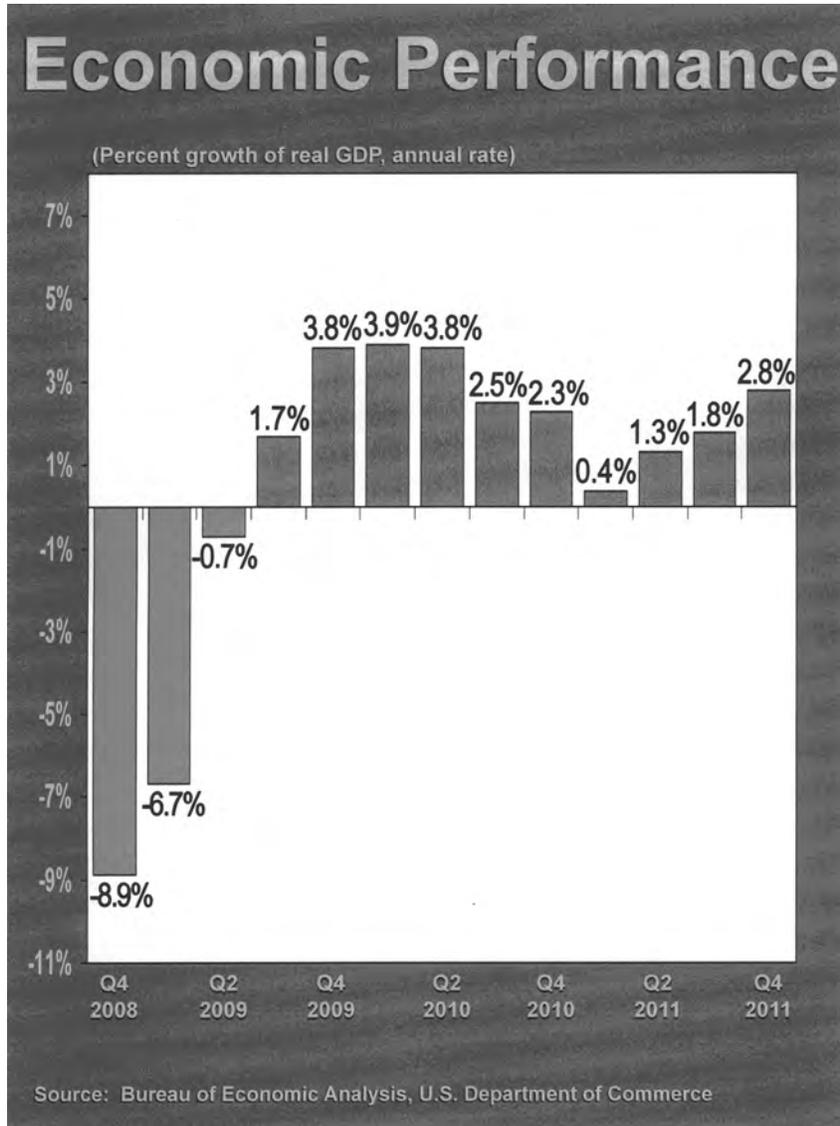
## **Economic Crisis of 2008-2009**

- **Worst recession since Great Depression**
- **Economy contracts 8.9% in 4<sup>th</sup> quarter of 2008**
- **800,000 jobs lost in January 2009 alone, unemployment surging**
- **Housing market crisis ripples through economy – homebuilding and sales plummet, record foreclosures**
- **Financial market crisis threatens global economic collapse – lending frozen**

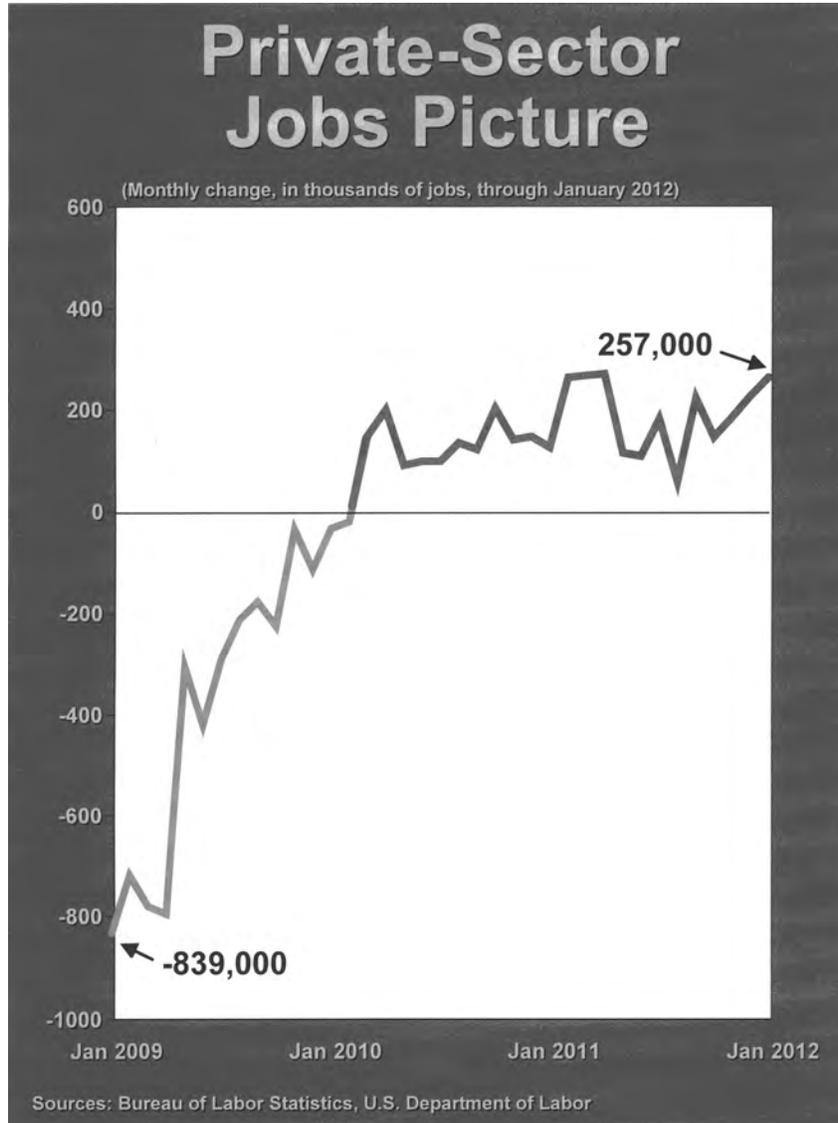
He also faced a housing market that was in crisis, with home building and home sales plummeting and a record level of foreclosures. And we faced a financial market crisis as well that threatened to set off a global financial collapse.

We have come a long way since then. The Federal response to the crisis, including actions taken by the Federal Reserve—and, to be fair, in the final days of the Bush administration they took important actions, the Obama administration did as well, and Congress participated. Those actions successfully pulled us back from the brink, and President Obama, I believe, deserves considerable credit for avoiding what could have been a second Great Depression.

As I noted earlier, in the fourth quarter of 2008 the economy shrunk at a rate of almost 9 percent. Positive economic growth returned in the third quarter of 2009, and we have now had ten consecutive quarters of economic growth.



We see a similar picture in the private sector jobs market. In January of 2009, the economy lost more than 800,000 private sector jobs. Private sector job growth returned in March of 2010, and we now have had 23 consecutive months of growth, with the last month over 250,000 jobs being created in this economy.



I think all of us would like to see even stronger economic growth and more job creation, but although unemployment is still too high, it has certainly come down substantially.

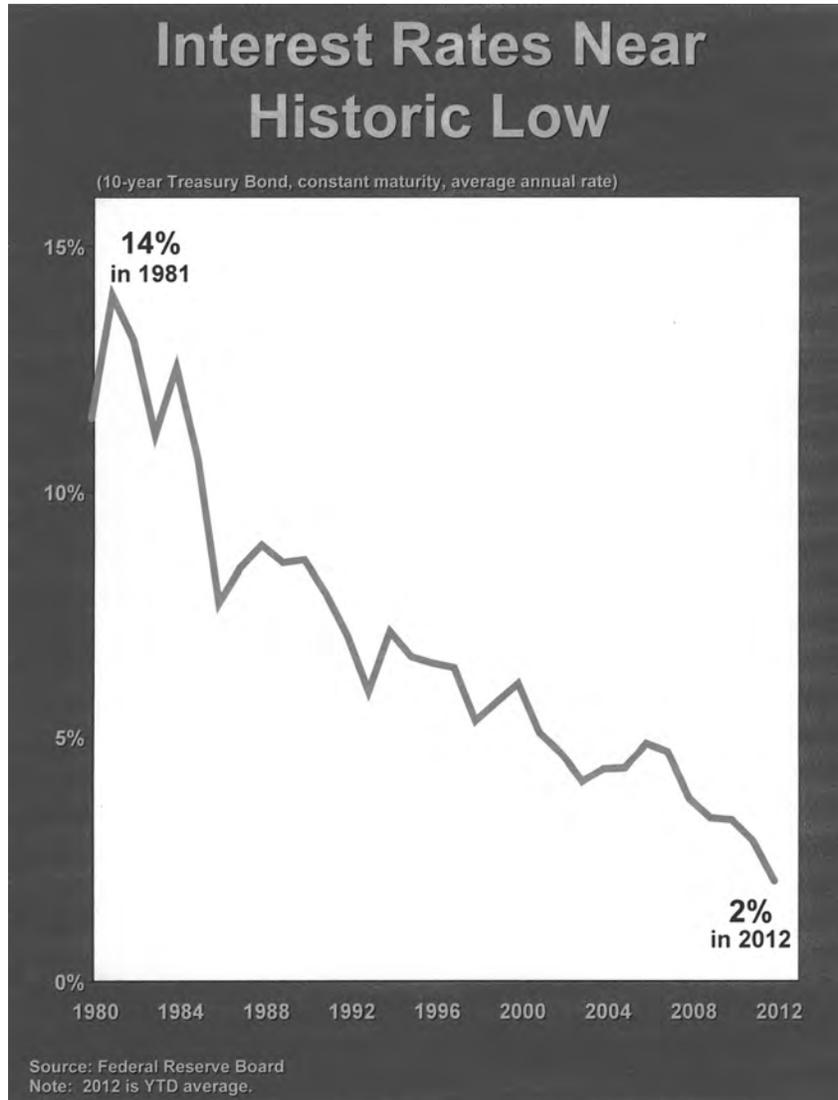
The pace of this recovery is somewhat predictable because the best scientific evidence we have now is that after a financial crisis, it takes longer to recover and weak unemployment continues for a longer period of time.

Looking forward, I believe we need to remember that we really face two critical problems in this economy, one short term and one longer term.

Short term, we are still recovering from the worst recession since the Great Depression, and that was not the result of the policies of President Obama. He inherited that condition. Although the economy is improving, we still have relatively weak demand for goods and services, which is holding back even stronger economic growth.

Longer term, we face a debt threat. Job one is to improve economic growth with steps to strengthen demand. Simultaneously, we need to enact a credible plan to bring down our debt. Our Republican colleagues I believe have completely overlooked the first problem of weak demand and would actively make that problem worse by imposing fiscal austerity right now. They have focused solely on the longer-term debt threat. As a result, their policy proposals of imposing fiscal austerity now would only further weaken demand, which would lower economic growth, kill job creation, and choke off the recovery.

I would just say to my colleagues, I believe they have it half right. Absolutely we have a long-term debt threat. We have to cope with that. But in the short term, what we have is weak demand, and we also have to cope with that.



The Republican proposals for immediate fiscal austerity would fit a circumstance in which we saw rising interest rates. But we do not see rising interest rates. In fact, interest rates are at a record low. The problem we have right now is weak demand.

Here is how another leading economist, Dr. Joel Prakken, the chairman of Macroeconomic Advisers, described the problem in his testimony before this Committee just weeks ago. He stated, "The number one problem that small businesses say they have to deal with right now is lack of demand. They do not say access to capital. They do not say the burden of regulation. They say their order books are thin."

## Economist Prakken on Lack of Demand

**“The number one problem that [small businesses] say they have to deal with right now is lack of demand. They do not say access to capital. They do not say burden of regulation.... They say their order books are thin.”**

– Dr. Joel Prakken, Chairman,  
Macroeconomic Advisers  
Testimony before Senate Budget Committee  
January 26, 2012

That is what we hear in every corner. The Chairman of the Federal Reserve has told us that. The head of CBO has told us that. And that is why companies are not hiring as fast as they might otherwise do, even though they have record profit levels and \$2 trillion sitting on their balance sheets. But we do need to address the second problem of rising debt, and this is where I agree with our colleagues on both sides who have made that a critical issue. And we should not wait to respond, but not by imposing fiscal austerity right now, but by adopting a plan that phases in fiscal discipline as the economy strengthens. We really need an economic two-step:

First, we need short-term strengthening of demand by investments in infrastructure. That would put people to work and make America more competitive.

Second, and simultaneously, we should adopt a credible and serious plan that puts us back on a sounder, long-term fiscal course by fundamental tax reform, by reforming the entitlements, and by cutting wasteful spending. All of that is required.

In his testimony before the Senate Budget Committee last week, Federal Reserve Chairman Bernanke addressed the need for this kind of two-step approach. He testified, and I quote: “Even as fiscal policymakers address the urgent issue of fiscal sustainability, they should take care not to unnecessarily impede the current economic recovery. Fortunately, the two goals of achieving long-term fiscal sustainability and avoiding additional fiscal headwinds for the current recovery are fully compatible. Indeed, they are mutually reinforcing.”

## Fed Chairman Bernanke on Addressing Long-Term Budget and Near-Term Economy

**“Even as fiscal policymakers address the urgent issue of fiscal sustainability, they should take care not to unnecessarily impede the current economic recovery. Fortunately, the two goals of achieving long-term fiscal sustainability and avoiding additional fiscal headwinds for the current recovery are fully compatible – indeed, they are mutually reinforcing.”**

– Federal Reserve Chairman Ben S. Bernanke  
Testimony before Senate Budget Committee  
February 7, 2012

To address the short-term lack of demand, the President’s budget includes a number of proposals that include:

One, extending the payroll tax cut and unemployment insurance benefits through 2012. I welcome the fact that we seem to have a breakthrough, at least on the payroll tax cut front;

Second, providing \$50 billion in up-front infrastructure investment for the construction of roads, bridges, rail, and airport facilities;

Third, extending the 100-percent business depreciation deduction for new investments. I can just say, as a small business participant myself, I can testify to the value of that;

Provide \$30 billion for school modernization;

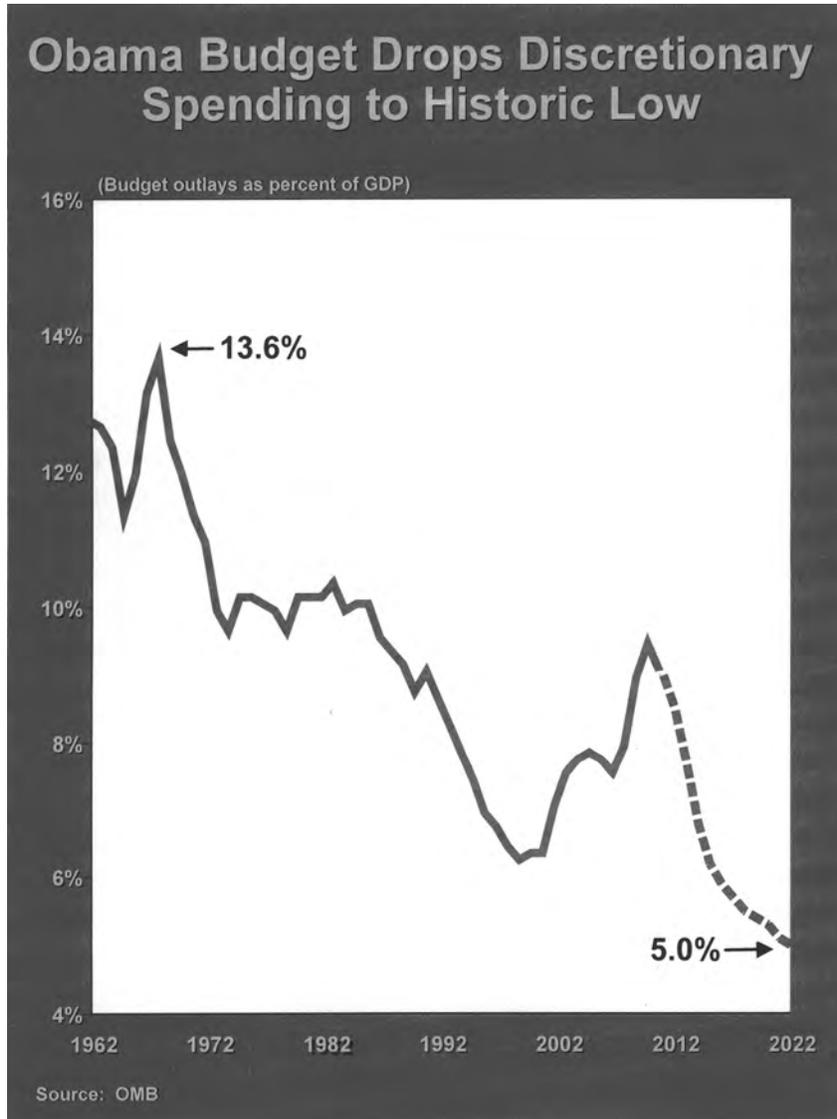
Provide \$30 billion to help States and localities retain and hire teachers and first responders establishing Project Rebuild to create jobs by restoring distressed communities;

And, finally, creating a new tax credit for small businesses that add jobs and increase wages.

## President Obama's Near-Term Job Creation Proposals

- Extend payroll tax cut and UI benefits through 2012
- \$50 B upfront infrastructure investment
  - road, rail, airport construction
- Continue 100% business depreciation deduction for new investments
- \$30 B for school modernization
- \$30 B to help states and localities retain and hire teachers, first responders
- Project Rebuild – creating jobs by restoring distressed communities
- New tax credit for small businesses that add jobs, increase wages

So my own evaluation of this budget is that it moves in the right direction. It does substantially reduce the deficit as a share of GDP, cutting it by two-thirds over the budget period. It reduces discretionary spending—let me put that slide up, if we can—to the lowest levels of share of our economy in 50 years—actually, in 60 years. You can see discretionary spending drops. Its previous high was 13.6 percent. This brings it down to 5 percent of our national income. That is a substantial change.



This budget also indicates the need for additional steps, but for additional steps to be taken, it is going to take all of us to find some way to come together.

I very much hope that even though this is an election year, we will come together on the longer-term challenge that we confront.

With that, we will turn to Senator Sessions for his remarks, and then we will go to the testimony of our witness, and then go to each of the members for their questions.

**OPENING STATEMENT OF SENATOR SESSIONS**

Senator SESSIONS. Thank you, Mr. Chairman, for your good leadership, and we appreciate the opportunity to work together.

Mr. Zients, thank you for appearing before the Committee. I wish it were in better circumstances and we had more money. The President of the United States, in my view, has no higher duty, no greater responsibility, than to protect the American people from a clear and present danger. Every expert and every witness that has testified before this Committee, they have said that we are on an unsustainable financial course that can lead to major deficits, a financial crisis.

Those appearing before our Committee have often called for a minimum of \$4 trillion in 10-year deficit reduction. Many of us, including Chairman Conrad, would like to achieve savings beyond that figure. Really, what we are trying to do and should do is lay out a plan to balance this budget over a period of years. Ten years would be a good goal, in my opinion.

We are not attempting through a massive austerity program to balance the budget this year. That cannot be done. That is not realistic, and that is not what I or Republicans would propose. Yet in the face of an existential economic threat, President Obama has submitted a budget yesterday which makes no alteration in our debt course.

Under the President's budget plan, using the White House's own numbers, the total Federal debt will hit approximately \$26 trillion, an increase of 75 percent from 2011. A 75-percent increase in total debt. Interest costs—interest costs—will rise from \$225 billion this year to \$850 billion annually, and the spending will increase. Spending overall will not be cut but will be increased by more than 60 percent by your own budget submission. This year's deficit will be the fourth consecutive deficit in excess of \$1 trillion.

Meanwhile, Medicare and Social Security, for which the President proposes no reforms, will continue on the path to insolvency. But if this were not bad enough, no serious solutions to serious problems, the White House has deliberately misrepresented their budget to the American people. The intent seems to be to lull them into complacency. The President claims his proposal would achieve \$4 trillion in deficit reduction over the 10 years. I guess we should all relax.

This is false, and I hope you will not repeat that number. Under the President's proposal, we will accumulate \$11.2 trillion in new debt. Under the debt limit agreement that we achieved as part of the debate over the debt limit last August, under current law—that is the law today—we will accumulate \$11.5 trillion to the gross debt over 10 years. At most, there is \$300 billion of deficit reduction in the President's budget, reducing debt to \$11.2 trillion, despite an almost \$2 trillion in job-killing tax increases.

So I would like to put to rest the argument that your predecessor, Mr. Jack Lew, now the White House Chief of Staff, made about avoiding short-term cuts in favor of long-term savings. So that is the mantra, and the Chairman mentioned it. But there are no spending cuts, short or long, in this budget.

Mr. Lew, now the President's Chief of Staff, made another false claim this weekend, saying that the Democratic Senate is not doing

a budget for the third straight year because it requires 60 Senate votes. The law is clear. It only takes 51 votes to pass a budget. If the Republicans are given the honor by the American people to lead this chamber next year, we will pass a budget, and it will be an honest budget, and it will change the debt course of America.

By contrast, the President sadly uses accounting tricks to conceal his budget's true cost. For instance, the White House repeals \$1.2 trillion in the Budget Control Act cuts we made just last summer. He does not count that as new spending, repealing the cuts we agreed to in law. They rightly—your budget rightly stops the planned cuts to Medicare providers, the doctor cuts, but without any money to pay for it.

The budget takes credit for discretionary caps, spending limits that are already in law, not part of this budget. And the budget pretends that war spending will continue at higher levels so that long-planned reductions in borrowing magically produce free money that can be spent somewhere else.

The war costs were not paid for by a dedicated stream of money. They were paid for by borrowed money. There is no money there to harvest.

So, Mr. Zients, I hope that we can have a candid discussion today. I hope we can move past election year rhetoric and convenient sound bites and talking points. The American people have a right to expect honesty, transparency, and accountability from the elected people. They deserve a budget that takes them off the unsustainable debt course Washington spenders have put them on. Your budget does not do so, and I look forward to the discussion today, and perhaps we can reach some agreements, even in this election year, that would at least modestly alter the course we are on.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Sessions.

Director Zients, please proceed with your testimony, and then we will open it up for questions from the members.

Mr. ZIENTS. Great.

Chairman CONRAD. And, again, welcome to the Committee, and thank you for your service. This is a very tough job at a difficult time, and I for one, and I think all members of the Committee, appreciate your service.

**STATEMENT OF THE HONORABLE JEFFREY ZIENTS, ACTING  
DIRECTOR AND DEPUTY DIRECTOR FOR MANAGEMENT, OF-  
FICE OF MANAGEMENT AND BUDGET**

Mr. ZIENTS. I appreciate being here, and I want to thank you, Mr. Chairman and Ranking Member Sessions and other members of the Committee.

Before I joined OMB 3 years ago, I had spent all of my time, about 20 years, in the private sector, and one thing that I found was that it was often helpful to boil things down to a few key graphics. So I am going to use some graphics here on the screen to walk through the highlights of the President's 2013 budget.

I am going to cover four topics: first, the current policy baseline; second, the key elements of deficit reduction; then an overview of our investments in the areas that are critical to our future competi-

tiveness and growth; and, finally, the bottom line of the President's budget and how it puts us on a sustainable path.

First, the baseline. We believe we have a baseline that accurately reflects current policy. In essence, in business we would think of this as "business as usual." The baseline includes the extension of the 2001 and 2003 tax cuts, estate and gift taxes; the permanent extension of the AMT and the SGR; the presentation, we believe, is more honest than patching these year after year; enforcement of the BCA caps and Joint Committee sequester; and accounting for future disaster costs rather than ignoring them. The baseline results in an annual deficit of 4.7 percent of GDP at the end of the budget window in 2022. This is where we start out before our policy takes effect.

Let me now turn to our deficit reduction policies. Last April, the President put forward a framework to achieve more than \$4 trillion in deficit reduction. You can see it here. I am going to take a few minutes to walk through this.

He maintained the \$4 trillion commitment in his proposal to the Joint Committee last September, and this year's budget is very similar to the September proposal, with the addition of a year to the budget window. As you can see on the far right in the green bar, the budget actually includes over \$5 trillion of total deficit reduction with the addition of this extra year to the budget window.

Let me walk you through the critical elements. I am going to go from left to right to build up to the \$5 trillion.

First, you will see on the far left \$676 billion in savings from the appropriations bills enacted last year, including both the 2011 appropriations in April and the OCO savings from the 2012 appropriations.

Next, over \$1 trillion in reductions in discretionary spending consistent with the caps in the BCA. There are \$362 billion in reduction from Medicare, Medicaid, and other health programs that will make these programs more effective and more efficient. Then \$272 billion in savings from reforming non-health mandatory programs in areas such as agriculture, Federal civilian worker retirement, the PBGC. These costs are net of the cost of new mandatory initiatives.

The next category, \$1.5 trillion of revenue for deficit reduction, including the expiration of the 2001 and 2003 tax cuts for the highest earners, and the elimination of inefficient and unfair tax breaks. The \$1.5 trillion number is a net number as we further cut taxes for the middle class and for small businesses.

Next, \$617 billion in net savings from capping OCO and investing in a 6-year surface transportation reauthorization. Capping OCO, importantly, closes the back door on security spending.

Then there is another category. It is a net savings of \$141 billion. It is a bit of a catch-all. This includes disaster adjustments, program integrity, and the general fund transfers for transportation that are no longer necessary given that we are paying for them in the previous bar. As a result of these proposals, debt service costs decrease by a total of \$800 billion.

Finally, in that small pink bar, there are \$176 billion of investments in short-term job initiatives that actually cut the other direc-

tion. These are investments. This is the remainder of the \$354 billion of job initiatives that are not spent in 2012.

I want to be clear that we do not count the sequester in our total deficit reduction. We believe that the sequester is bad policy, and we propose that it be replaced by this larger, more balanced package of deficit reduction. The bottom line is these efforts represent a total of more than \$5 trillion in net deficit reduction.

Even as we achieve this deficit reduction, we continue to make key investments in priority areas. These include: short-term measures for job growth totaling \$354 billion; tax breaks for the middle class and small businesses, amounting to \$352 billion; and continued investment in our long-term priorities. These include education and training for American workers, innovation in R&D, clean energy, and infrastructure. We make these investments in a budget that abides by the very tight spending caps and makes hard trade-offs.

Let me pull this all together now. On the left, I have compared the adjusted baseline we discussed in the first slide with the results of the President's policies. As you can see, in 2022 deficits from the President's policies are below 3 percent of GDP compared to 4.7 percent in the baseline. Furthermore, debt as a percent of GDP is stabilized from 2018 on. This is important for maintaining a strong investment environment.

The President's budget replaces the sequester with a balanced approach to deficit reduction, with \$2.50 in spending cuts for every \$1 of revenue increases. We have made tough choices, and we all need to work together to maintain this balanced approach.

In closing, as a business person and now as Acting OMB Director, I believe the President's budget makes the right investments to make us even more competitive in the global marketplace, and achieving declining deficits and stabilizing our debt are critical for business confidence and investment. This is good for business, good for the middle class, and good for America.

I look forward to taking your questions.

[The prepared statement of Mr. Zients follows:]

**TESTIMONY OF  
JEFF ZIENTS  
ACTING DIRECTOR AND DEPUTY DIRECTOR OF MANAGEMENT  
OFFICE OF MANAGEMENT AND BUDGET  
BEFORE  
SENATE COMMITTEE ON THE BUDGET**

*February 14, 2012*

Mr. Chairman, Mr. Ranking Member, members of the Committee, thank you for welcoming me here today, and giving me the opportunity to present the President's 2013 Budget.

Let me start by saying that at the beginning of the year, I did not expect to be sitting in this seat before you today. But, as you know, the President asked Jack Lew to serve him as White House Chief of Staff, and then asked me to serve as Acting Director.

I do not come to the job with the same experience as my two predecessors: I am not a former OMB Director or former CBO Director. What I do bring to this role is a perspective forged from nearly three years at OMB overseeing the agency's management efforts and from two decades before that in the private sector, leading public companies. I know many of you also bring private sector experience to your public service, and I look forward to the discussion we can have today.

The President's Budget is built on the idea that our country has always done best when everyone gets a fair shot, everyone does their fair share, and everyone plays by the same rules. We are all in this together: when the middle class is shrinking and families no longer can afford the goods and services that businesses are selling, it drags down the entire economy. Similarly, countries with less inequality tend to have stronger and steadier economic growth over the long term.

By following these quintessentially American values of equal opportunity for all and responsibility from all, we can build an economy that will grow robustly and create good jobs for years to come – and we can pursue deficit reduction that is balanced and will put the country on a sustainable fiscal path. This Budget lays out the President's vision to do both. In it, we make tough choices – cutting waste where we can as well as some valuable programs that we would not cut if not for the fiscal situation. We put forward a plan to support and strengthen economic growth now so we can get more Americans back to work. And to meet the tight spending constraints that the President signed into law and insisted be a part of his Budget, we re-allocate resources to allow targeted investments so that we have an economy in years to come that is based not on speculation and bubbles, but one that is built on the solid foundation of an educated and skilled workforce, cutting-edge innovation, and world-class infrastructure.

To understand our approach to the Budget, let me review the progress we have made since the President was elected and the challenges that we face today.

*WHERE WE HAVE BEEN*

When the President took office, the economy was losing over 700,000 private sector jobs a month, and experiencing the worst two quarters of growth since the end of World War II. Many thought that we were on the brink of a second Great Depression.

But long before this recession hit, there was a widespread feeling that hard work had stopped paying off; that fewer and fewer of those who contributed to the success of our economy actually benefited from that success. Those at the very top grew wealthier while everyone else struggled with paychecks that did not keep up with the rising cost of everything from college tuition to groceries. And as a result, too many families found themselves taking on more and more debt just to keep up—often papered over by mounting credit card bills and home equity loans.

Then, in the middle of 2008, the house of cards collapsed. Too many mortgages had been sold to people who could not afford—or even understand—them. Banks had packaged too many risky loans into securities and then sold them to investors who were misled or misinformed about the risks involved. Huge bets had been made and huge bonuses had been paid out with other people's money. And the regulators who were supposed to prevent this crisis either looked the other way or did not have the authority to act.

In the end, this growing debt and irresponsibility helped trigger the worst economic crisis in generations. Combined with new tax cuts and new mandatory programs that had never been paid for, it threw our country into a deep fiscal hole. And millions of hardworking Americans lost their jobs, their homes, and their basic economic security.

Due to swift action taken by the President shortly after taking office, the nation avoided what could have been a second Great Depression. We have now experienced 23 consecutive months of private sector job growth, with 3.2 million jobs created. In just the first few months of 2009, the President's strong leadership produced a Recovery Act to bolster American families against the worst of the crisis, as well as a rescue of the auto industry and the stabilization of our financial system which, together, prevented our economy from spiraling into a deep depression.

When my predecessor last appeared in front of this Committee to present the President's budget, our economy was gaining traction after enduring a historic recession and coming back from the brink of a depression. During the previous six quarters, real gross domestic product (GDP) had grown at an average annual rate of 3 percent and, over the previous 12 months, the private sector had created 1.3 million new jobs. The financial system was no longer in crisis. The credit and capital markets were functioning, and the cost of stabilizing the financial and automobile sectors was amounting to a fraction of initial estimates. Yet we also subsequently have learned that the recession was deeper than many experts first thought: revised estimates showed that the economy contracted at an 8.9 percent annualized rate in the last quarter of 2008, from an original projection of 3.8 percent, the largest quarterly downward revision in history.

Then, a trio of world events created strong headwinds that challenged the economic expansion: uprisings in the Middle East that sent oil prices higher; an earthquake in Japan that prevented American auto and manufacturing companies from getting the supplies they needed to keep our

factories producing; and widespread sovereign debt concerns in Europe that roiled markets across the globe. In addition, the willingness of some Republicans in Congress to risk the first default in our Nation's history over the statutory debt ceiling and the subsequent downgrade by Standard & Poor's of the long-term sovereign rating of U.S. Treasuries and other debt tied to the U.S. credit rating kept financial markets on edge and appeared to rattle consumer confidence.

In the face of these headwinds, the policies enacted by the President played a key role in keeping the economy moving forward. Because of the policies that the President fought for, the typical working family received a \$1,000 payroll tax cut in 2011, and millions of Americans pounding the pavement looking for jobs could continue to receive unemployment insurance. This provided crucial insurance against headwinds buffeting our economy.

While there are lingering concerns over the financial developments in Europe and the risk they pose to the U.S. economy, the pace of real GDP growth picked up in the second half of last year. Despite these encouraging signs, economic growth is not strong enough to create enough good jobs for all the Americans who want to work or robust enough to restore for the middle class the security and opportunity they deserve.

At the same time, our country still faces the consequences of years of fiscal irresponsibility. When the President took office, he inherited an annual deficit of \$1.3 trillion and projected deficits of trillions more in the years thereafter. Driving these deficits were decisions made over the previous eight years not to pay for two tax cuts and a Medicare prescription drug benefit. The deficits were then exacerbated by the recession: the sharp decline in receipts, steep increase in automatic outlays to help those in need, and efforts needed to jumpstart economic growth.

Recognizing the challenges still facing the economic recovery over the past year, the Administration pursued both short-term efforts to boost economic growth and job creation plus comprehensive, balanced initiatives to put the United States on the path toward fiscal stability were both needed. These are complementary policies: A growing economy is necessary for long-term deficit reduction, and likewise, long-term deficit reduction and fiscal sustainability is necessary to sustain and strengthen economic growth for years to come.

That is why the President pursued significant, balanced deficit reduction throughout calendar year 2011: first, in his 2012 Budget; then, in the Framework for Shared Prosperity and Shared Fiscal Responsibility released in April that built on the Budget to identify \$4 trillion in deficit reduction; next, in a similarly sized plan presented to congressional Republicans during negotiations over extending the debt ceiling during the summer; and finally in the President's Plan for Economic Growth and Deficit Reduction that was presented to the Joint Committee on Deficit Reduction in September. It also is why the President proposed the American Jobs Act (AJA) in September of 2011, a plan to put more people back to work, put more money in the pockets of working Americans, and do so without adding a dime to the deficit. This combination of tax cuts, infrastructure investments, and aid to those seeking work would give the economy a needed boost through this difficult time.

Unfortunately, at each step, partisan divides and an unwillingness by many in Congress to ask the wealthiest among us to pay their fair share through any revenue increases prevented a

comprehensive deficit reduction agreement or measures in the AJA to boost demand from being enacted. Indeed, this lack of real progress on both the AJA and deficit reduction actually became a drag in and of itself on an economy already struggling to recover from a severe recession and battling significant headwinds from events around the globe.

As we look toward the next fiscal year, the challenges of this past year persist: we need to boost economic growth and job creation now and take the steps necessary to put the country on a fiscally sustainable path.

***PUTTING THE NATION ON A FISCALLY SUSTAINABLE PATH***

In this year's Budget, the President continues to pursue policies that will shore up our economy and our fiscal situation. Together with the deficit reduction he signed into law this past year, this Budget will cut the deficit by well over \$4 trillion over the next decade. This will put the country on a course to a level of deficits below 3 percent of GDP by 2018, and will also allow us to stabilize the Federal debt relative to the size of the economy. To achieve these results, this Budget contains a number of steps to put us on a fiscally sustainable path.

First, this Budget implements the tight discretionary spending caps that the President signed into law in the Budget Control Act of 2011. These caps will generate more than \$1 trillion in deficit reduction over the next decade, and reduce discretionary spending from 8.7 percent of GDP in 2011 to 5.0 percent in 2022, the lowest this type of spending has been since President Eisenhower sat in the Oval Office.

Meeting the spending targets in this Budget meant some very difficult choices: reforming, consolidating, or freezing programs where we could; cutting programs that were not effective or essential and even some that were, but are now unaffordable; and precisely targeting our investments. Every department will feel the impact of these reductions as they cut programs or tighten their belts to free up more resources for areas critical to economic growth. In fact, for every \$1 in new revenue from those making more than \$250,000 per year, the Budget proposes \$2.50 in spending cuts.

And throughout the entire Government, we will continue our efforts to make programs and services work better and cost less: using competition and high standards to get the most from the grants we award; getting rid of excess Federal real estate; and saving billions of dollars by cutting overhead and administrative costs.

Second, to build on the work we have done to reduce health care costs through the Affordable Care Act, the President is proposing more than \$360 billion in reforms to Medicare, Medicaid, and other health programs over 10 years. The goal of these reforms is to make these critical programs more effective and efficient, and help make sure our health care system rewards high-quality medicine. What it does not do—and what the President will not support—are efforts to turn Medicare into a voucher or Medicaid into a block grant. Doing so would weaken both programs and break the promise that we have made to American seniors, people with disabilities, and low-income families.

Third, to address other looming, long-term challenges to our fiscal health, the Administration has put forward a wide range of mandatory savings. These include reductions in agriculture programs, changes in Federal employee retirement and health benefits, reforms to the unemployment insurance system, and new efforts to provide a better return to taxpayers from mineral development. Reflecting the plan the President presented to the Joint Select Committee on Deficit Reduction, these mandatory proposals would save \$270 billion over the next decade.

Fourth, this Budget begins the process of implementing the President's new defense strategy that reconfigures our force to meet the challenges of the coming decade. Over the past three years, we have made historic investments in our troops and their capabilities, military families, and veterans. After a decade of war, we are at an inflection point: American troops have left Iraq; we are undergoing a transition in Afghanistan so Afghans can assume more responsibility; and we have debilitated al Qaeda's leadership, putting that terrorist network on the path to defeat. At the same time, we have to renew our economic strength here at home, which is the foundation of our strength in the world, and that includes putting our fiscal house in order. To ensure that our defense budget is driven by a clear strategy that reflects our national interests, the President directed the Secretary of Defense and military leadership to undertake a comprehensive strategic review.

The President presented the results of the review, reflecting the full support of our Nation's military leadership, at the Pentagon on January 5. There are several key elements to this new strategy. To sustain a global reach, we will strengthen our presence in the Asia Pacific region and continue vigilance in the Middle East. We will invest in critical partnerships and alliances, including NATO, which has demonstrated time and again—most recently in Libya—that it is a force multiplier. Looking past Iraq and Afghanistan to future threats, the military no longer will be sized for large-scale, prolonged stability operations. The Department of Defense will focus modernization on emerging threats and sustaining efforts to get rid of outdated Cold War-era systems so that we can invest in the capabilities we need for the future, including intelligence, surveillance, and reconnaissance capabilities. The Administration will continue to enhance capabilities related to counterterrorism and countering weapons of mass destruction, and we will also maintain the ability to operate in environments where adversaries try to deny us access. And, we will keep faith with those who serve by giving priority to our wounded warriors, servicemembers' mental health, and the well-being of military families.

Adapting our forces to this new strategy will entail investing in high-priority programs, such as unmanned surveillance aircraft and upgraded tactical vehicles. It will mean terminating unnecessary and lower-priority programs such as the C-27 airlift aircraft and a new weather satellite, and maintaining programs such as the Joint Strike Fighter at a reduced level. All told, reductions in the growth of defense spending will save \$487 billion over the next 10 years. In addition, the end of our military activities in Iraq and the wind-down of operations in Afghanistan will mean that the country will spend 24 percent less on overseas contingency operations (OCO) this year than it did last year, saving \$30 billion. The Budget also includes a multi-year cap on OCO spending so that we fully realize the dividends of this change in policy.

Finally, the President believes deeply that in our country, everyone must shoulder their fair share — especially those who have benefited the most from our economy. In the United States of

America, a teacher, a nurse, or a construction worker who earns \$50,000 a year should not pay taxes at a higher rate than somebody making \$50 million. This is not about class warfare; this is about the Nation's well-being. This is about making fair choices that benefit not just the people who have done fantastically well over the last few decades –such as myself or the President, but that also benefit the middle class, those fighting to get into the middle class, and the economy as a whole.

In the Budget, the Administration calls for individual tax reform that: cuts the deficit by \$1.5 trillion, including the expiration of the high-income 2001 and 2003 tax cuts; eliminates inefficient and unfair tax breaks for millionaires while making all tax breaks at least as good for the middle class as for the wealthy; and observes the Buffett Rule that no household making more than \$1 million a year pays less than 30 percent of their income in taxes. In addition, the Administration proposes a \$61 billion Financial Crisis Responsibility Fee on largest financial institutions to fully compensate taxpayers for their extraordinary support during the depths of the financial crisis. This will offset the cost of TARP and pay for the President's mortgage refinancing program which will help thousands of homeowners keep their homes.

Reining in our deficits is not an end in and of itself. It is a necessary step to rebuilding a strong foundation so our economy can grow and create good jobs. That is our ultimate goal. And as we tighten our belts by cutting, consolidating, and reforming programs, we also must invest in the areas that will be critical to giving every American a fair shot at success and creating an economy that is built to last.

That starts with taking action now to strengthen our economy and boost job creation. We need to finish the work we started last year by extending the payroll tax cut and unemployment benefits for the rest of this year. We also need to take additional measures to put more people back to work. That is why the President introduced the AJA last year, and why the Budget contains nearly \$375 billion in short-term measures for job growth starting in 2012, including many planks of the AJA that were not enacted plus some new job creation initiatives to put people back to work by rebuilding our infrastructure, providing businesses tax incentives to invest and hire, and giving States aid to rehire teachers and first responders.

We also know that education and lifelong learning will be critical for anyone trying to compete for the jobs of the future. That is why the President will continue to make education a national mission. What one learns will have a big impact on what he or she earns: the unemployment rate for Americans with a college degree or more is only about half the national average, and the incomes of college graduates are twice as high as those without a high school diploma.

When the President took office, he set the goal for America to have the highest proportion of college graduates in the world by 2020. To reach that goal, we increased the maximum annual Pell Grant by more than \$900 to help nearly 10 million needy students afford a college education. The 2013 Budget continues that commitment, provides the necessary resources to sustain the maximum award of \$5,635, and takes tough steps to improve the financial footing of the Pell program in 2014 as well. In this Budget, the President proposes a series of new proposals to help families with the costs of college including making permanent the American Opportunity Tax Credit, a partially refundable tax credit worth up to \$10,000 per student over four years of

college, and rewarding colleges and universities that act responsibly in setting tuition, providing the best value, and serving needy students well.

To help our students graduate with the skills they will need for the jobs of the future, we are continuing our effort to prepare 100,000 science and math teachers over the next decade. To improve our elementary and secondary schools, we are continuing our commitment to the Race to the Top initiative that rewards the most innovative and effective ways to raise standards, recruit and retain good teachers, and raise student achievement. The Budget invests \$850 million in this effort, which already has been expanded to cover early learning and individual school districts.

And to prepare our workers for the jobs of tomorrow, we need to turn our unemployment system into a re-employment system. That includes giving more community colleges the resources they need to become community career centers—places that teach skills that businesses are looking for right now, from data management to high-tech manufacturing’ creating a Pathways Back to Work Fund, which will support summer and year-round jobs for low-income youth, and will help connect the long-term unemployed and low-income adults to subsidized employment and work-based training opportunities; and reforming Career and Technical Education.

Once our students and workers gain the skills they need for the jobs of the future, we also need to make sure those jobs end up in America. In today’s high-tech, global economy, that means the United States must be the best place in the world to take an idea from the drawing board to the factory floor to the store shelves. In this Budget, we are investing \$140.8 billion for R&D overall; increasing the level of investment in non-defense R&D by 5 percent from the 2012 level, even as overall budgets decline; and maintaining the President’s commitment to double the budgets of three key basic research agencies (National Science Foundation, Department of Energy’s Office of Science, and National Institute of Standards and Technology Laboratories). To make sure that more goods are stamped with “Made in America,” the Budget dedicates \$2.2 billion for advanced manufacturing R&D, a 19 percent increase over 2012. And while a tight budget environment means that we are proposing level funding for biomedical research at National Institutes of Health (\$30.7 billion), we are getting out of the money through new grant management policies that will increase the number of new research grants by 7 percent.

Moreover, this Budget continues the Administration’s commitment to developing America’s diverse, clean sources of energy. The Budget eliminates unwarranted tax breaks for oil companies, while extending key tax incentives to spur investment in clean energy manufacturing and renewable energy production. The Budget also invests in R&D to catalyze the next generation of clean energy technologies. These investments will help us achieve our goal of doubling the share of electricity from clean energy sources by 2035. By promoting American leadership in advanced vehicle manufacturing, including funding to encourage greater use of natural gas in the transportation sector, the Budget will help us reach our goal of reducing oil imports by one-third by 2025 and position the United States to become the first country to have one million electric vehicles on the road by 2015. We also are working to decrease the amount of energy used by commercial and industrial buildings by 20 percent to complement our ongoing efforts to improving the efficiency of the residential sector. And we will work with the private

sector, utilities, and States to increase the energy productivity of American industries while investing in the innovative processes and materials that can dramatically reduce energy use.

It is also time for government to do its part to help make it easier for entrepreneurs, inventors, and workers to grow their businesses and thrive in the global economy. The President is calling on Congress to immediately begin work on corporate tax reform that will close loopholes, lower the overall rate, encourage investment here at home, simplify taxes for America's small businesses, and not add a dime to the deficit. Moreover, to further assist these companies, we need a comprehensive reorganization of the parts of the Federal Government that help businesses grow and sell their products abroad. If given consolidation authority—which Presidents had for most of the 20<sup>th</sup> century—the President will propose to consolidate six agencies into one Department, saving money, and making it easier for all companies—especially small businesses—get the help they need to thrive in the world economy.

Finally, this Budget advances the national security interests of the United States, including the security of the American people, the prosperity and trade that creates American jobs, and support for universal values around the world. It increases funding for the diplomatic efforts that strengthen the alliances and partnerships that improve international cooperation in meeting shared challenges, open new markets to American exports, and promote development. It invests in the intelligence and homeland security capabilities to detect, prevent, and defend against terrorist attacks against our country.

As we implement our new defense strategy, my Administration will invest in the systems and capabilities we need so that our Armed Forces are configured to meet the challenges of the coming decade. We will continue to invest in improving global health and food security so that we address the root causes of conflict and security threats. And we will keep faith with our men and women in uniform, their families, and veterans who have served their Nation.

These proposals will take us a long way towards strengthening the middle class and giving families the sense of security they have been missing for too long. But in the end, building an economy that works for everyone will require all of us to take responsibility. Parents will need to take greater responsibility for their children's education. Homeowners will have to take more responsibility when it comes to buying a house or taking out a loan. Businesses will have to take responsibility for doing right by their workers and our country. And those of us in public service will need to keep finding ways to make government more efficient and more effective.

Understanding and honoring the obligations we have to ourselves and each other is what has made this country great. We look out for each other, pull together, and do our part. But Americans also deserve to know that their hard work will be rewarded.

This Budget is a step in the right direction. And we hope that it will help serve as a roadmap for how we can grow the economy, create jobs, and give Americans everywhere the security they deserve.

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.

Jeff Zients

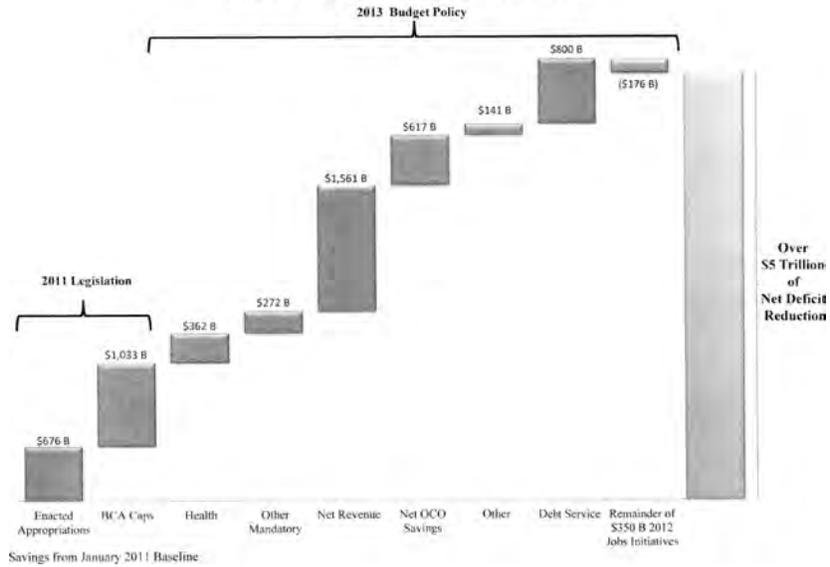
Acting Director and Deputy Director of  
Management

Office of Management and Budget

## **Current Policy Baseline**

- Extension of '01-'03 tax cuts, estate and gift taxes
- Permanent extension of the AMT and SGR (“doc fix”) patches
- Includes BCA caps and Joint Committee enforcement
- Placeholder for future disaster costs
- Deficit as percentage of GDP 4.7% in 2022

# Deficit Reduction

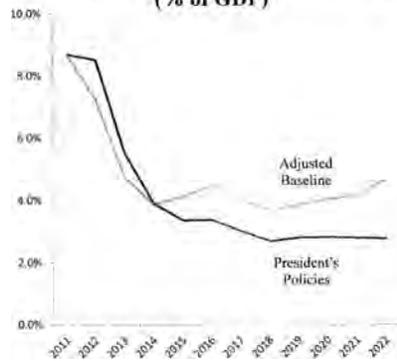


## **Key Initiatives**

- Short-term measures for job growth to maintain progress of the economic recovery (\$354 Billion)
- Tax breaks for the middle class and small businesses (\$352 Billion)
- Continued investment in key priorities, including:
  - Education and job training
  - Innovation and R&D
  - Clean energy
  - Infrastructure

## Balanced Deficit Reduction

**Adjusted Baseline and Policy**  
(% of GDP)



- Deficit below 3% of GDP with debt stabilized from 2018 on
- Replace \$1.2 trillion sequester with the President's larger package of deficit reduction
- Balanced approach -- \$2.50 in spending cuts for every \$1.00 of revenue increases

Chairman CONRAD. Thank you, Director Zients, for that testimony.

Let me start out by saying that I have seen the President criticized for not cutting the deficit in half in his first term. What was the deficit of the share of GDP that he inherited? Do you recall?

Mr. ZIENTS. It was over 9 percent.

Chairman CONRAD. I believe that first year it was 10.1 percent. In 2013, what will the deficit be as a share of GDP?

Mr. ZIENTS. 5.5 percent.

Chairman CONRAD. So that is pretty close to being cut in half. What will it be in 2014?

Mr. ZIENTS. It will achieve the cutting in half. The exact percent I can get for you, but by 2014 we will cut it in half.

Chairman CONRAD. All right. The second question I would have is the question of revenues. Under the President's plan, revenues will average what share of GDP over the budget period?

Mr. ZIENTS. A little below 20 percent.

Chairman CONRAD. A little below 20 percent. I would just say, the Fiscal Commission, which has been lauded for reaching a bipartisan agreement, had a level of 20.3 percent at the end of its budget period. During the Clinton years, revenue averaged about 19.4 percent. So the level of revenue that the President is calling for is completely in keeping with what the bipartisan Fiscal Commission members recommended and what we saw during the Clinton years, which as the longest period of uninterrupted economic growth in the Nation's history.

Let me ask a second question—a third question. The Ranking Member has said that the President over the 11 years that is included in his calculation increased spending 62 percent. Do you know how much President Reagan increased spending in the 8 years of his administration?

Mr. ZIENTS. I believe that was 69 percent across the 8 years from 1981 to 1989.

Chairman CONRAD. And can you tell us how much President Bush increased spending in his 8 years? I am talking about Bush 44.

Mr. ZIENTS. Yes, from 2001 to 2009, 89 percent.

Chairman CONRAD. So the fact is those Republican Presidents over shorter periods of time increased spending much more than this President is proposing. So I just think those facts are important.

Again, President Reagan in just 8 years increased spending 69 percent. President Bush, George W. Bush, increased spending 89 percent over 8 years. This President is being criticized for increasing over 11 years, a longer period, 62 percent, which is less than either of the others.

With respect to the question of Mr. Lew's statement of a budget requiring 60 votes, I assume he was referring to the Budget Control Act that we passed last year that did require 60 votes. Is that your understanding?

Mr. ZIENTS. Absolutely.

Chairman CONRAD. You know, that is different than a budget resolution. A budget resolution does only require a simple majority. But a budget resolution never goes to the President for signature.

Mr. ZIENTS. Right.

Chairman CONRAD. Last year, we passed a Budget Control Act that is a law. That passed not only the House and the Senate—and, of course, required 60 votes in the Senate—but was signed by the President. So it is the law.

Let me ask one other question, if I could, because I am running out of time. The hard reality here is that budgets and what we do with fiscal policy is inextricably linked to the economic outcomes that this country experiences. And if we look back at what this President walked into, isn't it true that the economy was shrinking at a rate of almost 9 percent in the final quarter of the previous administration?

Mr. ZIENTS. Yes, it was.

Chairman CONRAD. And isn't it a fact that the economy is now growing in the most recent quarter at a rate of about 2.5 percent?

Mr. ZIENTS. Yes.

Chairman CONRAD. So that is a turnaround that is really quite remarkable, from the economy shrinking at a rate of 9 percent to an economy growing at a rate of 2.5 percent. I believe the President deserves some credit for helping engineer that turnaround.

The same is true with respect to jobs. Isn't it true that in the first month of 2009 that we lost 800,000 jobs in the private sector?

Mr. ZIENTS. Unfortunately, yes.

Chairman CONRAD. Of course, that was not a result of this President's policies. He did not take office until two-thirds of the way through that month. And now, in the most recent report, the most recent monthly report, we gained 250,000 jobs in the private sector. Isn't that the case?

Mr. ZIENTS. Yes.

Chairman CONRAD. So it appears to me the President should be able to ask the American people to support a policy that has brought us back from the brink, and I assume that it is his intention with this budget to try to further the economic recovery and further help create jobs in the private sector. Is that the underlying strategy?

Mr. ZIENTS. I think you captured it well in your opening statement, that it is a two-step: it is to make sure that we continue this recovery, starting with making sure that we extend the payroll tax holiday so 160 million Americans do not have a tax increase; doing the types of investments, the \$50 billion that you mentioned in infrastructure, the \$30 billion to modernize our schools; and at the same time start to put ourselves on a path towards deficit reduction that by 2018 has debt as a percent of GDP stabilized with our deficits coming down each year.

Coming back to the figure for 2014 that you mentioned, by 2014 we are down to 3.9, which is not where we want to go but a heck of a lot better than the 10.5 percent that you referenced that the President inherited up front.

Chairman CONRAD. I thank you.

We are going to do 5-minute rounds this morning. Hopefully we will get to a second round. Senator Sessions certainly may consume the time I did.

Senator SESSIONS. Thank you, Mr. Chairman.

Well, putting us on the path to deficit reduction—sometime in the future we will have deficit reduction—is not achieving deficit reduction, and the President surged spending the first two years of his time in office, which the Chairman did not refer to when he talked about how much the proposed growth of 62 percent would include. It would be a lot more if you included the surging of spending, including the stimulus and the 24 percent increase in two years in discretionary non-defense spending.

But I would say that Mr. Lew, on his CNN program, said, “You cannot pass a budget in the Senate of the United States without 60 votes,” close quote.

Mr. Zients, is it not true that based—that the current law, which included the Budget Control Act, the legislation that passed as part of raising the debt limit, that your budget spends more money than Congress proposed to spend through the Budget Control Act process over the next ten years?

Mr. ZIENTS. As I said earlier, we have \$5 trillion of deficit reduction—

Senator SESSIONS. No, do you propose to spend more money over the next ten years—

Mr. ZIENTS. I think what we have—

Senator SESSIONS. —than the Budget Control Act—

Mr. ZIENTS. I think what we have—

Senator SESSIONS. —would cause us to spend?

Mr. ZIENTS. I think what we have is a much more honest baseline, a baseline that has SGR, AMT, not patched year over year, but extended through the period.

Senator SESSIONS. You do not pay for the SGR, the doc fix. That is not paid for. But let us go back to the simple question I asked you. Does your plan spend more money over the next ten years than the agreement in current law that we reached just last August?

Mr. ZIENTS. The baseline is—

Senator SESSIONS. Yes or no.

Mr. ZIENTS. What we are doing—I think what we have to focus on here is the bottom line and we are taking deficits down to 2.8 percent of GDP.

Senator SESSIONS. But you are not answering my question. I asked a simple question. You are the Director of the OMB. Does your budget call for spending more money—

Mr. ZIENTS. Actually, our budget is a more honest budget that looks at what is happening, business as usual, basis—

Senator SESSIONS. Mr. Chairman—

Mr. ZIENTS. —each year we are passing the AMT—

Senator SESSIONS. Will the witness not answer the simple question?

Mr. ZIENTS. Each year, we are passing—

Senator SESSIONS. I just asked a simple question.

Mr. ZIENTS. It is a more accurate reflection of what we are going to spend and it—

Senator SESSIONS. Will it spend more or less?

Mr. ZIENTS. It will spend—it will actually spend less money because of the deficit reduction that we have and a baseline that reflects the current policy.

Senator SESSIONS. Because of deficit reduction, it could only be assumed that is caused by increased taxes. But let us go back to that question. When you propose—your budget proposes eliminating the sequester, the \$1.2 trillion in spending cuts we all agreed to last year, difficult as it was. That is a \$1.2 trillion increase in spending, is it not?

Mr. ZIENTS. No, it is not. I think that is—

Senator SESSIONS. Well, why is it not? We agreed to—current law is the cuts reduced the projected spending rate by \$1.2 trillion. You eliminate that. That means you intend to spend that, do you not?

Mr. ZIENTS. I think this is a very important point. The President is not proposing that the sequester go away. The sequester is a very important forcing function for us to do deficit reduction. So the sequester will be replaced with a balanced approach to deficit reduction—

Senator SESSIONS. You are replacing the sequester—

Mr. ZIENTS. The sequester itself is bad policy. The sequester is bad policy on the defense side, \$500 billion of required—

Senator SESSIONS. Mr. Zients, we have looked at the numbers in your budget—

Mr. ZIENTS. It is bad policy—

Senator SESSIONS. Your budget increases spending by \$1.5 trillion more than the budget agreement last year, and it is in a lot of different places. You do make cuts in some places out there, but your net is to increase spending more than the current law and that is not the path we need to be on. And the increase in taxes you propose, almost \$2 trillion, is used to pay for that spending.

Mr. ZIENTS. So I want to be crystal clear here. We are complying by the BCA. There will be \$2 trillion of deficit reduction from the BCA. You brought up taxes a few times. We absolutely believe in a balanced approach.

Senator SESSIONS. Well, let me ask you this—

Mr. ZIENTS. This was—

Senator SESSIONS. If you are incorrect in saying that you do not increase spending more than current law, would you consider resigning your office?

Mr. ZIENTS. Let me go back to the balanced—

Senator SESSIONS. We looked at the numbers.

Mr. ZIENTS. The balanced—

Senator SESSIONS. Are you that confident in your projection?

Mr. ZIENTS. I am confident that with our baseline, which accurately reflects current policy and business as usual, that we have deficit reduction of more than \$4 trillion, and we do it in a balanced way. For every \$2.50 of spending cuts, there is a dollar of revenue. That is a good, balanced approach.

Senator SESSIONS. Mr. Zients, there is no spending cuts in this budget. This budget increases spending. Surely you know that. It increases taxes. So to say you cut \$2.50 in spending for every dollar in tax increase is beyond the pale.

Mr. ZIENTS. Well, we have \$360 billion of cuts from health care. We have \$270 billion of cuts from other mandatory programs. We have savings from OCO that CBO scores. In total, it is \$2.50 of

spending cuts for every dollar of revenue. That is a balanced approach—

Senator SESSIONS. That is—

Mr. ZIENTS. —and that is the approach that we should have.

Senator SESSIONS. Mr. Chairman, this budget taxes more and it spends more. It does not alter the debt course of America and I am disappointed that we cannot get an honest response to these difficult questions at this important time in our history.

Chairman CONRAD. I thank the Senator for his questions.

Senator MURRAY.

Senator MURRAY. Yes. Director Zients, thank you so much for your service to our country. We all really appreciate it in this difficult time.

You know, as we all know, budgets are about choices and they are about priorities. They are about making investments in our workers and our families and our future. They are about making some tough decisions about how we pay for those investments and reduce our debt and deficit.

I spent a lot of time tackling those issues on the

Joint Select Committee on Deficit Reduction. We didn't get the result that we were all hoping for, but I think our work really highlighted the deep divisions on this issue and the sharp contrast between the two parties on the path forward today.

I feel very strongly that deficit reduction should not simply be put on the backs of the middle class. I believe that the wealthiest Americans and the biggest corporations should contribute their fair share as well as we try to work our way out of this. I do believe that we need to cut responsibly where we can, and I think we all need to remember that we have, including a trillion dollars that we have cut in the Budget Control Act.

But that cannot be all. A balanced approach is what every single bipartisan group that has tackled this has advocated for and it is what all of our constituents expect and they deserve.

So as we work on the potential changes to bipartisan sequestration process, I believe we cannot simply add to the burdens of the middle class again. They have paid a lot. I think the only fair way to change this process is through shared sacrifice and a balanced approach.

So it is that important budget value, balance, that I want to start off with today in asking you about the President's budget proposal. My question to you is how does your budget tackle this issue of balance and fairness for the middle class, and what are your specific proposals to make sure that as we tackle the goals of jobs, investment in the future and deficit reduction we are also calling on everyone to share in the sacrifice, not just the middle class and most vulnerable.

Mr. ZIENTS. Well, I think you are right. I mean, a balanced approach has been central to everybody's recommendation here, including the Simpson-Bowles recommendation, and it is central to the President's budget. And asking the wealthiest Americans to pay their fair share, that \$1.5 trillion comes from that and from ending some corporate tax loopholes and unnecessary corporate tax expenditures like not taxing carried interest at ordinary income,

corporate jets, et cetera. Asking everybody to pay their fair share, raising revenue, is a central part of that.

At the same time, there will be no tax cuts for the middle class. So no family earning under \$250,000 will have any tax increase—I am sorry—

Senator MURRAY. Increase—

Mr. ZIENTS. No tax increase. In fact, there will be tax cuts, including the AOTC and extending that. We also are investing—

Chairman CONRAD. But for those listening, and we use these acronyms here. People listening—

Mr. ZIENTS. Yes—

Chairman CONRAD. —have no idea what—

Mr. ZIENTS. Okay. Let me explain.

Chairman CONRAD. What is an AOTC?

Mr. ZIENTS. The American Opportunity Tax Credit, which allows families to get up to \$10,000 of tax relief for college, and making college affordable is a central emphasis in this year's budget, continuing Pell Grants at their higher level. Encouraging colleges and universities to stop their year over year tuition increases. All important for the middle class.

The President has done about \$300 billion of tax cuts for the middle class. So central to this budget is a balanced approach. I talked about the \$2.50 of spending cuts for every dollar of revenue, making sure that the wealthiest Americans do their fair share, and making sure that we give the middle class a fair shot.

Senator MURRAY. Well, I thank you very much for that principle. I think it is really important for America today, where so many families have really been hit hard in the last two or three years with their house prices going down, and their jobs being cut, that they feel and have contributed to trying to get this economy back on track. We need to make sure that we have a fair and balanced approach and I really appreciate the President's emphasis on that value.

I did want to ask on the issue of sequestration and cuts to spending, I believe that the VA medical care spending is exempt from future cuts, but there is some ambiguity, apparently, between the Budget Act and existing law. I am concerned that by not settling this issue now, we are failing to provide our veterans today with the clarity they deserve. So I wanted to ask you, when can we expect OMB to weigh in on that issue?

Mr. ZIENTS. Well, first of all, I want to emphasize that this year's budget absolutely recognizes the importance of our veterans and veterans' families—

Senator MURRAY. Correct, and I thank you for that.

Mr. ZIENTS. In terms of the sequester, it is bad policy. It is bad policy all around. It would lead to cuts on the defense side that go across the board or indiscriminate totaling \$500 billion. We have similar cuts of a similar magnitude on the discretionary side and elsewhere which are not appropriate. So, overall, the sequester is bad policy. Right now, we are focused on replacing the sequester with balanced deficit reduction. If, unfortunately, we reach a point where we need to do more planning for the sequester, we will address issues like the one you raised. But right now, we are very fo-

cused on this is bad policy and it should be replaced by balanced deficit reduction.

Senator MURRAY. Well, I appreciate that, but as soon as you can let us know on that, we would really appreciate it.

Mr. ZIENTS. Will do. We will do.

Chairman CONRAD. I thank the Senator.

Senator CRAPO.

Senator CRAPO. Thank you, Mr. Chairman, and Mr. Zients.

I want to go back to an issue that has been discussed here and in many places regularly and it is this notion that it is not time yet to start controlling the spending side of the equation. We still need to keep stimulating the economy. We still need to keep the government spending going so that we can generate jobs. The two-step approach that the Chairman mentioned and that you have confirmed is the approach taken by this budget.

I have a concern about that. As I am sure, I served on the President's Commission, on the Bowles-Simpson Commission, and that Commission report adopted that same two-step approach. This was in December of 2010. And we agreed in that Commission report that we would delay the caps on spending and the spending restraints for a year or two to allow for this stimulative impact on the economy that was claimed to be needed.

The concern I have, that it is now time to prepare the 2012 budget and we still hear that it is not time yet for us to begin the austerity part of controlling spending at the Federal level but we still have to engage in the spending side. We are not there. My question, rhetorically—I will not ask you to answer this, but my question rhetorically is, when will we ever get to step two?

The question I do want to ask you is about this budget. I have seen a lot of budgets in Congress and I have analyzed a lot of Congressional budgets and one of the biggest problems that I think we have that we overlook every year is that you have a budget, in this case a ten-year budget, that makes all kinds of proposals over a ten-year period of time, but it is only the first year of the budget that really counts. It is only the first year of the budget that Congress will operate from in this year. And it seems that in the first year of almost every budget I have seen Congress establish, there is just more taxing and more spending, but the control of spending does not happen.

And I note that that is happening again in this budget, and this is the question I want to refer to you. Two years ago, the President's budget claimed billions in savings by freezing non-security discretionary spending in fiscal year 2013 at \$446 billion. One year ago, the President in his budget proposal claimed even additional savings in that same non-security discretionary spending category for fiscal year 2013, saying that in fiscal year 2013, we should get to an even lower level of \$397 billion.

Now, we are looking at fiscal year 2013. It has arrived. And the President proposes not the 446 that he said in his budget two years ago, not the 397 that he said in his budget one year ago, but 501, if I read the numbers correctly. And so the same dynamic that I am describing has occurred again in this circumstance. In previous budgets, we say, well, in the future, we will fix things and here is how we will fix them. And then we get to the future budgets and,

lo and behold, the fix is gone and the spending is back in place. Could you respond to that?

Mr. ZIENTS. Yes. I think that on the discretionary side, we are abiding by the BCA caps, which, as control discretionary spending. If you look at DOD as an example, they have put together a budget that follows a new strategy, and the budget as a result of that strategy actually results in a one percent decrease in DOD spending, not counting OCO. With OCO, it is down five percent. If you look across agencies beyond DOD, half of our agencies have flat or negative spending in 2013 versus 2012. So this is a budget that I would argue has a lot of spending control.

And at the end of the day, the bottom line, as I mentioned earlier, is that we are down in 2013 to 5.5 percent of GDP. And then in 2014, 3.9 percent of GDP. So—

Senator CRAPO. But you have—

Mr. ZIENTS. —not where we need to go. We need to get those deficits lower. We need to have debt stable as a percent of GDP. But we are on the right path in this budget.

Senator CRAPO. But you have adjusted the baseline, which is what allows you to make the claims that you are making in a number of contexts here.

And let us forget about the baseline. Let us forget about the percentages and all of the arguments that have been made about how we are going to be reducing percentages of spending. Is it not accurate to say that the President proposes in this budget for 2013 more spending than he proposed for this same 2013 budget last year and the same 2013 budget the year before?

Mr. ZIENTS. I think you have to go back and benchmark those numbers. I do not have them in front of me. What I can tell you is this is a very tight budget and certainly a budget that abides by the BCA caps, which has us making a lot of trade-offs. I think the most powerful datapoint here—

Senator CRAPO. Except the sequestration is eliminated in the President's proposal.

Mr. ZIENTS. The sequestration—I want to be very clear on the sequestration. It is not eliminated. The President believes that it is a very important forcing function. In the fall, Congress was not able to come up with a proposal—

Senator CRAPO. I thought you said it was—I think your word was “replaced.”

Mr. ZIENTS. Well, it is—the \$1.2 trillion that the sequestration would require through what we think is bad policy—in the DOD area, a \$500 billion across-the-board cut on top of the efficiencies we have already realized is bad policy. On the discretionary side—

Senator CRAPO. So it will be replaced.

Mr. ZIENTS. —bad policy. It will be replaced with balanced deficit reduction. We will have that \$1.2 trillion. It is mutually assured destruction. We have to get it. No one wants to sequester—

Senator CRAPO. But you are replacing it—

Mr. ZIENTS. —and it will be replaced—

Senator CRAPO. —with a \$1.2 trillion tax increase, are you not?

Mr. ZIENTS. A combination of revenue raisers and spending cuts. Overall, \$2.50 of spending cuts for every dollar increase in revenue.

Senator CRAPO. Well, I can tell you, I do have the numbers, and two years ago, it was 446. One year ago, it was 397. This year, it is 501. The same thing is happening. The budget proposals go up in the year that we really are doing the budgeting.

Chairman CONRAD. Let me just say that I served with Senator Crapo on the Fiscal Commission, served with him in the Group of Six. I have spent hundreds of hours with him. He is a serious person. In the Group of Six, we devised an enforcement mechanism that has never been used before, in part to get at the underlying issue that he raises, which I think those of us who have served on the Budget Committee for many years—whatever the merits of the current budget or the demerits of it, the underlying dynamic that he is stressing here, he stressed in many, many hours, I can tell you, in the Fiscal Commission and the Group of Six, and he is right that enforcement mechanisms have almost always had loopholes in them. And I will tell you, Congress is genius at getting through loopholes.

Senator CRAPO. Mr. Chairman, I appreciate you saying that. I actually wrote the Gang of Six enforcement mechanism on my pad here because I would love to see the President endorse at least that much of some of the work we have done here.

Senator SESSIONS. I would just say that that Gang of Six proposal, the strength of it was good enforcement. But one of the things that we know, if you pass a sequester that requires a \$1 trillion reduction and you waltz into the Congress less than a year later and propose to eviscerate it, it does not give confidence that anything we ever do will be followed through.

Mr. ZIENTS. If I may—

Senator SESSIONS. I know what you are suggesting—

Mr. ZIENTS. If I may—

Senator SESSIONS. —that you have other cuts, and I know you have other tax increases. But you have walked away from those cuts and replaced them with, fundamentally, tax increases, as the Senator just said.

Mr. ZIENTS. Well, I do not think we have seen a specific proposal as to how to achieve the \$1.2 trillion that is anything other than the sequester itself, which is bad policy, and I think we could all agree that is bad policy. What we are proposing here is to replace it with a balanced approach and the President's budget has more than the \$1.2 trillion of spending and revenue to replace the sequester.

But I want to be crystal clear. The President believes the sequester is very important as a forcing function to make sure that we achieve at least that level of deficit reduction—

Chairman CONRAD. Well, we cannot ad hoc this. We have to— Senator Cardin is waiting. Senator Cardin.

Senator CARDIN. Thank you, Mr. Chairman.

I think we can learn from our past experience, Mr. Chairman, and that is in the 1990s, when we had a serious budget problem, we had a balanced approach to deal with it. We enhanced revenues, we did, for deficit reduction and we reduced spending. And we were able to get our budget not only under control, we got our budget balanced and we saw economic expansion in this country and job growth and everyone benefitted from that.

So I think the Chairman's exchange with the Director as to getting our budget and deficit manageable should be our goal. And if we can, in fact, reduce the deficit by one-half as a percentage of our economy, that is progress. That is real progress that is being made and that will be reflected in the growth of our economy and we all will benefit from it. So I think that is an extremely important point and I appreciate the fact of how you are trying to balance the revenues and the spending over this period of time.

I want to talk about the revenues for one moment because I understand that there is going to be a lot of comment about it. But if we were to use current law as it relates to revenues, the previous tax cuts, allowing them all to expire and not extending the Alternative Minimum Tax, what would be the revenue impact versus what you have in your budget over the ten-year window? Do you have those numbers?

Mr. ZIENTS. I am sorry, sir. You are suggesting if we were to allow the middle class tax cut—

Senator CARDIN. I am suggesting if we were to compare this to current law rather than current policy—if we were to allow current law to take effect rather than continuing current policy as it relates to the revenue issues.

Mr. ZIENTS. Right. I believe CBO has done that work. We do not spend time on that because we believe that no family with less than \$250,000 of income should have any tax increase. In fact, we believe there is opportunity for further tax cuts. We believe that the tax cuts should expire for the wealthiest two percent, that that is central to having this balanced approach—

Senator CARDIN. And I support you on that, and I think the point that Senator Murray made about the middle class is extremely important.

Mr. ZIENTS. Yes.

Senator CARDIN. The middle class needs help, and they need help as far as the amount of taxes they pay. They need help on college expenses, and I strongly support what the administration is trying to do and continuing the Pell Grants, hopefully expanding the Pell Grants because college costs are becoming greater.

My point is this. When we look at the revenue number, it is my understanding that the revenues that you are bringing in would actually—if we allowed current law to take effect, we would actually have more revenue coming in—

Mr. ZIENTS. Yes.

Senator CARDIN. —to the Treasury than what the President's budget is proposing.

Mr. ZIENTS. Absolutely.

Senator CARDIN. So I am not—and I agree. None of us want to see that happen. But I think the point is this, that we need to come together in order to make sure that our tax policies are sensible. We would all like to see reform. But the revenue part of what the President has in his budget is actually less revenue coming into the Treasury than if we were to allow current law to take effect.

Mr. ZIENTS. That is right. That is right, and it returns us to a point for the wealthiest two percent that brings us back to that period of time that you were talking about in the 1990s. Tax rates would be very similar. Having been in the private sector during

that period of time, I can tell you that there is plenty of incentive to be an entrepreneur, to grow a business, to make investments, and it is essential to this balanced approach that we are talking about, that we have an appropriate amount of revenue. That \$1.5 trillion allows a balanced approach and, I think, is good for America. It is good for the middle class.

Senator CARDIN. And I would just add one more lesson from the 1990s, when we were able to get the budget under control and actually have a surplus. We gave predictability to the private sector that they knew that they had confidence that the budgets would be there and that government policy would be there. And again, it allowed for the expansion of our economy.

I think it is critically important that we act, that we do not let current law take effect—

Mr. ZIENTS. Yes.

Senator CARDIN. —because of the impact it has on middle income families. But I think the President has given us a balanced approach. Learning from history, I think that if we allow that to take effect, we will see the type of progress in our economy that everyone will benefit from and I think that is what we are all trying to do.

Mr. ZIENTS. I think we need to achieve what this budget achieves, which is to stabilize debt as a percent of GDP. That will allow us to continue to be the place for American businesses and global companies to invest.

Senator CARDIN. Thank you. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

There is much being said about a fair share, that people need to pay their fair share when it comes to taxes. What is a fair share? Can you put a number on it?

Mr. ZIENTS. I think, rather than putting a number on it, let us look at empirical data and—

Senator GRAHAM. Well, my question is, let us put a number on it.

Mr. ZIENTS. Okay. So I think the number that the President has in the budget—and again, the President prefers to do tax reform—

Senator GRAHAM. Right.

Mr. ZIENTS. —but tax reform takes time. So having the Bush tax cuts expire—

Senator GRAHAM. Wait. Whoa, whoa, whoa. The President prefers to do something. Why does the President not lead? I mean, you have people on this committee who have led. They got their brains beat out, but I admire them all of the Gang of Six. So I just do not buy the idea that the President cannot lead. Why did the President not have a budget that led on tax reform?

Mr. ZIENTS. Well, the President has very specific proposals in this budget, to answer your question, which would take the top rate from 35 percent back to 39.6 percent—

Senator GRAHAM. Okay. Is that—

Mr. ZIENTS. —which was a level that existed in the 1990s—

Senator GRAHAM. Is that a fair share?

Mr. ZIENTS. —the last time we—

Senator GRAHAM. Is that—should it be higher than 39.6?

Mr. ZIENTS. I think that the \$1.5 trillion, which is raised here primarily through individual taxes, somewhat through corporate taxes, represents a fair share. The ratio I have talked about—

Senator GRAHAM. So the President believes and you believe that the number that we should be shooting for is 39.6, not 35?

Mr. ZIENTS. That is right.

Senator GRAHAM. Now, what does that do to our long-term fiscal outlook? If we told everybody in America we have now found the fair number, 39.6, can I go home and tell people we have solved our budget problems?

Mr. ZIENTS. Let me explain the tax reform piece. This budget has very specific proposals, 35 going to 39.6, capping deductions for Americans with more than \$250,000 of income to 28 percent. At the same time, the President has put forward principles for tax reform which would simplify the tax code, lower rates—

Senator GRAHAM. So when we say a fair share, we really need to reform the tax code to have a fiscal impact.

Mr. ZIENTS. That is right.

Senator GRAHAM. Okay.

Mr. ZIENTS. We need to have tax reform—

Senator GRAHAM. So when people tell me, you have to pay your fair share, really, what you need to be saying is, no, you need to reform the tax code in a way that gets us to where we need to go as a nation, and 39.6 versus 35 is not going to solve the nation's problems—

Mr. ZIENTS. I think that 39-point—the specific proposal has us return to where we were, which was a successful system—

Senator GRAHAM. Okay. Let us talk about what got us into \$15 trillion worth of debt now and in the future. Do you agree that the Social Security Trust Fund is going to be exhausted in 2036?

Mr. ZIENTS. According to the actuaries, it is solvent through 2036.

Senator GRAHAM. Now, I am not beating up on you because we have all failed in the area of entitlement reform. I am just trying to express what I think is the elephant in the room, and the Gang of Six and others, Bowles-Simpson, actually did try to do something about this. Is there anything in the President's budget that adjusts the age for retirement?

Mr. ZIENTS. No.

Senator GRAHAM. Is there anything in the budget that adjusts—means tests Social Security benefits?

Mr. ZIENTS. No. The President does not believe—

Senator GRAHAM. Is the—

Mr. ZIENTS. —our immediate problem is Social Security—

Senator GRAHAM. Well, but—

Mr. ZIENTS. At the same time, the President has put forward—

Senator GRAHAM. Would he—

Mr. ZIENTS. —principles for Social Security reform, and it, too, needs to be done—

Senator GRAHAM. Right.

Mr. ZIENTS. —in a balanced way.

Senator GRAHAM. Okay. If we do nothing with Medicare, Social Security, and Medicaid, how much of the revenue stream in the future do those three programs consume?

Mr. ZIENTS. Well, across this budget window, which is the next ten years, what the President's budget achieves is a deficit below three percent and a stabilization of the GDP—

Senator GRAHAM. Does the President's budget do anything to save Social Security from going bankrupt?

Mr. ZIENTS. Social Security is solvent through 2036—

Senator GRAHAM. Okay.

Mr. ZIENTS. —and I believe the President—

Senator GRAHAM. Is he against personal accounts? Does he oppose personal investment accounts?

Mr. ZIENTS. The President looks forward to sitting down with Congress and making fundamental Social Security reform—

Senator GRAHAM. In his budget—

Mr. ZIENTS. —want to emphasize this is not our immediate problem.

Senator GRAHAM. Does a millionaire under this budget receive subsidies from the government when it comes to their Medicare premiums?

Mr. ZIENTS. The President has, through the ACA—

Senator GRAHAM. Well, I asked a simple question. If you are a millionaire receiving Medicare benefits, you have a million dollars of income, do you receive subsidies from the Federal Government under this budget?

Mr. ZIENTS. You are entitled to Medicare.

Senator GRAHAM. I mean, do you get a subsidy from the General Treasury to pay the premium?

Mr. ZIENTS. You pay a large portion of—

Senator GRAHAM. Are there any subsidies coming to millionaires under this budget for Medicare premiums, from the General Treasury?

Mr. ZIENTS. The Medicare compact with seniors is maintained.

Senator GRAHAM. So the compact is that we are going to let millionaires be subsidized forever? Is that the compact we all signed?

Mr. ZIENTS. That is the compact that we have—

Senator GRAHAM. Well, count me out. If AARP is watching—

Mr. ZIENTS. —pay a higher share of premiums, yes—

Senator GRAHAM. —I did not sign that compact. I do not believe that. I think millionaires—I think I should be paying the full premiums, but anyway, thanks for coming.

Chairman CONRAD. Thank you.

Next, Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and I appreciate Director Zients' being here. I do concur with my friend, the Senator from South Carolina, that we do need to take on a comprehensive approach to the long-term deficit issue. I think one of the—a lot of statistics are thrown around, but if there is one takeaway that I think constantly I come back to, it is that in the last couple of years we have seen spending close to 24, 25 percent of our GDP, an all-time high. We have seen revenues in that 15-percent range, a 75-year low.

If you look at any time over the last 75 years, anytime there has been anything close to balance, it has been when revenues and spending have been in that basically 19-to 21-percent range. And I guess the feeling I have is that while it will require us to take

on changes to the engagement programs—and I do wish we would have seen more—it will also take us looking at the revenue half of the ledger as well.

I guess one of the things I want to take a moment on—and I understand the administration and the President's reluctance and need to phase in appropriately long-term deficit reduction. I think we have seen in the press today the U.K. potentially being put on credit watch because they may be moving too quickly on an austerity path only.

But one of the questions I would like your comments on is: What should be the economic indicators and the growth numbers, GDP numbers, jobs numbers, what have you, that would allow us to start phasing in more dramatic and comprehensive deficit reduction?

One of the things I am concerned with, Mr. Chairman, I understand—and I think probably both sides of the aisle do—that the payroll tax cut at this point, while quite popular, does also have some current stimulative effects. I am afraid at times we may be hoisted on our own language at some point, that eliminating that would then be viewed as a tax increase at some point into this year going forward. I personally would like to see, if the economy continues to improve, that automatically phase out.

I am concerned as well that it looks like the House leadership now, after a great deal of talk about fiscal responsibility, may decide to try to extend that without paying for it at all. I think that is totally irresponsible and against the grain of everything that this Committee, both the Chairman and the Ranking Member, has been about. I personally would be opposed to that. If we are going to do it, we ought to pay for it.

But I guess, Mr. Zients, what I am asking is: What should we look at as the metrics on economic growth that would allow us to take on deficit reduction with both the revenue side increases and the entitlement side reductions to get us back in greater balance?

Mr. ZIENTS. So a few reactions, Senator Warner.

First, on revenue, you talked about the 19-, 20-percent range. That is exactly where our budget is, so at the end of the budget window, we hit 20.1 percent, and we are in that 19-percent range through the window. So that, we agree, is a historical range that has worked and one that we need to get back to.

Second, I want emphasize that the budget does have declining deficits year over year. We get below 3 percent in 2018. That gets to the point where we stabilize the debt as a percentage of GDP.

On payroll tax, let me answer that one specifically. We think it is essential. You cannot have a tax increase on 160 million Americans at this point in time. We are starting to recover. Unemployment is at 8.3 percent, which is better than where it was but not where we need to go. I think we feel, absent any major shock to the system, that once it is extended through the end of the year, that is it.

Senator WARNER. Paid for?

Mr. ZIENTS. You know, I think that the most important thing is that it be extended. I know there are conversations that many of you are involved in. I think it is important that we have unemployment extended, UI extended, and the SGR, and that that package

should get done as soon as possible. It is not a period of time when we can afford any delay. The President looks forward to signing that bill.

Senator WARNER. I did not hear the answer of whether it would be paid for or not. The other question I would have is: What are the indicators of when we can either phase that out—you are saying end of the year—or other economic metrics that would allow us—

Mr. ZIENTS. Yes, I think continued decrease in unemployment. I think we believe that if the President's policies are enacted, a year from now we will be below 8 percent. We look forward to GDP growth in the mid 3s or higher, and at that point we can begin to pivot toward deficit reduction.

Senator WARNER. Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

Senator Portman is next.

Senator PORTMAN. Thank you, Mr. Chairman. And welcome, Mr. Zients. A couple quick questions for you.

Senator Reid has recently said we do not need to bring a budget to the floor this year. Do you agree with that?

Mr. ZIENTS. I think that the most important thing is that—

Senator PORTMAN. Just say yes or—

Mr. ZIENTS. —Congress act and that we pass the President's policy as we did with the BCA.

Senator PORTMAN. So yes or no, do you think we should take a budget to the Senate floor? Yes or no.

Mr. ZIENTS. I think the mechanics and the process are not my area of expertise. What I do know is the President's policy—

Senator PORTMAN. I will take that as a no, which is consistent with what the White House has said. I find it pretty amazing that the Director of the Office of Management and Budget—

Mr. ZIENTS. I will note that the BCA, as the Chairman said—

Senator PORTMAN. Second question. What do you think is the most significant policy issue facing the country in terms of our fiscal policy? What is the single most important thing in terms of our fiscal posture?

Mr. ZIENTS. I think it is actually two things, a short term and a long term. Short term is continuing this recovery, and we need to make sure that payroll taxes I talked about and other initiatives like transportation, schools, rebuilding our—

Senator PORTMAN. Okay. What is your long term?

Mr. ZIENTS. And the second is driving down those deficits to a sustainable level, and I think we make serious progress here—

Senator PORTMAN. But in terms of policy areas, what is the area that troubles you the most in terms of our fiscal posture?

Mr. ZIENTS. I think it is getting a balanced approach. If you look at the revenue right now, our revenue is much below where Senator Warner says, and I would agree with him, it needs to be. And we need to continue to bring down our spending.

Senator PORTMAN. Okay. I was hoping for something a little more specific. It is funny. I have asked that question of a lot of folks, including the CBO Director who sat in your seat, and the question usually gets answered with, one policy area, which is

health care and entitlements. I know you come from the management side, and welcome to this Budget Committee—

Mr. ZIENTS. Well, I do have some background in health care from the private sector, and I think it is important—

Senator PORTMAN. Yes, well, I think if you look at the budget, I think it is difficult not to see the entitlement side, the mandatory spending side, and health care is our number one problem. Look, we are borrowing about 40 cents of every dollar spent at the Federal level. We have had trillion dollar deficits the last several years. We are looking at another one this year. We have already had a downgrade. As was mentioned earlier by Senator Warner, we are looking at a fiscal crisis on our doorstep, a \$15 trillion debt, historic levels. We are spending more than we ever have in this country, as a percent of GDP spending more than we ever have since World War II. So, I would just like to suggest, having heard a lot of the conversation today, that there does not seem to be the urgency that I would hope for, particularly with regard to the mandatory spending side.

As a percent of spending to GDP on the mandatory side, this year it is about 65 percent. In 1971, it was 42 percent. At the end of your budget window, do you know what the percent of GDP will be on the entitlement spending, mandatory spending? This includes Social Security, Medicare, Medicaid, and interest on the debt. So 42 percent in 1971, about 65 percent now. What will it be at the end of the 10-year window?

Mr. ZIENTS. I do not have the figure in front of me.

Senator PORTMAN. It is 78 percent. So think about the budget. I mean, you have some interesting graphs and charts here, and when you look at this—I am sorry. This is as a percent of the budget, not as a percent of GDP. It is a percent of the budget.

Mr. ZIENTS. Got you.

Senator PORTMAN. So as a percent of the budget, we have gone from 42 percent in 1971—and I use 1971 because that included, of course, the Great Society programs and so on, so there was a big expansion. Back in the 1960s, it was in the 20s. Then we get to the mid-60s now. We are going to 78 percent. And yet in this budget, when you look at it, there is nothing, as Senator Graham indicated, on Social Security. Nothing, even though we are in cash deficit in Social Security, and we have this huge growth.

On Medicare, what is there in Medicare on the benefit side during the next term of whoever is President? So during the next 4 or 5 years, what is there in Medicare on the benefit side?

Mr. ZIENTS. Let me start with health care, and then I will—

Senator PORTMAN. Well, let me answer that question for you because I am not going to get an answer from you, it sounds like, but nothing. You know, you have a little means testing, which I applaud you for, and Republicans have been willing to get out front and talk about the need to get entitlements under control, as has Senator Warner and some other Democrats, as has the Chairman. You have nothing. What you do is actually after this President's term.

So, look, I appreciate your testimony today. I look forward to talking to you on the management side where you have a lot of background and expertise, and I would hope on these other issues

that, when someone asks you what the top issue is, it is not a balanced approach or more taxes, but we have really got to get this mandatory spending and entitlement spending under control. And this budget is an interesting political document, but it frankly does nothing to move the country forward on what is the most urgent issue facing our Nation on the fiscal side. And if we do not, I fear we are heading down the road of our Southern European allies, and it will have an enormously negative impact on our economy and on jobs.

Thank you for coming in. I look forward to talking to you more about these and other issues, particularly on the management side.

Mr. ZIENTS. Thank you.

Senator PORTMAN. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Toomey. Let me just say that, in fairness to witnesses, if we ask a question, we have to give the witness a chance to answer the question.

Senator Toomey? Oh, no, I am sorry. Senator Whitehouse and then Senator Toomey. I apologize. Senator Whitehouse is next. Senator Toomey, you will be next, then Senator Begich, then Senator Johnson.

Senator SESSIONS. We would ask that the witness answer the question. Many of these are simple questions, and—

Chairman CONRAD. Well, he has got to be given the chance to—  
Senator SESSIONS. —he ought to answer the question—

Chairman CONRAD. Well, let me just say, let me just say, when we ask a question here, a witness deserves the chance to answer. That is the way this Committee will be conducted—for anyone.

Senator Whitehouse.

Senator SESSIONS. And—

Chairman CONRAD. Senator Whitehouse is recognized.

Senator SESSIONS. —the witness should give a straight answer to the question.

Chairman CONRAD. Senator Whitehouse is recognized.

Senator WHITEHOUSE. Welcome, Mr. Zients.

Mr. ZIENTS. Thank you.

[Laughter.]

Senator WHITEHOUSE. For as long as there has been discussion about Medicare, there has been opposition to Medicare, and there has been resentment that Medicare exists. The forces that opposed Medicare initially and that have resented it since are still out there. There is enormous value to certain sectors in the private sector of turning Medicare over to private control. Giving people vouchers and sending them off into the private health insurance industry, for instance, would be a significant windfall, I expect, for the private health insurance industry. So I think it is important that we recognize that political fact and recognize that the debt and deficit problems that we have can be used to become a leveraging vehicle for this longstanding opposition to and resentment of Medicare and a desire to try to disable or change that Government program.

We saw dramatic and I think very unhelpful changes to it proposed and actually passed by the Republican House of Representatives just recently, and I think the American people responded to that with a very negative point of view. And the next thing that

appeared out of the Republican House was something called “cut, cap, and balance,” which was even worse for Medicare than the original budget which had been so immediately rejected.

So I think we have to face the fact that there is the fact that the American people really count on Medicare, the fact that people in Rhode Island, I know, are, some of them, a year or two out from Medicare and they are forgoing health care, when they finally get to Medicare it is safe harbor at last after years of storm and uncertainty, that that program remains under constant attack, and we have to, I think, do our level best to defend it.

As I believe very strongly that there is an efficiency problem, a quality problem, an information technology problem, and an incentives problem that runs throughout our health care system. Medicare is seeing its costs go up, but the defense budget, Secretary Gates just testified that health care is “eating his defense budget alive,” I think was the phrase that he used. The private sector is getting clobbered with health care cost increases. The VA is seeing its costs go up in health care.

There is a systemic cost problem that does not just land in Medicare. It touches on all of the different elements of our health care system.

Mr. ZIENTS. Yes.

Senator WHITEHOUSE. We burn 18 percent of our gross domestic product as a country on health care. The next least efficient industrialized country, a competitor of ours, is at 12.

Mr. ZIENTS. Yes.

Senator WHITEHOUSE. We are 50 percent more inefficient at delivering health care than our most inefficient industrialized competitor. And when you put Commonwealth Fund measures of how good the care is that we are getting, what the outcomes are, we are not better than they are. We are actually worse in some areas.

So there is a huge opportunity here, I think, that I believe the administration needs to seize. I think that a lot of good work has been done already. I am working in the HELP Committee to try to put more focus on the administrative implementation of the reforms that need to be done.

But here is my question to you. You are now in charge of OMB, and you are an important emissary and member of this administration. I understand perfectly well from discussions with CBO over many years, from hearings with OMB over many years, that because of the nature of the reform that is required, it is not something that is actuarially scorable. It is hard to calculate a score for this. In certain very well developed areas like hospital readmissions, we have been able to calculate narrow sort of pinpoint scores. But as a general proposition, we are embarked on what Atul Gawande called “an experiment in innovation,” and it is hard to see around corners of innovation.

The fact that you cannot calculate a score does not mean that you cannot set a goal, and I will continue to urge this administration to move beyond the standard it has set for itself of bending the health care cost curve, which to me is a metric-free standard, and try as the different elements in the Affordable Care Act get implemented, as we learn more about this, as success out of Kaiser and Intermountain and Geisinger and Gundersen Lutheran and

Palmetto and private health organizations across the country prove this proposition with real savings from improved care, that you all push to—as I have said, I appreciate you cannot calculate a score. You can set a goal.

Mr. ZIENTS. Yes.

Senator WHITEHOUSE. And you can set a firmer goal than this bending the cost curve business. Could you talk about that in the 30 seconds I have left you in my inordinately long—

Mr. ZIENTS. Well, first of all, we do have a compact with our citizens on Medicare, and we have to live by that compact, and voucherizing Medicare is not—

Senator WHITEHOUSE. Is not in the program.

Mr. ZIENTS. Is not in the program, so the Republican House bill, which actually would shift \$6,400 to seniors as an additional expense is completely unacceptable to the President.

Having spent time in the private sector on health care, there are inefficiencies. You have places where costs are higher and outcomes are actually lower, so you do not have the correlation between costs and outcome. In essence, the productivity gains that have been made across the private sector outside of health care, 1.5 percent year-over-year productivity gains, productivity gains are both cost decreases and quality increases happening at the same time. We need to do more of that in health care. Technology is central to that; best practices, making sure that we understand what is working at Intermountain that we can import across—take across the country, because, again, there is a correlation between lower-cost care and higher-quality care, that we need to find that intersection and stamp that out across the country.

Senator WHITEHOUSE. Thank you.

Mr. ZIENTS. So we need to have those productivity gains in health care. I could not agree more.

Chairman CONRAD. Senator Toomey.

Senator TOOMEY. Thanks, Mr. Chairman.

Acting Director Zients, thanks very much for being here.

Mr. ZIENTS. Thank you.

Senator TOOMEY. You have a tough job. I appreciate your time. A couple quick questions here.

The President has talked a lot about fairness, obviously. In your judgment, in the interest of fairness, what percentage of the American people should pay no net income taxes at all?

Mr. ZIENTS. I think that is a hard thing to put a percentage on. What we want to do is we want to grow the middle class, and as we grow the middle class, more and more people will pay—

Senator TOOMEY. But it is about half right now, and this budget would increase that number. So I can only infer that the belief is that a fairer system is one in which more than half of all Americans pay no net income tax at all.

Mr. ZIENTS. Well, we have a situation where wealth is very concentrated in a few percent of people, and what we are asking is for that top 2 percent to pay their fair share, which is a share consistent with the share they paid in the—

Senator TOOMEY. That is not all you are asking for, but I have another question. Do you agree with White House Chief of Staff Jack Lew that it takes 60 votes to pass a budget in the Senate?

Mr. ZIENTS. It takes 60 votes to pass a budget like the BCA, which was passed.

Senator TOOMEY. No, no. That is not a budget. You know—it is a budget resolution.

Mr. ZIENTS. A budget resolution is 51 votes.

Senator TOOMEY. It is 51 votes, okay. So the clear and unambiguous fact is that the Democrats who control the Senate could pass a budget without a single Republican vote if they chose to exercise the leadership of actually pursuing a budget.

Mr. ZIENTS. Well, I would say that there was a lot of leadership involved in passing the \$2 trillion of deficit reduction which was included in the BCA which passed—

Senator TOOMEY. Well, I want to commend our Chairman, who has indicated an interest in marking up a budget in this Committee. I welcome that. I think that is the responsible thing to do. I will be extremely disappointed if the Democratic majority chooses to go yet another year without laying out the case to the American people of how much money they think we should spend and on what and in which categories and where the revenues should come from.

Mr. ZIENTS. But I would say just one thing. I would say beyond process, the most important thing here is getting outcome, getting policy enacted in law—

Senator TOOMEY. So—

Mr. ZIENTS. —like the BCA. There is now an—

Senator TOOMEY. Yes, okay—

Mr. ZIENTS. —opportunity to do balanced deficit reduction, so we look forward to the President's policies being put into law.

Senator TOOMEY. Well, part of the problem is that we have not addressed the big policy issues that we ought to, and Senator Portman addressed this. You know, when I look at just a few categories of Federal spending—Social Security, Medicare, Medicaid, and interest on our debt—do you know how much they grow in the President's budget over the 10-year window, just those items? I would not expect you to have the number off the top of your head. It is almost 8 percent per year compounded. It is 7.9, to be precise.

Now, as your own forecast for GDP, which is quite ambitious given the very anti-growth policies you have in there, but nominal GDP growth is not anywhere near that level. So my question for you is: Is it even arithmetically possible to sustain indefinitely growth in big Government programs that is consistently—in fact, always higher than the economy grows?

Mr. ZIENTS. Let me take it piece by piece. On health care, the President and Congress put forward and passed the Affordable Care Act, which CBO scores at \$100 billion of savings in its first decade, \$1 trillion in its second. This budget puts forward \$360 billion of additional health care savings.

On the Social Security side, it is not our immediate problem. At the same time the President stands ready to address Social Security. At the root cause of much of what you are talking about are our demographics, our baby boomers retiring, and we view this budget as a very important milestone, real progress.

At the end of the day, more needs to be done. Let us get this chapter under our belt—

Senator TOOMEY. Well—

Mr. ZIENTS. —let us achieve this level of deficit reduction, and then we can look up and talk about more.

Senator TOOMEY. Well, I just have to say, this is an extremely disappointing approach to this. What you ran through does not—it is fully reflected in the numbers that I am citing, and despite whatever savings you attribute to the programs the President is proposing, these programs are still growing far faster than anything that is sustainable. And everybody who has looked at this honestly and every bipartisan commission and group comes to only one conclusion—in fact, the President has acknowledged that mandatory health care spending is the problem, and this President refuses to propose a solution. I think this is extremely irresponsible, and what you are doing with the huge tax increases jeopardizes economic growth while not addressing the fundamental driver of our deficits. I just think this is a huge absence of leadership.

Chairman CONRAD. Senator Begich.

Senator BEGICH. Thank you very much, Mr. Chairman. It has been somewhat entertaining today, and thank you for surviving the first several rounds of conversation.

Let me first give just more of a statement, because people who watch this and watch us engage, their assumption is somehow magically even if we had a budget here, we would vote for a budget, then it would go to the floor, it would be voted on. In theory the appropriators would follow that budget, and then the President would go for it. That is fantasyland. That is not what happens here. The President's budget is more—I am talking through you to the people who are watching because they think somehow magic occurs here and there will be this budget process that will lay out the expenditures of the Federal Government. Actually, the President proposes the budget. We set it aside. We write our own budget. Then the appropriators set it aside. And then we appropriate money, and then the President must spend toward the appropriations. Is that a fair—

Mr. ZIENTS. Yes.

Senator BEGICH. So it is great, all this “show-and-tell” that is going on here, but it is not reality. And the poor folks that are watching us believe that we have a budget, we will take the President's budget, we will amend it, we will add, we will delete, we will vote on it, the appropriators will follow it, then they have a budget. That is not how it works. And it is really somewhat appalling.

I know the Chairman has been working on trying to align these things, when the President prepares a budget, then we follow it. So just for the education of the folks that are watching, it is great “show-and-tell” today, but the fact is at the end of the day it is a whole different process. So I just wanted to make sure in a nutshell. Thank you for that very decisive answer you gave on that, so let me hold you there.

Second, I would like to ask you for a document if you can produce it for us. We have done one, but I would like to get it because I think it is very interesting, what we have already seen. The President's budget—over the last several years, when the President proposes a budget, then there is a deficit built into it under the last administration, under this administration. Then CBO, the Congres-

sional Budget Office, goes in some room, magically comes up with another number that they project. And then there is reality at the end of the year. Let me give you an example.

In 2008, not under this administration—and I am going to give you one under each one—a \$2.9 billion budget proposed; deficit, \$240 billion proposed. CBO says \$226 billion is really going to be the deficit, and actually it was \$459 billion. CBO off half, the administration off half.

Then just take the following year, \$3.1 trillion budget, deficit requests \$400 billion. CBO says it is going to go down, 342. Actually, it went to \$1.4 trillion.

So, I want to make sure—and I want to get a chart, if you could produce it, with those lines. I want to know exactly at the end of the day—we have the numbers, but I want them to be confirmed by OMB, the actual expenditure rate.

Mr. ZIENTS. We can provide that.

Senator BEGICH. Okay. All the way through, go back to 2006 through today. What is interesting, when you check the difference, because I heard the comment earlier, surge in spending. I heard that. When I look at the actual budgets, I see—and I will just use these last 3 years since I have been here—\$3.5 trillion, approximately \$3.8 trillion, \$3.7 trillion, \$3.77 trillion. They have actually slid a little bit. Now, “surge” usually means—I have seen surges.

Mr. ZIENTS. Right.

Senator BEGICH. When you have a tsunami, it is a surge. It wipes out things. This is slight increases, and, yes, a couple of those—one of those years, we had a pretty big one because we were in the worst recession in this country’s history. But put that all aside.

So if you can show me—because I think the American people need to understand what we are talking about. We use a lot of words around here because it gets headlines, and Politico will write something tomorrow, and The Hill and Roll Call and all that. So if you could produce that, that would be very important.

And just to clarify, you are not replacing the automatic budget—or you are suggesting another route, if budget cuts do not happen, here is another suggestion. If the budget cuts happen because we are unable to act, they are happening, right?

Mr. ZIENTS. Absolutely. It is a terrible policy, but the President is clear that that forcing function remains.

Senator BEGICH. Right. But if we do not do something, your budget will have to adjust to reflect that.

Mr. ZIENTS. Yes.

Senator BEGICH. And in some ways you have tried to do that through another means. But at the end of the day, if we do not act, we do not have the money, you do not spend it. Is that fair?

Mr. ZIENTS. You are speaking of the sequester.

Senator BEGICH. Yes.

Mr. ZIENTS. Yes.

Senator BEGICH. I like to say “budget cuts”—

Mr. ZIENTS. I think it would be a terrible outcome if that is how we did the spending cuts, but the President is committed to the sequester.

Senator BEGICH. Okay. I like to say “automatic budget cuts,” because no one understands who is watching TV the other words we use around here.

Let me say this: Under the 2011 Budget Control Act—this is just for your staff, if you could follow up—under Section 255, the Veterans Administration was exempt from these automatic budget cuts, but then Section 256 establishes a process for them to be reduced. Can you send us some clarity of what—are they part of—

Mr. ZIENTS. Right, this question came up earlier.

Senator BEGICH. Okay. I missed it. I apologize.

Mr. ZIENTS. We are hopefully not at a point where any of that matters because we have replaced those automatic cuts, but we will work on that answer for you.

Senator BEGICH. Okay. And last—and thank you, Mr. Chairman, for letting me go on a little bit here. Last, has OMB done an assessment or an analysis of if there is a military BRAC put into place, the employment impact or any of the economic impacts? And can you do that if that comes down to reality?

Mr. ZIENTS. Let me have my staff follow up.

Senator BEGICH. Okay. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator JOHNSON.

Senator JOHNSON. Thank you, Mr. Chairman and Mr. Zients.

Senator Begich, I think I have a graph that will show you that surge in spending. And also, to answer Senator Sessions’ question to you outcome, in fact—

Senator BEGICH. I will look to OMB to give me that, no disrespect to my friend.

Senator JOHNSON. I will use OMB’s numbers. This comes right out of Table S–1 from President Obama’s budget last year and then Table S–1 from President Obama’s budget this year. It is called “Total Outlays for 10 Years.”

You can see in the 1990s, the go-go 1990s, we spent \$16 trillion over 10 years. The last 10 years, we spent \$28 trillion. Last year’s budget showed spending at \$46 trillion. This year’s budget, in the tables in President Obama’s budget, shows spending of \$47 trillion. So, again, I am just doing you a favor in answering Senator Sessions’ question for you. This budget spends more than last year’s budget and spends more in the baseline.

I actually have a question for you, though. You are claiming \$4 trillion in deficit reduction, but, again, going back to your budget, last year in Table S–14, it shows total gross Federal debt in the year 2021, and it showed a figure estimating or projecting it \$26.3 trillion. This year’s budget, Table S–15, shows total gross Federal debt, for 2021, same year, at \$25 trillion. Now, that is a reduction of \$1.3 trillion, but didn’t we pass as part of the Budget Control Act \$900 billion in the first tranche? That kind of uses up that \$1.3 trillion. Where is the other \$4 trillion in deficit reduction?

Mr. ZIENTS. Well, the \$4 trillion of deficit reduction is the sequester money, which we believe should come through a balanced approach. And then there’s \$2 trillion more—

Senator JOHNSON. Well, Mr. Zients, I realize those are your segmented talking points, but if you take a look at the growth in debt,

one year versus another for 2021, the baseline last year would have had debt at \$23.6 trillion. This year's budget shows it at \$25 trillion in 2021—

Mr. ZIENTS. We have a much more honest baseline. We have a baseline that assumes the patch—

Senator JOHNSON. But we are not reducing the deficit by \$4 trillion, because if you were, that debt level would go from \$26.3 trillion minus \$900 billion for the Budget Control Act, so then you would be at \$25.4 trillion. And then take away 4, we should be about \$21.4 trillion, shouldn't we? If we were really reducing the deficit by \$4 trillion—

Mr. ZIENTS. What we are doing here is we are taking into account what is truly business as usual, using a baseline that includes—

Senator JOHNSON. So what we are not—

Mr. ZIENTS. —the annual patching of SGR—

Senator JOHNSON. What we are not doing—

Mr. ZIENTS. —and the annual patching of AMT.

Senator JOHNSON. What we are not doing is reducing the deficit by \$4 trillion. That is smoke and mirrors. It is not being reduced by \$4 trillion. Not even close.

Mr. ZIENTS. It is being reduced by \$4 trillion versus the business-as-usual approach of patching things like SGR and AMT.

Senator JOHNSON. Okay. Well, anyway, just so everybody understands, we are not reducing the debt and deficit by \$4 trillion in this budget. It is not happening.

It was interesting. In response to what is a fair share, you quote a couple figures. On the one hand, you said it would be fair, a fair share and then you would be satisfied, Democrats would never come to us again going, "The rich have to pay a little bit more, their fair share," at 39.6 percent. I did not come prepared to put this on a chart, but Congressman Paul Ryan has done a pretty effective job showing that with the health care law, marginal tax rates are going to rise to about 44.5 percent. So that would be above the fair share, wouldn't it?

Mr. ZIENTS. I am sorry. I am still focused on your prior question. Then I—

Senator JOHNSON. No, no, because I want to move on. So, anyway, you said that 39.6 percent top marginal tax rate would be the fair share.

Mr. ZIENTS. That is what the President is proposing in this budget.

Senator JOHNSON. But with the health care law, already things in place—and Congressman Paul Ryan has laid this out—we are at 44.5 percent. So that is above the fair share. The 44.5—

Mr. ZIENTS. Well, we are talking about ordinary income rates. There are different taxes, obviously. I am talking about in the President's budget—

Senator JOHNSON. You load up some more, okay.

Mr. ZIENTS. The President is suggesting that the 35 percent, which was enacted in 2001 and 2003, go back up to where it was in the Clinton era, which is 39—

Senator JOHNSON. And then some. And then with Obamacare knock it up to 45 percent. Now you are thinking that is fair.

Another way you said it would be fair is if we went back to the share that the top 1 percent paid during the 1990s, during the Clinton administration. The average over the Clinton administration's 8 years was 32.8 percent of the total income tax burden was paid by the top 1 percent—32.8 percent. Under Bush, it was 36.7 percent. And in 2007, the top 1 percent paid 40.6 percent, which was a larger share than the entire bottom 95 percent.

Now, again, you are saying that is not quite enough, that is quite a fair enough share yet—

Mr. ZIENTS. But, Senator Johnson, the root cause there is the tremendous wealth accumulation by a few and the fact that our middle class is not growing, is not benefiting—

Senator JOHNSON. But, again, we have a very progressive tax rate. Very progressive. It is actually one of the reasons when we have recessions we have such a fall-off in revenue, because we have such a progressive tax rate. But, again, that is just not quite fair enough that the top 1 percent in the best years paid more than 40 percent and paid more than the entire 95 percent bottom part of the income—

Mr. ZIENTS. I think it is fair that we are in a situation where we need deficit reduction and that that deficit reduction should come in part through revenue. The President is proposing \$2.50 in spending cuts for \$1 of revenue. That is a fair share—

Senator JOHNSON. I know that is—

Mr. ZIENTS. —and that the wealthiest 2 percent should pay their fair share, and that we should have no tax cuts whatsoever on families earning under \$250,000.

Senator JOHNSON. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Nelson.

Senator NELSON. Good morning.

Mr. ZIENTS. Good morning.

Senator NELSON. Senator Hutchison from Texas and I have had quite a round with OMB and the two of us having responsibility for passing the NASA bill back in 2010 and then going through the process of getting it funded. And basically, not until the head of OMB came and met with us, OMB had stonewalled the NASA budget, and since you are now the Acting Director, I think the constructive dialogue that we have with Mr. Lew having come and met with the Congress and continued the discussion on NASA funding so that there was some certainty in the program, I would like to know what your attitude is about continuing those discussions.

Mr. ZIENTS. Well, as it is a difficult budget environment. NASA is held about even in this budget environment, and what we have done in this budget is to honor the 2010 discussions around the appropriation with a balance between things like the heavy-lift rocket and the International Space Station. I would love to continue those dialogues.

Senator NELSON. I believe that you have, and I think that the budget was basically a flat-line budget, and given the cutting-edge agency of research and development that it is, it has to have some certainty in those programs. But when there is a complete lack of dialogue when OMB, that is what makes it difficult. And I want to raise that issue to you. That has been the case in the past, and until it finally got to the point that Mr. Lew, as the Director, un-

derstood that we were going nowhere, we finally had a meeting of the minds between OMB, the White House, and the Congress.

Mr. ZIENTS. Well, let us make sure that we continue those dialogues.

Senator NELSON. Very good. All right. I want to ask you about housing.

We have tried a bunch of programs. We have tried the Home Affordable Modification Program, HAMP; we have tried the Home Affordable Refinance Program, HARP; and then the Hardest Hit Fund. What makes this most recent attempt to help homeowners different?

Mr. ZIENTS. Well, I think that this is obviously a hard problem, and the housing market is starting to stabilize but is still mixed and needs a lot of work. I think the settlement of last week is an important settlement. That will get money out to approximately 2 million homeowners, much needed money to help with modification and refinancing.

The program that the President just announced, which takes advantage of one of those charts that we talked about earlier, the historic low interest rates, we have too many homeowners who are paying interest rates that are above the current rates. They are stuck. Yet they are responsible payers of their mortgages. They are current. And the President's program, which he announced a week or so ago, will allow those folks, both GSE—those mortgages that are owned by Fannie and Freddie—and also non-GSE holders to refinance and take advantage of what are historic low rates.

Senator NELSON. I applaud you for this. What is the source of revenue that you are going to use to basically fund what is the underwater mortgages so that people who are current on their payments but their mortgage is way underwater and they could never have a chance getting the bank to refinance it? You are going to come in with a fund that is going to basically make up the difference.

Mr. ZIENTS. Yes.

Senator NELSON. So where is that money coming from?

Mr. ZIENTS. It is estimated to be \$5 to \$10 billion, and that will come from a tax or a fee charged to the recipients of TARP. That will be recouped through the TARP Financial Responsibility Fee.

Senator NELSON. And that is going to—

Mr. ZIENTS. So at no expense to taxpayers.

Senator NELSON. That is going to be pursuant to us passing legislation that would allow you to enact that?

Mr. ZIENTS. Yes. We do need Congress to act.

Senator NELSON. Do you have any flexibility administratively in case Congress is wound around the axle and cannot get it done?

Mr. ZIENTS. Well, I think we are pushing as hard as we can administratively on programs like HAMP and HARP. We need Congress to act on this refinancing proposal that the President recently announced. We will continue to push as hard as we can administratively, but on the refinancing and the back-up of the fees being paid through the Financial Responsibility Fee, we need Congress to act.

Senator NELSON. Do you need that same revenue for refinancing the underwater mortgages in Fannie and Freddie?

Mr. ZIENTS. That money goes primarily to the FHA, which will be the vehicle to refinance the non-GSE mortgages.

Senator NELSON. So do you need a source of funds to fund that?

Mr. ZIENTS. Yes. That is the \$5 to \$10 billion.

Senator NELSON. So it is the same as in the mortgages that are not—

Mr. ZIENTS. It will allow us—the \$5 to \$10 billion paid for by the Financial Responsibility Fee will allow for the whole program across the GSEs and the non-GSE-held mortgages.

Senator NELSON. Thank you.

Chairman CONRAD. Senator Ayotte.

Senator AYOTTE. Thank you, Mr. Chairman. I want to thank the witness for being here today. I appreciate it.

You know what is astounding to me about the President's budget as I reflect upon it is he manages to propose the largest tax increase close to the history of our country while still having a \$1.3 trillion deficit in 2012 and bringing our national debt to \$26 trillion in the next 10 years, while again proposing this huge tax increase. I mean, it is like the worst of both worlds. It is staggering to me.

I guess I have a fundamental question for you, which is: The trustees of Medicare, an independent group, not Republicans, not Democrats, have said that Medicare is going to go bankrupt in 2024, and so what is the President's plan to preserve Medicare?

Mr. ZIENTS. I think just to come back to your first comment, I think we have to look at the bottom line here. The bottom line is that by 2018 deficits as a percent of GDP are below 3 percent and debt as a percent of GDP is stabilized. So I think it is wrong to focus on our current and instead to look at the deficit reduction—

Senator AYOTTE. Am I missing something, though—

Mr. ZIENTS. —takes us to a—

Senator AYOTTE. —or if we look 10 years forward, is our national debt not close to \$26 trillion under the proposal?

Mr. ZIENTS. It is if you look at it on a gross basis, and a lot of that is what the President has inherited in terms of unfunded 2001 and 2003 tax cuts and unfunded, unpaid-for Medicare Part D, wars that were not paid for. So the President inherited a lot and an economy, as Senator Conrad said up front, which was in a great recession.

Senator AYOTTE. But he did add during his Presidency close to \$5 trillion to the debt, did he not?

Mr. ZIENTS. So to pivot back to your question on Medicare—

Senator AYOTTE. Well, just to be clear, just so we are clear, because you were coming back at me in terms of what the President inherited, but during his Presidency we have added close to \$5 trillion to the debt.

Mr. ZIENTS. I think the key here is the bottom line. The bottom line is we get below 3 percent of GDP, and we get debt as a percent of GDP to a stable—

Senator AYOTTE. Well, just so we are clear, did he add close to \$5 trillion to the debt?

Mr. ZIENTS. I would want to confirm that.

Senator AYOTTE. Well, 4.9.

Mr. ZIENTS. The situation that the President inherited—if you look at root cause—

Senator AYOTTE. So you do not know the answer—

Mr. ZIENTS. —the root cause problem here—

Senator AYOTTE. —to that question.

Mr. ZIENTS. The root cause problem here is what the President inherited in terms of unfunded Medicare Part D, unfunded Bush tax cuts. We are now putting ourselves on a much more sustainable path, one that results in debt as a percent of GDP of less than 3 percent—

Senator AYOTTE. But if we owe \$26 trillion in the coming—if our national debt goes to \$26 trillion in the coming 10 years, I just—how are my children going to repay \$26 trillion?

Mr. ZIENTS. I think the important thing here is that this is a major step forward, and the President has shown a lot of leadership, starting back in April, leadership around the debt ceiling talks in the summer, leadership in September around the proposal to the super committee, leadership here with this budget. This budget represents a major milestone. It is not the end stage, but it is a major milestone. It is a big step forward, and we should work together to make it law.

Senator AYOTTE. I just want to be clear. So it is your testimony that a budget that increases our national debt to \$26 trillion, close to, in the next 10 years is a mark of leadership by this President.

Mr. ZIENTS. A budget that ensures that we continue this economic recovery, create jobs, brings down unemployment, gets us to a situation where the deficit as a percent of GDP is below 3 percent, where debt as a percent of GDP is stabilized, is a major milestone and step forward. There is obviously more work ahead.

Senator AYOTTE. Well, you and I disagree on what a major milestone is, but can I get back to my original question? By 2024, Medicare is going to bankrupt. What is the President's plan to save Medicare?

Mr. ZIENTS. So the Affordable Care Act saves over \$100 billion, according to CBO, in the first decade, more than \$1 trillion in the second decade. In the President's proposal is \$360 billion of health care savings. These are all steps forward—

Senator AYOTTE. Is that going to save Medicare so can I go home to my seniors and say that is going to be enough to preserve Medicare so that my grandparents in 2024 will not have to worry that it is going away?

Mr. ZIENTS. Medicare needs to continue to increase, as we talked about earlier, its productivity, decrease the variation in care which leads oftentimes to poor outcomes and higher costs. We need to just keep going after Medicare in terms of making sure that we preserve the compact that we have with our citizens, and at the same time continue to drive down the costs.

Senator AYOTTE. Well, my time is up, but I do not see anything in this budget that is going to preserve the compact we have with seniors which would require real strong leadership to preserve Medicare, which very shortly in 2024 is going bankrupt, which is a huge driver of our budget issues. And I just wanted to point out that, as critical as you have been about the tax state and blaming that for the \$5 trillion of debt that the President has added, it was

the President who signed an extension of those tax provisions into law in 2010. So I appreciate your being here today, but I do not agree that putting our national debt to \$26 trillion in the next 10 years is the mark of leadership of the type of fiscal responsibility we need to address the debt crisis our country faces.

Chairman CONRAD. Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman. We appreciate this opportunity.

In the 2013 budget, there is a variety of proposals to eliminate any tax preferences for oil and gas and the coal industry, whether they call them preferences or incentives or expenditures or whatever. But repealing those tax preferences in one year will eliminate a lot of small businesses who will not have the cash to be able to pay what has accumulated over a period of time, and I worry about the transition on any of these tax preferences. But this proposal is like a broken record. It has been in the budget every year. It never moves forward. And yet we continue to claim the savings as though it moved forward.

Isn't it disingenuous to claim savings from this proposal when you are unable to pass it when Democrats even had total control, the President, 60 votes in the Senate, and the majority in the House? That has never been done.

Mr. ZIENTS. Is that a specific question around the oil and gas?

Senator ENZI. Yes.

Mr. ZIENTS. So we are at a point of record or near-record production. Our imports are the lowest they have been. Oil companies are making a lot of money. They do not need this subsidy. And it has been a good idea to get rid of it, and it continues to be a good idea to get rid of it. So we would encourage—

Senator ENZI. I want to emphasize that transition. Again, with your small businessmen, if you impose those elimination of taxes instantaneously instead of putting them over a small period of years, you put a lot of small businessmen out of business. You do not put those big companies that you always like to refer to—

Mr. ZIENTS. Right, but as you have suggested, we have been signaling that we think this is good policy for some time. People have the time to plan for it. There is plenty of profit in this industry, and we should be investing in clean energy, reducing our dependence on foreign oil, and improving our efficiency through CAFE standards, through—

Senator ENZI. I think even all of business would agree with you on that with the transition. I have some other questions here.

There are some trust funds that get delved into in this budget. I thought we had a policy that we were not going to take away any trust funds.

Mr. ZIENTS. What are you referring to specifically?

Senator ENZI. Well, the one I am mostly concerned about is the Abandoned Mine Land program, which was a massive compromise that deals with health care for orphan miners, which are ones where the mines already went broke, and it accelerated the rate at which we would reclaim mines in States that had very little revenue coming in, and it would repay money from the trust fund that some of the other States had paid in that they had never been able to get, primarily those west of the Mississippi.

I am just hoping that that does not become a policy of this administration or any other administration to delve into trust funds. There is already little enough trust in the trust funds, like the Social Security Trust Fund, which is mostly bonds, which means we would have to put money in in order to take money out. There is a feeling by the people of this country that there is money in trust funds.

Mr. ZIENTS. Yes.

Senator ENZI. And there is not money in trust funds, and I did not find out about it until I went into the Abandoned Mine Land—

Mr. ZIENTS. Well, Social Security certainly is a trust fund, and it is functioning as a trust fund. As to your specific question on the mining, I will make sure my staff gets back to you.

Senator ENZI. Thank you.

I have some questions on the interest. What is the composite interest rate that we are paying on our debt right now?

Mr. ZIENTS. As interest rates are at a very low level. What we have in our assumptions is that interest rates return to their historic levels. I can get you those numbers.

Senator ENZI. Which would be?

Mr. ZIENTS. I think it is around 4 percent, but let me get you the exact numbers.

Senator ENZI. Okay. I think I have that chart here.

Mr. ZIENTS. It is S-14.

Senator ENZI. So right now we are paying about one-tenth of 1 percent?

Mr. ZIENTS. Hold on one second.

Senator ENZI. S-14.

Mr. ZIENTS. If we used—it depends whether you want to use the 91-day Treasury bill note, which obviously is going to be a lot lower, or the 10-year Treasury note. The 10-year is currently in the 2013 budget year assumed to be 3.5, and it goes up to the low 5s, which is consistent with its historic average.

Senator ENZI. Looking at your Table S-5, I was not able to get the net interest that we are paying to ever match up with the interest rates that you are showing in your other chart. But I did notice—

Mr. ZIENTS. It is hard math to do real time, but I can certainly have my staff follow up with you to make sure that everything squares there.

Senator ENZI. I would appreciate that, because I noticed that, again on Table S-5, the deficit increases every single year in actual dollars. I understand the GDP stuff, but I do not think America understands the GDP stuff. They do not get to pay their bills based on their GDP and holding down—getting a continual loan to cover so they just have to pay the interest rate. They actually expect us to pay something down at some point in time.

Mr. ZIENTS. Right.

Senator ENZI. And this shows accumulation of dollars, and that means an accumulation of interest. And I am really worried about the international situation now and the rate of interest at the international and what is going to happen to that. I think these estimates may all be low, which means we are going to be spending

\$850 billion a year in interest rate. That has to come out of somewhere.

Mr. ZIENTS. Well, Senator, as we know, right now the interest rates here are very low, which reflects our standing in the world. Make no mistake. If we do not get our deficit issues under control and get on a sustainable path of deficit reduction and stabilize debt as a percent of GDP, as the President's budget does, then interest rates could go higher. In a situation where we get our house in order and we do the deficit reduction we are talking about, I think the assumption that interest rates will return, as GDP growth kicks in, to their historic levels is a good, sound, conservative assumption. But I could not agree more in terms of the need to get our house in order, decrease deficits and get us on a sustainable path.

Senator ENZI. I hope your assumptions are correct. I do not think they are.

Chairman CONRAD. I thank the Senator, and I thank all Senators for participating today. I thank Mr. Zients for being here. We appreciate it very much.

You have heard here, we have different views, strong views. That is a healthy thing. That is the strength of our democracy. And we will have a hearing tomorrow with the Secretary of Treasury. I hope colleagues will attend and participate—no, the Secretary of Transportation tomorrow. I am sorry. Secretary of Transportation LaHood tomorrow, and I hope Senators will participate then as well.

Senator SESSIONS. Is it possible that some of our Senators might have another question, Mr. Chairman?

Chairman CONRAD. I cannot because I have a presentation at caucus that I have been asked to do, and so I have to close at noon. But we will have two more hearings this week with administration witnesses, so there will be lots of additional opportunity. And, of course, Secretary Geithner is coming, so there will be lots of opportunity for additional questions.

I thank my colleagues.

[Whereupon, at 12:00 p.m., the Committee was adjourned.]





**Sen. Murray**

**On a related note, I am concerned that the Pacific Coastal Salmon Recovery Fund was cut by over 23 percent in the President's Budget to \$50 million, which would be a major blow to salmon restoration efforts across the West Coast.**

**I hope the Administration will work with me to provide an adequate level of funding for this critical program that has a track record of success.**

The Administration appreciates the work being done and its value as a consistent funding source to recover Pacific salmon. We would like to note that most of the extramural funding in the National Oceanic and Atmospheric Administration's (NOAA) budget for habitat restoration, land protection, and species recovery is concentrated within the Pacific Coastal Salmon Recovery Fund (PCSRF)—a reflection of the Administration's focus on supporting salmon fisheries and improving the economy of coastal communities in Washington and the Pacific Northwest.

Salmon restoration requires a robust effort, involving Federal, State, and tribal funding as well as making management decisions that minimize impacts on salmon stocks. Within NOAA, the PCSRF is complemented by the efforts of NOAA's coastal programs and the National Marine Fisheries Service. The Department of the Interior, U.S. Army Corps of Engineers, and Bonneville Power Administration, among other Federal agencies, also fund activities in support of Pacific salmon. Coupled with steady support from State and tribal governments, we can continue to recover Pacific salmon despite fiscal constraints.

**Sen. Murray**

**Acting Director Zients, I appreciate the efforts of OMB and DOE to put forward this year's budget request for the Environmental Management program.**

**Now, I know you've been focused on the regulatory work during your time at OMB, but as you know the Department of Energy is responsible for the safe clean up of the federal government's nuclear weapons program, which is done through the Environmental Management program.**

**During my time in the Senate - and even during this Administration - I have worked with several OMB heads and I want to make sure that, in your new role, you fully understand the federal government's legal obligation to clean up this waste. It is both a legal and a moral obligation, to states and to the people of the communities who worked to help our country win World War II and the Cold War.**

**I look forward to working with you to ensure that EM has a clear, consistent budget. For fundamental legal reasons, and because we waste massive amounts of human and monetary capital when EM doesn't have stable budgets, we have to make sure that the Administration budgets effectively over the long term to meet required compliance deadlines.**

- **What will you do as the Director of OMB to ensure a clear and consistent approach to EM budgets?**

The FY 2013 Budget reflects a clear and consistent approach to funding for the Department of Energy's (DOE) Environmental Management program, which includes resources to allow DOE to meet all FY 2013 enforceable milestones in its various cleanup agreements, including the Hanford Tri-Party Agreement to protect the Columbia River. The Budget proposes \$5.65 billion for the cleanup program, \$60 million (1 percent) below the 2012 enacted level. The Administration is concentrating on improvements in management and oversight of the program and activities in EM, with the intention of getting more work from the funds we allocate to the program. The Administration recognizes the Department's cleanup obligations and will work with the Congress to meet these environmental requirements over the long term in a fiscally responsible manner. I look forward to working closely with you on this important issue.

**Sen. Murray**

Acting Director Zients, agriculture is critically important to our country and to my home state of Washington. Our farmers grow our food and they also grow our economy. And research is the backbone of our agricultural economy - ensuring that our crops can withstand disease and pests and making our growers competitive in a world marketplace. And basic research, like the kind done at the Agricultural Research Service, is critical to our farmers. That's why I was concerned to see that the President's budget proposes to "reallocate" \$70 million within ARS from "lower priority" areas to "higher priority" areas, but unfortunately we are left to guess what research programs may be affected.

- Will you please provide a list of the ARS programs that would be "reallocated" as part of the President's budget request?

The USDA research budget funds high priority projects to respond to key national issues within overall constrained funding levels. USDA made difficult decisions about what could be supported within the available resource levels. The ARS budget request includes \$78 million of increases, offset by reductions of \$70 million in lower priority projects, of which \$20 million represents grants and contracts performed by non-USDA scientists. The reductions were determined based on specific criteria developed by the agency, including whether other organizations were undertaking the research, if ARS had the appropriate resources, including staff, to be effective, and if the projects' goals had been substantially accomplished.

The list of specific projects and agency justifications is in the USDA budget justification. It can be found in the Agricultural Research Service "Justification of Increases and Decreases" (volume 1, pages 16-18 to 16-47) or through the following web site: <http://www.obpa.usda.gov/16ars2013notes.pdf>.

**Sen. Murray**

**Acting Director Zients, the President's budget request includes a proposal to impose a tax on interest on municipal bonds owned by certain high-income earners. In my home state of Washington, many of my constituents get their electric power from public power utilities and municipal utilities, which rely on tax-exempt financing to construct power generation and infrastructure. I am concerned that imposing this tax on the interest of municipal bonds for high income earners will result in investors requiring higher interest rates from these bond issuances in order to compensate them for lost benefits and uncertain tax treatment.**

- **Does the President intend for this proposal to be applied retroactively?**
- **What effects do you expect this will have on the municipal bond market, particularly if it would be applied retroactively?**
- **I am concerned that implementing this proposal will effectively result in raising the cost of borrowing for local communities and utility customers. What is your plan to ensure that municipalities, public power and others currently utilizing tax-exempt financing will not face higher costs to borrow?**

The Administration's goal is to continue strong support for tax preferred financing by State and local governments and other entities—and to do so in a way that is efficient as possible. That is why, as part of the Budget, the Administration proposed to permanently continue the Build America Bonds program. This program, which was a very successful part of the Recovery Act, will allow State and local governments to finance investments in a way that is often more efficient than the current system. Additionally, the Administration proposed to limit the value of itemized deductions and certain other tax expenditures to 28 percent for the highest Americans—and this limit also applies to tax exempt interest. The provision would apply starting in 2013 and give equal treatment to tax-exempt interest paid by bonds issued before and after that year.

The current system can be reformed to work better. For the most well-off Americans, the current exclusion for interest paid on these bonds provides a tax subsidy above and beyond what is required to get a competitive after-tax return from municipal bonds at their current interest rates. This generosity doesn't help States and local governments. It helps only these very wealthy taxpayers at the expense of the Federal government, and we'd expect the vast majority of the revenue generated by this proposal to come from those wealthy taxpayers and not from bond issuers such as State and local governments.

The combination of Build America Bonds and the limitation on the value tax exempt interest is intended to open a discussion about tax reform, and we look forward to working with you and others in the Congress to reform tax preferred financing so that, as intended, the system provides strong support to State and local governments and other entities, rather than subsidies to high-income Americans.

**Sen. Murray**

Acting Director Zients, I was very excited to learn the Navy recently purchased the largest quantity of biofuels in DOD history. This is a huge step forward in our march toward reducing our dependence on foreign fossil fuels. But this leap forward may be limited in the short term by the cost of biofuels. Through the DOD we have a great opportunity to build a market for biofuels while enhancing our national security, but we also have a challenge before us in the current way DOD acquires fuel. It is my understanding DOD budgets for the cost of fuel yearly, although the true cost of fuel is very volatile and the budgeted amount may not be sufficient to cover the Department's actual need. However, if the DOD purchased biofuels on a long-term contract, the price of fuel would be certain for both DOD and biofuels producers.

With that in mind, I'd like to ask you the following questions:

- What is the estimated cost of fuel for FY 12 and FY 13? Can you please tell me the factors that go into these estimates?
- What was the actual cost of fuel for FY 11?
- How does OMB and/or DOD take into account world events, including possibilities like closure of the Strait of Hormuz?

It is my understanding the Navy has the authority to sign a five year fuel contract, but in practicality cannot do so because the cost of the five year contract is counted against the Navy up front. In these difficult budget times, this scoring mechanism is not only a huge disincentive but may also be a dealbreaker for the Department to meet its commitments on biofuels.

- It is my understanding DOD would not take immediate delivery of biofuels, but rather as needed or on a yearly basis. In that case, please explain why the full contract cost would be assessed in one fiscal year?
- DOD must purchase fuel, whether that fuel is gasoline or biofuels. Therefore, it seems to me the cost of gasoline should not be included in determining the cost of long-term contracts for biofuels. Does OMB take into account the cost of gasoline as a base cost to DOD when it evaluates the cost of a proposed long term contract for biofuels? Why or why not?

**Operational Fuel and Budgeting Questions**

The Defense Logistics Agency–Energy (DLA-E) provides all non-nuclear operational fuels for the Department of Defense (DOD) including fuel for generators, motor vehicles, aircraft, and ships. DOD spent \$18.4 billion for fuel in FY 2011 and plans to spend \$19.3 billion in FY 2012 and \$18.5 billion in FY 2013. Predictions are based on consumption estimates provided by DOD customers such as the military services (e.g., Army, Air Force) and components (e.g., SOCOM, TRANSCOM, and defense agencies). DOD customers estimate fuel usage based on prior-year consumption patterns, consumption rates of various weapons platforms, and the estimated length and operational requirements of training and operational deployments. DLA-E also assumes specific rates of loss from evaporation, spillage, and combat loss.

**Fuel Price Forecasts**

Twice each year OMB provides agencies with the Administration's economic assumptions: major economic indicators including the price of crude oil. The assumptions package is developed by a team at OMB, the Department of the Treasury, and the Council of Economic Advisors. In the case of oil prices, the projections through 2019 are based on market futures prices for crude oil. The team does not directly anticipate potential geopolitical or economic events, but to the extent that the markets put a premium on futures contracts for such events, they are reflected in the Administration's assumptions.

#### Contract Scoring

A multi-year contract for a product or service—such as the type needed to create enough alternative fuel to meet DOD requirements—will require a substantial obligation of funds, meaning that U.S. government must agree to pay hundreds of millions of dollars over the lifetime of the contract. Whether DOD pays upfront or over time, the government is still obligated to honor the full value of the contract. Scoring budget authority in each year equal to the outlays for that year—instead of the full contract value in the year the contract is signed—misrepresents the total liability of the U.S. government at the time the contract is signed. Moreover, obligations agreed to in prior years constrain policy and budget options in future years.

#### Alternative Fuel Contracts

I understand DLA-E plans to sign long-term contracts only for fully-blended fuel. At the quantities required to support operational requirements, DLA-E will buy only pre-blended alternative/conventional fuel—likely at a 50/50 blend—which can be immediately put into the DOD fuel supply system with no further processing required. Therefore, the price of the long-term contract is for the blended fuel. DLA-E can provide additional information on the details of potential long-term contracts.

**Sen. Sessions**

**Page 25 of the President's Budget volume states that the budget will "bring discretionary spending to its lowest level as a share of the economy since Dwight D. Eisenhower sat in the Oval Office." Please provide the data that supports this statement.**

The attached table shows a history of nominal discretionary outlays as a share of GDP from fiscal year 1962 onward with 2011-2022 equal to the levels included in the President's FY 2013 Budget. Where appropriate, comparability adjustments are included to account for the Administration's six-year (FYs 2013-2018) Surface Transportation Reauthorization proposal, under which Surface Transportation programs are reclassified from discretionary outlays to mandatory outlays. The table shows that nonsecurity falls to its lowest share of GDP since 1962 by about 2015 while total discretionary falls to nearly 5 percent of GDP by 2022, which is the lowest share of discretionary outlays versus GDP that OMB has on record. Hence, the 2013 Budget brings discretionary to its lowest share of GDP since at least the Eisenhower Administration.

**Attachments**

Estimate of Discretionary Nonsecurity as a Percent of GDP In 2013 Budget, FY 1962 - FY 2022  
(Net discretionary outlays in billions of dollars)

Fiscal Year	Discretionary Outlays*										Total Disc. as % of GDP				Security		Nonsecurity as % of GDP		OMB GDP
	Total	Security	Nonsecurity	Surplus		SubFunction		Nonsecurity Less:		Total Disc.		Adjusting for:		Percent of GDP	Adjusting for:				
				Trans Accts.	DOI	Surf. Trans.	SubFct DOI	Surf. Trans.	SubFct DOI	Surf. Trans.	SubFct DOI	Surf. Trans.	SubFct DOI		Surf. Trans.	SubFct DOI			
1962	72.1	59.7	12.4	---	0.1	12.4	12.3	72.1	72.0	12.7%	12.7%	10.5%	2.2%	2.2%	568				
1963	75.3	60.6	14.6	---	0.1	14.6	14.6	75.3	75.2	12.6%	12.6%	10.1%	2.4%	2.4%	599				
1964	79.1	61.5	17.7	---	0.1	17.7	17.6	79.1	79.1	12.3%	12.3%	9.6%	2.8%	2.7%	642				
1965	77.8	57.7	20.1	---	0.1	20.1	20.1	77.8	77.7	11.3%	11.3%	8.4%	2.9%	2.9%	688				
1966	90.1	66.2	23.9	---	0.1	24.0	23.9	90.1	90.1	11.9%	11.9%	8.8%	3.2%	3.2%	756				
1967	106.5	79.5	26.9	0.0	0.1	26.9	26.8	106.5	106.4	11.1%	11.1%	9.8%	3.3%	3.3%	810				
1968	116.0	89.3	28.6	0.0	0.2	28.6	28.5	116.0	117.8	11.6%	13.6%	10.3%	3.3%	3.3%	865				
1969	117.3	89.2	28.1	0.0	0.1	28.1	27.9	117.3	117.0	12.4%	12.3%	9.4%	3.0%	2.9%	948				
1970	120.3	88.8	31.5	0.0	0.3	31.5	31.2	120.2	120.0	11.9%	11.8%	8.8%	3.1%	3.1%	1,013				
1971	127.5	86.0	36.6	0.0	0.5	36.5	36.1	127.5	122.0	11.3%	11.3%	8.0%	3.4%	3.3%	1,080				
1972	128.5	87.7	40.9	0.1	0.6	40.8	40.3	128.5	127.9	10.9%	10.9%	7.5%	3.5%	3.4%	1,177				
1973	130.4	86.4	44.0	0.1	0.8	43.9	43.2	130.3	129.6	9.9%	9.9%	6.0%	3.4%	3.3%	1,177				
1974	138.2	91.7	46.5	0.1	0.9	46.4	45.6	138.1	137.3	9.6%	9.5%	6.4%	3.2%	3.2%	1,430				
1975	158.0	101.5	56.4	0.1	2.1	56.3	54.3	157.8	155.8	10.1%	10.0%	6.5%	3.6%	3.5%	1,560				
1976	175.6	103.8	71.7	6.2	9.1	65.5	62.6	169.8	166.5	9.7%	9.6%	6.0%	3.8%	3.6%	1,738				
1977	197.1	113.0	84.1	5.8	8.5	78.2	74.6	191.2	187.6	9.7%	9.5%	5.7%	4.0%	3.8%	1,974				
1978	218.7	121.7	97.0	3.8	9.9	91.2	87.0	212.9	208.8	9.6%	9.4%	5.5%	4.1%	3.9%	2,215				
1979	240.0	134.8	105.2	6.8	11.7	99.3	93.5	233.2	228.3	8.3%	8.1%	5.4%	3.9%	3.7%	2,501				
1980	276.8	157.9	118.5	8.7	14.8	109.7	103.7	267.6	261.6	9.8%	9.6%	5.8%	4.0%	3.8%	2,724				
1981	307.9	182.6	125.3	8.7	14.8	116.6	110.6	299.2	293.1	9.8%	9.6%	6.0%	3.8%	3.6%	3,057				
1982	326.0	210.3	115.7	7.7	13.2	108.0	102.5	318.3	312.8	9.9%	9.7%	6.5%	3.3%	3.2%	3,224				
1983	353.8	216.4	116.9	8.8	13.9	108.3	103.1	344.7	339.4	10.0%	9.9%	6.9%	3.1%	3.0%	3,443				
1984	379.4	258.1	121.3	10.3	14.6	111.0	106.7	369.1	364.8	9.6%	9.5%	6.7%	2.9%	2.8%	3,664				
1985	415.8	285.2	130.6	12.9	17.1	117.7	113.5	402.9	398.7	9.7%	9.6%	6.9%	2.8%	2.7%	4,146				
1986	438.5	306.6	131.9	14.1	17.9	117.7	114.0	424.4	420.6	9.6%	9.6%	7.0%	2.7%	2.6%	4,404				
1987	444.2	313.1	130.8	12.6	16.2	118.2	114.6	431.5	428.0	9.3%	9.2%	6.7%	2.5%	2.5%	4,651				
1988	464.4	323.6	140.8	14.0	17.4	126.8	123.4	450.4	447.0	9.0%	8.9%	6.5%	2.5%	2.5%	5,009				
1989	488.8	338.2	150.7	15.9	16.9	137.2	133.7	475.8	471.9	8.8%	8.7%	6.3%	2.5%	2.5%	5,400				
1990	500.6	338.8	161.7	15.9	17.6	147.8	144.1	485.6	483.0	8.5%	8.4%	5.9%	2.6%	2.5%	5,725				
1991	533.3	353.1	180.2	14.2	18.0	166.0	162.1	519.1	515.2	8.8%	8.7%	6.0%	2.8%	2.7%	5,931				
1992	533.8	337.7	196.1	15.2	18.9	180.9	177.2	518.6	514.9	8.3%	8.2%	5.4%	2.9%	2.8%	6,242				
1993	539.8	331.0	208.7	17.0	19.9	191.7	188.9	522.7	519.9	7.9%	7.8%	5.0%	2.9%	2.9%	6,587				
1994	541.3	321.8	219.5	20.5	22.1	199.0	197.3	520.8	518.1	7.5%	7.4%	4.8%	2.9%	2.8%	6,977				
1995	544.8	311.7	234.0	20.8	23.5	212.2	209.6	523.9	521.4	7.1%	7.1%	4.2%	2.9%	2.9%	7,361				
1996	522.7	303.3	229.5	21.2	23.6	208.3	205.9	511.5	509.1	6.6%	6.6%	3.9%	2.7%	2.7%	7,718				
1997	547.0	311.9	235.1	22.7	25.0	212.5	210.3	524.4	522.1	6.4%	6.4%	3.8%	2.6%	2.6%	8,212				
1998	552.0	309.7	242.3	23.0	24.5	219.3	217.8	529.0	527.5	6.1%	6.1%	3.6%	2.5%	2.5%	8,663				
1999	572.1	320.6	251.5	23.8	26.6	225.2	224.9	546.3	545.5	5.9%	5.9%	3.5%	2.5%	2.4%	9,208				
2000	614.6	341.8	272.8	30.6	30.6	241.2	241.2	584.0	584.0	5.9%	5.9%	3.5%	2.5%	2.5%	9,823				
2001	640.0	358.0	291.0	33.3	34.4	257.9	256.4	615.9	614.4	6.0%	6.0%	3.5%	2.5%	2.5%	10,225				
2002	714.0	408.7	325.3	36.6	39.0	288.7	286.2	697.4	694.9	6.6%	6.6%	3.9%	2.7%	2.7%	10,544				

Estimate of Discretionary Nonsecurity as a Percent of GDP in 2013 Budget, FY 1962 - FY 2022

(Net discretionary outlays in billions of dollars)

Fiscal Year	Discretionary Outlays*										Total Disc. as % of GDP		Security		Nonsecurity as % of GDP		OMB GDP
	Total	Security	Nonsecurity	Trans Accts	Subfunction 401	Surf. Trans	Subfunction 401	Percent of GDP	Surf. Trans	Subfunction 401	Percent of GDP						
2003	824.3	482.8	341.6	33.5	35.8	308.1	805.7	790.9	788.5	7.2%	7.2%	4.4%	2.8%	2.8%	10,980		
2004	895.1	534.1	360.9	36.8	39.9	324.1	821.0	858.2	855.1	7.4%	7.3%	4.0%	2.8%	2.7%	11,676		
2005	968.5	590.2	378.3	39.1	41.8	339.2	836.8	929.4	927.0	7.5%	7.5%	4.7%	2.7%	2.7%	12,429		
2006	1,016.6	629.0	387.6	39.0	44.2	348.5	858.8	977.6	972.4	7.8%	7.8%	4.8%	2.6%	2.6%	13,207		
2007	1,041.6	646.3	395.3	42.2	45.8	353.1	899.4	999.4	995.8	7.3%	7.2%	4.7%	2.5%	2.5%	13,861		
2008	1,134.9	721.6	414.3	46.1	49.1	367.2	964.2	1,088.8	1,085.8	7.6%	7.6%	5.0%	2.6%	2.5%	14,134		
2009	1,237.5	782.5	455.1	48.0	51.4	407.0	1,016.3	1,189.5	1,184.1	8.5%	8.5%	5.6%	2.9%	2.9%	13,938		
2010	1,347.2	816.1	511.2	47.3	59.9	488.9	1,011.3	1,305.2	1,287.6	9.1%	9.0%	5.7%	3.4%	3.3%	14,160		
President's 2013 Budget Levels (shading indicates published levels on Summary Table S-5)																	
2011	1,347.1	817.8	509.4	47.5	12.5	461.9	1,001.1	1,299.6	1,287.1	8.7%	8.6%	5.6%	3.1%	3.0%	14,959		
2012	1,370.0	868.3	502.5	52.1	7.1	450.4	1,013.3	1,318.8	1,311.0	8.5%	8.4%	5.6%	2.9%	2.8%	15,002		
2013	1,301.7	851.3	450.2	40.2	6.3	410.0	1,013.7	1,281.5	1,255.1	7.7%	7.7%	5.3%	2.5%	2.5%	16,335		
2014	1,181.8	767.0	414.0	21.4	3.8	392.6	888.8	1,160.8	1,156.5	6.8%	6.7%	4.5%	2.3%	2.3%	17,156		
2015	1,148.4	749.5	398.9	13.6	3.1	385.8	882.2	1,134.8	1,131.7	6.2%	6.2%	4.1%	2.1%	2.1%	18,178		
2016	1,152.7	757.1	395.7	10.0	2.3	385.7	883.4	1,147.8	1,140.4	5.9%	5.9%	3.9%	2.0%	2.0%	19,261		
2017	1,169.0	771.2	397.8	7.4	2.0	390.5	885.5	1,161.7	1,159.7	5.7%	5.7%	3.8%	1.9%	1.9%	20,369		
2018	1,167.8	786.0	401.4	4.7	0.4	396.7	896.3	1,183.1	1,182.7	5.5%	5.5%	3.7%	1.8%	1.8%	21,444		
2019	1,211.7	805.8	408.4	3.2	0.4	405.2	894.8	1,208.8	1,208.0	5.8%	5.8%	3.8%	1.8%	1.8%	22,421		
2020	1,237.5	830.4	417.2	1.8	0.4	415.4	915.0	1,235.8	1,235.4	5.3%	5.3%	3.5%	1.8%	1.8%	23,409		
2021	1,258.7	837.3	421.3	0.9	0.4	420.4	920.0	1,257.7	1,257.3	5.1%	5.1%	3.4%	1.7%	1.7%	24,427		
2022	1,287.2	856.3	440.9	0.5	0.4	430.4	930.0	1,286.7	1,286.3	5.0%	5.0%	3.4%	1.7%	1.7%	25,488		

\*The President's FY 2013 Budget included a six-year (FYs 2013-2018) Surface Transportation Reauthorization proposal, under which Surface Transportation programs, a number of which are funded out of the General Fund, are reclassified as mandatory and funded out of the Transportation Trust Fund. As a way of estimating a comparable historical level of nonsecurity as a percent of GDP, this presentation shows different adjustments in an attempt to account for the reclassification through history. A fiscal discretionary level is also included for each of the nonsecurity comparability scenarios:

**Scenario #1 - adjustment for Surface Transportation accounts:** This comparison attempts to adjust for, as far back as possible, the actual accounts associated with the Surface Transportation reclassification through history.

**Scenario #2 - adjustment for Subfunction 401:** This second comparison sets aside all subfunction 401 on ground transportation given that it is comprised mostly of surface transportation programs. This comparison is done to confirm the trends found after adjusting for surface transportation accounts.

Under both scenarios - regardless of the adjustments made - the resulting trends are similar. Nonsecurity falls to the lowest share of GDP since 1962 by 2015 and then continues to fall as a share of GDP. Total discretionary falls to about 5 percent of GDP by 2022, which is the lowest share recorded for which OMB has records. Therefore, the President's budget brings discretionary to the lowest share of GDP since at least the Eisenhower Administration.

**Sen. Sessions**

**CBO says it can't accurately estimate how spending will change next year under automatic sequestration because OMB has not told them which specific federal programs are excluded from the automatic sequestration process. Here is what CBO said in the January 2012 Budget and Economic Outlook (page 12):**

**"The CBO has estimated how much discretionary and mandatory funding will change under the automatic enforcement mechanisms. CBO's analysis can only approximate the results, however; the Administration's Office of Management and Budget is responsible for implementing the reductions on the basis of its own estimates."**

**Can you let CBO know forthwith which specific programs OMB would exclude from the automatic sequestration so CBO can provide a more accurate estimate to Congress when they do their March update?**

The President put forward a balanced package of deficit reduction proposals that exceeded the amount required to avoid sequestration. We urge the Congress to act on these proposals to avoid sequestration. Should it become necessary, the Administration will be addressing important technical questions concerning a sequester, but now is the time to focus on enacting the balanced framework proposed in the President's Budget.

**Sen. Grassley**

**The President's budget raises taxes by more than \$1.5 trillion over the next decade. Yet, public debt as a share of GDP will actually be slightly higher in a decade (76.5%), than it is now (74.2%).**

**Can you explain how, even with a \$1.5 trillion tax increase and rosy economic assumptions, that debt as a share of GDP goes up? Does the President believe that a debt to GDP ratio of 76.5% in ten years from now is a blueprint for an economy that is built to last?**

The eventual level of debt held by the public in the President's Budget is 76.5 percent of GDP from FY 2020 through 2022. While this level is modestly higher than the level of debt as a percent of GDP in FY 2012, it is substantially lower than what would result in the baseline if the policies in the President's Budget were not enacted. In the baseline, debt in FY 2020 is 80.2 percent of GDP (3.7 percentage points higher than in Budget policy), debt in FY 2021 is 81.3 percent of GDP (4.8 percentage points higher than in Budget policy), and debt in FY 2022 is 83.0 percent (6.5 percentage points higher than in Budget policy).

The deficit reduction proposed in the President's Budget policy is considerable. As a result of the policies in the President's Budget, deficits are at or below 3 percent of GDP for the final six years of the budget window. In the near term, debt increases as a share of GDP because deficits remain above levels necessary to stabilize the debt. However, running deficits below 3 percent of GDP and running primary balances are widely held measures of fiscal sustainability; as such, debt held by the public as a percent of GDP falls, and ultimately stabilizes as these sustainable levels of deficits are realized.

**Sen. Grassley**

**You and the President's economic team have obviously spent a great deal of time compiling this budget for 2013. I presume you're aware that Senate Majority lead Reid has already indicated that he has no intention to bring a budget to the Senate for consideration.**

**Given the work that you've done, and the importance you place on President Obama's budget blueprint, will you or the President call on the Senate Democratic leadership to allow a vote on the President's budget? After all, the President called on the Congress to pass the STOCK Act, so surely he would call on the leadership to vote on his own budget.**

Last year, the Congress passed, and the President signed, the Budget Control Act that included discretionary spending caps representing significant cuts agreed to by Democrats and Republicans.

The BCA provides discretionary spending levels through 2021 that will reduce the deficit by \$1.2 trillion over the next 10 years. It is our strong hope that this deficit reduction will be the result of elected leaders in the Congress sending the President a series of tough but balanced proposals instead of the sequester that is now called for in 2013.

The President made it quite clear that we have to tackle our long-term deficit. The President's Budget includes many proposals and policies that will reduce the deficit significantly, and we hope the Congress will act on all of them.

**Sen. Grassley**

**In describing the President's budget, you and other Administration officials have claimed that it takes a balanced approach to deficit reduction. You've stated that it includes \$2.50 in spending cuts for every \$1 in tax increases. I'm concerned that this ratio assumes spending cuts that were actually enacted last year, and that it also counts debt servicing savings as spending cuts.**

**How are reductions in interest payments on the national debt calculated for the purposes of this ratio? What would the ratio of tax increases to spending cuts be if you only included new proposals put forth in the 2013 budget and backed out the savings in interest payments on the national debt?**

The calculation of \$2.50 in spending cuts for every \$1 in revenue increases includes deficit reduction since January 2011 to produce a comprehensive view of our deficit reduction efforts. It includes interest savings among the spending reductions because, consistent with concepts in OMB's Circular A-11 and GAO's *Glossary of Terms Used in the Federal Budget Process*, interest payments on the debt are classified as spending and reductions in interest payments are therefore spending reductions.

When accounting for how much the President is proposing to reduce spending, it is only right to include the spending caps that are now signed into law. This Budget reflects these savings and makes the tough choices needed to meet those targets.

**Sen. Grassley**

**The Social Security program is in permanent cash deficit. Tax revenue is no longer sufficient to cover the cost of benefits for retirees and disabled. Absent any policy changes, the retirement and disability benefits for future generations will be reduced significantly once the trust fund is exhausted.**

**Given the very predictable fiscal challenges facing the Social Security program, what proposals has President Obama included in his 10-year budget blueprint to strengthen Social Security for future retirees or for the disabled?**

The President recognizes that Social Security is indispensable to workers, retirees, survivors, and people with disabilities. It is one of the most important and most successful programs ever established in the United States. Although current forecasts project that Social Security can continue paying full benefits through 2036, the President is committed to making sure that Social Security is solvent and viable for the American people - now and in the future<sup>1</sup>. He looks forward to working on a bipartisan basis to preserve it for future generations and has put forward six principles for reform:

- 1) Any reform should strengthen Social Security for future generations and restore long-term solvency.
- 2) The Administration will oppose any measures that privatize or weaken the Social Security system.
- 3) While all measures to strengthen solvency should be on the table, the Administration will not accept an approach that slashes benefits for future generations.
- 4) No current beneficiaries should see their basic benefits reduced.
- 5) Reform should strengthen retirement security for the most vulnerable, including low-income seniors.
- 6) Reform should maintain robust disability and survivor benefits.

The Budget also includes measures designed to enhance program integrity and reduce costs, and proposes reinstating demonstration authority in the Social Security Disability Insurance program to explore new areas for reform.

<sup>1</sup>Budget of the United States Government, Fiscal Year 2013 (p. 195).

**Sen. Grassley**

**I recently sent you a letter urging you to allow Animal Plant Health and Inspection Services (APHIS) to issue the BSE comprehensive rule. This is an important rule for the beef industry and it will give our trade negotiators a stronger position to push other nations to adopt science based BSE policies. APHIS Administrator Parham has committed that this rule will be issued sometime in fiscal year 2012, but I am not aware of a reason this rule can't be published for public comment right now.**

**Can you please tell me if there is a reason your office has not allowed APHIS to issue this rule? If you cannot point to a specific reason, can you commit to me when this rule will be issued?**

I appreciate your comments, and very much understand the importance of the BSE comprehensive rule. The Office of Information and Regulatory Affairs received this rule for review on October 17, 2011, and concluded review of the rule on March 6, 2012. The rule was published by USDA in the Federal Register on March 16, 2012, and can be accessed at: <https://www.federalregister.gov/articles/2012/03/16/2012-6151/bovine-spongiform-encephalopathy-importation-of-bovines-and-bovine-products>.

**Sen. Grassley**

**The Environmental Protection Agency proposed raising the 2013 Renewable Fuel Standard (RFS2) volumetric requirement for biodiesel in June of 2011. The EPA made this recommendation after an extensive review demonstrating that the requirement is readily achievable in a sustainable manner, with significant benefits to the nation in terms of economic growth, national security and the environment.**

**What is the reason for the delay in issuing the final rule establishing the 2013 biodiesel requirement under the RFS? Will OMB finalize the 2013 volumetric requirements for biodiesel as proposed by the EPA? Can you commit to me when this rule will be issued?**

In a Notice of Proposed Rulemaking (NPRM) published on July 1, 2011, EPA proposed an applicable volume of 1.28 billion gallons for biomass-based diesel (BBD) for 2013. The Clean Air Act specifies that the minimum volume of biomass-based diesel for years 2013 and beyond must be at least 1.0 billion gallons. In determining the biomass-based diesel applicable volume, the statute requires an analysis of the impact of the biomass-based diesel volume on a variety of factors such as the impact of the biomass-based diesel volume on energy security, transportation fuel costs, job creation, water quality, and other factors.

The final rule, published on January 9, 2012, ultimately did not include an applicable volume for biomass-based diesel for 2013. EPA explained this decision in its final rule: "We are continuing to evaluate the many comments on the NPRM from stakeholders as well as fulfilling other analytical requirements...EPA intends to gather additional information to enhance our analysis of these factors including consideration of costs and benefits consistent with the provisions of E.O. 13563, to ensure an appropriately balanced decision. For these reasons, we are not finalizing an applicable volume for 2013 BBD in today's rulemaking. We recognize that the statute calls for EPA to promulgate the applicable volume of BBD for 2013 no later than 14 months before that year. We do intend to issue a final determination setting the applicable BBD volume for calendar year as expeditiously as practicable."

**Sen. Enzi**

**The FY 2013 budget includes a variety of proposals to eliminate any tax preferences for the oil, gas, and coal industries. Repealing those tax preferences will cost jobs in states like Wyoming where American energy is produced. Further, increasing taxes on those industries will lead to higher prices for consumers on their electricity bills and at the pump. With a weak economy and rising oil prices, does it really make sense to propose a tax increase that will make energy more expensive for all Americans?**

The price of crude oil and gasoline are largely determined in world markets, and would be little affected by eliminating the tax preferences as proposed by the Administration. U.S. oil and gas production has increased rapidly in response to technological changes and higher prices, and that production boom will continue even if these special tax preferences are eliminated. The increase in production has resulted in oil imports declining to their lowest level since 1999. To put it another way, the strength of this sector shows producers are not in need of special tax preferences.

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21<sup>st</sup> Century energy economy. Repeal of oil, gas, and coal tax preferences will reduce greenhouse gas emissions, remove distortions that inhibit the market penetration of clean energy technologies, and save \$41.4 billion over the next 10 years. These tax preferences represent, by far, the largest fraction of fossil fuel subsidies; therefore, their repeal is a necessary step in our transition to a clean energy economy and a fairer tax code, at a time when oil and gas companies are accruing record profits. The Administration strongly supports increasing investments in clean energy — the future of the energy industry — that will support American workers and American-made energy.

**Sen. Enzi**

**In December, your department cleared a "bulletin" on essential health benefits - the mandates that all new health plans sold to individuals and small businesses will be required to provide in 2014 and beyond. By issuing a "bulletin" rather than a proposed rule, the Administration has sidestepped the requirement to publish a cost benefit analysis estimating the impact these mandates will have on health insurance premiums and the increased costs to the federal government. In general, the "bulletin" raises more questions for states and employers than it answers. The "bulletin" tells states they must choose among four options before September 2012. My question is, will a rule be finalized before the September 2012 deadline the "bulletin" places on states? How can states be expected to implement a "bulletin" which has no force of law?**

On December 16, 2011, HHS released a bulletin describing the regulatory approach it plans to propose to define the essential health benefits (EHB) under the Affordable Care Act. HHS released this intended approach to give consumers, States, employers, and issuers timely information as they work towards establishing Affordable Insurance Exchanges and making decisions for 2014. This approach was developed with significant input from the public, as well as reports from the Department of Labor, the Institute of Medicine, and research conducted by HHS.

This bulletin also provides information and solicits comments on the regulatory approach HHS will take in future rulemaking. HHS plans to issue a Notice of Proposed Rulemaking in the near future, which will fully comply with the APA rulemaking process. HHS will take public input into consideration as HHS works towards proposing and finalizing its rule.

**Sen. Enzi**

**CBO has informed us that there is sufficient funding to maintain the maximum Pell Grant next year, but that it will require an additional \$8 billion in discretionary funding in FY 14 in order to maintain the maximum grant. Your budget generates roughly \$8 billion in savings over ten years through revisions to the Perkins Loan program, elimination of subsidized student loans for students in school longer than six years and by lowering subsidies to guaranty agencies. However, these provide only temporary relief and Pell funding is likely to be a problem for many more years. What other proposals does the President have to ensure long term stability for the Pell Grant program? And how can we justify spending on your other proposals when we know that Pell is going to require substantially more funding in the years to come?**

As you know, the Budget continues the Administration's strong commitment to the Pell Grant program and to increasing the maximum award to \$5,635 in the 2013-14 school year. It includes measures that ensure full program funding in 2013 and 2014 while still meeting our overall fiscal targets. We are proud of the \$904 increase in the maximum award since 2008 and are committed to preserving it. While the long-term health of the program is critical, the Budget stresses the need for immediate action to meet the shortfall in 2014.

If the Congress waits until fiscal year 2014 to confront a 2014-15 Pell Grant funding gap, and if the Congress again concludes – as it did in the 2012 appropriations process – that savings from the subsequent fiscal year cannot be used to cover a current-year problem, then deep reductions in Pell Grants will likely be required in 2014. These reductions will be much more severe than the reductions needed if the Congress tackles the 2014-15 problem in fiscal year 2013, using savings from multiple years. Over the long term, the Administration will work with the Congress to make the difficult choices needed to maintain this vital program. This can be accomplished while still funding other priorities reflected in the President's Budget and meeting our overall fiscal targets.

**Sen. Enzi**

**I am pleased that the Administration's Fiscal Year 2013 Budget contains a commitment to build a Job Corps Center in every state. As you know, Wyoming and New Hampshire are the only states that do not have a Job Corps Center. Can you share any details on the timing for putting out a bid on the proposed Wind River Job Corps Center in Riverton, WY?**

The Department of Labor intends to follow its normal internal procedures for procuring a bid to construct the Wyoming center. The Department of Labor can provide more specifics regarding the timeline for construction.

**Sen. Thune**

**Debt as a percentage of GDP has reached 100%. The budget crisis is the most predictable crisis facing our nation. Yet, under the President's budget, debt to GDP is expected to increase. We have seen the effects high levels of debt to GDP have had on economies of countries such as Greece. Ironically, Greece passed a fiscal austerity package hours before the President's budget was released.**

**The President's own Fiscal Commission recommended discretionary spending caps that froze discretionary spending at the 2011 level and then cut spending before letting it slow again. The Commission proposal would save well over \$1 trillion in the next ten years compared to the current budget caps.**

**Mr Zients, why did the President ignore this proposal from his own Fiscal Commission?**

The President created the Bowles-Simpson Commission to address head-on the Nation's fiscal challenge, and he welcomed the Commission's balanced approach to deficit reduction.

Since the Commission released its report, the President has repeatedly advocated a balanced plan for deficit reduction – one that includes both spending cuts and increased revenues from the wealthiest Americans. That is the general approach taken by the Bowles-Simpson Commission, as well as in the President's Fiscal Framework he described last April; the "grand bargain" he pursued last year; his recommendations to the Joint Select Committee on Deficit Reduction last fall; and his FY 2013 Budget.

The discretionary budget authority caps enacted in the Budget Control Act were negotiated on a bipartisan basis and did indeed follow much of the Commission's recommendations. The BCA set a cap level in 2012 at \$1,043 billion - \$7 billion below the 2011 enacted level as scored by the Congressional Budget Office - and then applied modest but reasonable growth to those levels through 2021. Table S-3 of the Budget shows that final 2012 appropriations, along with staying within the caps beyond 2012, saves more than \$1.2 trillion through 2021. When savings from final 2011 appropriations are included, which were achieved through negotiations between the Congress and the Administration after the Bowles-Simpson Commission released its report, the total savings climb to \$1.6 trillion, nearly the level of overall discretionary savings that the Commission recommended through FY 2020 in Figure 17 of its report.

In addition, Table S-5 shows that the overall level of discretionary outlays in the President's Budget over the same 2011 to 2020 window as the Fiscal Commission is about \$12,107 billion. This is about \$411 billion less than the \$12,518 billion level of discretionary outlays that was included in the Commission's plan in Figure 16. The President's Budget level, however, should include a comparability adjustment of \$565 billion (found in table S-8) over the same time period to account for baseline levels of surface transportation outlays that the budget proposes to reclassify as mandatory and fund out of the Transport-

ation Trust Fund. Even with this adjustment, the level of discretionary spending in the President's Budget is only about \$150 billion above the Commission's recommendation over the time frame.

By maintaining discretionary budget authority at the bipartisan cap levels set in the Budget Control Act, the President's Budget brings discretionary spending to a level that is not far off from the Commission's recommendation and to its lowest level as a share of GDP since at least the Eisenhower Administration.

**Sen. Thune**

**The Social Security program is in a permanent cash deficit. Tax revenue is no longer sufficient to cover the cost of benefits for retirees and the disabled. While the Social Security Administration has relied on trust fund interest to pay current benefits, benefits costs will outstrip all trust fund income by 2022, forcing the Social Security Administration to begin selling off trust fund assets to meet benefit promises. Once the trust fund is exhausted, benefits for future retirees will be significantly reduced.**

**Mr. Zients, why did the Administration decide against including in its budget much-needed reforms to strengthen Social Security for future beneficiaries?**

**Do you agree with Majority Leader Harry Reid, who said "Social Security does not add a single penny, not a dime, a nickel, a dollar to the budget problems we have. Never has and, for the next 30 years, it won't do that."?**

The President recognizes that Social Security is indispensable to workers, retirees, survivors, and people with disabilities. It is one of the most important and most successful programs ever established in the United States. Although current forecasts project that Social Security can continue paying full benefits through 2036, the President is committed to making sure that Social Security is solvent and viable for the American people - now and in the future<sup>1</sup>. He looks forward to working on a bipartisan basis to preserve it for future generations, and has put forward six principles for reform:

- 1) Any reform should strengthen Social Security for future generations and restore long-term solvency.
- 2) The Administration will oppose any measures that privatize or weaken the Social Security system.
- 3) While all measures to strengthen solvency should be on the table, the Administration will not accept an approach that slashes benefits for future generations.
- 4) No current beneficiaries should see their basic benefits reduced.
- 5) Reform should strengthen retirement security for the most vulnerable, including low-income seniors.
- 6) Reform should maintain robust disability and survivor benefits.

Social Security is not a primary driver of our near-term deficits or our long-term debt and does not face an immediate crisis. The Social Security trust funds have sufficient income, assets, and interest income earned from those accumulated assets, to pay full benefits through 2036. However, taking action, sooner rather than later, will help ensure that Social Security's compact remains strong for future generations.

<sup>1</sup>Budget of the United States Government, Fiscal Year 2013 (p. 195).

**THE PRESIDENT'S FISCAL YEAR 2013 BUDGET  
REQUEST FOR THE U.S. DEPARTMENT OF  
TRANSPORTATION**

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**WEDNESDAY, FEBRUARY 15, 2012**

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, Whitehouse, Merkley, Begich, Sessions, Johnson, and Ayotte.

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 this morning. Our hearing today will focus on the President's transportation budget request. Our witness is the Secretary of Transportation, Ray LaHood. This is Secretary LaHood's third appearance before the Budget Committee. We are delighted that he could be with us this morning.

Before we begin, Mr. Secretary, I want to note my thoughts are with your son, Sam LaHood. Most of us I think know that Sam is one of the 16 American nongovernmental organization workers currently banned from leaving Egypt. Sam is with the International Republican Institute.

One of my constituents, Staci Haag, from Fargo, is also among those barred from leaving. Staci is with the National Democratic Institute.

Both the IRI and the NDI were created by Congress to foster and strengthen democratic institutions around the world. The fact that Egypt has taken this action is beyond the pale. It is completely unacceptable. These young people are doing important work, work that is supported directly by the Congress of the United States to support constitutional governments, to support democracy. There could be no higher calling. And for the Egyptian Government or Egyptian authorities to trump up these really farcical charges—I was on the phone with Staci the day before yesterday, just after they received the formal charges. She read them to me. They are farcical. I do not know any better way to put it.

So I just wanted to say to you, Mr. Secretary, I have reached out to the Egyptian Ambassador to express my concern about these absurd charges. I urged the Egyptian leaders to drop them against Staci, against Sam, and all of their colleagues. We will be taking additional steps in the days ahead to register our very serious concern about these actions that are absolutely outside the boundaries of the relationships between countries that respect each other.

So I wanted to begin that way. Now I want to turn my attention—

Senator SESSIONS. If I could respond?

Chairman CONRAD. Senator Sessions, anything that you would want to say?

Senator SESSIONS. Yes. Mr. Secretary, this is a very troubling matter. Your son and the others that are held there are in Egypt to try to help Egypt, to help them and work with the people, and it is deeply distressing that this is have a nation that I have supported relationships with, believe that it has been good for Egypt and the United States. We want to see Egypt prosper and do well. And they have had some traditions of freedom and liberty in Egypt, and to see this happen now is very distressing.

I was briefed on this subject yesterday, and I take it very seriously. If I have the opportunity—and maybe I will—in the days to come to raise that in different forums, I will be looking forward to doing so. But I take it very seriously. It is personal because it is your son, and we know and respect and like you, but it is also a matter of national interest to the United States that our young people officially part of our Government institutions being detained like this is not acceptable. And we just have to make that clear, and we will not accept it.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Sessions, for your very clear statement as well. We hope people are listening and they understand how seriously we take this.

I graduated from high school from an American air force base right next door in Tripoli, Libya, North Africa, Wheelus Air Force Base, so I lived in that part of the world for several years, and I know Senator Sessions may be traveling to that region in the days ahead. I hope that in a combined effort we can send a clear message of what is acceptable behavior and what is completely unacceptable. It is completely unacceptable to be detaining young people who are there to try to help the people of Egypt.

With that, I want to go to our hearing this morning, which focuses on transportation. I believe 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 it is critical to our ability to keep up with our global competitors.

So even as we look to cut spending to bring down the deficit, which we 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 it. We cannot afford to cut areas that are vital to future growth. That would be counterproductive and would ultimately worsen our long-term budget outlook as well as our long-term competitive position.

Investment in transportation can also play an important role in strengthening the economy and creating jobs in the near term, so I am pleased the President has called for a significant up-front investment in infrastructure as part of his economic recovery effort. Investing in infrastructure right now also provides a good value to the American taxpayer because interest rates are low.

In my State of North Dakota, investment in our transportation infrastructure is not keeping pace with our growing needs. Mr. Secretary, you have been to my State. I appreciate your going there. We have an energy boom that is unparalleled in the United States. The Bakken formation, which has now made North Dakota the fourth largest oil producer in the country—we are very close to a time in which we believe we will be the second largest oil producer in the country. That has created a demand on infrastructure that is truly staggering. I have just been in that region of my State in the last several weeks. For every well that is drilled, it takes 2,000 truckloads for equipment, for water, and for mud—2,000 truckloads for every well.

Now, Mr. Secretary, the major highways in that part of our State are two-lane roads. We have chaos.

I met with law enforcement throughout the region just weeks ago. They showed me what has happened to accidents, what has happened to waiting times, what has happened to people trying to get on the highway to get from their farm or ranch to the town.

I had a guy come and tell us that there have been times that he had to wait an hour at his road getting onto the main highway because of truck traffic. No stop sign, no stoplight.

So we have an absolute critical need that really is a national priority because developing this resource is a national priority. Our road network simply cannot handle the extraordinary increase in truck traffic as a result of energy development.

So our vast energy reserves can only benefit the Nation if significant investments are made to upgrade our roads. I believe there needs to be a national energy corridor funding as part of the next transportation bill. There are places that are simply a national priority, and we have to make them a national priority.

It is clear there is a tremendous need for infrastructure investment throughout the country. The American Society of Civil Engineers created a report card on America's infrastructure. They gave our infrastructure a grade of "D"—"D" as in dumb. That is dumb, because infrastructure is really the foundation for our competitive position.

## Engineers' Report Card on America's Infrastructure

<u>Infrastructure</u>	<u>Grade</u>
<b>Aviation</b>	<b>D</b>
<b>Bridges</b>	<b>C</b>
<b>Rail</b>	<b>C-</b>
<b>Roads</b>	<b>D-</b>
<b>Transit</b>	<b>D</b>
<b>Infrastructure GPA</b>	<b>D</b>

Source: American Society of Civil Engineers, 2009

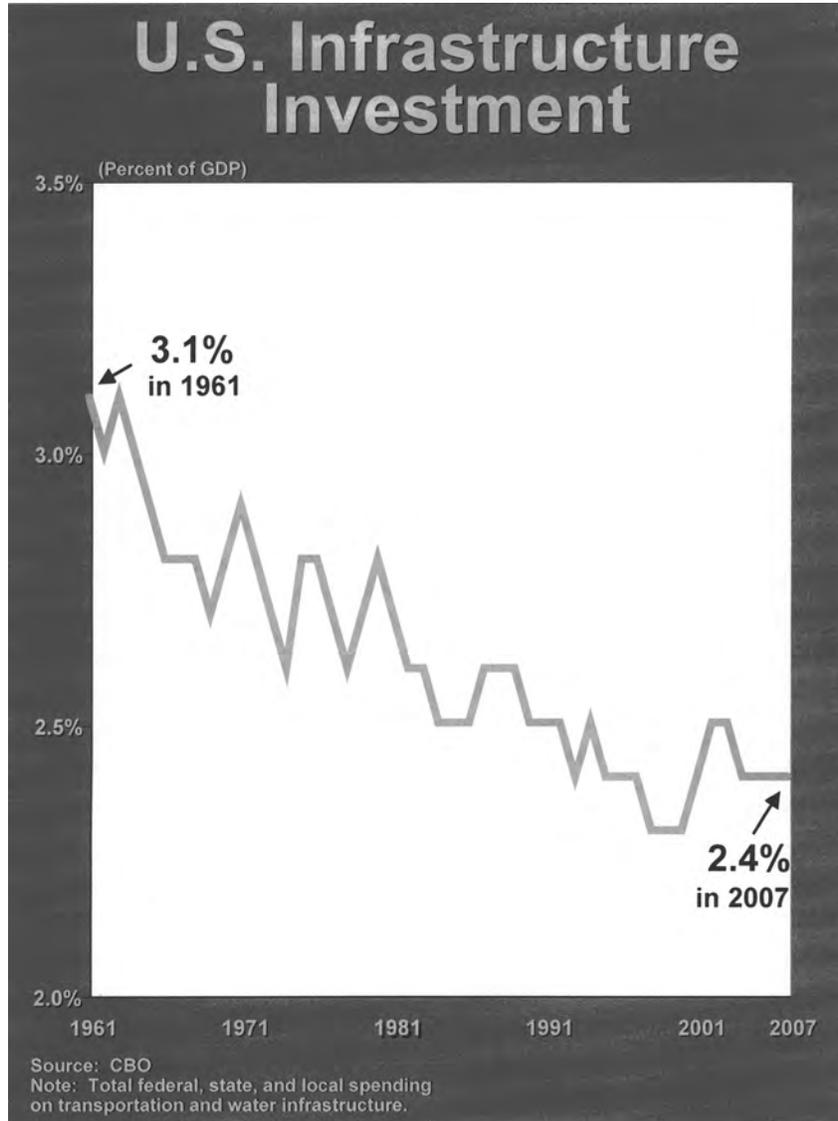
According to the World Economic Forum's Global Competitiveness Report, the United States ranks 24th in the world in the quality of its overall infrastructure. We even rank behind countries like Barbados and Oman. And I would note we have fallen one spot from our ranking last year when we came in 23rd.

## U.S. Ranks 24<sup>th</sup> in World in Quality of Overall Infrastructure

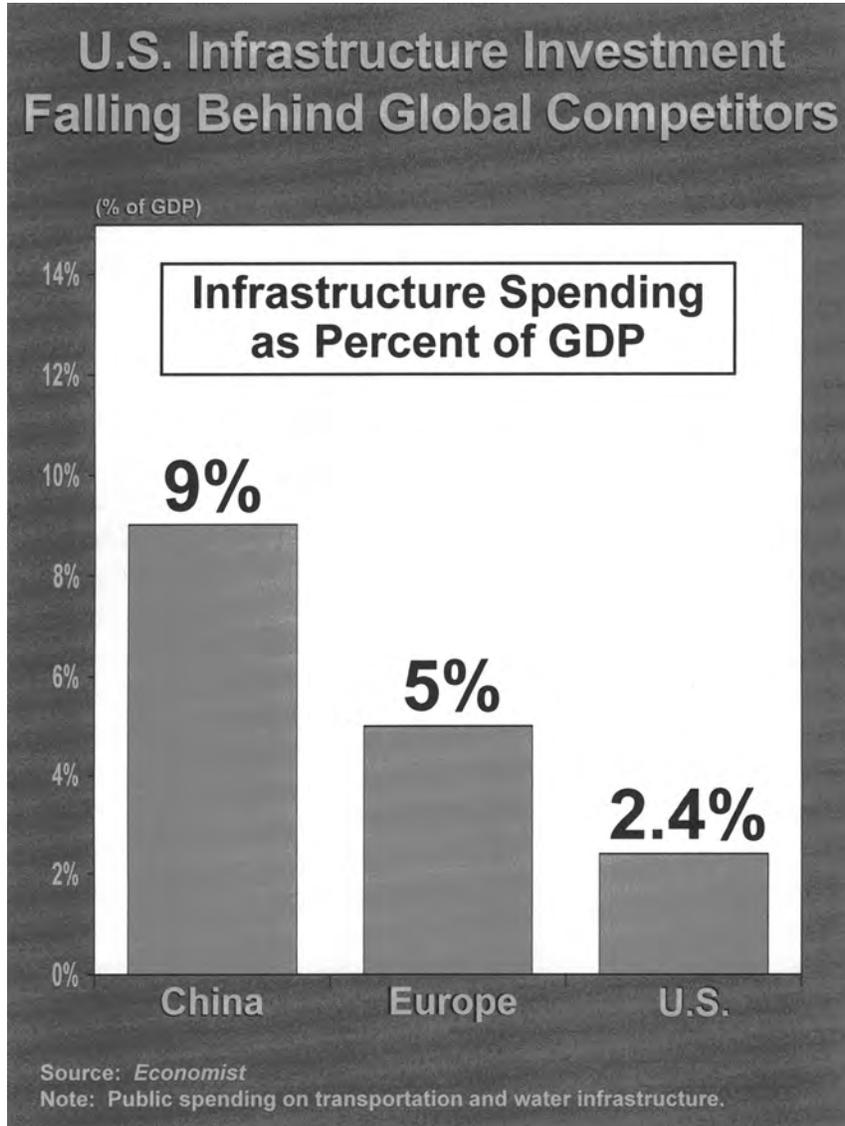
1. Switzerland
2. Singapore
3. France
4. Hong Kong
5. Denmark
6. Finland
7. Iceland
8. Austria
9. United Arab Emirates
10. Germany
11. Sweden
12. Portugal
13. Japan
14. Netherlands
15. Canada
16. Luxembourg
17. Belgium
18. Republic of Korea
19. Bahrain
20. Oman
21. Barbados
22. Spain
23. Malaysia
- 24. United States**
25. Taiwan
26. Qatar
27. Saudi Arabia
28. United Kingdom
29. Czech Republic
30. Cyprus

Source: World Economic Forum Global Competitiveness Report, 2011-2012  
Note: Overall infrastructure includes transport, telecom, and energy.

U.S. investment in infrastructure has been falling as a share of the economy. According to the Congressional Budget Office, total Federal, State, and local spending on transportation and water infrastructure has fallen from 3.1 percent of GDP in 1961 to 2.4 percent in 2007. We risk falling behind our chief global competitors. Already we see China and Europe are investing far more in infrastructure as a share of their economies than we are as a share of ours.



According to the Economist Magazine, China is spending 9 percent of its gross domestic product on transportation and water infrastructure. Europe is spending 5 percent of GDP. As I noted, the U.S. is half that amount at 2.4 percent of GDP.



There is, I think, widespread and bipartisan agreement on the need for further infrastructure investment. Last July, the Carnegie Endowment completed a study on the Nation's infrastructure. The study was spearheaded by former U.S. Senator Bill Bradley, former Homeland Security head Tom Ridge—somebody you know well—and former U.S. Comptroller General David Walker, somebody who has testified before this Committee many times. They concluded in their report the following:

“Integrated, efficient, and cost-efficiency transportation networks that provide timely access to goods and services are the foundation

of a 21st century economy. If America is to remain a global economic power while advancing our common aspirations for a better quality of life, we need to reinvest in America, especially in our transportation infrastructure. If living within our means includes good husbandry of our existing system, we need more, not less, investment in transportation. That means more revenues that are wisely spent to meet our obligations for ourselves and our future generations.”

## Bipartisan Consensus on Need for Infrastructure Investment

“Integrated, efficient, and cost-effective transportation networks that provide timely access to goods and services are the foundation of a twenty-first century economy....

“If America is to remain a global economic power while advancing our common aspirations for a better quality of life, we need to re-invest in America, especially in our transportation infrastructure....

“If ‘living within our means’ includes good husbandry of our existing system, we need more, not less, investment in transportation. That means more revenues that are wisely spent to meet our obligations for ourselves and for future generations.”

– Bill Bradley, Former U.S. Senator  
Tom Ridge, Former Secretary of Homeland Security  
David Walker, Former U.S. Comptroller General  
“Road to Recovery: Transforming America’s Transportation”  
Carnegie Endowment for International Peace  
July 2011

I hope people take a look at this report. Senator Bradley, Secretary Ridge, and Comptroller General Walker make, I think, a compelling case.

Here is what the Obama administration has proposed in its budget for transportation: first, \$50 billion for an up-front infrastructure investment in 2012 to boost economic growth and create jobs.

## Obama Budget Transportation Proposal

- \$50 B upfront infrastructure investment in 2012 to boost economic growth
- \$476 B six-year surface transportation reauthorization
  - \$318 B for roads, bridges, safety
  - \$108 B for transit
  - \$47 B for high-speed rail
  - \$3 B for TIGER grants
  - Paid for with savings from reduced Overseas Contingency Operations
  - Reclassify transportation spending as mandatory, subjecting it to PAYGO rules

Let me just say parenthetically that when we were in the debate over a recovery package, I argued strenuously for a \$200 billion package for infrastructure. That did not happen. I regret that it did not. The chief argument that was made against it was that it would take time for that infrastructure money to get into the economy. Well, it would be coming at the right time. It would be coming at the right time.

Beyond that, I would say—I asked those who opposed it, “How long did it take to build the Pentagon?” Well, they were not sure. It took 9 months. We built the Pentagon in 9 months. I said, “We have to get back to that American spirit.” They said, “Well, we have a lot of regulations.” You know, I said, “There are times when regulations need to be waived.”

I understand the need for regulations. I think all of us do. But there are times when you have urgent demands and needs when there has got to be some common sense applied. And I hope very much we are able to find a way to do that.

The second piece of the President’s proposal is \$476 billion for a 6-year surface transportation reauthorization. That 6-year reauthorization includes \$318 billion for roads, bridges, and improving safety; \$108 billion for transit; \$47 billion for high-speed rail; and \$3 billion for TIGER grants, which are grants to States and localities to fund high-priority transportation projects. And I must say we were the recipient of a TIGER grant in North Dakota for Minot, North Dakota, which is right in the heart of the energy boom, to have a bypass for that city, and it is going to make a world of difference—an absolute world of difference. That is the same community, by the way, that was hit by the devastating floods. We had 4,000 homes destroyed in that town. This bypass, you should know,

Mr. Secretary, not only did it make a world of difference for energy traffic, it is going to help the recovery of the town from the devastating floods because it is one of those things of serendipity. That bypass is going to make the recovery for that city go much more efficiently. It is almost as though, some greater power were looking down and got you to make that TIGER grant for that particular intersection and bypass at just the critical time. It is a godsend.

The President's budget proposes to pay for the 6-year transportation reauthorization with savings from reduced overseas contingency operations, that is, from capping war costs. Look, that is controversial. We all know that is controversial. We need to talk about it.

The budget also calls for reclassifying transportation spending as mandatory, subjecting it to PAYGO rules, which is a proposal the administration offered last year. There are people on this Committee who are strongly opposed to that. They are, unfortunately, not going to be here this morning to register their views, but I am sure they have registered those with you directly.

I look forward to hearing more from the Secretary about these proposals.

With that, I turn to Senator Sessions, and, Senator Sessions, I have taken a fair amount of time here. Feel free to consume a like amount of time in your statement.

#### **OPENING STATEMENT OF SENATOR SESSIONS**

Senator SESSIONS. Well, thank you, Mr. Chairman. We have a spirited Committee, but you have presided fairly. You have treated us right. If we cross the line sometimes, the Chairman has the right to get us in line. And I appreciate that, and I appreciate your fairness.

Thank you, Secretary LaHood, for joining us today as we examine the President's budget and his transportation funding request.

First, I just would repeat that your family is in our prayers, and we intend to be as helpful as we possibly can in that situation.

As America is faced with a growing fiscal crisis. We are borrowing 40 cents of every dollar we spend. We are facing our fourth straight annual deficit in this country, annual deficit in excess of \$1 trillion. We have never had this kind of debt path before.

All across the country families are tightening their belts. Cities and counties and States are doing that. The Federal Government has got to do the same. Our severe fiscal challenges present an opportunity to make Government leaner, more productive, and less expensive to achieve more more efficiently and effectively.

As the Chairman said, we have to set priorities. Priorities mean making choices. I am prepared to support and choose transportation as a high priority. Unlike so much of what Washington does with taxpayers' money, good roads are tangible, long-term, quality of life improving matters that make the Nation more productive; not just for 1 year or 2 years but for decades. It creates American jobs, and virtually all of the matters that go into those highways are American produced, and they cannot be produced in a foreign country. It is here. So I think it is a way to create jobs and permanent improvements in productivity.

Now, the tragedy is that there was a great opportunity, as you alluded to, Mr. Chairman, to advance our highway system as part of the President's stimulus package. Instead, nearly \$1 trillion of borrowed money was frittered away on failed proposals that succeeded only in sinking our Nation deeper in debt. I do not believe it made a significant improvement in our economy, although you and I would disagree, and good people can disagree on that. Certainly more people are out of work today than when that bill passed.

But the President said his stimulus would be used to repair our Nation's crumbling infrastructure. It was sold on that basis. Repeatedly we were given stories that our infrastructure is crumbling. At the last minute, I noticed how little of that money was actually going to infrastructure. It went to State aid and it went to social programs. It went to all kinds of things.

Here in the Los Angeles Times, just a few days ago, "Taxpayer money used to maintain million-dollar yacht." The yacht of the city, over \$500,000 went to that.

Now, we have those kinds of stories time and again, but too little of it went to roads and bridges and crumbling infrastructure.

Now the President's budget will further undermine America's future by using foreign loans for costly and unnecessary projects in this infrastructure. The President's budget includes another \$47 billion for high-speed rail, which Congress has already declined to fund. We cannot justify a massive nationwide high-speed rail system at this time. There may be specific projects that are justified in special areas but not nationwide, not the kind of program that would utilize \$47 billion. And it lumps Amtrak now into the Highway Trust Fund where it would further destabilize the fund that has already been weakened through a lot of gimmicks and difficulties we are having here in making it funded.

The President's highway reauthorization proposal increases spending \$231 billion above incoming revenue. That is a lot—\$231 billion above the revenues we have been operating under for the trust fund.

Last year, the President proposed to pay for a similar increase in transportation spending with this famous "not gas tax" tax—a tax that somebody was supposed to pass, but it would not be a gas tax because people might not like that. And, of course, no tax of any kind was passed to fund the highways. CBO scored it to bring in zero dollars, and they were correct. It brought in zero dollars, this mystery tax.

This year, the President offset the cost of this new spending program through imaginary money that would be obtained from long-planned reductions in our military operations abroad.

Now, I think we should talk about that. There is no dedicated source of funding for the war. The war was funded with borrowed money. We talked about it. We debated it. Some people said there should be a tax to pay for the war. But no tax was raised to pay for the war. It was borrowed money. And so when the war comes down, we simply do not have to borrow as much.

So I was taken aback at the State of the Union when the President said we are going to use half of the war savings to fund infrastructure. There is no money there. It just means we are going to

borrow, continue to borrow half as much as we were borrowing before, if you assume his assumption is right.

This is the kind of gimmick that has put America in this fix. We know there is no money there. We know what you are saying is—when you say we are going to spend OCO money, war money, we know you mean you are going to borrow the money for the road program. We need the road program on a sound financial basis, not on borrowed money. We have to reduce that tendency to borrow money.

Ultimately, as we have established, the President's budget is a big gimmick. It is not going to save \$4 trillion. It is just not reducing our deficit \$4 trillion. But it does raise taxes by almost \$2 trillion, and to my knowledge, none of the \$2 trillion in new taxes—\$1.9 trillion—is spent on roads. So if it is a priority, why don't we use some of the new tax revenue at least for roads? In truth, if we raise taxes, they should be used for reducing our deficit, not for new spending.

So if we are to strengthen America, we need to create growth and productivity in America, create American jobs. We have to grow the economy fundamentally and not grow the Government. We have to prioritize and control Federal spending and create an environment where hard-working taxpayers can thrive in their own private sector jobs and where their livelihoods come from. A smart road program, however, can be an asset to that. I think it can help the economy grow and create some jobs, real jobs in the short term.

So I look forward to discussing this matter. I am just deeply disappointed, Mr. Chairman, in the bill that is moving today. I think there are some gimmicks in it. The Finance Committee, Senator Baucus, I supported the bill in Committee. It is on the floor today. We were promised that there would be legitimate pay-fors and this bill would be on a sound basis. I am afraid that is not entirely accurate. And we are looking to get \$6 or \$12 billion—that is what the shortfall is—to make the fundamental program sound. And now we waltz in, and we are just going to borrow another 250 billion out of thin air to spend on infrastructure without any source of income. And now we are also talking about, what 250 or 300 billion borrowed for this tax holiday, which really does not pay your pension, Social Security pension, and the Government in effect gives a person making \$300,000 a \$2,000 check, and, by the way, we do not have to pay for that either, not in the short term, not in the long term.

So I am really worried that our people have not gotten the message that this world is dangerous. Our financial world is dangerous. The Chairman served on the Debt Commission, and came back a little worried, were you not? And I still think our Congress thinks business as usual here, we will just borrow, borrow, borrow for new programs and new programs, when cities, counties, and States are acting differently, and it goes—I like to blame the President, but we have some things going on in both parties that are not as good as they should be, that is for sure.

Thank you. I appreciate the opportunity, Mr. Chairman.

Chairman CONRAD. Yes, sir. Thank you, Senator Sessions.

I noticed, Mr. Secretary, that you have Chris Bertram with you. Chris is the Assistant Secretary for Budget and Programs and the

Chief Financial Officer for the Department, as you so well know. Until August of 2009, Mr. Bertram, was here as a senior professional staff member of the Senate

Committee on Commerce, Science, and Transportation, and I know in his previous career he also was at the FAA in an important position and also served as staff director for the House of Representatives Subcommittee on Highways and Transit. He certainly comes with a tremendous background and is somebody who is respected here, so we are delighted that he is with you at the witness table.

Mr. Secretary, please proceed.

**STATEMENT OF THE HONORABLE RAY LAHOOD, SECRETARY,  
U.S. DEPARTMENT OF TRANSPORTATION; ACCOMPANIED BY  
CHRISTOPHER P. BERTRAM, ASSISTANT SECRETARY FOR  
BUDGET AND PROGRAMS/CHIEF FINANCIAL OFFICER**

Secretary LAHOOD. Mr. Chairman, Senator Sessions, and Senator Whitehouse, thank you for the opportunity to testify on President Obama's 2013 budget proposal for the Department of Transportation, but as importantly, thank you for the kindness and your kind words about my son and what is happening in Egypt and your interest in that. We appreciate that very much.

As transportation has been in the news a lot lately, and that is a good thing. This week, both the House and Senate will debate long-stalled legislation, and as I am sure you have heard, President Obama and I are strong supporters of the Senate's bipartisan approach, and I congratulate Senator Boxer and Senator Inhofe and those who serve on the EPW Committee for the work that they have done, and also to Senator Baucus for working very hard to find the pay-for.

At the same time, on Monday, the President detailed his plan for a 6-year surface transportation reauthorization proposal which is part of his blueprint for an America built to last, and here are the facts. Our budget proposal has three broad goals: number one, creating jobs by investing in our infrastructure; number two, spurring innovation across our transportation systems; and, three, maintaining our laser focus on safety, our number one priority. And all of this would be fully paid for.

President Obama is proposing to cap the funding for the overseas contingency operations over the next 10 years, thereby saving hundreds of billions of dollars. Then we would use half of those savings to pay down the debt and the other half on a 6-year transportation bill that lets us do some nation building at home. So let us take these goals one at a time.

Number one, an America built to last needs a strong transportation infrastructure. That is why the President's budget will improve America's highways, railways, and transit networks and will continue to ensure that these systems are safe.

Of the President's \$476 billion proposal, \$305 billion would fund road and bridge improvements, a 34-percent increase over the previous authorization. The President's plan also will modernize and simplify the highway program structure by consolidating more than 55 programs into 5 programs.

Of course, investing in our transit systems is another critical need. The President's budget includes \$108 billion over 6 years for transit, a 105-percent increase. It will prioritize projects that rebuild and rehabilitate existing transit systems and include an important new \$45 million transit safety program, which we believe is critical. We have been talking to all of you about that for the last couple of years, and the President's budget provides \$2.5 billion in 2013 as a part of a \$45 billion 6-year investment to continue the support of inner-city passenger rail, including the construction of a national high-speed rail network.

Second, innovation. As we rebuild, we can no longer afford to continue operating our transportation system the same way we did 50 years ago with outdated processes and financial tools that were made for yesterday's economy. The President's 2013 budget will invest in research and technologies that our children and grand children will need to boost America's economic competitiveness.

For example, the Federal Aviation Administration, as you all know, is in the midst of the largest transformation of air traffic control ever. The 2013 President's budget requests \$15.2 billion to support FAA programs. More than \$1 billion of these funds will be used to advance the modernization of our air traffic system through NextGen, the next generation of air traffic control technology, which we have all talked about for a long time, through the use of satellite surveillance and new methods of routing. Pilots, planes, and landing procedures NextGen will change how Americans fly, significantly reducing travel times and delays.

Our proposal also will elevate the vital role research plays in transportation decision making by moving our Research and Innovative Technology Administration, RITA, into a new Office of the Assistant Secretary for Research and Technology under the Secretary's office. This change will provide a prominent centralized focus on research and technology, which is very important to the President, which will improve collaboration and coordination among the Department's operating administrations and their research programs.

Third, and finally, keeping our transportation system safe will always be our top priority. Consistent with this commitment, President Obama has proposed a record level of investment in safety. In fact, the President's proposal will provide \$7.5 billion over the next 6 years to the National Highway Traffic Safety Administration, NHTSA, our safety organization, to promote seat belt use, get drunk drivers off the road, and reduce distracted driving; and this will help ensure that traffic fatality numbers continue dropping from the current historic lows.

In addition, we will nearly double the investments in highway safety infrastructure by promoting \$17 billion to Federal Highway Administration safety construction programs. The budget also will dedicate \$4.8 billion to Federal Motor Carrier Safety Administration. These dollars will ensure that commercial trucks and bus companies maintain high operational standards, and our dedicated safety professionals can get high-risk trucks and bus companies and their drivers off the roadways.

Finally, our safety focus must also include the transportation of hazardous materials in our network of pipelines. That is why the

President's 2013 proposal requests \$276 million for the Pipeline and Hazardous Material Safety Administration to help ensure that families, communities, and the environment are unharmed by the transport of chemicals and fuels on which our economy relies.

So, with that, Mr. Chairman, again, thank you for the last 3 years for allowing us to come and talk about our budget. It is a privilege always to do that, and not every Committee affords us this opportunity. So we are grateful to your Committee for that.

[The prepared statement of Secretary LaHood follows:]

**STATEMENT OF  
THE HONORABLE RAY LAHOOD  
SECRETARY OF TRANSPORTATION**

**BEFORE THE  
COMMITTEE ON THE BUDGET  
UNITED STATES SENATE**

February 15, 2012

**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) 2013 budget request for the U.S. Department of Transportation. The President is requesting \$74 billion for Transportation in FY 2013.

The President has called on us to rebuild America – to put people back to work repairing our roads, bridges, transit systems, and airports. He has called on us to restore our values – to ensure that America, once again, is a place where everyone gets a fair shot, everyone does their fair share, and everyone plays by the same set of rules. To achieve this, he has laid out a blueprint for “an America that's built to last” -- a plan that will equip American workers to seize the opportunities of tomorrow and make certain that businesses and families have the safest, fastest, and most efficient ways to connect with these opportunities.

At this make or break moment for the middle class, President Obama has proposed a six-year transportation jobs plan that puts people back to work rebuilding our airports, roadways, railways, and transit systems. The FY 2013 President's Budget reflects the first year of this bold six-year \$476 billion reauthorization proposal that will transform the way we manage surface transportation for the future.

This proposal will be fully paid for. We will pay for the investments proposed under the Surface Transportation Reauthorization Proposal with the savings achieved from ramping down overseas military operations to do some Nation-building right here at home.

**Investing in America's Future**

Investment in transportation is critical to the success of our Nation's economy. The FY 2013 President's Budget will enable us to build America's infrastructure for the future – while putting people back to work today. The President's six-year surface transportation reauthorization proposal will improve the Nation's highways, transit, and rail infrastructure and will ensure that these systems are safe. The President's FY 2013

Budget request also reflects an additional \$50 billion in funding for Immediate Transportation Investments in FY 2012. We will invest in critical areas of transportation to provide a targeted economic boost and jump start the creation of jobs throughout America.

The President's Budget provides \$47 billion over six years to continue construction of a national high-speed rail network. The Federal Railroad Administration is working with States to plan and develop high-speed and intercity passenger rail corridors across the country. These projects include upgrades to existing services, as well as entirely new rail lines exclusively devoted to 125 to 220 mph trains. These corridors will promote economic expansion, create new choices for travelers, reduce National dependence on oil, and foster livable urban and rural communities. In FY 2013, the President's Budget proposes \$2.5 billion for this program.

The President's Budget will provide \$305 billion over six years in funding for road and bridge improvements and construction – a 34 percent increase over the previous authorization. It will also simplify the highway program structure, accelerate project delivery, and realize the benefits of highway and bridge investments to the public sooner. These investments and reforms will modernize our highway system while creating much-needed jobs. The proposal consolidates more than 55 programs into five new programs that invest in roads most critical to the National interest: the National Highway Program; Highway Safety; Livable Communities; Federal Allocation; and, Research, Technology, and Education. It also establishes a performance-based highway program in the critical areas of safety and state of good repair, and provides resources and authorities to spur innovations that will shorten project delivery and accelerate the deployment of new technologies.

The President's Budget also includes \$108 billion over six years – a 105 percent increase – in funding for transit. It will prioritize projects that rebuild and rehabilitate existing transit systems, include an important new transit safety program, and allow larger transit authorities (in urbanized areas of 200,000 or more in population) to temporarily use formula funds to cover operating costs in limited circumstances.

The Administration's Surface Transportation Authorization proposal also 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.

Recognizing that competition often drives innovation, the budget provides nearly \$20 billion for a "race-to-the-top" style incentive program, called the Transportation Leadership Awards, to encourage fundamental reforms in the planning, building and management of transportation system. This program would reward States and regions that implement proven strategies that further the Department's strategic goals, strengthen collaboration among different levels of government, focus on performance and outcomes; and encourage the development of a multimodal transportation system that connects people to opportunities and goods to markets. Examples of best practices that applicants might implement to compete in this program include passage of a primary seatbelt law, use of lifecycle cost analysis, aggressive deployment of operating practices that reduce

need for more costly congestion solutions and implementation of a performance-based funding distribution system.

We will also be leveraging our Federal investment farther than we ever have before through the use of Federal infrastructure loans, which enable state and local governments to significantly leverage Federal dollars when financing transportation infrastructure. The budget provides \$3 billion for the Transportation Infrastructure Finance and Innovation Act (TIFIA) program over six years. The TIFIA program leverages each \$1 of Federal funds into \$10 of credit assistance which supports \$30 in transportation infrastructure investment. Therefore our \$3 billion TIFIA investment is expected to produce up to \$90 billion in transportation infrastructure projects.

In addition, the Budget makes the investments that we need to strengthen 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.

### **Modernizing Our Nation's Transportation System through Research and Technology**

The FY 2013 budget request will support the success of our economy by ensuring that our transportation investments keep pace with the latest innovations and advancements in technologies.

This generation's success is only possible because past generations felt a responsibility to each other – and to their country's future. Think about the transcontinental railroad that connected our coasts, the interstate highway system that enabled a half-century of prosperity, and the ports through which our businesses move goods to markets around the world. American workers wielded the shovels, forged the iron, laid the tracks, and poured the concrete that brought these things to life. They passed these things on to us – their children and grandchildren. The President's FY 2013 Budget will invest in research and technologies that our Nation's next generations will need to sustain the economy.

For example, the Federal Aviation Administration (FAA) is in the middle of undertaking the largest transformation of air traffic control ever. The FY 2013 President's Budget requests \$15.2 billion to support the FAA current programs in the areas of air traffic controller and safety staffing, research and development, and capital investment – and over \$1 billion of these funds will be used to advance the modernization of our air traffic system through "NextGen" – the next generation of air traffic control technology. Through the use of satellite surveillance, new methods of routing pilots, planes, and landing procedures, NextGen will change how Americans fly.

In addition, we will be focusing our efforts on unmanned aircraft systems (UAS), which will play an increasing role in both federal and civil missions, including homeland

security, National defense, law enforcement, weather monitoring and surveying. Currently, technical and procedural barriers still exist in the interoperation of UAS with manned aircraft in the National Airspace System (NAS). In FY 2013, the Joint Planning and Development Office (JPDO) will lead efforts with the NextGen partners to formulate and develop a National plan that will achieve the integration of UAS into the NAS, and accelerate strategic decision making on UAS implementation issues.

The FY 2013 budget also proposes to elevate the vital role research plays in transportation decision-making by moving the Research and Innovative Technology Administration (RITA) into a new Office of the Assistant Secretary for Research and Technology. This proposal will strengthen research functions across the Department by providing a prominent centralized focus on research and technology, which will improve collaboration and coordination between the Department's Operating Administrations.

We will also promote research into Intelligent Transportation Systems, including Vehicle-to-Vehicle technologies. Vehicle-to-Vehicle (V2V) connectivity provides constant communication between vehicles to warn drivers of the potential risk of a collision. In FY 2013, the Intelligent Transportation Systems (ITS) program will dedicate a total of \$22.4 million to the V2V program, and the corollary programs including human factors research, the implementation of a safety pilot, vehicle connectivity policy research and standards development to further explore and advance technologies that will ultimately reduce the number of collisions and save lives.

#### **Pressing Forward on 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. In FY 2010 highway fatalities were the lowest since 1949 – and yet over 30,000 lives are still lost each year on our Nation's highways.

Our budget proposes a record level of investment in safety. The DOT Surface Transportation Reauthorization proposal will provide \$7.5 billion over six years to the National Highway Traffic Safety Administration to promote seatbelt use, get drunk drivers off the road, and ensure that traffic fatality numbers continue dropping from current historic lows. Within this amount, \$330 million is provided for the Department of Transportation's ongoing campaign against America's distracted driving epidemic. In addition, we will almost double the investment in highway safety infrastructure funding, providing \$17 billion to Federal Highway Administration (FHWA) safety construction programs. The Budget will also dedicate \$4.8 billion to the Federal Motor Carrier Safety Administration (FMCSA) to ensure that commercial truck and bus companies maintain high operational standards, while removing high-risk truck and bus companies and their drivers from operating.

Transit safety is another important priority. Rail transit provides over four billion passenger-trips each year, and safely moves millions of people each day. However, as shown by recent accidents and safety-related incidents, we need to strengthen the existing Federal transit oversight authorities in order to maintain the safe performance of our transit systems. The FY 2013 President's Budget proposes \$45 million to enable the

Federal Transit Administration to oversee rail transit safety across America. Funds will be used to develop, promote, and conduct safety oversight activities for rail transit systems Nationwide.

Finally, our safety focus must also include the transportation of hazardous materials and our network of pipelines. The President's FY 2013 budget requests \$276 million for the Pipeline and Hazardous Materials Safety Administration to help ensure that families, communities, and the environment are unharmed by the transport of chemicals and fuels on which our economy relies. We are proposing a new Pipeline Safety Reform initiative that will expand the oversight of our Nation's pipeline system. Under this initiative, we will hire 120 new inspectors and provide \$20.8 million in grant funding to work collaboratively with the States on the oversight of interstate and intrastate pipeline facilities.

### **Conclusion**

Thank you for the opportunity to appear before you to present the President's FY 2013 budget proposal for the Department of Transportation and our Surface Transportation Reauthorization proposal. Our infrastructure belongs to all of us. It's more than the way we get from one place to another; it's the way we lead our lives and pursue our dreams. The President's plan charts a bold new course for transportation infrastructure investment in the United States over the years to come. I look forward to working with the Congress to put people back to work making a transportation system that's the envy of the world – and an America that's built to last.

I will be happy to respond to your questions.

###

Chairman CONRAD. Well, look, we think it is an absolute priority. I think Senator Sessions and I are joined in that, that transportation has got to be a priority. It is good for the economy. It is good for jobs and good for the competitive position of the United States.

Let me go right to that question. I have heard a number of rules of thumb for how many jobs are created for each \$1 billion of transportation investment, investment in transportation infrastructure. Do you have a rule of thumb that you apply, number of jobs created in the United States for every \$1 billion of investment?

Secretary LaHood. Let me just say this: You all gave us \$48 billion in the economic recovery plan—\$48 billion. We spent every penny of that, and what we did, we created 65,000 jobs with 15,000 projects. We started the high-speed rail initiative that the President wanted. We started the TIGER program. We gave \$28 billion to roads and bridges, \$8 billion to transit, and all the money was spent the way Congress said it should be spent. You have not read any bad stories about any of the \$48 billion that we spent. But what we did, we put 65,000 Americans to work building roads, bridges, and transit systems around America.

Now, if you use that as a gauge, you can—

Chairman CONRAD. How much could you have spent effectively?

Secretary LaHood. A lot more.

Chairman CONRAD. Let me just tell you, I argued strenuously—strenuously—for \$200 billion. We had done a great deal of due diligence on how much money could be spent, and it would not have ended when it did. We would have actually spread it—it would still be going right now.

Secretary LaHood. Sure.

Chairman CONRAD. But we believed that we could have absolutely spent \$200 billion more effectively than some of the money was spent. You know, we all know that package was put together as the President was coming into office. Actually, a lot of it was put together before he was ever in office, so he was at a distinct disadvantage.

But I remember that debate so clearly and the arguments being made; it would take too much time. My argument was if you tell the States there is this money and right now with the economic downturn there was a lot of contractors available at very favorable rates—did you find in that \$48 billion that you got very good—

Secretary LaHood. We got bids below what we anticipated, which gave us additional money and, also, jobs done way ahead of schedule also, because there was a pent-up demand with contractors and availability of workers and the great partnerships that we had with the States, whether it is the Governors or the State DOTs or the commissioners ready to go. And it worked very well. It really did. And like I said, not one bad story written about any money, any boondoggles, any earmarks—none of that.

Senator SESSIONS. Well, I just would join you in saying that I made several speeches, and one of my prime concerns about the bill was that it did not do enough for highways. Our basic bill is about \$40 billion a year. So to have \$200 billion could have been a transformation, a transformative act for our infrastructure. But nobody would listen. They moved forward as they did. But I thank you.

You did say that at the time, Mr. Chairman, and I thought you were right.

Chairman CONRAD. Well, I appreciate that. You know, as I look back, it is one of the things I regret the most, that I was not able to persuade certain people who had this idea. And I know the economists, I mean, I have heard it 100 times, it takes too long to get infrastructure into the bloodstream.

The second question I wanted to ask you about was: Do you have any measures for how improved transportation strengthens America's competitive position?

Secretary LaHood. Well, we know now that we are being outcompeted—your chart shows that—by a lot of other countries. China is right now building roadways, airports, runways, high-speed rail, transit systems. I mean, 10 years ago that would not have been the case. Today it is. We are being outcompeted by lots of other countries.

You look what is going to be happening in Brazil, particularly in Rio, what they are going to be doing there with their infrastructure. And we need to keep pace. We do not keep pace by extending the transportation bill. We keep pace by passing a 5-or 6-year bill, which is a blueprint for what we do to put Americans to work: build roads, build bridges, build transit systems. And that is what America has always done. Congress has always done that.

Chairman CONRAD. I want to go back to my first question because you gave an answer—the thing that is in my head is I have been told many times for every \$1 billion of road expenditure, it creates 18,000 to 20,000 jobs. Is there some rule of thumb like that that you apply?

Secretary LaHood. Yes, you know what, Senator? I will get that for the record. I would rather do that than say a figure that may not be accurate.

Chairman CONRAD. Okay.

Chairman CONRAD. Let me go to the next point on my list, which is high-speed rail. You have \$47 billion for high-speed rail. What is the status of high-speed rail? Where is it being taken up? What are the prospects? What does that offer us in terms of enhanced competitive position, jobs, economic opportunity? Give us your view of this expenditure of \$47 billion.

Secretary LaHood. Well, we start from the premise that anybody that has ever gone to Europe or Asia and ridden the trains over there comes back and says, "Why don't we have this kind of transportation in America?" Because we have never had anybody with the vision or the willingness to put the money into it. President Obama stepped up real early in his administration, put \$8 billion in the economic recovery plan, which jump-started our opportunity to implement high-speed rail, which, by the way, many of the States were way ahead of the Federal Government on. California has been working on high-speed rail for two decades. We know along the Northeast corridor people have been using passenger rail for decades.

And so what we did, we took the \$8 billion and did like we do with all of our partners. We partnered with groups around the country that have been working on high-speed rail.

So we have invested \$3.5 billion in California. I just spent a week in California. I met with the Governor. He is totally committed. He is on board. I met with stakeholders. I met with people in agriculture. I met with small business people. They have a good plan.

In the Midwest there is a good plan. The Governor of Michigan, Governor Snyder, has accepted almost \$1 billion for a connection to fix up the tracks between Detroit and Chicago. The Governor of Illinois and the Governor of Missouri have a very good plan. We have invested more than \$2 billion in the Midwest. We just made significant investments in the Northeast corridor, not just between Washington and New York but further north in other States that want to get into the high-speed rail business.

So the President had a vision. He put the money in the economic recovery. You all gave us some additional money. So totally we have invested over \$2 billion, but the important point to make here is there are a number of companies that were building high-speed rail in Europe and Asia, in California, in Illinois, along the Northeast corridor that want to make investments.

I have said all along that there is not enough money in Washington to do all we want to do with high-speed rail. We need private investment, and the private investors are in America. They are in California, they are in Illinois, they are along the Northeast corridor, making investments, partnering with States in order to make the kind of investments to get—this is the next generation of transportation for the next generation. This is what we are doing for our next generation. The last generation left us a state-of-the-art interstate system. Thank goodness they did. It took us 50 years to build it. What we are going to do for the next generation is leave them the next generation of transportation, which is passenger rail.

Chairman CONRAD. Well, I personally believe we do need high-speed rail in this country. I have seen what other countries are doing. I have seen what Japan has done. I see what China is doing, and I see what Europe has done. And we cannot fall behind in that area either. You know, anybody who travels in the Northeast corridor knows we are way, way behind.

Let me just briefly go to the question of funding. You mentioned overseas contingency operations. There is a fair amount of skepticism here with respect to that as a pay-for, and let me try to capture why there is skepticism.

There are many of us that believe that while we understand CBO says this is a savings—we understand that, but here is what troubles me. It just strikes me that what we commit in terms of war funding has very little to do with what we write down in a budget table. What we commit to war funding as a Nation is guided by the national security interests of the United States, and it is very unpredictable when you are going to have conflict and what that conflict is going to be and what it is going to cost.

And so I understand, that CBO says if you cap overseas contingency operations because we are drawing down in Iraq and Afghanistan and that registers savings, I understand that.

I have always been reluctant to use overseas contingency operations to pay for something. I have always kind of considered, well, that is a bonus in terms of bringing down deficits and debt. But

I have always been very reluctant—in fact, in the Commission and the Group of Six, we did not use OCO as an offset. What is your position?

Secretary LaHood. My position is this: The last 2 years that I have appeared before Congress, I have taken a heap of criticism for bringing proposals forward that are not paid for. That is over. You know, the idea that the President did not want to pay for these things over the last 2 years, we were criticized royally for that by a bunch of people here on this side of the Capitol and a bunch of people on the other side.

So the President came up with a pay-for. Debate it. Talk about it. Figure it out. But no more excuses about no pay-fors. We have one. We take the Highway Trust Fund, which is \$230 billion, and we take half of the money from the Iraq/Afghanistan fund, and we pay for what we are talking about here.

I am proud of that. I am proud the President came up with that. And I am also very happy that nobody around here can criticize us for not having a pay-for.

Chairman CONRAD. All right. I have exceeded my time.

Senator Sessions.

Senator SESSIONS. Well, you do not have a pay-for in any realistic sense, and Mr. Elmendorf basically told us that at the hearing, that there is no real money in the war. But the way CBO scores matters, if you had \$100 billion for the war last year, they assume it is going to continue for 10 years. And if you reduce that trend, then you have saved money under their scoring. But it is unrealistic in terms of the debt of the United States. It is totally unrealistic because there is no money there. There is no fund of money there. And it is not paid for.

This money that you are saying is going to be paid for from the war funding is going to be borrowed. It is money we are no longer borrowing for the war. Instead of being able to take a deep breath and relax because we did not have to borrow that money, you propose to spend it, or half of it, on the roads. And that is just not commonsensical, and it is the reason the country is going broke.

I remember asking Mr. Elmendorf on the eve of the health care vote, Christmas Eve, when the vote was the night before, weren't we double-counting \$500 billion to justify the health care bill and make it look like it is going to make money for the Government instead of cost money for the Government. He said, "Yes, you are double-counting."

I asked him would he put it in writing, and he works for us, he said, "I will put it in writing." So he put it out the next morning. He said, "We are double-counting the money even though"—and I am quoting here—"the conventions of accounting would suggest otherwise."

So I would say to you that you may say you have paid for this, but it is because—but it is not reality even though the conventions of accounting might suggest that it is.

All right. Well, and this is important. You indicated in your remarks that the road, bridge improvements and construction represent a 34-percent increase over the previous authorization. That is a pretty substantial increase at base level, is it not, at a time the country is suffering—

Secretary LaHood. Senator, America is one big pothole right now. We have not paid attention to our roads and bridges. We have not.

Senator SESSIONS. Well, I know that. I know that.

Secretary LaHood. I am going to submit for—what I would like—

Senator SESSIONS. If we stopped buying motors for yachts, we could fill a lot of potholes.

Secretary LaHood. I agree with you. I am going to submit for the record how far deficient we are in fixing up our roads and bridges, because it is significant. It is billions of dollars. We are way behind.

Senator SESSIONS. And with regard to California, I see now the numbers are coming in that instead of the early estimates of \$30 billion for this plan, it is going to be \$100 billion more. This is a program that is being rejected by Governors all over the country, and we are not going to start out a massive nationwide high-speed rail program. It is dead on arrival. It is not going to happen. We do not have the money. And we are not going to see—and we are not seeing any numbers that would justify—the traffic count would justify such a massive program. There may be some areas of the country that could certainly benefit from high-speed rail, and they will need to be justified item by item.

With regard to consolidating the 55 programs, I think that is a good step, but it is mainly your headquarters and your administration, as I understand it, that would be improved and that could save money, and I think that is important. But what I am hearing is the real problem out there is the long, arduous, expensive regulatory Federal planning processes that are driving up costs for our State, county, and local officials when they try to execute a project that is now, from planning to cutting the ribbon, as much as 13 years. The Chairman made reference, I think, to some of that.

How can we reduce that time? Do you have any plans that you believe could actually reduce that time and any statistics that would back that up?

Secretary LaHood. Yes, sir. On the highway side, we have a program called “Every Day Counts,” which was implemented by our Administrator, Victor Mendez. It was implemented more than 2 years ago, and it does speed up highway projects. We have had lots of compliments and kudos from our partners around the country on that program.

The Transit Administrator, Peter Rogoff, just announced a way to speed up New Starts program. It is on our website. We reduce the amount of time dramatically from which somebody submits a New Starts to when it is approved and when we so-call cut the ribbon. Both of those programs are—certainly Every Day Counts has been in place. The New Starts is just being implemented, and I believe it will speed up dramatically the time within which we—

Senator SESSIONS. We certainly have seen roads take too long, I think. Some of that may be unwise management by certain State and local governments. But I do hear a lot of complaints, and I am glad that you are focusing on that. I think it would be a great way to get more highway capability sooner at less cost, and that is one of the things that would make the taxpayers happy instead of just spending more money.

On the high-speed rail, Wisconsin, Florida, and Ohio have given back their money, realizing it is too costly for them to participate.

In Florida, the Tampa-to-Orlando project, \$2.4 billion, was rejected by the Governor, and they calculated there could be cost overruns as much as \$3 billion. Governor Kasich in Ohio rejected \$385 billion for a passenger rail line to connect Cincinnati and Columbus and Cleveland. The Governor of Wisconsin rejected \$810 million to connect Madison and Milwaukee. It would be a \$50-per-head round-trip. An 80-mile trip would cost twice as much as driving.

In California, the 800-mile line to connect San Diego to Sacramento, \$5 billion was awarded for the first segment to connect Madera, population 56,000, to Bakersfield, population 388,000, basically in the California desert. Estimated costs have grown from \$33 billion in 2007 to as much as \$100 billion, as estimated by the State Review Board. And the ridership numbers, according to the Review Board, to justify the projects were overblown and costs for alternative to the line were wildly exaggerated to make the line look better.

So I know it sounds good to have a nationwide high-speed rail project, but at this point in history, we do not have the money and we do not have the possibility of anything close to paying for that plan. I just would say to you that I think that is the reality you will face in Congress. But we do understand that there are traffic jams in cities. Some cities could use mass transit. Some cities could use improvements to their interstates. Most of them could use high-speed interstate improvements throughout.

I will give you a chance to respond to that. Thank you for your commitment to the program. We should have a person in this office that is committed to transportation. But I have to tell you, when you are talking about these kinds of increases and these kinds of programs, when we are running the largest deficits in history, you have to understand Congress is not going to be able to agree to everything.

Secretary LaHood. Well, having served in Congress for 14 years, I know that. I am proud that during the 14 years, 5 of those years we had balanced budgets thanks to the work of Senator Conrad and others. And we still had priorities. You have priorities. One of the priorities is to pay down the debt. That is what we did during that 5-year period. But we still had priorities.

One of our transportation priorities is implementing passenger rail. When Florida turned back \$2.3 billion, we had \$10 billion worth of requests. Some of that came from Republican Governors, one in Michigan that we just gave almost \$1 billion to so he could fix up the tracks from Detroit to Chicago so people can get little higher speeds. We have invested in the Northeast corridor, which a lot of people in this town use from Washington to New York, to get to higher speeds, to fix up the catenary. And we are going to continue to make these investments because this is what America wants. They want the next generation of transportation.

Chairman CONRAD. To fix up—you said to fix up the?

Secretary LaHood. Detroit to Chicago?

Chairman CONRAD. No, in the Northeast corridor.

Secretary LaHood. We have invested about \$1 billion just recently.

Chairman CONRAD. And what will that do?

Secretary LaHood. It will get new catenary, buy new cars, and get the tracks in a position where they can go higher speeds.

Chairman CONRAD. "Catenary," that is what—

Secretary LaHood. That is the electrification.

Chairman CONRAD. I see.

Senator SESSIONS. Well, fixing up tracks, identifying systems that are cost-effective, I say do that and report to us, and we will see if it can be justified.

Secretary LaHood. Good.

Senator SESSIONS. But what you are talking about is major rail systems, new ones across Florida or some of these other areas, Governors are running the cost totals, and the costs are coming in much higher than projected. The ridership and the income is below what is projected, and it would be a massive, colossal error to try to build a nationwide system right now when it cannot possibly be justified in my view.

Mr. Chairman—

Secretary LaHood. Mr. Chairman, can I just say one thing?

Chairman CONRAD. Yes.

Secretary LaHood. America has always been about vision, particularly when it comes to transportation. Now, I am glad that when President Eisenhower signed the interstate bill there were a few visionaries here in Congress and in subsequent administrations because what they did, they built large chunks of concrete that did not really connect for a while, but there was a vision to connect America. Fifty years later, we have a state-of-the-art interstate system because of visionaries like Eisenhower and like Members of Congress. That is the kind of vision that President Obama, some Governors, some people in America have for getting to the next generation of transportation, for connecting our kids and grandkids so they can get out of cars, so they can get out of congestion, so they can ride in a comfortable train that goes a decent speed.

If we do not have that vision, we are going to really short-circuit our ability to get what other generations did for us.

Senator SESSIONS. Well, you have a vision. It is just not connected sufficiently to reality, in my opinion.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you. Senator Whitehouse.

We are doing 7-minute rounds today because we have fewer members here, so we can do 7-minute rounds and still get done by noon, which we have promised to do with the Secretary.

Senator WHITEHOUSE. Thank you, Chairman, and thank you, Secretary LaHood, for being here. I join the Chairman and the Ranking Member in extending our best wishes to Sam and to your family.

Secretary LaHood. Thank you.

Senator WHITEHOUSE. We are delighted he is safe in the embassy and hope he comes home safe and sound and soon.

Secretary LaHood. Thank you.

Senator WHITEHOUSE. I appreciate very much your energetic support of the rail initiatives. We were one of the States that was able to put rapidly to use some of the \$2.3 billion that Florida declined. That will, in fact, expedite the speed of trains coming through

Rhode Island and serving our Boston and New York markets. The Northeast corridor does go north of New York and I appreciate that you recognize that. And I think that the Boston to Washington corridor is an area that is heavily used and should be a national priority to bring it up to speed, and there are still many areas in which the rails need improving. I know you are working on it, but I wanted to express my appreciation for that.

I also know that you are coming up to Rhode Island in a couple of weeks to speak at Brown University. We will probably be stuck here, so I will not be able to welcome you in person, but if you have a free moment, I would love to have you go and take a look just down the hill from Brown University at the Providence viaduct, which is a quarter-mile long bridge that goes through the middle of Providence right by the big Providence Place Mall where people come to shop and enjoy the wonderful new shopping mall that we have. It was built in 1964, and when you go underneath it, you look up and you see there are planks across the I-beams. Those planks are there to keep the road, which is falling in, from landing on the cars driving underneath it to go into the mall. And if you go to where Amtrak shoots by underneath the highway there, same thing. They have the planks under the highway across the I-beams to keep the road that is falling in from landing on the track or from landing on trains.

So this is a really important project to get rebuilt. It is way overdue. Rhode Island is a small State with significant budget issues. There is zero shot that the State is going to be able to pay for it.

The bill that came out of the Environment and Public Works Committee has a provision for Projects of National and Regional Significance. I would submit to you that the I-95 corridor going through Rhode Island is a project of regional and national significance and I have no doubt that we will be able to compete successfully for the funding in that authorization, but we do not presently have funding for it.

So I would urge your assistance, if you could, request your assistance in trying to locate funding for that Projects of Regional and National Significance program.

Secretary LaHood. Well, first of all, I will be happy to visit the bridge and—

Senator WHITEHOUSE. We will arrange that. It is very close to where you will be.

Secretary LaHood. We will work with your office on that, and I will also be happy to work with you and your staff on maybe some opportunities to jump-start this project. So we will pay attention to it when we go there.

Senator WHITEHOUSE. Good. Well, I appreciate that, Mr. Secretary. Let me also just say that I think the Budget Committee reflects a variety of different economic views. My economic view is that when home, corporate, municipal, and State economies are shrinking and collapsing, that is a good time for the Federal Government to spend countercyclically to avoid adding to the negative economic cycle and worsening the situation. I have seen reports that say that if we had had a Balanced Budget Act of the kind that is being proposed now and it had been in place in the recent meltdown that we would have lost, I think, 17 percent of GDP and we

would have been in a serious cataclysmic depression rather than just a recession.

So I do not think it is so easy to throw Keynesian economics completely over the side and pretend that there is absolutely no truth to it and that austerity is the way to help people when an economy is in recession. And in particular, it seems to me that it makes sense to invest in infrastructure at that point, because unlike spending that goes out the window, you are left with something. You are left with a hard, tangible asset. And if you have been smart about it, America is actually richer for having an asset—some assets are more valuable once they are built than the amount of money that went into them. That is how people make money investing in tangible assets.

I think the notion that if it is spending, that is the only thing we can possibly look at and we should never look at the positive side of the balance sheet where you end up with a highway system so that everybody can get to visit their grandmother, to get their goods to market, to travel safely and smoothly, to have a modern train system that can be at least the equal of what is being developed in Asia and in Europe. I think it is a misguided economic theory, both with respect to the countercyclical value of spending and with respect to the national value that solid infrastructure creates.

And we have not talked about it, but one other place to look at is water and wastewater. I know that is less your purview, but we have \$600 billion worth of water and wastewater infrastructure needs in this country. That is clean drinking water for people. That is proper disposal of sewage. That is reaching to meet the growth in our population and we are simply way behind the ball on that. I think the Recovery Act—I agree with the Chairman about this—I think we have \$6 billion in water and wastewater in the Recovery Act out of \$600 billion that we need, one percent of the need.

So thank you for your continued emphasis on infrastructure, particularly transportation infrastructure. Thank you for agreeing to make that stop in Rhode Island.

Secretary LaHood. We will do it.

Senator WHITEHOUSE. And again, my very best wishes to you and to Sam.

Secretary LaHood. Thank you, Senator.

Senator WHITEHOUSE. Thank you, Chairman.

Chairman CONRAD. Thank you, Senator Whitehouse.

Senator AYOTTE.

Senator AYOTTE. Thank you, Mr. Chairman.

Secretary LaHood, I also wanted to share in the sentiments of my colleague from Rhode Island. We are all praying for your son and appreciating what he has done for democracy—

Secretary LaHood. Thank you.

Senator AYOTTE. —and hoping he comes home soon.

Secretary LaHood. Thank you.

Senator AYOTTE. I wanted to ask—to follow up on the questions about the high-speed rail funding. Can you help me? In other areas of the world where there is high-speed rail, including where we have rail in the United States, has it been able to sustain itself?

Secretary LaHood. Well, certainly, on the Northeast corridor, it has. Last year, Amtrak made money. Ridership is way up on Amtrak this year.

Senator AYOTTE. But between Washington and Boston, does it make money?

Secretary LaHood. Amtrak on the Northeast corridor—I will put this in the record and I will be happy to share it with you—Amtrak on the Northeast corridor, ridership was way up and they made money last year.

Senator AYOTTE. So you do not—

Secretary LaHood. And ridership is up this year.

Senator AYOTTE. So just to be clear, that will sustain itself without any Federal subsidy?

Secretary LaHood. It is subsidized by the Federal Government up to about 43 percent.

Senator AYOTTE. Well, that is my question. Can you tell me where we can sustain rail based on what people pay to use the rail so that we do not have to continually provide Federal subsidy support.

Secretary LaHood. But we subsidize a lot of forms of transportation.

Senator AYOTTE. But my question to you is simple. We are—

Secretary LaHood. We subsidize transit. We subsidize highways.

Senator AYOTTE. My simple question to you is, can you tell me where we have rail where we do not have to continuously provide Federal subsidies to sustain it, where it can pay for itself. Does that happen anywhere?

Secretary LaHood. No.

Senator AYOTTE. Because to my knowledge, there—

Secretary LaHood. No, it has not.

Senator AYOTTE. There are only two lines in the world where that happens, and that is actually in Tokyo and Paris, where you can actually have the rail to pay for itself, but nowhere else in the world can it pay for itself once you build it.

Secretary LaHood. You are right about that.

Senator AYOTTE. And so just to be clear, when we build these, we are going to have to continuously subsidize them going forward.

Secretary LaHood. Just like we do transit and just like we do our highways.

Senator AYOTTE. I just want people to understand.

Secretary LaHood. Got it.

Senator AYOTTE. And you cited California as an example, a productive example of where we should build high-speed rail, and yet the estimated cost for the program, which would be the line, as I understand it, to connect Madera to Bakersfield, the costs have grown from a \$33 billion estimate when that question was put before the voters of California in 2007 to at least a \$100 billion estimate in 2012. So, therefore, the costs of building it have tripled three times of what it was estimated when this issue was put to the voters of California.

And I would just point out that there are serious questions that have been raised by California, by independent individuals who have looked at it, including the State auditor who had said that the California Bullet Train Project has become increasingly risky be-

cause of fiscal issues with it. Even the first phase, they are concerned about it. And with respect to California, the California High-Speed Rail Peer Review Group, which is an expert body mandated by State law, not a Federal group, expressed serious doubts about it and concluded that it cannot at this time recommend that the California legislature approve appropriations for the bonds of it because the project, quote, “represents an immense financial risk.”

Why would we designate additional Federal dollars for something that in California itself in looking at it has designated it an immense financial risk?

Secretary LaHood. Because the Governor supports it. Because the elected leaders there support it. I just met with the President, which is called the Pro-Tem, of the Senate, and also the Speaker of the House. I just met with the Governor. I just met with the two U.S. Senators from California. This is what the elected officials in California would like to do for the next generation. They would like to have passenger rail in California because California is one big traffic jam.

Senator AYOTTE. So you are asking—

Secretary LaHood. They want to get people out of cars and into passenger trains.

Senator AYOTTE. You are asking the rest of the country to put up billions of dollars for something that has been described as an immense financial risk based on the officials of one State. Well, we have to look at the entire whole and I do not think that we should provide taxpayer dollars to something that we are going to have to continuously provide Federal subsidies for, number one. Second, where we are taking on immense financial risk.

And so that is really the issue, I think, with high-speed rail, and also, I think if you look at the bills that are up right now, one in the House, one in the Senate, neither body included money for this purpose. So Congress is concerned about, I think, this issue, as well, in terms of what is the financial measurement. What are the outcomes that we are going to get from the investment we put in high-speed rail. So I think the fact that it is in neither bill, neither the House or the Senate, speaks volumes in terms of where we are on this issue, and that is my concern with it.

I do have a question for you. Does the President believe that we are going to be fighting the wars—well, we have taken ourselves out of Iraq. Does he believe that we are going to be fighting in Afghanistan for the next ten years?

Secretary LaHood. Look, fighting wars is not in my portfolio. I have never talked to the President about this.

Senator AYOTTE. Okay.

Secretary LaHood. What I know is that we provided a pay-for in our budget this year. The criticism for the last two years from this committee and committees on the other side of this Capitol was, where is the pay-for? We provided one.

Senator AYOTTE. But you have assumed that we are going to be fighting a war or wars for the next ten years, and in the absence of some indication that that is really going to happen, let us just call it for what it is.

Secretary LaHood. Well, we are not in Iraq, so we have that savings.

Senator AYOTTE. Well, we were not planning on being in Iraq. How is that? So the notion that we were going to be somehow having a full contingency in Iraq for the next ten years, I do not think by anyone who has looked at that war would come to that conclusion. But particularly in Afghanistan, this notion that you are going to use savings for something that we were not going to spend in the first place—groups that have looked at this, including Maya MacGuineas for the Committee for a Responsible Federal Budget, called it to take credit for a policy that was already intended as stretching the definition of budget savings. This is such a glaring gimmick at such a serious moment.

I understand that you took some heat for not having a pay-for, but the fact that the pay-for that is in this budget is a budget gimmick does not solve the problem, and to take credit for savings that were never going to happen, I cannot go home and tell my constituents with a straight face that this is paid for.

So I hope that we will be working on a real way to pay for the funding, and I know that you said that we are certainly facing a situation where you are concerned about the infrastructure in this country, and I respect that and I think that is very, very important. And we also have great fiscal challenges here, as well, so we have to look at these things in a very serious fashion. So thank you for appearing today.

Secretary LaHood. Thank you.

Chairman CONRAD. Senator Begich.

Senator BEGICH. Mr. Chairman, thank you very much.

Mr. Secretary, thank you, and thank you—

Secretary LaHood. Good morning.

Senator BEGICH. —coming to Alaska, as you did.

Secretary LaHood. Of course.

Senator BEGICH. And as you know—we have had conversations—I wish your son the best.

Secretary LaHood. Thank you.

Senator BEGICH. As my brother has been doing work over there, also, for the secular group to try to create stability there. He has been there, I think, five times now, and so as we think about your son, we hope it all works out.

Secretary LaHood. Thank you, Senator.

Senator BEGICH. Absolutely. I am listening to the discussion. I am assuming, because I came in a little late here, so I apologize, I mean, the pay-for is OCO, which CBO has scored.

Secretary LaHood. Yes. The pay-for is the Highway Trust Fund—

Senator BEGICH. Right, and also—

Secretary LaHood. —in addition to the Iraq money.

Senator BEGICH. Right, which CBO has given a score on.

Secretary LaHood. That is correct.

Senator BEGICH. Right. So this body has a habit, if you do not like CBO, then you say—I have a lot of problems with CBO, but when they score something, they score something, so that means there is a value to it. Now, maybe we could argue what that total value is, but they at least assume there is a value.

So I am all for the pay-for. I have no interest in being in Afghanistan for ten years with combat troops. That is a poor policy and I am glad 2014 is a target, and if we get out by 2013, great on that, because I think they are moving forward in the right direction.

But again, I want to make that point that CBO has scored OCO—

Secretary LaHood. That is correct.

Senator BEGICH. —helps pay for the project.

Secretary LaHood. That is correct.

Senator BEGICH. Now, I missed it, but my staff told me—I liked your phrase, as a former mayor, the country—I may paraphrase—is one big pothole. I agree with you, and there is no better investment than the infrastructure of this country. I know when I was mayor, in five-and-a-half years, we built more roads than the last 20 years of mayors, and you got to drive on some of them—

Secretary LaHood. That is right.

Senator BEGICH. —when you were there. Also, the work we did on the Recovery money, we always hear the body here, it did not do anything. Well, I can show you, and you saw some of it, where we put that money to work building roads, roads that you cleaned up congestion, which in turn made people more productive, because they could get to work on time or school or whatever it might be, saving fuel, a win-win as a long term. Of course, CBO never scores that, but that is the value when you improve the infrastructure of this country, just from my perspective of roads. You know, I am a builder. I love to build everything, roads, verticals, whatever it takes to improve an economy, so I think it is important.

Let me ask you, specifically within your testimony, you noted the integration of the unmanned aircraft into airspace. In the defense authorization bill, an element we offered—I sit on that committee—was making sure there is language in there that we start designating these areas. FAA has a role to designate.

My first question is, I am assuming the two are coordinating—

Secretary LaHood. Absolutely.

Senator BEGICH. Excellent.

Secretary LaHood. Yes.

Senator BEGICH. Second, of course, being biased, there is no better airspace in the country than what sits in Alaska. The military will tell you that. Open airspace, especially for unmanned aircraft.

So what is your timetable, or maybe for the record you can get it to me, kind of the timetable that FAA is looking at to kind of say, okay, here are the two sites, four sites, six sites that will be analyzed—

Secretary LaHood. Yes. We hope to be able to name those sites this year. I do not—I will get it for the record, but—

Senator BEGICH. Just a schedule.

Secretary LaHood. Yes, absolutely.

Senator BEGICH. That would be great. Of course, I am biased. I think the University of Alaska at Fairbanks is doing some incredible research around this UAS and we have an enormous amount of airspace that no one competes against and no neighbors to complain.

Secretary LaHood. Right.

Senator BEGICH. And so I will just leave that for that schedule.

The second thing is, and I know we have had this discussion, the Senate bill on the FAA reauthorization did not have the \$100 fee. I know we have had this discussion on general aviation. I think general aviation, and I want to differentiate between Lear jets, big jets and small general aviation, but generally, most general aviation folks that I talk to, they understand they have to participate. But creating a new permit system or a \$100 fee does not seem logical to them when they have the tax, which they have all volunteered in the past to adjust, that basically that is a better mechanism to deal with revenues than another system.

And I will 100 percent agree with them, because I tried this when I was mayor, got my head kicked in and realized, that is not a good system to do this. And I worked with the general aviation folks and we came up with a better solution on existing structures they already had in place.

Do you have any comment on that, not the fee but the method, a \$100 fee versus deal with the tax on the gas? Any comment on that, or maybe you want to give it to the record. Either way.

Secretary LaHood. Our CFO—I am just going to have him comment just on the process.

Senator BEGICH. Okay.

Mr. BERTRAM. In terms of the \$100 fee, that was never proposed to be applied to sort of the propeller general aviation. That was really sort of for commercial aviation and for sort of high-end business jets. We never proposed that for sort of the lower-end jet.

Senator BEGICH. So your budget that you proposed does not have that. Can you get something for the record just to—

Mr. BERTRAM. Sure.

Secretary LaHood. Absolutely.

Senator BEGICH. We will probably still have some issues on the additional fee on the small, but we can have that conversation another time.

In the transportation bill that we are now starting, in theory, to move through, as I was one of just a few that voted against moving it forward and there is a reason. The Indian road component literally takes Alaska roads and cuts them in half in the amount of money coming through this formula, Map 21. I am very concerned because it is hitting the most impoverished areas of this country which can have the least ability to afford the development of infrastructure.

We are working now with the Chairwoman of the committee and others to try to get something rational here. We recognize that budgets are tight, but a 50 percent reduction is severe for our system within Alaska, as you experienced.

Secretary LaHood. Sure.

Senator BEGICH. And so I am just putting that on the note. It is more in our camp right now, but I am sure your folks will be asked a lot of questions about the distance and the variety of other things that calculate—

Secretary LaHood. Sure. Is that in Senator Boxer's bill?

Senator BEGICH. Senator Boxer's bill, and we have made note to that.

Secretary LaHood. Yes. Good.

Senator BEGICH. We are working with them, but it is, as you can imagine—and now we understand the folks from—the tribes in Minnesota are now concerned. They are doing the formula and realizing there is a problem here.

Secretary LaHood. Sure.

Senator BEGICH. We know there is some reform that needs to be there—

Secretary LaHood. Right.

Senator BEGICH. —but we have to do it on the right kind of glide-path. So I just want to—

Secretary LaHood. Well, we will get in touch with the committee and try and provide some technical assistance on that, also.

Senator BEGICH. Excellent. And let me just close and say, Mr. Chairman, just to make sure, and I have some views on high-speed rail and the efficiency of it, but putting that aside, your point, and I want to emphasize it again, is we subsidize roads big time. I mean, I know all the bonds that I passed but the rest of the community paid and my city when I was mayor of Anchorage for a road that might be in a small little area. But the objective was to create a system, a network that moves people, for commerce, transportation for individuals, and so forth. Very important.

So I understand the Senator's concern about high-speed rail, but the point that we—do we subsidize? We subsidize all of it, transit, roads, ferries, ports. You name it, we subsidize it because it is good for business if we do it right, and that is why when we get goods delivered in volume, it is because we pay for some of those ports with Federal dollars.

Secretary LaHood. Thank you for that.

Chairman CONRAD. Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman, Ranking Member Ayotte, Secretary LaHood.

Secretary LaHood. Good morning.

Senator JOHNSON. I also want to express my concern for your son.

Secretary LaHood. Thank you.

Senator JOHNSON. It sounds like you have a contingent of some pretty capable individuals going over there to hopefully resolve the situation—

Secretary LaHood. Thank you.

Senator JOHNSON. —but until that time, certainly your son, you and your family will be in our thoughts and prayers.

Secretary LaHood. Thank you very much.

Senator JOHNSON. I also want to—

Secretary LaHood. Congratulations on your bridge, by the way.

Senator JOHNSON. Well, I was just going to thank you for that. Thank you for your help in kind of breaking the logjam.

Secretary LaHood. Absolutely.

Senator JOHNSON. Hopefully, we can get that done in the House.

Secretary LaHood. Absolutely.

Senator JOHNSON. And that really is a prime example of how important infrastructure is, and I will just start out with that. I mean, I certainly understand government is the only entity that really can provide certain types of infrastructure. In the case of Stillwater Bridge, though, we had to break through a logjam, and

the question really is who should pay for the infrastructure. Should it be the Federal Government? Should it be the State and local governments? In the case of the Stillwater Bridge, that is largely funded by the State of Minnesota and the State of Wisconsin, so they have skin in the game.

And when we talk about subsidizing, whether it is high-speed rail versus highways, what Senator Begich said is if we do it right, and I think that is the main question. Who is making the choice of subsidizing things when we are running a \$1.3 trillion deficit? I think these are very legitimate questions.

I just kind of want to throw that open to you. First of all, in terms of highway spending—again, I am new to this, so these are legitimate questions—what is the percent that the Federal Government provides in funding for basic infrastructure versus State and local governments?

Secretary LaHood. Chris, do you know that percent?

Mr. BERTRAM. I do not know the current percent. I am not sure of the current percent, but I believe, generally, off the Interstate, the majority of the funding actually comes from State and local governments, not the Federal Government. Most of the Federal money gets really spent on the Interstate and the National Highway System. But we can get that for you.

Senator JOHNSON. I mean, part of the concern, and Senator Ayotte raised it, too, is when we make these funding decisions, these subsidy decisions, we really are subsidizing one region of the country or one State at the expense of others. How efficient, how effective do you think that has been going on over the years?

Secretary LaHood. Well, it has helped, I think, build an Interstate system. We did not start in all 50 States.

Senator JOHNSON. Right.

Secretary LaHood. You know that. And so was one State disadvantaged over another when they started in New York but not in my home State of Illinois? Well, maybe temporarily, but over 50 years, we ended up with a state-of-the-art Interstate system.

If you look at transit systems in America, every community has some form of transit, whether it be buses or light rail or in some communities streetcars. A lot of that was subsidized by Federal taxpayers. Now, when one community got one and another one did not have one, does that mean one was disadvantaged? Over time, I think it has pretty much evened out.

The fact that some things start ahead of other things, eventually, I think the country has benefitted from a national transportation view which almost every President has had and, really, Congress has had. When I served on the Transportation Committee for six years, we passed two transportation bills with over 400 votes in the House and over 80 votes in the Senate. It was bipartisan.

Senator JOHNSON. And truthfully, though, a lot of that was bipartisan pork going into different areas, to be honest about it. Again, I do not want to be contentious. Let me—in terms of Wisconsin, for example—

Secretary LaHood. But it did help—

Senator JOHNSON. I understand.

Secretary LaHood. —develop good transportation systems for America.

Senator JOHNSON. I am a supporter of infrastructure. I really am.

Secretary LaHood. I know you are.

Senator JOHNSON. In terms of Wisconsin, it is high-speed rail. The question came for Governor Walker, and really, certainly as I traveled around the State, a great deal of support for this position, the annual operating cost would be about \$16.5 million. The estimate was that you cover about \$9 million of that by fees and by fares, so leaving about \$7.5 million per year to be subsidized by the Wisconsin taxpayer and they just rejected it. And I think that is the question.

When you take a look at the articles I have read on the California high-speed rail, we have airlines and we have already invested in that infrastructure. Air travel can take care of some of that. So again, I just have a real question of how long government can subsidize operations of something that will never, ever be economically viable.

A highway system is different than a high-speed rail system. You know, there are some real questions as to whether or not those will ever be economically viable and should they be subsidized by taxpayers long-term.

Secretary LaHood. Well, I mean, Governor Walker decided he did not want high-speed rail, probably for the reasons that you just stated. But other governors have said they want it. Governor Snyder decided he wanted it in Michigan—

Senator JOHNSON. Elected officials do like bringing bacon home to the State, and I think that is part of this as opposed to real, honest economics—

Secretary LaHood. Well, I mean—

Senator JOHNSON. —because they are not going to be around to be paying the bills in four or eight or 12 years sometimes. Their term is over. So they just like bringing the—I think that is just a basic fact.

Secretary LaHood. My point is this, Senator. We did not shove high-speed rail down anybody's throat. We did not. When Governor Scott and Governor Walker and Governor Kasich made their decisions, we said, fine. You are the ones that got elected.

Senator JOHNSON. We would have liked to have seen—

Secretary LaHood. But there is a pent-up demand in America, as I said. For the \$2.3 billion in Florida, there was \$10 billion worth from governors—

Senator JOHNSON. For bringing home the bacon—

Secretary LaHood. —not from Ray LaHood, from governors.

Senator JOHNSON. And I would say for bringing home the bacon also to districts, and irrespective of how economically viable those projects will be long-term. Certainly from Wisconsin, we would have liked to have seen that \$810 million go toward deficit reduction. I mean, that is certainly where I would have liked to have seen it go.

But let us just talk about, in general, this transportation bill that we are arguing over right now in terms of the level that the gas tax is not funding. Just to kind of restate, what is that amount that is being covered by the OCO?

Secretary LaHood. Half. About half. Just generally, about half.

Senator JOHNSON. Which is about how much?

Secretary LaHood. Two-hundred-and-thirty billion.

Senator JOHNSON. Part of the—as I have come to town here realizing, part of the reason our gas tax revenue is down is because fuel efficiency is up. And, of course, it is politically poisonous to even think about increasing the gas tax to refill that revenue stream. Why not look more seriously at utilizing energy resources as a funding mechanism, more drilling in the Gulf, opening up ANWR? I just—

Secretary LaHood. Well, I assume—when we put out—when the President puts out a pay-for, I assume that is what the debate is going to be about, Senator. That is what they are debating over in the House now. They have had to split their bill up into three bills. One of them is transportation. One of them is energy, because they are trying to figure out a pay-for.

Senator JOHNSON. Well, I was just asking your opinion. Do you think that is a good idea?

Secretary LaHood. I like the idea the President put out. I like the idea of half of it Highway Trust Fund and half of it Iraq money. I think it is a pretty good formula.

Senator JOHNSON. Okay. Well, I appreciate it. Thanks.

Secretary LaHood. Yes, sir.

Senator JOHNSON. Thank you, Mr. Chairman.

Chairman CONRAD. I thank all Senators who have participated. I thank the Secretary very much for being here. As I have said many times, you ought to give seminars on how to testify.

Secretary LaHood. Thank you, sir.

Chairman CONRAD. You know, I have been here 25 years. I do not think I have ever seen a more able witness—

Secretary LaHood. Thank you.

Chairman CONRAD. —than Secretary LaHood.

Secretary LaHood. Thank you.

Chairman CONRAD. With that, I want to thank our colleagues. We have another hearing tomorrow. It is an important hearing. I hope colleagues will participate.

[Whereupon, at 11:30 a.m., the committee was adjourned.]

**Questions for the Record from Senator Portman  
For Secretary of Transportation Ray LaHood  
Hearing re: The President's FY 2013 Budget Request for the U.S. Department of  
Transportation  
February 15, 2012  
Senate Budget Committee**

**Question 1:** The FAA bill that the President signed into law yesterday includes language that establishes six test sites to work on the integration of unmanned aircraft systems into the National Air Space. One of the criteria in selecting those sites is to take into consideration the "location of ground infrastructure and research needs". Another is to consult with NASA and the Department of Defense. How does the FAA plan on selecting the test sites, how will they factor in existing research infrastructure into the selection of the test sites, and how will you be taking NASA and DOD's input into consideration?

**Answer:** The recently signed FAA Authorization included language directing the Secretary to establish a pilot program to integrate unmanned aircraft systems (UASs) into the National Airspace System at six test ranges. The research done at the test sites will help the FAA develop regulatory standards to foster UAS technology and operational procedures.

Due to the high interest in the test ranges (to date we have heard from at least 25 states) the Department will use a competitive process to select these sites. The process of selecting the test sites began with publication of a Request for Comments (RFC) in the Federal Register on March 7, 2012. The RFC asks for public comment on a number of questions to help develop UAS test site requirements, designation standards and oversight activity. The RFC contains the specific criteria identified in the legislation: geographical location and climatic diversity; ground infrastructure and research needs; and consultation with NASA and the Department of Defense. The existing research infrastructure of potential test site operators will also be factored into the weighted selection criteria. The FAA will host national webinars to provide further information and obtain feedback regarding the six test ranges. All comments are due on or before May 8, 2012.

The Department will carefully review and consider the feedback provided in developing the actual solicitation. Consultation with DOD and NASA will be continuous throughout the process. The Department expects to make site selections late in 2012 and for the first site to be operational in 2013.

**Question 2:** As states are struggling to pay for their transportation needs, some states are looking for innovative ways to generate revenue. One of those ways is the concept of privatizing rest areas. The maintenance and operations of rest areas can be quite expensive. In Ohio, it is estimated ODOT spends around \$50 million per year to maintain and improve its rest areas. As our transportation system has developed over time and we now have countless restaurants, gas stations and interchanges, do you support allowing states to privatize rest areas and use the proceeds to help pay for infrastructure projects in the state?

**Answer:** The Administration has not taken a position on this proposal; the Administration appreciates the struggles that so many States face in generating sufficient revenues to sustain their transportation systems. As a result, the President's Budget requests a targeted economic boost, and jump-start for the creation of jobs throughout America. This proposal includes an additional \$50 billion in Immediate Transportation Investments this year, of which \$26 billion would be used to maintain and improve the National Highway System. Furthermore, it would provide this funding with a 100 percent Federal share – freeing up State funds for other projects that would otherwise have been reserved for a non-Federal match.

**Question 3:** Last year President Obama visited my hometown to do an event at the Brent Spence Bridge that connects Ohio and Kentucky on Interstates 71 and 75. The bridge is one of the busiest trucking routes in the country, but is way over capacity. The estimated cost to build a new bridge is between \$2 billion and \$3 billion. Now to put that into perspective—if we used 100% of the stimulus funds for highways and bridges that *both Ohio and Kentucky* received, we would still be over a billion dollars short. Do you support a program that funds these types of large infrastructure projects that are critical to our nation's commerce corridors?

**Answer:** The Administration recognizes the role that projects of regional or national significance, such as those serving major freight corridors, can play in supporting the national economy. We acknowledge the challenges that States and communities can face in funding (and financing) these large-scale – and typically extremely expensive – projects. Within the realities of budgetary constraints, we realize the need to increasingly leverage limited local, State, and Federal funds. Consequently, the President's FY 2013 Budget includes four elements that are designed to address these needs:

1. **Increased TIFIA funding.** The Budget proposes to dramatically increase funding for the Department's Transportation Infrastructure Finance Innovation Act (TIFIA) Program. In recent years, the Department has seen an overwhelming demand for TIFIA, which offers credit assistance to advance large-scale projects that otherwise might be delayed or deferred due to size, complexity, or uncertainty over the timing of revenues. To respond to this demand, the Budget would increase TIFIA funding from \$122 million in FY 2012 to \$500 million in FY 2013.
2. **Continuation of the TIGER discretionary program.** The Administration is currently in the process of administering the fourth year of the Transportation Investment Generating Economic Recovery (TIGER) discretionary grant program. TIGER provides a unique opportunity for the Department to fund (predominantly via grants, but also through other credit assistance) road, rail, transit and port projects that promise to achieve critical national objectives. In each of its four years, TIGER has been heavily oversubscribed. In response, the Budget proposes to provide \$500 million for TIGER in FY 2013.
3. **Immediate funding for Transportation Infrastructure Grants and Financing.** As part of the Budget's proposal for \$50 billion in Immediate Transportation Investments in

FY 2012, the Administration proposes to provide \$4 billion for Transportation Infrastructure Grants and Financing. This program, similar to TIGER, would provide grants and credit assistance to State and local governments and transit agencies for capital investments in the Nation's surface transportation infrastructure, including roads and highways, public transportation facilities, freight and passenger rail, and ports.

4. **Establishment of a National Infrastructure Bank.** The President's Budget calls for the establishment of an independent National Infrastructure Bank (NIB) and an initial investment of \$10 billion in FY 2012, which would help finance infrastructure projects that demonstrate the most merit but that may be difficult to fund under the current patchwork of Federal programs. The NIB would issue loans and loan guarantees on a competitive basis to support a broad range of large-scale (\$100 million minimum) transportation, water, and energy infrastructure projects.

**Question 4:** Deficits for the Highway Trust Fund (HTF) are projected for the foreseeable future, and the Federal gas tax coming into the HTF has not adequately funded the surface transportation program enacted by Congress since 2007, resulting in General Fund transfers of \$34.5 billion. Now that the Interstate Highway System is complete, do you think it is time to turn the power back to the states, allowing them to use their Federal gas tax as state dollars or phasing out the Federal gas tax to allow states to have more control of their gas tax dollars and infrastructure funding?

**Answer:** To maintain and improve our nation's surface transportation system, create jobs, and spur economic growth the U.S. needs to increase its investment in surface transportation infrastructure. The President's Budget supports this necessary additional investment by including a fully-offset, deficit-neutral alternative; which funds additional transportation investment with half of the savings generated by ramping down overseas military operations. In addition, the National economy depends on high quality infrastructure for interstate and local travel, which can be supported by a continued investment at the Federal level.

The Administration also supports increasing State flexibility in the use of Federal-aid highway funds, and has called for dramatic consolidation of the current assortment of Federal highway programs. Under the President's surface transportation authorization proposal, States would be able to use their highway funds in the way that best met their individual geographic, economic, and demographic needs as long as they met performance targets. Overall there remains a clear and compelling Federal interest and Federal role in surface transportation. If the United States is to effectively compete in the global economy, we cannot devolve the system to the States and risk the fragmentation of the nationwide system that we have spent decades building and maintaining.

With transit investments, there remains a need for a strong Federal commitment to surface transportation as part of the ongoing partnership between Federal, State, and local governments. States and local governments already have a significant amount of authority over how Federal transit funds which they are allocated are spent. In addition, there remains a strong Federal interest in seeing that the assets provided with Federal funds attain a State of Good

Repair and are maintained and operated in a safe manner.

**Question 5:** Senator Stabenow and I have worked together to introduce the Great Lakes Short Sea Shipping Enhancement Act of 2011. This bill would amend the Internal Revenue Code of 1986 to exempt from the Harbor Maintenance Tax (HMT) non-bulk commercial cargo loaded or unloaded at United States ports in the Great Lakes or St. Lawrence Seaway. According to the Joint Committee on Taxation, "the impact [of this bill] on Treasury revenues is minimal." Do you support the exemption of HMT for short sea shipping in the Great Lakes?

**Answer:** We have not taken a formal position on the bill, but understand that it aims to increase the viability of using short sea shipping operations in the Great Lakes, which could help reduce current highway and rail congestion, encourage alternative freight transportation options, and improve the flow of commerce, and foster the maritime industry and workforce.

Questions for the Record from Senator John Cornyn  
For Secretary of Transportation Ray LaHood  
Hearing re: The President's FY 2013 Budget Request for the U.S. Department of Transportation  
February 15, 2012  
Senate Budget Committee

**Question 1:** Secretary LaHood, as I'm sure you know, the formula proposed under MAP-21 is tied to each state's share of funding under SAFETEA-LU. I'm concerned that, as drafted, MAP-21 continues old earmark payments contained in SAFETEA-LU over and above a state's normal allocation.

While the Administration supports MAP-21, I understand that you will not agree with everything in it. In my view, this is a basic matter of fairness. Do you have a position on this issue?

**Answer:** The Administration has long called on Congress to reduce or eliminate its practice of earmarking funding for projects in individual districts, and we applaud the decision not to include earmarks in MAP-21. However, the Administration has traditionally deferred to Congress regarding the distribution of formula funding among the States. We have not taken a position on MAP-21's apportionment formula.

**Question 2:** Secretary LaHood, the TIFIA program has been successful in helping communities to leverage their transportation resources and accelerate project delivery. As demand has increased, my understanding is that the Department of Transportation has developed its own supplemental evaluation criteria, with no basis in legislation, rules or published guidelines, based on notions of "livability" and "sustainability." Could you comment on the criteria used in approving TIFIA applications? If we do have additional resources for the TIFIA program, as contemplated by the Senate and House transportation bills, do you believe that the USDOT should have discretion to turn down credit-worthy projects that meet statutory criteria?

**Answer:** The demand for TIFIA credit assistance exceeds program resources by a ratio of more than 10:1. To help manage that demand, the Department of Transportation solicits Letters of Interest (LOIs) from project sponsors interested in applying for TIFIA support. The Department evaluates the LOIs against the TIFIA statutory selection criteria of Regional and National Significance, Private Participation, Environmental Benefits, Project Acceleration, Creditworthiness, Use of Technology, Consumption of Budget Authority, and Reduced Grant Assistance. In the Notice of Funding Availability (NOFA) issued December 3, 2009, the Department provided clarification to potential project sponsors about how the statutory selection criteria would be applied, noting that Livability, Economic Competitiveness, and Safety would be considered as part of the Regional and National Significance criterion and that Sustainability and State of Good Repair would be considered as part of the Environmental Benefits criterion. The Department's evaluation of the Letters of Interest is based on the TIFIA statute, the TIFIA regulation, and TIFIA NOFA.

Because the TIFIA program is oversubscribed, the Department currently has to choose between meritorious, creditworthy projects. If TIFIA resources were augmented to where the program was no longer oversubscribed, the Department would still evaluate projects in accordance with the statutory selection criteria which correlate with the Department's strategic goals. However, the increased funding would allow for more projects to be invited to submit an application. In this way, the benefits of TIFIA financing would be available to additional project sponsors, accelerating project delivery, encouraging new revenue streams and private participation, lowering costs, and leveraging budgetary resources.

**Questions for the Record from Senator Bernie Sanders**

For Secretary of Transportation Ray LaHood

Hearing re: The President's FY 2013 Budget Request for the U.S. Department of Transportation  
February 15, 2012

Senate Budget Committee

**Question 1:** Mr. Secretary, I very much appreciate your comments about the need to have a "vision" for a transportation future that includes a national network of high-speed intercity rail. Rail is not just an issue for urban areas, but also to provide 21<sup>st</sup> century connections between our rural communities and other parts of our great nation.

My state of Vermont was fortunate to have received funding through the Recovery Act to improve the rail line on which Amtrak's *Vermont* runs from St. Albans, Vermont to Washington D.C. The improvements being made are creating jobs in my state, and are essential for increasing reliability of the service and reducing travel times.

However, a second proposal, to improve the Ethan Allen Express – which currently terminates at Rutland, Vermont – has not yet been successful in its various applications to FRA for funding. This line badly needs improving, and should be expanded north to serve Vermont's largest city, Burlington.

I would very much like to know how my office, and how the Governor of Vermont, can work more closely with you to see that these improvements are made in as short a time as possible.

Additionally, as you know, we are also trying to extend the *Vermont* line to Montreal, but there have been unresolved questions regarding how the U.S. Customs and Border Protection and U.S. Citizenship and Immigration Services would process passengers. I know those agencies are not in your jurisdiction, but I would like to know can your office work more closely with these federal agencies to facilitate a direct rail connection between Canada's largest city and our Nation's capital?

**Answer:** The President's FY 2013 Budget includes \$2.55 billion for passenger rail. It is unfortunate that no additional funding was made available in FY 2011 or FY 2012. As you know, high demand for this program exists. For the \$2.4 billion made available from redirected funding, FRA received nearly 100 grant applications from 24 states totaling more than \$10 billion, making the program more than four times oversubscribed.

To reach final funding selections, FRA executed an extensive review process using the pre-defined criteria outlined in each solicitation. A panel of DOT subject matter experts reviewed each application first for eligibility then to ensure alignment with broad program objectives and with the Department's strategic transportation goals.

While the *Ethan Allen Express* extension project is eligible for funding under the high speed and intercity passenger rail program, it was not among the selected FY10 projects due to funding limitations. As you noted, the Amtrak *Vermont* rehabilitation project was selected and

funded through the American Reinvestment and Recovery Act. Construction is ongoing, and the project is scheduled to be completed in fall of 2012.

If additional funding is provided in FY 2013, the *Ethan Allen Express* would receive full consideration in an open competition. The Department is happy to work with you to identify other funding opportunities for the *Ethan Allen Express*.

With regard to the extension of the *Vermont* line to Montreal, both the United States and Canada have an interest in increasing safe, reliable travel options across their shared border. In December 2011, Transportation Secretary LaHood met with Department of Homeland Security (DHS) Secretary Napolitano and Canadian Transport Minister Denis Lebel to discuss, among other things, passenger rail issues related to our border with Canada. While these issues are complex and subject to resource considerations over which DOT has no authority, we are glad to facilitate ongoing discussion through our bi-national Transportation Border Working Group (TBWG), of which DHS is also a member.

The State of Vermont participates in the TBWG and is welcome to join the recently-formed TBWG Passenger Rail Sub-Committee. The next meeting will be held on April 17-18, 2012, in Seattle, Washington. At this meeting the members of the TBWG will be discussing cross border passenger rail issues between the State DOT's, AMTRAK, DHS/Customs and Border Protection, and our Canadian counterparts.



Statement of U.S. Senator Bernie Sanders  
**Senate Budget Committee Hearing on the  
President's FY 2013 Transportation Budget Request**  
*Wednesday, February 14, 2012*

Mr. Secretary, let me begin by saying that our thoughts are with you and your family regarding the detention of your son, Sam, in Egypt. We all hope that he released soon and is able to return home safe and sound.

I have heard it suggested in recent days that the President's transportation budget is no longer relevant, since both the Senate and the House are taking-up their respective reauthorizations bills. I do *not* agree with that perspective. I think it is *very* relevant to hear the administration's perspective on investing in our nation's transportation infrastructure, and I thank you for working hard to pull together this budget and reauthorization proposal.

In fact, given the enormous infrastructure needs this country faces, I think Congress could stand to pay closer attention to the higher levels of investment that you propose. The House reauthorization bill is a disaster. And even the Senate bill, which is far better than the House bill, is a very modest proposal compared to the need.

Mr. Secretary, the American Society of Civil Engineers has said we must invest \$2.2 *trillion* over the next five years simply to get our roads, bridges, and transit to a "passable" condition. Level funding for our transportation infrastructure – even in these challenging budgetary times – simply is not enough.

I see this need every weekend when I return to Vermont: Just under a third of Vermont's bridges are "structurally deficient or functionally obsolete." 36% of our federal-aid roads are in need of major repairs.

Investing in infrastructure is a proven way to create jobs; which is especially important at a time when the country remains in the grips of the worst economic downturn since the Great Depression. With official unemployment hovering at 8.3%, and underemployment exceeding 15%, we desperately need these good-paying manufacturing and construction jobs.

And, unless we take bold steps to improve our infrastructure, it will be more difficult for our nation to compete in the global economy. The United States invests just 2.4% of GDP on infrastructure. Europe invests twice that amount. China invests almost four times our rate – roughly 9% of GDP.

The president proposes to close the Highway Trust Fund's estimated \$230 billion funding gap with a "peace dividend" from ramping down military operations in Iraq and Afghanistan. I understand that from a budgetary standpoint, this is considered revenue-neutral – although I have also heard some Senators say that this somehow a "deceptive budget gimmick." Considering that many of those same Senators never once had a problem with spending hundreds of billions of dollars -- year after year -- on the wars themselves, I find comments like that rather curious.



To my mind, after spending billions and billions over the past ten years to first destroy, and then to rebuild infrastructure in Iraq and Afghanistan, I think it is a *great* idea to use some of that money to instead rebuild our own infrastructure right here in the United States.

Thank you.

**Question:**

Mr. Secretary, I very much appreciate your comments about the need to have "a vision" for a transportation future that includes a national network of high-speed intercity rail. Rail is not just an issue for urban areas, but also to provide 21<sup>st</sup> century connections between our rural communities and other parts of our great nation.

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I would very much like to know how my office, and how the Governor of Vermont, can work more closely with you to see that these improvements are made in as short a time as possible.

Additionally, as you know, we are also trying to extend the Vermonter line to Montreal, but there have been unresolved questions regarding how the U.S. Customs and Border Protection and U.S. Citizenship and Immigration Services would process passengers. I know those agencies are not in your jurisdiction, but I would like to know can your office work more closely with these federal agencies to facilitate a direct rail connection between Canada's largest city and our nation's capitol?

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## THE PRESIDENT'S FISCAL YEAR 2013 BUDGET AND REVENUE PROPOSALS

THURSDAY, FEBRUARY 16, 2012

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

The Committee met, pursuant to notice, at 10:04 a.m., in Room SD-608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Nelson, Sanders, Whitehouse, Merkley, Begich, Sessions, Graham, Thune, Portman, Toomey, Johnson, and Ayotte.

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 focus on the President's budget and revenue proposals. Our witness is the Treasury Secretary, Tim Geithner.

Mr. Secretary, welcome back to the Committee. Always good to have you here. We look forward to your testimony.

I want to begin by noting how far the Nation has come over the last few years. It is important to remember the fiscal and economic disaster that President Obama inherited. We were losing more than 800,000 private sector jobs a month when the President took office. We are now gaining more than 200,000 private sector jobs a month. That is a dramatic turnaround by any measure. The President deserves, I think, considerable credit for that success. And I would note that Secretary Geithner deserves credit for the part he has played in that performance as well.

In the fourth quarter of 2008, the economy contracted at a rate of nearly 9 percent. Positive economic growth returned in the third quarter of 2009, and we have now had 10 consecutive quarters of economic growth.

We see a similar picture in private sector job growth. As I noted, in January of 2009, the economy lost more than 800,000 private sector jobs. Private sector job growth has now seen 23 consecutive months of growth, and, of course, we would like to see even stronger growth. But, nonetheless, we have seen a dramatic turnaround.

I believe the President's budget would continue to move the Nation in the right direction, but I think we all know that we have more that needs to be done in terms of dealing with our long-term debt.

According to the administration, under the President's budget the deficit as a share of the economy would fall from 8.5 percent of GDP in 2012 to 2.8 percent in 2022. That represents real progress. In terms of revenue, the President's budget actually calls for a lower revenue level than we reached during the Clinton ad-

ministration and a lower revenue level than called for in the final year of the bipartisan Bowles-Simpson plan, which I was part of.

Revenue reached 20.6 percent of GDP in 2000 during the Clinton administration when we were experiencing the longest period of uninterrupted growth in our Nation's history. That ought to tell us something.

The Simpson-Bowles plans called for a revenue level of 20.6 percent of GDP in the final year of its plan. In comparison, the President's budget calls for a revenue level of 20.1 percent of GDP in its final year of 2022.

Some of my Republican colleagues have argued that revenue should not exceed 18 percent of GDP, but 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. We will likely need an even higher revenue level in the future because the country now faces an unprecedented demographic situation with the retirement of the baby-boom generation.

Let me just say I am part of that generation. I am going to be retiring. I am going to be eligible. I am not going to be taking Social Security anytime soon, but, nonetheless, I am part of the generation that is going to be retiring, and that is not a forecast. These people have been born. They are alive today. They are going to retire, and they are going to be eligible.

The fact is we are also facing growing income inequality in this country. We have seen the wealthiest among us become much wealthier, and we have nothing against people becoming wealthy. I think we all hope that as many people as possible will be successful and become well-to-do. That is a good thing.

But what the share of the burden is in our society is not fair. This chart shows that since 1979 the pre-tax household income for the top 1 percent has grown about 240 percent. Over the same time, the income for the middle quintile, the middle 20 percent, has grown about 19 percent, less than one-tenth as much. And our tax system is certainly contributing to this income inequality.

The Bush tax cuts for 2001 and 2003 were particularly notable for how much they were tilted to benefit those who are the very best off. The effective tax rate for the wealthiest people in this country, the rate actually paid after factoring in exclusions, deductions, credits, and other preferential treatment has fallen dramatically. The effective tax rate for the 400 wealthiest taxpayers in America dropped from about 30 percent in 1995 to 18.1 percent in 2008. Certainly we can have a more fair distribution than that.

As the Fiscal Commission and the Group of Six proposed, we can make the Tax Code simpler and fairer. We proposed additional revenue, but not by raising tax rates but by reducing tax expenditures, broadening the base, using some of that revenue to actually reduce rates to make the country more competitive, but to do it in a way that maintained the progressivity of the system—actually improve the progressivity of the system in the case of the Fiscal Commission and the Group of Six.

Adopting comprehensive tax reform will spur economic growth and allow us to compete better in the global marketplace. Here is how the Congressional Budget Office Director described the economic benefit of tax reform in his testimony before this Committee.

He said, and I quote: "I think analysts would widely agree that reform of the Tax Code that broadened the base and brought down rates would be a positive force for economic growth, both in the short term and over the longer period."

I recognize the difficulty of considering comprehensive tax reform in an election year. I am a realist. But I am also hopeful, because I think if we are honest with each other, we know we are on an unsustainable course as a country.

I applaud the President for the blueprint he has laid down. It is a step in the right direction. I also believe deeply that we have to do more, and we really need an economic two-step—in the short-term steps to increase demand to strengthen the economy, but over the longer term we need a comprehensive plan of tax reform, entitlement reform, and going after wasteful spending to take on this debt threat. If we do not as a country, at some point we will face very severe consequences.

With that, I will turn to Senator Sessions for his opening remarks.

#### **OPENING STATEMENT OF SENATOR SESSIONS**

Senator SESSIONS. Thank you, Mr. Chairman. I appreciate your leadership. And, Secretary Geithner, I appreciate your appearing before the Committee today and hope that we can reach some measure of agreement on the plain facts regarding the President's budget proposal. This is about the President's budget proposal and how it affects our future, and the taxes under it are to go up, and in one sense it is just a question of how much would be taken from the American people and sent to the Government in Washington. That is what the tax debate is fundamentally about.

You are a capable and respected loyal member of the administration, but more fundamentally, you are a servant of the American people. You have an opportunity today to help us understand both the dangerous unsustainability of our fiscal path, as the Chairman has said and you have warned us about previously, and the depth of change needed to right our course. It will be hard, but I am totally confident it is doable if we begin to take action today. And we do not have to make dramatic changes in spending this year, but we need to have a clear, firm, relentless course to alter our debt path.

On Tuesday, the Acting Budget Director offered some of the most misleading testimony I have heard in my time in the Senate. Should America suffer a debt crisis as a result of our recklessness, Mr. Zients' testimony would provide future generations with a useful illustration of how America failed to prevent what has been described to us by the Debt Commission as "the most predictable economic crisis in our history."

In the words of Michael Tanner from the Cato Institute, President Obama's latest budget proposal should be hailed as the "da Vinci of fiscal obfuscation."

Well, Federal Reserve Chairman Bernanke testified before this Committee last week. He was explicit about the danger ahead. "Having a large and increasing level of Government debt relative to national income runs the risk of serious economic consequences. Over the longer term, the current trajectory of Federal debt threat-

ens to crowd out private capital formation and, thus, reduce productivity growth. To the extent that increasing debt is financed by borrowing from abroad, a growing share of our future income would be devoted to payments on foreign-held Federal debt. High levels of debt also impair the ability of policymakers to respond effectively to future economic shocks and other adverse events.” Those were his words last week.

In your own testimony before the Senate Finance Committee yesterday, you seemed to suggest that the President’s budget achieves fiscal sustainability. At the time Chairman Bernanke issued these warnings last week before the budget, our Nation’s gross debt was projected to reach \$26 trillion. This week, the President’s budget did not change that number or our course. It did not. The gross public debt had already risen above 100 percent of GDP during this President’s term, the highest since World War II, and will remain above 100 percent of GDP every year under this budget.

Chairman Conrad I know believes, as I do, that debt-to-GDP is an important metric. We could have—well, I will not call that chart up today, but we are in the danger zone of debt-to-GDP. There is just no doubt about it. And this budget does not call for us to get out of it.

Thus, it is clear the President’s budget proposal has made no improvements to the long-term fiscal outlook of America as it relates to the agreement we reached last year. It did not reduce deficits by \$4 trillion over current law. Debt spending and taxes all increase dramatically. So you will forgive me if I do not see sustainability here.

During Chairman Bernanke’s recent appearance, I recall comments that he and you and other officials made at the Federal Reserve meetings in the run-up to our last fiscal crisis. At that time you were president of the New York Federal Reserve. It is clear from those remarks that you and your colleagues failed to see the growing and nearing financial danger.

People like Mr. Roubini were mocked as prophets of doom, warning of the danger. In fact, the Federal Reserve policy was a central component in helping form the housing bubble. I say that just to say it is difficult to predict the future. I am not blaming you for missing that. Most people missed it. But we have to understand there are dangers there.

History will judge our conversation today. Do you believe the President’s budget provides a solution to our fiscal problems? Do you believe that \$11.2 trillion in new Federal debt, annual interest payments approaching \$1 trillion a year, and a budget where health care spending grows twice as fast as our economy is a sustainable future?

We do not know the day, the time, the hour when a debt crisis might erupt. We have been wrong before. We cannot predict what event might set that in motion. But we do know that we are on a dangerous course. The longer we wait to change that course, the graver the danger becomes. The debt cloud over our economy I believe is already depressing growth. We have not bounced back as much as we would like. I think the cloud of debt is a factor in keeping that growth bounce-back so low.

This Nation needs a more optimistic future, one with less debt, leaner Government, and a thriving private sector that provides good, high-paying jobs for everyday Americans. I know we can get there. But there is a definite lack of confidence in the marketplace today. It cannot be altered by fine speeches. That day is past, if it ever existed. A definite course change founded on sound, mature action is required. Sadly, this budget says we are not going to get it.

I hope we are on a recovery today and that the millions of Americans out of work will soon find jobs, and I hope we are about to see a rebound that can continue. But experts have told us that the largest threat to our economic and national security is our debt, and that is something we are responsible for. The Government is responsible for the Government's debt. This administration had in its last year of its term an opportunity to put forward a budget plan that would have changed the debt course of our country. Yes, it would have required some belt tightening, some pain, but nothing this Nation could not handle. The American people are ready to stand together to make the tough choices. Instead of leading, our President has attacked even those who had the integrity and courage to make realistic proposals that would actually work.

So I look forward to your testimony today, Mr. Geithner, and I respect your efforts on behalf of our country.

Chairman CONRAD. I thank my colleague.

We will turn now to Secretary Geithner's testimony, and then we will go to rounds of questioning. Again, welcome to the Committee, Secretary Geithner. Thank you for your service and please proceed.

**STATEMENT OF THE HONORABLE TIMOTHY F. GEITHNER,  
SECRETARY, U.S. DEPARTMENT OF THE TREASURY**

Secretary GEITHNER. Thank you, Mr. Chairman and Ranking Member Sessions. I appreciate both your comments, and nice to be before you and your colleagues today to talk about the President's budget.

I want to make four basic points: first, about the economy because, of course, you have to start by looking at the challenges we face as a country, the economic challenges we face as an introduction to a discussion about a budget and fiscal priorities.

Our economy today is gradually getting stronger, but we have a lot of tough work still ahead of us. Over the last 2-1/2 years, despite the financial headwinds from the crisis, despite the severe cutbacks by State and local governments, despite the crisis in Europe, despite the rise in oil prices earlier last year, despite the tragedy in Japan, despite all those shocks and headwinds, the economy has grown at an average annual rate of 2.5 percent. Private employers have added 3.7 million jobs over the past 33 months—23 months. Private investment in equipment and software is up more than 30 percent. Productivity growth has improved. Exports across the American economy from agriculture to manufacturing are expanding rapidly. Americans are saving more and bringing down their debt burdens. The financial sector is in much stronger shape, helping to meet the growing demand for credit and capital.

Now, these improvements are signs of the underlying resilience of our economy, the resourcefulness of American workers and busi-

nesses, and the importance of the swift and forceful actions that we took with the Federal Reserve to stabilize the financial system and to pull the economy out of the worst economic crisis since the Great Depression. But I want to emphasize that we still face very significant economic challenges, particularly for the average working family in the country today.

Americans are still living with the acute damage caused by the crisis. The unemployment rate is still very high. Millions of Americans are living in poverty, looking for work, suffering from the fall in the value of their homes, struggling to save for retirement or pay for college. As the Chairman said, we have said seen an enormous, alarming rise in inequality, and for a country this rich, we have alarming, unacceptable, shameful levels of poverty.

For these reasons, the President's budget calls for substantial additional support for economic growth and job creation alongside longer-term reforms to improve economic opportunity and to restore fiscal responsibility.

Second point: I want to commend the congressional leadership for the progress we have seen reported towards an agreement on extending the payroll tax cut and emergency unemployment insurance. These measures are terribly important, critically important, to providing support to the millions of Americans still suffering from the crisis. But I just want to make it clear: Do not stop there. Let us try to build on this bipartisan moment of cooperation on something good for growth and move beyond that to do things that will help get construction workers back to work with investments in infrastructure, help Americans refinance their home, and strengthen the incentives we create for companies to invest here in the United States.

Now, beyond these immediate steps—and this is my third point—the President's budget lays out a long-term strategy to strengthen economic growth, to improve economic opportunity, while reducing our deficits to more sustainable levels. I know the conventional wisdom in Washington is that the debate that we are having this week does not matter because Congress is too divided to legislate in this election year. But this is a very important debate. It matters because it is a fundamental debate about economic priorities, how to increase growth, as I said, how to strengthen health care and retirement security, how to reform our Tax Code, how to live within our means. We govern with limited resources, and we have to make some hard choices about how to use those resources more wisely, particularly given the millions of Americans that become eligible for Medicare and Social Security over the next few decades, and particularly given the sets of difficult challenges posed at the end of this year by the expiry of the Bush tax cuts and the possible imposition of the sequester.

Now, any strategy to address these challenges, these economic challenges and these fiscal challenges, has to answer a few key questions: How much do we have to cut these deficits? Which programs should be cut, expanded, or protected? And how should we share the burdens of deficit reduction? So let me just explain briefly how we in the President's budget answer those questions.

The President's budget would reduce projected deficits by roughly \$4 trillion over 10 years, or roughly \$3 trillion on top of the con-

trols and caps legislated in the Budget Control Act. Overall, the President's plan would lower the deficit from just under 9 percent of GDP last year to around 3 percent of GDP in 2018. That would stabilize the overall level of debt-to-GDP in the second half of the decade, putting us back on a path towards fiscal responsibility and in better position to confront the remaining challenges, still very significant challenges we will face and that build on future decades, as millions more Americans retire.

Now, in this budget discretionary spending is projected to fall to its lowest level as a share of the economy since Dwight Eisenhower was President, and the President's plan would also significantly slow the rate of growth of spending in Medicaid and Medicare through both the Affordable Care Act and additional reforms proposed in the budget.

But as we reduce spending—and I want to emphasize this: As we reduce spending, we have to protect investments that are critical to expanding economic growth and opportunity, and that is why the budget proposes a series of targeted investments in education, innovation, and manufacturing and infrastructure.

Now, in order to achieve this balance, significant savings with crucial investments, we are proposing to raise a modest amount of additional revenue through tax reform. The President's plan includes \$2.50 of spending cuts for every \$1 of revenue increases. Our tax reform proposal would raise taxes by roughly 1 percent of GDP. These revenue proposals are focused on the top 2 percent of Americans, not the remaining 98 percent. Focusing these revenue proposals on the top 2 percent of the income distribution, those who have fared the best in the past few decades, is a more fair and a better way and better for our economy than an equivalent magnitude of cuts in Medicare benefits, in infrastructure spending, in national security programs, or other programs to help the poor and the most vulnerable.

We propose tax reforms that raise revenues because we do not believe it is possible to meet our national security needs to preserve a basic level of benefits, health care and retirement benefits, or to compete effectively in the global economy without revenue increases as part of a balanced fiscal consolidation plan.

Now, although we illustrate in the budget a range of specific tax proposals that could be added on to the present tax system to generate the necessary increase in revenue, we think the best approach to get there, as the Chairman said, is through comprehensive tax reform. We have laid out a broad set of principles for tax reform to make the system more simple and more fair and better encouraging investment in the United States. And as I said earlier this week, we plan to lay out in the next couple weeks a more detailed framework with elements for corporate tax reform to encourage more investment here in the United States.

I just want to conclude, though, by emphasizing the following: I know there are Members of Congress who are critical of these proposals and would prefer a different strategy, and you should judge these proposals against the alternatives. So let me just conclude by highlighting where I think we disagree the most.

I think we agree that our fiscal deficits are unsustainable. We agree they need to be brought down to a sustainable level if we are

going to grow in the future. We agree that the commitments we have made in Medicare and Medicaid are unsustainable.

Let me describe where I think we disagree. There are some who have suggested we cut deeper and faster with more severe austerity now. But that approach, in our judgment, would damage economic growth, reverse the gains we have achieved in getting more Americans back to work, and would push more Americans into poverty. You cannot cut your way to growth, and in the current economic circumstance we face, severe immediate austerity is not a growth strategy.

Some have suggested we try to restore fiscal balance without raising any additional revenue from anyone or even by cutting taxes further. But to do that, to try to restore fiscal sustainability without any revenue increases, would entail deep cuts in benefits for retirees or for low-income Americans, cuts in investments in education and infrastructure that would hurt growth, or cuts in defense spending that would damage our national security interests. So for those reasons, we will not support those alternative strategies.

Now, this is a plan that includes very tough reforms, but with a balanced mix of spending cuts and tax reforms. It preserves room for us to make some important investments that will increase opportunity for Americans, help make growth stronger in the future. It protects our basic commitments to retirement security and health care for the elderly and the poor, and it provides substantial immediate help for the average American alongside reforms to restore fiscal sustainability over the medium term.

This plan will not solve all of the Nation's challenges, but it will put us in a much stronger position to meet those challenges.

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

[The prepared statement of Secretary Geithner follows:]

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**Secretary Timothy F. Geithner  
Testimony on the President's Budget for FY 2013**

Chairman Conrad, Ranking Member Sessions, and members of the Committee, thank you for giving me the opportunity to appear before you today to discuss the President's Fiscal Year 2013 Budget.

**I. INTRODUCTION**

Three years after the worst financial crisis since the Great Depression, our economy is gradually getting stronger. The decisive actions we took to combat the financial crisis, combined with the President's policies to restart job growth and support the economy, have helped lay the foundations for continuing growth. Over the last two and a half years, the economy has grown at an average annual rate of 2.5 percent, exceeding growth in the year prior to the recession. Private employers have added 3.7 million jobs over the past 23 months, including more than 400,000 manufacturing jobs. Growth has been led by exports, which have grown 25 percent in real terms over the last 2 ½ years, and by business investment in equipment and software, which has risen by 33 percent during the same period.

While the economy is regaining strength, we still face significant economic challenges. Unemployment, at 8.3 percent, is still far too high, and the housing market remains weak. The damage inflicted by the crisis presents continued difficulties for consumers and businesses alike. In addition, the debt crisis in Europe and the slowing of major economies elsewhere in the world present potential impediments to our economic growth.

The harm caused by the crisis came on top of a set of deep, preexisting economic difficulties. In the years leading up to the crisis, the average middle-class family saw few gains in income, productivity growth slowed, and the fiscal policies of the previous Administration turned record budget surpluses into substantial deficits.

In my testimony, I want to outline the President's strategy for addressing these immediate and underlying challenges. This strategy entails a carefully designed set of investments and reforms to improve opportunity for middle-class Americans and strengthen our capacity to grow, combined with reforms to restore a sustainable fiscal position.

The Budget proposes three specific steps to boost growth and secure the United States' position as the most competitive economy in the world.

- Improving access to education and job training, so that our workers are the best prepared in the world for the jobs of the 21<sup>st</sup> century.
- Promoting manufacturing and innovation, with a particular focus on research and development and jumpstarting advanced manufacturing, so that the United States remains the world's most competitive economy and firms create well-paying jobs here at home.
- Investing in infrastructure, in order to create job opportunities now and enhance productivity in the long run.

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Under the President's plan, these critical investments are combined with a balanced plan for deficit reduction. The Budget reduces projected deficits by a total of more than \$4 trillion over the next 10 years by adding more than \$3 trillion in deficit reduction to the approximately \$1 trillion in savings already enacted through the discretionary caps included in the Budget Control Act (BCA). These savings are sufficient to stabilize our debt as a share of the economy by 2015 and begin placing our debt on a downward path.

More than two-thirds of the total deficit reduction is achieved through savings in entitlements and other spending programs, and discretionary spending is projected to fall to its lowest level as a share of the economy since Dwight Eisenhower was President.

These significant cuts are phased in over time to protect the economic recovery. Cutting spending too deeply or too soon would damage the economy in the short-term, impede our ability to make necessary investments for long-term growth, and achieve deficit reduction at the expense of the most vulnerable Americans, including seniors and the poor.

In order to achieve a sustainable fiscal position, we must combine these cuts with savings achieved through reforms to our tax code that make it simpler, fairer, and more efficient.

Sustainable deficit reduction requires the right combination of policies: we must have a tax system that collects revenue fairly and supports growth and investment, but does not place undue burdens on families and businesses; spending cuts and entitlement reforms that reduce expenditures but do not harm the economy or the most vulnerable Americans; and investments that give us the ability to grow but do not misallocate valuable government resources.

The central challenges addressed in the President's Budget—strengthening growth now, investing in our future, and putting our nation on a sound fiscal footing—complement and depend on each other. Investing in our economy will help us grow and make our fiscal challenges more manageable. Locking in credible deficit reduction, in turn, will make room for investments that enhance our long-term growth.

## **II. INVESTING IN OUR COMPETITIVENESS**

### **Education and Training**

An educated and skilled workforce is critical for the United States to compete in the global economy. We once led all advanced economies in the percentage of our population that graduated from high school and college, but today we are not providing enough Americans with the educational skills they need. America has fallen to 16<sup>th</sup> among advanced countries in the proportion of young people with a college degree, and many Americans of all ages need further education and training in order to succeed in today's economy.

The Budget takes a number of steps to make sure that higher education is attainable and affordable. The President has increased the maximum Pell Grant by 20 percent to \$5,635, and in academic year 2010-2011, Pell grants supported the educational aspirations of 9.3 million low- and moderate-income students, who received \$35.6 billion in grants, an average of \$3,831 for

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each student. This year's Budget maintains the expanded maximum Pell grant of \$5,635 through FY 2013.

Moreover, as part of the bipartisan December 2010 tax compromise, the President extended through 2012 the American Opportunity Tax Credit (AOTC) he created as part of the Recovery Act. The AOTC is projected to provide nearly \$19 billion in credits to over 9 million families this year. This year's Budget proposes to make the American Opportunity Tax Credit permanent, so it can offer up to \$10,000 in tax credits over a four-year college career.

In addition, the Budget provides \$8 billion for the Community College to Career Fund in the Departments of Labor and Education to support State and community college partnerships with businesses to build the skills of American workers. A \$12.5 billion Pathways Back to Work Fund will also help jump-start America's economy by putting thousands of long-term unemployed and low-income Americans back to work and helping them gain skills for the jobs of the future. The Budget also provides support for a new initiative designed to improve access to job training across the nation and make it easier for those looking for work to access help in their communities and online.

#### **Innovation and Manufacturing**

As the global economy becomes more and more advanced, it is crucial that U.S. firms and workers remain on the cutting edge. Investment in research and development (R&D) creates good jobs for American workers, raises living standards, and keeps our economy competitive.

Private businesses are likely to underinvest in R&D, because they cannot capture all of the gains from their investment. A substantial portion of the benefits, however, accrues to the broader business community or the public at large. Federal investments in research and development have played an important role in spurring the internet, global positioning systems, and clean energy.

Though private sector investment in R&D has continued to grow, when the President took office, public investment in R&D was near its lowest levels in half a century as a share of the economy. The FY 2013 Budget proposes a number of important investments in R&D:

- The Budget includes \$141 billion for Federal R&D – investments that will promote the development of a variety of high-priority technologies, from next generation robotics to nanotechnology to improved cybersecurity. The budget also keeps spending on the National Institutes of Health steady at \$31 billion.
- Of this, the Budget provides \$2.2 billion for Federal advanced manufacturing R&D, a 19 percent increase over 2012.
- The Budget proposes simplifying, expanding, and making permanent the Research and Experimentation Tax Credit, to provide a crucial incentive for businesses to invest in R&D.

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Another key part of creating good-paying jobs for American workers is to make sure that our manufacturing sector remains on the cutting edge. The Budget includes several key investments to support manufacturing:

- The Budget sets aside \$149 million in the National Science Foundation, an increase of \$39 million above the 2012 enacted level, for basic research targeted at developing revolutionary new manufacturing technologies in partnership with the private sector.
- The President's Advanced Manufacturing Partnership invests in a national effort to develop the emerging technologies that will create high-quality manufacturing jobs. For example, the Budget includes \$21 million for the Advanced Manufacturing Technology Consortia program, a new public-private partnership that will develop road maps for long-term industrial research needs and fund research at universities and government laboratories directed at meeting those needs.
- The Administration also supports a range of investments and initiatives to bring about a clean energy economy and create jobs for the future, especially manufacturing jobs. For example, the Budget provides \$290 million to help meet the goal of doubling the pace of energy intensity improvements across America's industries over the next decade, as well as funding to double the share of electricity that comes from renewable energy sources by 2035.

### **Infrastructure**

Our nation's aging infrastructure is a drag on growth and productivity. In order to compete in the global economy, American businesses require a world-class infrastructure. In the long-run, a modern infrastructure lowers costs for both businesses and individuals. And there is tremendous short-term value as well—according to the Congressional Budget Office, infrastructure investment is one of the most efficient job-creation programs available. With more than 2.2 million fewer construction workers on the job than at the pre-crisis peak, and with interest rates at historically low levels, now is the right time for greater public investment in infrastructure.

- The President's Budget provides funding for crucial infrastructure investments. Specifically, the Budget proposes investing \$476 billion over the next six years in our nation's surface transportation system, which builds upon our proposal to immediately invest \$50 billion to help workers get back on the job. The savings achieved through our orderly drawdown of forces in Iraq and Afghanistan will pay for these investments, with the other half of those savings used to reduce projected deficits.
- The Budget also calls for the creation of a National Infrastructure Bank, a bipartisan idea that will leverage private capital with more flexible financing so that we can build worthwhile projects efficiently and effectively, based on their merits.
- The Budget also provides significant new investments for the modernization of public schools and community colleges so that those who attend have access to a safe environment with modern technology.
- Finally, the President has proposed a national effort through the \$15 billion Project Rebuild to put construction workers back to work rehabilitating and refurbishing hundreds of thousands of vacant and foreclosed homes and businesses, which will also help counteract the effects of blight on home prices in affected neighborhoods.

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### **III. CONTINUING TO BUILD FISCAL SUSTAINABILITY**

When President Obama came into office he inherited an annual budget deficit equal to 9.2 percent of GDP. Moreover, there was a need for additional steps to stop the economy's free fall, and so Congress and the President enacted the American Recovery and Reinvestment Act and other short-term programs, which temporarily added to the deficit. The expiration of this recession-related spending, economic growth, and the spending cuts mandated by the BCA, including both the approximately \$1 trillion in spending caps and the \$1.2 trillion that is to occur through sequestration, by themselves are projected to reduce the deficit to 3.7 percent of GDP by 2018.

However, between 2018 and 2022 the deficit under this baseline budget would actually start rising again, reaching 4.7 percent of GDP in 2022. The President's Budget therefore goes beyond the additional \$1.2 trillion in deficit reduction required by the BCA, identifying additional spending cuts and revenue raisers that reduce the deficit by over \$3 trillion over the next 10 years, while paying for the policies to strengthen growth and invest in our future.

By identifying savings far greater than the BCA, the Budget allows us to meet the BCA's goals while replacing the sequester's \$1.2 trillion in damaging, arbitrary cuts with more responsible—and more substantial—reductions. We believe this is the right approach. As the President has made clear, it is not acceptable to simply repeal the sequester without a responsible combination of policies to replace it—policies such as the ones outlined in this Budget.

Overall, the President's plan lowers the deficit from just under nine percent of GDP in 2011 to around three percent of GDP in 2018, after which it stabilizes through 2022.

Our fiscal situation is improved by the fact that taxpayers are being repaid for many of the investments made in banks under the Troubled Asset Relief Program (TARP). We estimate that investments made through TARP bank programs, for example, will return more than \$20 billion in gains to taxpayers.

#### **Spending Cuts**

Meaningful deficit reduction requires serious cuts to government spending. This will not be easy, but the President's Budget identifies areas where cuts are necessary, while protecting the most vulnerable Americans and investments in our future. As described below, President Obama proposes to reduce spending by reorganizing the government, cutting discretionary spending consistent with targets set forth in the bipartisan BCA, and reforming entitlements.

#### Non-security Discretionary Spending

The \$1 trillion in savings from the discretionary spending caps mandated by the BCA, which the President signed into law, reflect the hard choices that need to be made in order to meet our obligation to building a fiscally sustainable foundation. Achieving these cuts will not be easy and will require us to continue to make tough choices.

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The President's Budget meets this challenge, identifying more than 200 cuts, consolidations, and savings proposals. This is on top of the ongoing effort by the Administration to make government more efficient by reducing administrative overhead costs, reforming the government purchasing process, and embracing competitive grant programs. The Budget makes these cuts in a way that asks all to shoulder their fair share.

The President has also asked for the power to reorganize the executive branch to cut out needless duplication, enhance the efficiency and effectiveness of government programs, and improve service delivery. The President has already proposed consolidating into one department the business and trade components of the Department of Commerce, the Small Business Administration, and several additional agencies to better support our nation's economic growth through trade, entrepreneurship, and innovation.

As a result of these cuts, non-security discretionary spending will fall to just 1.7 percent of GDP in the final year of the Budget horizon, as compared to approximately 3 percent this year.

#### Discretionary Defense Spending

Just as we must reprioritize our non-security spending to meet the challenges of the new economy, we must also rethink our defense spending in light of the evolving global environment. The conflicts our military confronted over the past decade are winding down: our troops have exited Iraq, operations in Afghanistan are increasingly being turned over to the Afghan people, and we have dealt a devastating blow to al Qaeda by eliminating Osama bin Laden and other leaders. This provides us with the opportunity not simply to cut spending, but rather to take the hard lessons learned from the past decade of conflict to create a military that secures the safety of the United States while taking into account the more fiscally constrained environment in which we are operating.

Over the next year, the overall defense budget, including overseas contingency operations reductions, will be down by 5 percent from the 2012 enacted level. On January 5, the President announced the Defense Strategic Review (DSR), which will set priorities for our national defense over a longer period. The review is designed to provide us with a leaner, more technically advanced fighting force, better designed to address the threats of today's world. In particular, the strategy calls for strengthening our presence in the Asia-Pacific region, along with continued vigilance in the Middle East and North Africa. We will also continue to invest in our critical partnerships and alliances, including NATO.

The DSR is designed to reduce defense spending over the next 10 years by \$487 billion relative to last year's Budget, which will slow the growth of defense spending. The President's Budget will allow us to make significant and thoughtful reductions in defense spending without implementing the damaging path of the BCA sequester.

#### Mandatory Spending

Achieving fiscal sustainability in the long term will require changes to mandatory spending programs. The President is proposing \$270 billion in savings over 10 years in mandatory programs outside of health care. This includes the modernization of the pay and benefits of

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federal workers and the military, and increasing the efficiency of our agricultural support programs. The Budget also proposes increasing the retirement security of American workers by giving the Board of the Pension Benefit Guaranty Corporation (PBGC) the authority to gradually adjust the premiums it charges pension plan sponsors, as well as a proposal to restore solvency to the unemployment insurance program. Together, these latter two proposals would reduce the federal deficit by more than \$60 billion over 10 years.

However, as the population ages and health care costs continue to rise, one of the biggest challenges in addressing our long-term fiscal sustainability results from projected spending on health programs due to aging of the population and excess health care cost growth.

The Affordable Care Act (ACA) was a significant step toward controlling health care spending. According to analysis from the Congressional Budget Office, the ACA is estimated to reduce the deficit by more than \$100 billion from 2012 to 2021 and by more than \$1 trillion in the second decade. It is projected to reduce Medicare's average annual growth by 1.5 percentage points. One of the most important steps we can take right now for long-term deficit reduction is to implement the ACA fully and effectively.

Still, more needs to be done. The Budget therefore proposes an additional \$362 billion in health care savings over the next 10 years, through better administration and innovation, strengthening program integrity, aligning payments with costs of care, and strengthening provider payment incentives to improve quality of care. The Budget also includes structural changes that will help encourage Medicare beneficiaries to seek high-value health care services.

#### **Tax Reform**

While the proposed spending cuts are an important component of reducing our deficit, the President has recognized that we cannot responsibly address our fiscal situation without raising additional revenue. As a share of GDP, tax revenues from 2009 to 2011 were at their lowest level as a share of the economy since 1950. Our current tax code is inefficient and filled with loopholes. We need a tax system that is simpler and more efficient, one where businesses and individuals play by the rules and pay their fair share. Comprehensive tax reform will strengthen our competitiveness, promote fiscal sustainability, and restore fairness.

As the President has emphasized, these reforms should follow a set of key principles. They should be fiscally responsible, so that the tax code promotes jobs and growth while collecting appropriate levels of revenue. The code should be simpler, combining lower tax rates for individuals and corporations with fewer loopholes and carve-outs—which will increase efficiency so that businesses compete based on the products and services they provide, not the tax breaks they are able to collect. And finally, it should be fair, so that middle-class Americans are not carrying more than their fair share of the tax burden.

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### Individual Tax Reform

As with corporate tax reform, for individual reform the best path would be to enact comprehensive tax reform that meets the principles the President laid out last September and revisited as part of the State of the Union. The key to these reforms is fairness.

The individual income tax cuts of the last decade were tilted toward the wealthy and have contributed to tax revenues falling to near their lowest level as a share of GDP in 60 years. As we consider individual reforms, families with incomes under \$250,000 should not see a tax increase. But the most fortunate Americans, the wealthiest 2 percent, must contribute a greater share of their income in order to correct the imbalance in our system. And in keeping with the Buffett Rule, high-income families should not face tax rates that are lower than those faced by middle-income families.

As we move to consider these reforms, the Budget presents a path that raises the appropriate amount of revenue within the context of the current tax system. The President's Budget proposes a number of steps in line with his tax reform principles, including:

- Allowing the high-income 2001 and 2003 tax cuts to expire;
- Setting a maximum 28 percent rate at which upper-income taxpayers could benefit from itemized deductions and certain other tax preferences to reduce their tax liability; and
- Eliminating the carried interest loophole that allows some to pay capital gains tax rates on what is essentially compensation for services.

These steps in the direction of a reformed system would reduce the deficit by about \$1.5 trillion over the next 10 years and would set in motion the process of broader reform.

### Corporate Tax Reform

Right now, the United States has one of the highest statutory corporate tax rates in the world, but the large number of loopholes and special interest carve-outs means that effective tax rates vary widely by industry, even by company, and allow some corporations to avoid paying income taxes almost entirely. Even though our statutory corporate tax rate is among the world's highest, the corporate tax revenue we collect, as a percentage of GDP, is relatively low for advanced economies.

There are too many tax provisions that favor some industries and investments and benefit only those who receive them, rather than society as a whole. This creates problems beyond forgone revenue: it forces some businesses to carry a larger share of the tax burden than they would under a more equitable system, and it also hurts overall economic growth by distorting incentives for investment and job creation.

Soon, the Administration will release a framework for reforming the corporate tax system. This proposal will lower the maximum statutory rate, limit the ability of firms to shift profits to low-tax jurisdictions, eliminate tax expenditures that have no positive spillovers to society as a whole, and bring a sense of permanence to various provisions in the corporate income tax code. In

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short, it will help level the playing field for businesses and allow the government to collect needed revenue while promoting economic growth. The President's Budget proposals, if implemented, would move the existing corporate tax code in the direction of these principles but would not eliminate the need for deeper reforms.

### III. Conclusion

In today's testimony, I have outlined the President's plan for addressing our substantial economic challenges through the combination of targeted investments, spending cuts, and tax reform.

In closing, I want to emphasize that bolstering economic growth in the long run and controlling our deficits both depend a great deal on us taking strong steps to support the economy right now.

A common mistake in the wake of financial crises is for governments to withdraw support for the economy too soon. Though recent economic data has been somewhat promising, we have a long way to go to fully recover from the worst shock to our economy since the Great Depression. Failure to act in the face of these challenges is one of the biggest threats to our economy ahead in 2012 and 2013.

I hope Congressional leaders make progress toward extension of the payroll tax cut and emergency unemployment insurance. These measures will put more money in the pockets of American families at a time when they need it most and will help support the broader economy. The savings to families are significant: a full year of the tax cut will save \$1,000 this year for the typical household earning \$50,000, and the extension of emergency unemployment insurance will prevent millions of UI claimants who are looking for work from losing or being denied benefits.

But we still have more to do. We must continue to work together to support the housing market, whose weakness is a stress on millions of families and a drag on overall growth. To this end, the President recently announced new policies designed to aid the housing market, including broad-based refinancing for responsible homeowners that would save the typical family \$3,000 a year. We are also working with the FHA and FHFA to take a range of steps to improve access to mortgage credit, and the FHFA also recently launched a pilot program to convert foreclosed homes into rental properties.

Congress should also consider the plan set forth by the President, first in the American Jobs Act, and now in the Budget, to create jobs and strengthen our economy. The President's Budget cuts taxes for American workers. It cuts taxes for small businesses, so they can hire more people, and cuts taxes for businesses that add employees. It protects the jobs of teachers, police, and firefighters. And it puts construction workers back to work on much-needed projects. There are 13 million Americans looking for work. We have an obligation to them.

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Implementation of these short-term steps will help strengthen the economy as we enter the next fiscal year. The President's Budget for FY 2013 provides a path forward that will help our nation grow now and in the future. These are important proposals. They are balanced proposals. And they will help make our economy and our nation stronger.

Chairman CONRAD. Thank you, Mr. Secretary.

Just to rivet the point, what was happening to economic growth in this country in the last quarter of the previous administration?

Secretary GEITHNER. Well, you said it well at the beginning, Mr. Chairman. The economy was shrinking at an annual rate of more than 8 percent. We were losing three-quarters of a million jobs a month. We were in the midst of a shock larger than the shock that caused the Great Depression. And within 6 months, really remarkably quickly, but because of the scale of the force we put behind trying to rescue the economy from this financial crisis, growth resumed in the summer of 2009. And as you said, we have now had more than 2-1/2 years of straight, positive, moderate economic growth. We want it to be faster. We think it should be able to be moderately faster. But I think it is unrealistic to judge that growth record against recoveries that followed much milder types of crises, because when you come out of a crisis caused by a huge build-up in debt, a huge increase—excess investment in housing and construction, growth by definition is weaker than we would like. And as we have had a series of pretty adverse shocks to the economy—oil, Japan, Europe, not to mention the damage to confidence caused by the debt limit fight.

The economy is getting gradually stronger, but I want to emphasize, as I know you all are aware, that we have a lot of tough work ahead of us still. It is still going to take time to heal the damage caused by the crisis, and that is why as we think about the long-term fiscal challenges we face, we have to make sure we focus right now still on how to make sure we are healing the damage caused by the crisis, making growth stronger in the short term.

Chairman CONRAD. So in the last quarter of the previous administration, the economy was shrinking at a rate of almost 9 percent. What has been the economic growth in the most recent quarter?

Secretary GEITHNER. Well, the economy over the last quarter, two quarters, three quarters, has averaged something closer to 2 percent. Most people look at the economy now and think we are growing at somewhere between 2 and 3 percent. We started stronger, but growth moderated a bit for the reasons I said, which is oil, Japan, Europe, the fiscal drag at the local level. It was a very substantial set of adverse shocks to the economy. But growth looks like it is gradually getting stronger, and, of course, our job is to make sure we are reinforcing that.

Chairman CONRAD. And you mentioned private sector job growth. The first month of 2009, we lost 800,000 jobs.

Secretary GEITHNER. That is right, more than three-quarters of a million jobs. And job growth has been averaging now slightly over 200,000 jobs a month, which is not surprising given the fact the economy is growing at roughly 2.5 percent. We have had 3.7 million private sector jobs since job growth started. Job growth is actually more rapid than it has been following the last two recessions, the recession of the early 1990s and the first Bush recession, a little more rapid than in those recoveries.

And, if you look at any other measure of business health outside the construction industry, if you look at profits, they are higher as a share of GDP than before the crisis, overall profits higher than they were in 2008, private investment up 30 percent, as I said, pro-

ductivity growth pretty good, balance sheets in the corporate sector really very strong, no credible argument that the broader health of the business sector is not dramatically stronger today than it was when the President took office.

Chairman CONRAD. Well, let me go to the next question that I have, which is the revenue proposal that you have brought to us. What would revenue be as a share of national income at the end of this budget period under the President's proposal?

Secretary GEITHNER. Roughly 20 percent of GDP, which I think, as you correctly noted, is lower than the peak in the end of the Clinton administration when, as you said, we had a remarkably strong record of economic growth and job creation and investment and productivity growth, and somewhat lower than proposed in the Simpson-Bowles Commission and, I think, in the bipartisan Senate Six process, as well, and I think probably in Rivlin-Domenici, as well.

Chairman CONRAD. Let me just make that point. As I read your proposal, you would have revenue at the end of this period just over 20 percent of GDP. You would average during the ten-year period about 19.2 percent of GDP. At the end of the Clinton administration, the revenue rate was 20.6 percent of GDP. And averaged over the ten years, 19.4 percent of GDP. And that was the longest period of uninterrupted economic growth in this nation's history, is that not the case?

Secretary GEITHNER. That is the case, Mr. Chairman, and I think it is very important to emphasize this. For the reasons you said, we do not believe that these—tax reform that would generate revenues in the manner we propose would have a material adverse impact on economic growth relative to trying to get an additional equivalent amount of savings through, for example, cuts in benefits to middle-income Americans. In fact, you could make an argument that if you tried to find the same amount of savings cutting the defense budget or cutting infrastructure or cutting basic benefits for middle-class Americans, those would do more damage to growth and income over the same period of time.

Chairman CONRAD. I thank you. My time is expired.

Senator SESSIONS. We are going to do six-minute rounds this morning given the number. We can have a little more time for each Senator this morning given the number of Senators who are here. Senator Sessions.

Senator SESSIONS. Thank you. Thank you, Secretary Geithner.

This is a hearing about the President's budget and the question is, does the President's budget put us on a path to sustainability fiscally for America? This is his fourth year. He has had time to observe. We have dealt with the debt crisis that blew up and, hopefully, we are beginning to move out of that. So I am not asking for severe austerity today. I think that is a false choice. But the question is, is this administration proposing any reductions or is it proposing more increases in spending?

So with regard to the President's budget and the question I asked to Mr. Zients the day before yesterday, is it not true that this budget spends more money than the current law that was passed last August?

Secretary GEITHNER. Well, let me try and answer it this way. We propose to reduce the deficit to below three percent of GDP over the budget window, and that achieves a critical measures of fiscal sustainability, meaning it is the level you need to stop the debt from growing as a share of the economy and start to bring it down.

Now, as I said in my opening remarks, that does not solve the nation's fiscal challenges.

Senator SESSIONS. Well, could I—

Secretary GEITHNER. Let me start with that one.

Senator SESSIONS. Well, I just asked the question because I would like to know, as we deal with the crisis before us, does the President propose to spend more money than the Congress agreed to spend last year, six months ago? And we agreed to make some cuts. Our two members here, Senators Toomey and Portman, were on the committee. They agreed to cut \$2.1 trillion. It had \$1.2 trillion in sequestered cuts. It appears to me, would you not agree, that the sequester cuts were eliminated under the President's budget?

Secretary GEITHNER. No—

Senator SESSIONS. No, no, on spending, not taxes, pay-for. The spending levels under the budget, were not they—was not this sequester eliminated?

Secretary GEITHNER. Good question. Let me try to respond to that. We propose \$4 trillion over ten years in deficit reduction. That is \$3 trillion on top of the discretionary cuts and caps enacted last summer. The balance of that \$3 trillion is a mix with roughly 50–50 between additional spending cuts on top of the \$1 trillion in discretionary cuts and caps and another \$1.5 trillion in revenues.

The sources of those spending cuts that we propose, which would replace the sequester, are roughly \$350 billion in cuts in Medicare and Medicaid, roughly \$275 billion cuts in other mandatory programs, a modest amount of the savings we get—and these are real savings from winding down the wars in Iraq and Afghanistan, and a series of other modest spending reductions. Together, those add up to an additional \$1.5 trillion in spending cuts on top of the \$1 trillion that were enacted in the Budget Control Act.

Senator SESSIONS. Well, the war spending was part of the agreement that Senators Portman and Toomey and the Committee of 12 agreed on. They did not claim another \$1 trillion in war savings when they reached their agreement to cut spending \$2.1 trillion. Neither did the Debt Commission that Senator Conrad served on. They knew that was not a legitimate number.

However, I would ask you to look at, if you have it, maybe not before you, page 206 of your table, Table S–2, that shows \$1.195 trillion in the effect—additional expenditure as an effect of replacing the Joint Committee Enforcement of the 2012 budget deficit reduction proposal. There is no doubt that this—you marked to the budget caps that were, in effect, not considering the sequester.

Secretary GEITHNER. We counted the—

Senator SESSIONS. You marked to the caps, but you did not mark to the sequester number.

Secretary GEITHNER. We—I think what I am about to say is completely fair—we took credit for the cuts and caps on discretionary spending and we propose additional spending measures so that we

could replace the sequester, which none of us would like to see go into effect. But those additional savings are larger than was proposed—would occur in the sequester.

Senator SESSIONS. Well, let me hold up this little chart I had here, a hand-made chart. This is what the document shows. We have looked at it very hard. It is on page 206 of your budget. It is on page 206. It indicates clearly you did not honor the sequester. It shows \$1.195 trillion.

Secretary GEITHNER. We do not want to honor the sequester. We want to replace it.

Senator SESSIONS. You repeal the sequester. That has added \$1.12 trillion in spending. You had a \$350 billion unpaid stimulus bill. You had a \$500 billion doc fix that was in the baseline but not paid for, as you well know. And that totals up \$2 trillion. You had \$600 billion, as you have referred to, to cuts in mandatory programs. It is a net new spending. Can you not agree with that?

Secretary GEITHNER. I do not agree with that. But—so let us go through the basic things again.

Senator SESSIONS. Even if you count the war—bogus war savings—even if you count them, there was no source of money for that war. There was no money there that you can spend. You have to borrow that. So—

Secretary GEITHNER. Senator, I know that we disagree—

Senator SESSIONS. My time is running out, but I do not think it is a disputable matter.

Secretary GEITHNER. Well, maybe this is helpful to just end, but I am sure we will have a chance to come back to this. By any measure—and CBO—one good thing about our country is that we will debate how to count these kind of things, but CBO will decide for you, and CBO will show—although their assumptions about growth might be slightly different than ours—they will show that the savings we proposed, if enacted by the Congress alongside these tax reform measures, would reduce our deficits to below three percent of GDP so we can save on the debt burden at an acceptable level. And we propose savings that go significantly beyond those in the discretionary caps complemented by a set of tax reforms to raise revenue.

Now, you are right to emphasize—and I commend you for it—that even if Congress were to enact this budget, we would still be left with, in the outer decades as millions of Americans retire, what are still unsustainable commitments in Medicare and Medicaid, and we are going to have to find ways to come together and make progress on those commitments. But if Congress were to enact this budget, these reforms, we would be in a dramatically better position, much closer to a sustainable position, and to give us some time to figure out how we resolve our major differences and how to make sure we reform Medicare and Medicaid in a responsible way.

Senator SESSIONS. Well, it is deeply distressing that the cuts we agreed to six months ago, you have eliminated in this budget—

Secretary GEITHNER. No, the only ones—

Senator SESSIONS. —and you are not marking to them and you increase spending. And even when you count the war savings, which are bogus—the CBO will technically agree with that, but we

know the other committees have not counted those—you will have an increase in spending.

Secretary GEITHNER. Can I say one more thing about the war savings thing? I am sure we will have a chance to do this. But I feel like we are being responsible in how we treat—and I am confident we are—the savings from the wars.

Just as one comparison, the Republican budget, some people call it the Ryan budget, included \$1 trillion in savings, OCO savings, from the wars as part of that framework. We count less than that, in fact, in that context. So you are right, some people disagree about how to count them, but we think we are doing it in the responsible way, certainly consistent with the way the Republicans' budget treated them. And so I would not look to that as a source of differences between us.

Our differences are really fundamentally about what to do for growth, what to do to Medicare, what to do with low-income programs.

Chairman CONRAD. We have to—

Senator SESSIONS. We will not agree that they counted war costs.

Chairman CONRAD. Senator, we have to go on. You are way over.

Senator SESSIONS. Thank you.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman. Welcome, Mr. Secretary.

I can recall sitting in this room, looking for the war funding in the Bush budgets. It was not there. We were actually at war and they did not put the number in. They waited to treat it later as an emergency. So it is interesting to see this sudden desire for budget specificity with respect to war costs.

But my topic is different. My topic is foreclosures and mortgage modifications and the continuing weight that that puts on the economy. I think we can agree that the HAMP and the other programs have been less successful than the administration had hoped. Only ten months remain in HAMP, as I understand it, and we need to figure out what is going to happen going forward. Is there money left in there? What happens to it when it expires? How does it integrate with the settlement that has just been reached?

As you know from our lengthy correspondence and conversations, and you were kind enough even to come to my office at one point to hear me and Senator Merkley and Senator Reed out on this subject, I remain, I guess I would say, disturbed and distressed that the administration is not doing more to put pressure on the banks to comply with the terms of the HAMP and to lift the administrative and bureaucratic burden off of people who are struggling through this process which is so bedeviling to ordinary Americans. Your home is at stake. You cannot get a straight answer. For a lot of people, they have not even gone to the one point of contact rule. There continue to be problems with short sales, being stepped on and foreclosed on by their own banks. And there is a really high human cost behind all that bureaucratic incompetence and I think the administration is in a position with all that it has going on, not only through Treasury but through the Fed and through the administration, to push harder to get this. It has been years now of this. So if you could respond to those points, I would appreciate it.

Secretary GEITHNER. think you are right in what you characterize as the state of the housing market and you are right to express concern and disappointment in it, and we share that very much, about the extent of challenges deserving homeowners still face in getting their banks to modify their mortgages to a more sustainable level.

Now, we are going to extend the deadlines for the HAMP program so we have more time to reach as many people as we can, and so we preserve the flexibility, continue to find ways to reach more people. And HAMP is going to be part of that solution, but it is not the only solution to it.

I think the settlement is going to be very helpful in providing additional relief on top of that to a substantial fraction of other households. We are working very closely with the GSEs to try to get them to do more on a number of fronts. We are encouraging Congress to make it easier for Americans to refinance, to take advantage of low interest rates. We propose significant amounts of spending to help support neighborhood stabilization. This is going to require a multi-front effort and it is going to require several more years of effort. Generally, on this kind of challenge, you have to keep at it. You cannot give up on it. And we need to see this through. We cannot stop prematurely on it.

Now, we will continue to do everything we can to get banks to do a better job of this, and we are trying to put enormous pressure on them to do so and to expose directly in the public eye how they are doing on basic measures of performance in these things in the hope that that encourages them to put much more resources than they have been into this stuff.

I am happy to continue to work with you on how best to do this, but we are not going to let the HAMP program end prematurely and we want to make sure we can preserve the ability to use the resources we have remaining in the most effective way we can.

Senator WHITEHOUSE. Well, whether you are using the GSEs or the bully pulpit or your ongoing discussions with the financial community on a variety of issues and using all that for leverage, I really think it is important that you do this. My experience has been that the HAMP program, however well intentioned, simply—I do not think, frankly, this is the administration's fault. I think the banks have dropped the ball. The administration's fault is not putting enough boot to them when they drop the ball to get them to pick it up and get back to work again.

The same with HARP. The Hardest Hit Fund in Rhode Island, our Rhode Island Housing actually negotiated with the big banks how the program would work, and they sat down and they agreed together on it and then the banks refused to comply with the program that they had agreed to and the only thing that they would go for is the part of the Hardest Hit plan that provides money to pay the banks the mortgage as if it were the—well, I mean, basically, everybody is going to accept that. But in terms of where it required the banks to move towards an agreement and a modification, they walked away from the agreement that they had reached.

So it seems to be local. It seems to be national. It seems to be that you can talk to these people and agree with them and then they just walk away. And so it is very frustrating, as my long cor-

response with you and our long conversation on this subject reflects.

So I will continue to urge you to put the pressure on. I think you have the capacity as the Secretary of the Treasury to ramp up this pressure, and I hope you do because it is inexcusable. This is bureaucracy at its worst. And, frankly, it is the banks and the shareholders and the people who own these notes who are often suffering, because when you cannot keep somebody in their home who is willing to pay a good price and you chuck them out and it goes into the foreclosure market and the property loses \$100,000 in value, that is no big win for the banks. I mean, they have a stake in this, too, but they do not seem to be responding to that.

Secretary GEITHNER. I completely agree with you and I very much share your disappointment and your concern and it sounds like I should come and see you again soon and we can talk through the remaining challenges.

Senator WHITEHOUSE. If it would help. Thank you.

Chairman CONRAD. Thank you, Senator.

Senator Graham is next.

Senator GRAHAM. Thank you, Mr. Chairman.

Secretary Geithner, I really appreciate your service to our country. I know it has been difficult times in which you have served as Treasury Secretary and you could be doing other things, but you have tried to serve your country well and I appreciate that.

Is this budget for the 2013 cycle by the President substantially different than the budget submitted last time?

Secretary GEITHNER. It is different in two ways. I am not sure they are ways you would agree with, but it is different in two important ways. One is, unlike last year's budget, we have included more than \$500 billion in reforms to Medicare, Medicaid, and other mandatory programs, very detailed reforms, some of them very painful, many of—all of them very unpopular changes. But we also include a substantial amount of additional investments in infrastructure, for example, and—

Senator GRAHAM. Would that be spending?

Secretary GEITHNER. Yes. I am sorry. You could call it spending, although that kind of spending, I think, is—most economists—

Senator GRAHAM. It is not that I oppose the idea of infrastructure spending. I just do not want to make people think that it is not their money.

Secretary GEITHNER. Okay. I will call it spending.

Senator GRAHAM. Okay. And it may be smart, but I guess the point I am trying to make, last year's budget was defeated 97 to nothing, and if that happened to a document I produced, I think I would have been up here saying, what happened? Have you come up here to talk to Republicans and Democrats and say, why did everybody vote against this budget and what can we do better next time?

Secretary GEITHNER. Well, as Senator, first of all, like I said, this budget is substantially different, but we spent—

Senator GRAHAM. Well, when you say “substantially different,” was it as a result of getting input from us to see what we would like to have different, or you all just did things on your own?

Secretary GEITHNER. Oh, absolutely. In fact, we spent—as we spent, I would say—

Senator GRAHAM. Who did you talk to on the Republican side to change the President's budget this time around?

Secretary GEITHNER. We spent four solid months negotiating with the leadership on the Republican and Democratic side—

Senator GRAHAM. No, wait a minute. Wait a minute. I am talking about the budget.

Secretary GEITHNER. No, but that is exactly what I am referring to. But in the discussions that Vice President Biden shared that included Senator Kyl on your side—

Senator GRAHAM. Did one member of Congress say that if you made the two changes you just suggested, I will vote for the budget?

Secretary GEITHNER. Uh—

Senator GRAHAM. Have you picked up one vote by increasing spending and infrastructure and taking \$500 billion in entitlement reform?

Secretary GEITHNER. We—

Senator GRAHAM. Has anyone said that that does it for me?

Secretary GEITHNER. Well, if you look at the shape of the mandatory reforms we proposed in this budget—

Senator GRAHAM. No. My question is, you are proud of what you did. I may agree, I may not. But from a political exercise, have you taken the time to say, if I make these two changes, will you now vote for the President's budget?

Secretary GEITHNER. Well, Senator, maybe I could try it this way. On infrastructure, there is very broad bipartisan support on—

Senator GRAHAM. Yes, but did you say that, okay, if we do this on infrastructure—have you tried to grow the vote?

Secretary GEITHNER. Oh, absolutely, and again, the—

Senator GRAHAM. Well, how do you grow the vote if you have not talked to anybody and said, my vote will change if you do these two things?

Secretary GEITHNER. Senator, I mean, you know this world better than I do. But we did spend four months negotiating with the Republican leadership on these—

Senator GRAHAM. Well—

Secretary GEITHNER. —and many of the changes in this budget reflect those conversations—

Senator GRAHAM. I am just suggesting, quite honestly, that there is plenty of fault to go around here. I am just suggesting that this budget was not a result of negotiations with the Congress in a serious way to go from 97 to nothing to 80 to 20. This is just a document produced by the President that is more political than it is trying to solve the problems. And I am not saying people on our side do not do that. I am just saying that the country is ready to move on, which gets me to my next topic.

There have been members of Congress who have rejected the model of political posturing through budgets—the Gang of Six, the Simpson-Bowles Commission—and when they—do you agree that tax policy affects job creation?

Secretary GEITHNER. I agree that—yes, I do, and I agree, tax reform done well would help.

Senator GRAHAM. Okay. Well, let us talk about tax reform done well. I think the Gang of Six and Simpson-Bowles said, let us not raise rates. Let us lower rates but eliminate deductions across the board in a dramatic way. Do you agree with that?

Secretary GEITHNER. I do. I absolutely agree, and—

Senator GRAHAM. Then why did you not do it?

Secretary GEITHNER. Well, as I said in my remarks, Senator, we have laid out—

Senator GRAHAM. Is there anything in this budget—would the Bowles-Simpson say, if you asked them about the President's budget, this is pretty well mirroring what we did? Would any Gang of Six member say, that is sort of the template that we had?

Secretary GEITHNER. In the broad balance of taxes and spending—

Senator GRAHAM. No, the way you do—

Secretary GEITHNER. Absolutely.

Senator GRAHAM. Yes, the way you do tax reform.

Secretary GEITHNER. Oh tax reform, as I said—can I finish my comment on this?

Senator GRAHAM. Please.

Secretary GEITHNER. On tax reform, we very much support, and I think this is what is going to have to happen, broad-based comprehensive individual tax report—

Senator GRAHAM. What was the top rate in Bowles-Simpson?

Secretary GEITHNER. It was not specified. There was an illustrative example. The key thing in Bowles-Simpson, though, Senator, was that they proposed \$2 trillion in revenue increases over ten years.

Senator GRAHAM. Right. Okay. They did this by eliminating deductions, did they not?

Secretary GEITHNER. Well, no. They do it by lowering rates, broadening the base.

Senator GRAHAM. Right.

Secretary GEITHNER. But the effective tax rate goes up for the most affluent Americans in their proposal, as it would under any proposal—

Senator GRAHAM. So what would the top rate be under Bowles-Simpson? Would it be more than 39.6?

Secretary GEITHNER. No, but the—but, Senator, I am agreeing with you. If the—

Senator GRAHAM. Well, your budget has a 39.6 top tax rate.

Secretary GEITHNER. No. What our budget says is if you are going to raise revenues on top of the current tax system we have today, then you should do some—

Senator GRAHAM. If we enacted your budget, what would be the top tax rate in this country?

Secretary GEITHNER. We restore the top marginal tax rates in the top brackets for the top two percent to where they were in the Clinton administration—

Senator GRAHAM. Did—did—

Secretary GEITHNER. —and we go beyond that.

Senator GRAHAM. Did the Gang of Six do that? Did Bowles-Simpson do that?

Secretary GEITHNER. Senator, I do not know if I could say it differently, but I am not going to convince you, but we showed you in some ways paths—

Senator GRAHAM. Well—

Secretary GEITHNER. —two paths—

Senator GRAHAM. —my point is, with all due respect, you have not showed me anything. You have not done anything. You have not showed me anything. You have not done the hard, heavy lifting that our colleagues in the Gang of Six have done, plenty of blame to go around. You have not followed Bowles-Simpson. You asked the committee to be formed and you basically did not follow their model. This is not—

Secretary GEITHNER. Well, I do not—

Senator GRAHAM. —tax reform. These tax increases, this is class warfare. This is more spending. There is no entitlement reform here.

Secretary GEITHNER. Senator, I—

Senator GRAHAM. We are going to have an election—

Secretary GEITHNER. Right. We are.

Senator GRAHAM. —Mr. Secretary, and you punted. You got no votes last time. You send us the same formula up here this time. You are not going to get any more votes this time. And the country has got its back against the wall and I wish you would take the Gang of Six product, the Bowles-Simpson product, and say, that is mine. Let us start talking. Let us get this done. You would not only do the country some good, you would do the President some good, and a lot of us would cheer you. Thank you.

Secretary GEITHNER. Could I respond just—

Chairman CONRAD. Yes, certainly.

Secretary GEITHNER. You and I agree on this more than you fear, more than you think.

[Laughter.]

Senator GRAHAM. Just put it in your budget.

Secretary GEITHNER. But I want to say—and I welcome your support for the Simpson-Bowles strategy or the Gang of Six or Domenici-Rivlin—if you are willing to come and join us on a tax reform that raised \$1.5 to \$2 trillion in revenue, then we would have the basis for substantial improvements in our long-term fiscal position with reasonable changes to the path of Medicare and Medicaid and Social Security and defense. We go deeper on discretionary spending than Bowles-Simpson has proposed. We do not go deeper on defense spending than Bowles-Simpson for reasons I think you understood and support. We have more detail on Medicare and Medicaid than is in the Bowles-Simpson plan. So—no, we have more cuts on health care mandates than are laid out in the—

Senator GRAHAM. So you believe you have done a better job than Bowles-Simpson—

Chairman CONRAD. Whoa, whoa, whoa, Senator. We have gone way over now.

Look, colleagues, I do not know what is happening to us here, but maybe my good nature is being kind of used against me here. You know, I am willing to be—I try to be very fair. We set six minutes. I try to let everybody go about a minute over. But now, come on, guys. We are going two minutes over. It is not fair to others

who are here to wait, on both sides. So, please, I am—as we have a good flow going on, which we did, those are excellent questions and we had good discussion, but we have to have some kind of limits.

Senator SANDERS.

Senator SANDERS. Mr. Chairman, thank you, and welcome, Mr. Secretary.

I always—the reason I enjoy being on the Budget Committee is I always find it extremely amusing about who poses as great deficit hawks. Many of the loudest voices about the serious crisis of deficit reduction and the national debt are people who have, more than anybody else, grown our deficit. So as a deficit hawk, unlike people on the other side, I did not vote for the war in Iraq. How much is that going to cost us, Mr. Secretary?

Secretary GEITHNER. Oh, I do not have those numbers now, but it is hundreds and hundreds of billions of dollars.

Senator SANDERS. No, it is more than that. By the time you take care of the last veteran, it is probably in the trillions of dollars. I did not vote for that, but the deficit hawks voted for that. I do not recall one question, Mr. Chairman, how much is that war going to cost? Do you recall that? I did not hear it coming from the other side.

The way I do arithmetic is if you give a trillion dollars in tax breaks to the wealthiest people in this country, you do not offset it. You know what? It results in a significant deficit. Mr. Chairman, do you recall anyone saying, gee, if we give tax breaks to the very rich, it is going to result in a deficit? I did not vote for that. I am the deficit hawk. But my friends over there, I did not see that.

The Chairman often shows—I do not know if you have that famous chart of this building in the Cayman Islands where we have, what, 18,000 corporations—18,000 mostly American corporations in one building who are avoiding about \$100 billion a year in taxes. Some of us think that that is insane, an insult to the American people. Some of us want to eliminate that. But my so-called deficit hawk friends, I do not hear very much coming from them on that issue.

Medicare Part D, Medicare does not negotiate drug prices with the pharmaceutical industry, wasting billions of dollars a year.

So my point is, I consider myself far more of a deficit hawk than many of my Republican friends, but I have to admit, I do have to admit, that some of them are very serious about the deficit because their response about deficit reduction is to give even more tax breaks to the wealthy and large corporations and then at the same time slash Social Security, Medicare, Medicaid, education, and the other needs of working people.

So I would suggest that there is a strong element of hypocrisy for those people who are willing to spend on wars, tax breaks for the rich, but then they really, really get tough in the middle of a recession on the elderly, the children, the sick, and the poor.

Mr. Chairman—Mr. Secretary, let me ask you this question, changing subjects a bit. I have voted against these payroll tax holidays because I worry very much about the future of Social Security. We are diverting hundreds of billions of dollars from the Social Security Trust Fund and the political argument is that if you

do not vote for this, you are voting for a, quote-unquote, “tax increase.” Now, we did that the last two years. What will—you guys are saying that this is the last year you are going to do that. But why would I suspect that somebody there, somebody here, somebody in the administration next year is going to say, hey, if you do not continue that payroll tax holiday, divert more and more money from Social Security, you are voting for a tax increase on the middle class. Can you be very specific in responding there?

Secretary GEITHNER. Well, I understand your concern, and you always have to worry, can people give up and commit themselves to give up a tax break that exists. We have a lot of experience with people unwilling to give this up. But this has to be a temporary tax cut. I do not see any reason to consider supporting its extension. But it poses no risk to the Social Security Trust Fund, because as the way the law is written, that temporary tax cut gets replenished by general revenues.

Senator SANDERS. I do know that, but when we have a \$15 trillion national debt and when some of our friends want to decimate every social program out there, I do worry about it. But I want it very specifically. Are you telling us right now this is absolutely, if Obama is reelected, absolutely the last year you will ask for an extension of this payroll tax holiday?

Secretary GEITHNER. That is my judgment based on everything we know today, yes. And I do not foresee and would not—could not consider supporting a rationale for extending. Now, we have some other tough things to deal with at the end of the year, you know. We have the expiry of all the Bush tax cuts. We have the sequester to deal with—

Senator SANDERS. If I could, please. I am sorry. Let me ask you another question. One of the issues—I am pleased that in the last year or two, probably because of the efforts of Occupy Wall Street, there has been growing discussion about income and wealth inequality in America, which is a huge issue. I want to ask you this question. Right now, we have 400 individuals who own more wealth—I am not talking about income—who own more wealth than the bottom 150 million Americans, 400 and 150 million. That is the most unequal distribution of wealth in the entire world, certainly in the modern history of the United States of America. We have six banks—six banks—that have assets equivalent to two-thirds of the GDP of the United States, about \$9 trillion.

Do you believe that it is healthy long-term for our economy when so few individuals own so much wealth, when so few banks, a half-a-dozen banks controlling—having assets equivalent to two-thirds of the GDP? Do you think, from a competitive point of view, from an economic point of view—forget the moral point of view—do you think that is healthy for the future of our economy?

Secretary GEITHNER. I think you understand the problems associated with the rise in inequality, not because you do not understand them—you understand them better than anybody—but it is the combination of alarming increase in inequality with alarmingly high rates of poverty, very low growth in the median wage for the average family, combined with very diminished prospects for mobility, for intergenerational mobility. It is the combination of those two things that we should be most worried about as a country, and

I think that every time we think about our fiscal priorities, we have to keep in mind the fact that this country, despite our enormous wealth, is living with, I would say, shameful levels of poverty, inequality, and diminished prospects for the average—

Senator SANDERS. You are absolutely right, and when we talk about the future of this country, every single person in this room should be terribly ashamed that we have, by far, the highest rate of childhood poverty, somewhere around 22 percent, of any major country on earth. Now, how do we expect to be going forward as a great nation when so many children are living in terrible poverty and not getting the education, among other things, or the health care that they need?

With that, Mr. Chairman, I yield the floor.

Chairman CONRAD. I thank the Senator.

Senator PORTMAN. Thank you, Mr. Chairman, and Mr. Secretary, thank you for being here again and for your service.

I just have to make a quick comment on my colleague's comments. The way to do it is to increase economic growth, and that is one of the serious challenges that we have, and I want to talk to you a little about that, because the Treasury plays a big role in economic assumptions and because economic assumptions play a key role in what these budget numbers really mean. A year ago at this same hearing, I asked you about your numbers, saying that I thought that they were too rosy and that it had a big impact on what your deficit reduction claims were. I noted that the private sector estimates represented by the Blue Chip forecast were more pessimistic than yours. Your answer at the time I think was to say, "Well, Portman, you were Budget Director 5 years ago, and you did the same thing." And I was kind of shocked you answered—

Secretary GEITHNER. No, I do not think I said that that way.

Senator PORTMAN. Well, you did but—so I went back and looked because I did not know at the time. Actually we did follow Blue Chip, FYI, but it turns out that it was even worse than, we all had hoped, because you look at 2011, last year under your budget you projected 3.1 percent growth in 2011, and it ended up being, as everyone knows, 1.7 percent growth last year. And, incidentally, your budget this year has lower estimates for 2012, 2013, and 2014 than your budget did last year. But even so, you are significantly above Blue Chip. On average, you are over half a point above. And it does matter. I mean, you look at this, rule of thumb might be each year about half a percent of GDP is about 200 billion bucks, so we are talking about \$600 billion less in deficit reduction over the next few years if you follow Blue Chip. That is conservative. This Blue Chip is actually a little bit lower than that.

So I just point that out again because Treasury plays a key role in looking at those. I hope that in these budget documents you guys can look at Blue Chip and CBO, which, as CBO is far less optimistic than you are, too.

Given that you have about \$2 trillion in tax hikes in this proposal and that, we have been off on the estimates in the past in your budgets, why do you think the continued rosier scenario is appropriate?

Secretary GEITHNER. You are absolutely right that we are somewhat above Blue Chip. You are also right that growth was weaker

in 2011 than we forecasted, and it was weaker for the reasons I said. You know, we had a substantial oil shock, the Japan disaster, and Europe, not anticipated at that time, and it goes to what Senator Sessions said. It just reminds us how uncertain these things are.

I think that you have to be very careful that when we budget we budget on a realistically conservative assumptions about the future growth, inflation, interest rates. We have tried to do that, but, again, one of the great strengths of our country is, it will be CBO's things that govern in this broad context. They are probably, I think—I am not sure exactly where they are going to be. I agree with you they are probably going to be more modest in the short term, but I think if you look over the longer budget horizon, I do not think we are going to be that far off of them.

Senator PORTMAN. They are more pessimistic, as over the next few years, and they are indicating that unemployment is going to rise. In fact, your own budget says unemployment is going to go up next year under your proposals.

Secretary GEITHNER. No, that is not quite true, Senator. As the Chief Economist said the last few weeks or so, the unemployment forecast in the budget was done—I do not know—5 or 6—

Senator PORTMAN. Yes, I understand. I am just saying if you look at your budget, it has a higher forecast, and CBO, the Congressional Budget Office, has come out with their forecast—

Secretary GEITHNER. Only because it was done in November, that is all.

Senator PORTMAN. Quickly, on entitlements because this was talked about a lot today, and a lot of people on this Committee have spent a lot of time and effort on it, and a bunch of us have voted for what you called the Ryan budget earlier, which was a budget that most members of this

Committee on the Republican side supported, which did deal with the issue of Medicare in a very difficult political way, but in a way to actually get costs down through competition and through dealing with the unsustainability of a fee-for-service, third-party payer system.

Just to make a point here on your budget, mandatory spending, which is now the biggest part of the budget—it is 64 percent of the budget, which includes Medicare, Medicaid, Social Security, interest on the debt—rises in your 10 years, as I look at it, from 64 percent of the budget—and, again, the fastest-growing part of the budget—to 78 percent of the budget. So when my colleague from Vermont talk about slashing, we are crowding out obviously the rest of the budget increasingly by not taking on this issue. And you do not touch Social Security. Medicare, you do have some means testing on the beneficiary side, but it happens, interestingly, after the next Presidential term. And, again, the growth is 64 to 78 percent.

Secretary GEITHNER. But, Senator, just on that one thing, in the Republican budget that was passed by many—or supported by many over the last year, none of the Medicare changes hit within the 10-year window.

Senator PORTMAN. That is correct. You would not know that from—

Secretary GEITHNER. And there were no Social Security reforms in that budget. And—

Senator PORTMAN. But let me be clear. If the administration were to put a Medicare reform proposal in the budget and say that it is not going to affect those who are currently 55, therefore, it would occur in the 11th year, I am sure that you would get a lot of support from this side of aisle. Certainly you would from me. And I think you would agree that that was a politically difficult but an important step forward. So that is—

Secretary GEITHNER. And we did propose—

Senator PORTMAN. That is what we are looking for.

Secretary GEITHNER. We do propose \$350 billion of Medicare and Medicaid changes within this budget window.

Senator PORTMAN. Yes, and that is—again, the means testing I applaud you for. I think it is appropriate. I think there are ways you can do more there, which I would be happy to talk to you about. But the rest of it all comes out of the provider side, as you know.

Final question on comprehensive tax reform. You have talked about the need for lowering rates and broadening the base. Can you talk about why you think that is so important, particularly with regard to corporate tax reform?

Secretary GEITHNER. Okay. I think in general on both sides that is true, that you have a more efficient system, better for growth, fairness, simplicity, if you lower rates and broaden the base.

On the corporate side, the single most important imperative for how you think about a principle to guide reform is how to improve the incentives for people who are going to design and create and build things here in the United States. And what you want to do is reform the system so that you are shifting those incentives in favor of the American company or the foreign company building that next plant here. That requires lowering the rate. It requires cleaning up a bunch of the less efficient distortions in the current Tax Code, and it is going to require some changes on the international side, too, so we are not encouraging people at the margin to build that next plant or shift their investment income outside the United States.

Senator PORTMAN. Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

Senator Begich.

Senator BEGICH. Thank you very much, Mr. Chairman. Mr. Secretary, thank you for being here.

Before I start with some of my questions, I always am starting in a lot of my Committee work that I do here or elsewhere, I want to make sure we echo what I think is happening out in the economy, and there is good news, a lot of good news. It is not perfect. It is not what we all would hope and dream for in the sense of a robust economy. But it is incredible news. I know the Chairman talked about GDP, and I do not have a big chart. I have just a small sheet of paper, but the colors tell the story, and it is what you talked about, Mr. Chairman. The red is bad, green is good, and you can see what is happening.

Now, it may not be a perfect trend line, but the most important part—and I am kind of talking through you to, again, the folks that

watch us here and try to understand all this language we use here. We have had very positive growth. Now, it is not as strong as we would like, but it is positive growth.

The other chart, which I think is interesting, a little smaller to see, but, again, the red lines show the loss of private sector employment, and you can see how deep it gets, 600,000 at one point per month. And then as you actually made a slight error in your testimony, you said 22, then you had to correct yourself, 23 consecutive months, not 22, now 23, which is, again, a good sign. Again, not as robust.

When you look at today's news, just the stuff that is on the line today, U.S. housing starts climbed more than expected in January. That is off of CNBC: "Jobless claims keep falling; inflation pressure still low." Again, not me saying that. It is what we are seeing in the market and what is happening. That number is very important because that is the underlying number to the unemployment as we see that consistently below 400,000 number, it is 381, or whatever it is today—or 361.

The other telling number under here—and I think you might echo this—is the small business component here. That is the backbone of this economy. And when in January unexpectedly unemployment went down, honestly, as a small business person, that did not surprise me one darn bit, because if you looked at the December numbers, it was small business people hiring. They do not hire for surges. They hire because demand is starting to increase, and they have been pent up. I know this because I have been in small business for a long time.

Also, this one I always love because—this is again today: "GM posts record profits 2 years after bankruptcy"—because the work—and it was risky, I will say that. The work we did here with you folks and a slim margin, to say the least, at the end of the day incredible. "Production at U.S. factories on the rise." You know, the good news is there. But we spend a lot of time here looking for the bad news because that gets better headlines and that is what is great to talk about and gets people fearful.

"Market is up double since May of 2009." Why is that important? Because so many people are tied with their retirement funds, education funds, all those things that matter to their long-term health. Is it better—can it be better? Yes. No one disagrees with that, to my colleagues on the other side. But we have done incredible things. And your deficit projection, which was one point—I know people always throw the 10-year numbers, as my colleague did yesterday. Ten years of projections. I am talking about reality. Reality was 1.4 trillion, now down by over \$200-plus billion, maybe \$300 billion when finally done. That is reality. That is actual. The 10-year projections are all what they are—projections, mythical numbers that CBO, we all—we put charts up, but it is actual that makes the difference. And so it is not perfect, but we sure have come a long way.

I want to make sure I understood your debate with Senator Graham, and that is on statutory rate versus effective rate, because the statutory rate, again, is a mythical number. Example A, former Senator Santorum, if I look at his tax return, has a 35-percent rate. If I look at Romney, 35-percent rate. But their effective

rates: Santorum, 27 percent; Romney, 15 percent, even though they are both in the 35 percent. So that is what your point—correct me if I am wrong—was trying to talk about effective rate. The effective rate of the top 2 percent will go up under your plan. But the overall statutory rate will come down.

Am I hitting that right?

Secretary GEITHNER. If we do tax reform—

Senator BEGICH. If we do tax reform. I am sorry. Yes. But your basic question was, before you get to tax reform, there has to be an understanding by all sides here that the number we need to get to in new revenue is about \$1.5 trillion. Did I hear that right? If you can answer that question, then it is just putting the pieces together. But everyone wants to argue about the pieces because they never want to answer the first question, because that is how you are going to solve this, between cuts, revenue, and growth.

When I was mayor of Anchorage, 40 percent of my new tax revenue was from growth. But I cut and I adjusted revenue streams.

I had kind of a list. I am actually just going to submit my questions for the record, but it is frustrating because what we should be doing here is agreeing that we are going to hit some of these things and do them. Tax reform, there are two things I would love to get your comment on—not now but for the record. There is a bill that I support on tax reform that Senator Wyden, Senator Coats, and I have put together. I would be anxious and interested—also Senator Isakson have a piece of legislation regarding reforming Fannie Mae and Freddie Mac, which I think is the right thing to do. It takes some of your guys' ideas, some of the Republican and Democratic ideas and kind of meld them in the housing industry. I would be very curious. I think that is something where we can recoup \$100-plus billion of taxpayer money and put it back into helping draw this deficit down. So I would be very interested in that.

And then the last one for the record, if you could, how confident are you regarding TARP? I know at one point it was a projected \$340 billion taxpayer bill by the past administration, but today it is \$68, \$78 billion. If you could, again, for the record—or if you can do it in 5 seconds—give me the answer to that. I will leave it at that, Mr. Chairman.

Secretary GEITHNER. Let me just answer quickly on the TARP question. You are right that at the beginning the estimates were \$350 billion or more in terms of losses on TARP.

Senator BEGICH. Losses to taxpayers.

Secretary GEITHNER. Losses to taxpayers. And the latest estimates from CBO are somewhere between \$30 and \$40 billion. We carry a higher number, a more conservative estimate than the CBO. But my own view is it will be lower than both those estimates, and—

Senator BEGICH. Very good. Thank you, Mr. Chairman—oh, I am sorry.

Secretary GEITHNER. It is important to recognize that the investments in the banks that were such a source of understandable outrage and anger are likely to generate a very substantial positive return to the taxpayer.

Senator BEGICH. Very good.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator JOHNSON.

Senator JOHNSON. Thank you, Mr. Chairman. Mr. Secretary, welcome.

I would like to talk about actual, I would like to talk about reality, and the reality situation is this is the President's fourth budget, and this is the fourth year in a row that he is not addressing Social Security, and he is really not in a meaningful way addressing Medicare, which we all realize are the real drivers.

I agree with Senator Sanders. I am highly concerned about why anybody would propose defunding America's retirement plan, not only just 1 year but 2 years in a row, and when is that ever going to stop. Because the chart behind me shows that by the year 2035 we will run a cash deficit of \$6 trillion, and that is a real concern.

Again, I want to talk about—I want to kind of cut through the poll-tested Washington speak that I think is so much of the explanation behind this budget and get to some facts.

First of all, let us talk about actual spending, getting to what Senator Sessions was talking about. Spending does increase compared to your last year's budget. On Table S-1, you projected 10-year outlays of \$46 trillion. Now, that—because we are not cutting spending. If you take a look at the last 10 years, we spent \$28 trillion over 10 years. Your projection was for \$46 trillion in your last year's budget. You are projecting this year \$47 trillion. These are correct numbers. Am I right?

Secretary GEITHNER. I do not think those help you at all explain the choices we face.

Senator JOHNSON. Those are correct numbers out of your budget. Last year, you projected 10-year spending of \$46 trillion. This year, you are projecting \$47 trillion. Correct? I just want—those are correct, right?

Secretary GEITHNER. You know this very well. Millions of Americans are retiring, becoming eligible for Medicare and Medicaid. So what that means is—

Senator JOHNSON. Okay—

Secretary GEITHNER. —that those spending grows over time.

Senator JOHNSON. Are these numbers accurate or not? This is your budget from last year and this year in terms of outlays, correct? It is 46 versus 47.

Secretary GEITHNER. I know you want to cut deeper than we are proposing—

Senator JOHNSON. No, no—okay, let me move—

Secretary GEITHNER. I understand—

Senator JOHNSON. I am not going to get an answer. Let me move on to my next question. I would think most Americans, when they hear that you are going to reduce the deficit by \$4 trillion, would think you are going to reduce the debt by \$4 trillion as well. Correct?

Secretary GEITHNER. I think I could save you time by saying I know you want to cut deeper faster. I got it—

Senator JOHNSON. No, no. I just want to cut through—I want to cut through the fiction that this budget is. So according to your budget last year, you were estimating in Table S-14 that the total debt in the year 2021 would be \$26.3 trillion. Take away the \$900

billion. The thing that we should compare it to is \$25.4 trillion. Right now in this budget you are estimating \$25 trillion for 2021. So the only thing I can come up with is that the total deficit reduction is \$400 billion, which, Congressman Ryan arrived at about the same number a different way. So we are not seeing \$4 trillion of deficit reduction, are we?

Secretary GEITHNER. Those are—3 days I have heard and listened to that argument, and it has no value as a way to expose the choices we face in this context. We—

Senator JOHNSON. I am just trying to cut through the fiction. Isn't it true, if you are really going to cut the deficit by \$4 trillion, you should be reducing the projected debt? Isn't that true?

Secretary GEITHNER. Senator, I think I can save you some time on this. Ask CBO what happens to the deficit if you were to enact our policies, and they will tell you the deficit falls dramatically as a share of GDP. That is the test of fiscal responsibility. What we differ on is whether we should cut more than that faster and how we should get there.

Senator JOHNSON. You are not answering my question. Let me just ask you another one. I have heard repeatedly over the last year that the President was for the grand bargain. Again, I know that is poll tested. You know, it sounds grand. It sounds like a real bargain. You know, I will bet you it is even balanced. What was it? What was the grand bargain? Was it ever on a piece of paper? Did the American people ever see the entitlement reform that the President was actually supposedly agreeing to?

Secretary GEITHNER. Senator, I spent, as the President did, months and months with the senior leaders of the Republican Party and Democrats—

Senator JOHNSON. Did Americans ever see what the President's proposal was to reform entitlements? Because he keeps talking about that he actually had a plan. What was the plan?

Secretary GEITHNER. We proposed in April of last year, in September of last year, and in this budget reforms to entitlement spending. They are in the budget. Now, you can disagree with them. You—

Senator JOHNSON. Is there a plan? How do you reform them? How do you reform Social Security? How do you save Social Security over the next 35 years?

Secretary GEITHNER. On Social Security, you are absolutely right, we have not proposed a plan to reform Social Security. We have not. Nor have you. Nor has your side.

Senator JOHNSON. But, again, the President said he is for the grand bargain that actually reformed entitlements. What was the plan? Can you provide it to my office so I can see a detailed plan of entitlement reform?

Secretary GEITHNER. You can see the detailed plan in the budget on Medicare and Medicaid, much more detailed.

Senator JOHNSON. For Medicare, \$350 billion.

Secretary GEITHNER. Medicare and Medicaid together, \$350 billion cut off the expected baseline over 10 years.

Senator JOHNSON. And Social Security, you are doing nothing to address the \$6 trillion deficit?

Secretary GEITHNER. No. On Social Security, we have left, as you have, a broad commitment to work to strengthen it, but we are not willing to come to where you are on how to do that because, frankly, your side wants to cut the benefits deeper.

Senator JOHNSON. Let me move on. When I was questioning Chairman Bernanke, certainly I realized it is the level of uncertainty because we do not have a plan. Americans are taking a look at these deficits as far as the eye can see, the fact that this President is not leading, is not proposing real tax reform, is not proposing any kind of—nothing to propose saving in Social Security and entitlements. And I asked, “Is that a problem?” Chairman Bernanke said, “Yes. That harms economic growth.” The White House—their answer was, “We have no opinion whether this body, the Senate, should pass a budget.”

Do you basically agree with that? You have no opinion whether we should actually show a plan for how we save America financially?

Secretary GEITHNER. Good question, so let me try to respond.

Senator JOHNSON. Sure.

Secretary GEITHNER. My view is, as you have heard me say many times, that if Congress and this country, this city, this capital, this building, does not find a way to begin to make progress, more progress than we did in the summer, putting our deficits on a sustainable path, then it will be bad for the country. Growth will be weaker. That will be damaging.

However, if you look at any measure we have today of the risk that those concerns about the future are hurting growth, I do not believe you can find evidence to support that, and let me just say in support of that the following things—

Senator JOHNSON. Are you going to press Senator Harry Reid to bring a budget to the floor of the Senate to actually vote on it?

Secretary GEITHNER. That is really a better question addressed to my colleagues, but I want to just finish this one thing. To borrow at 10 years now, we pay less than 2 percent. There is no evidence in any measure in financial markets today of concern about fiscal sustainability, about inflation risk, other things, in any measure of financial markets you can test every day. It does not exist today. Now, if we do not act on this, it will happen and it will hurt us but not today.

Now, again, if you look at any measure of the basic health of the American business sector outside construction today, profits, very, very high. Expected profit—and their stock prices are way above where we came in. And they are spending on investment and equipment and software and on employment at levels that are pretty healthy given where we are and where we are going.

So you are right to say that we cannot sit here and do nothing about these problems. We have to do more. We just started that process. It is going to take some time. It will hurt us if we do not get there, but there is not, I do not think, strong evidence today to suggest that you—the fact that you are not willing to move on it now, we cannot close our gap right today, is having a material impact on growth now.

Chairman CONRAD. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman, and, Mr. Secretary, thanks for being back. I guess this is your last time through for this purpose, for the budget.

Secretary GEITHNER. You can have me come back if you want. I am happy to come back.

[Laughter.]

Senator TOOMEY. I am referring to the annual ritual. You have been in the hot seat a number of times. I thank you for your service, as much as I disagree with you on many things.

But I did want to follow up on a couple—one thing I think you just said that I actually think is dangerous and I worry about, and that is, suggesting that long-term Treasury yields are somehow anything we could take any comfort from and that we should infer from a sub-2 percent 10-year, which I think is very abnormal, and, in fact, probably suggests that there is something deeply wrong when a 10-year Treasury has a yield that is lower than the rate of inflation. The negative real interest rates that far out the curve are deeply disturbing to me.

I would also point out that it is even more dangerous, since we have chosen to shorten the average life of our borrowings, increasing our risk of refinancing—okay, well, then, that has been my understanding.

And the last thing I would just say on this topic is for an extended period of time, Italy could borrow money at about the same rate that Germany could, routinely, and then one day they could not. And I am convinced that we are on a path to go through a similar type of experience.

The problem is we do not know when and we do not know how severe, but it could happen at any moment. So I take no comfort from the fact that we have—by the way, I think you could also make at least the argument that a Federal Reserve that keeps interest rates at zero, thereby allows people to have a carry trade on longer-dated securities, promises that they will keep rates at zero for an extended period of time, and then goes out and buys huge quantities of Treasuries, all of these things could very well be contributing to these very strange, very low rates, and so we really should not draw any comforting conclusions from them.

Secretary GEITHNER. I do not draw too much comfort, and I agree with you on much of what you said, so let me just clarify one thing.

First of all, we are gradually extending the maturity of our debt. It—

Senator TOOMEY. You did shorten it, though, for—

Secretary GEITHNER. But only in the crisis for reasons that you understand better than most people. But since then we have been successful in gradually extending maturity, which makes sense and is prudent.

You are also right to say that the current interest rates reflect lots of different factors.

Senator TOOMEY. Right.

Secretary GEITHNER. But I was just trying to say—and you are right that we should not live here with the expectation the market would look past inertia on the fiscal front for a long period of time. I do not share that view. I do not agree with that. That would concern me if people take too much comfort from that.

What I was just saying is that you cannot see today in those rates evidence of concern that this country does not have the ability to deal with these problems and come to it. Most people expect us as a country to do what we have done in the past, which is to look past our political differences and come together and fix—

Senator TOOMEY. And I certainly hope we will do that. I am simply suggesting that what you choose not to see in the current rate structure should not be a source of comfort because of so many other—

Secretary GEITHNER. Yes, and I do not take too much comfort. I really do not. What I am just saying is you cannot find evidence of the opposite, which is—

Senator TOOMEY. I understand. You have on several occasions pointed out that you in this budget propose \$350 billion in reductions in Medicare and Medicaid. You pointed out, correctly, that that is from the projected levels of spending. It is not actual cuts but from projected levels. But I think it is very important. First of all, about 300 of that I think is on the Medicare side, of which about 90 percent of that is just further ratcheting down reimbursements to the people who provide health care. A small portion of it is means testing, but most of it is provider cuts. And all of those proposed cuts are reflected in the numbers that you then project, which still grow, Medicare and Medicaid, at an average rate of about 7.3 percent per year over the 10-year period.

Your GDP number is about 5 percent. The CBO is about 4.7. The Blue Chip guys are lower than you guys are. So my point is that even your relatively optimistic growth numbers are easily eclipsed by a significant margin by the growth in these programs, and that is why I believe that the President is failing us by not laying out a specific plan that makes these programs sustainable. As I think you will acknowledge, it is not possible for these programs to continue growing at a rate greater than our economy, and yet that is exactly what this budget proposes. I think that is a failure in leadership to provide the concrete plan that is an alternative.

Secretary GEITHNER. Well, as I have a different view, and I do not claim—we are not claiming too much for this in the sense that our view is that the combination of the Affordable Care Act reforms, which CBO scores as substantially reducing the out-year deficits, combined with these additional modest savings in Medicare and Medicaid help restore or move these programs to a more sustainable path, but they do not solve it. I totally agree with you on that context.

But I think our difference is a bigger difference than that. Our difference is how we do it, and our concern with the approach that your side has embraced is that we think you put too much of the burden in cuts on middle-class beneficiaries, and the reason why you do that is not because you want to do it, I do not think. It is because you do it because you so far have been unwilling to contemplate modest amount of additional revenues as part of the plan.

Senator TOOMEY. Okay, I am sorry, that—no. I do not think that is a fair characterization at all. We disagree about how we go forward with reform. My own view is that the only way we are going to solve this problem is to change the architecture of the plan, and if we continue to go with an open-ended fee-for-service plan, we

will never get the dynamics right; we will never get the incentives right; we will never get the market forces bringing competition and price—some way of price controls. I believe that can be done without in any way jeopardizing an important safety net for people who really need it.

But I want to make another point, if I could. On page 7 of your testimony, you talk about how businesses ought to compete based on the products and services they provide, not the tax breaks that they can collect. I could not agree more with that. But when I look through this budget, we find case after case where this budget proposes the creation of new preferences, new tax credits, new subsidies. We are asking taxpayers now to spend not \$7,500 for every Chevy Volt someone buys but \$10,000. You have a new 18-percent deduction for companies that can get themselves classified as advanced technology. You create a HOMESTAR rebate for energy-efficient retrofits but that are not economically efficient. And the list goes on and on and on. Yet you suggest that, it is better for companies to compete on products and services, not tax credits and special favors.

You know, I think that this runs contrary to Americans' understanding of fairness when you guys decide that certain industries and certain businesses within industries are going to get special favors. And I think it impedes economic growth, and I would like your comments.

Secretary GEITHNER. Again, you may find us more in agreement on this than you fear, and we will have a chance to talk about this in the coming weeks. We are going to lay out in the next couple weeks a broad framework for proposals for corporate tax reform, and you are going to see in that context that we think it would be a better system for the country for us to eliminate dozens and dozens of the special preferences in the corporate Tax Code today, which is one reason why the rate is so high.

We are going to make the case in that context, though, for as we eliminate those, preserving and reforming a much narrower targeted set of measures that will focus on a much more specific set of objectives, generally within the context of encouraging investment in the United States.

I agree with you that if you look at our corporate tax system today, some industries pay very, very low effective tax rates. Others pay much closer to the average. And that is not a sensible way to try to run an economy. That is really inefficient. It is deeply unfair. Those that enjoy the very low effective tax rates are doing so just because other people are paying higher tax rates. And it would be good for us if we can find a way to clean that up.

Chairman CONRAD. Senator Thune? And let me just say to colleagues that I had committed to the Secretary that we would get him out of here at quarter of. He has got obviously some serious responsibilities, and I think people have had good time here, good time allocated to questions and answers.

Senator THUNE, thank you.

Senator THUNE. You might want to ask the Secretary if he has had a good time here, Mr. Chairman.

Secretary GEITHNER. I have had a pretty good time.

Senator THUNE. Thank you, Mr. Chairman.

Mr. Secretary, welcome. I appreciate you being here and we had a chance to discuss some things at the Finance Committee the other day. I did want to touch on one point that we—you and I discussed at that hearing. That has to do with the tax rates going up next year under the President's budget on people over \$200,000 and your assertion that that would not have, you did not think, significant impact on the economy.

I would just point out, I mean the Joint Committee on Taxation has said that half of flow-through business income would be taxed at those top two rates. It strikes me, at least, that there is going to be some significant impacts on the economy if you are taxing, if you are raising taxes on 50 percent of the business income, at least the income that is flow-through.

Secretary GEITHNER. Can I just clarify one thing, Senator, really quickly? What I tried to say is it is all relative, relative to what? And if—again, if you try to replace the cost of those tax cuts to the top 2 percent with say, for example, equivalent cuts in Medicare payments or infrastructure spending or other types of transfers, then the impact on growth would be worse.

Senator THUNE. I am just—yes, your statement about the impact of those tax increases was—I think the quote was very modest. So I understand it is in the context of a bigger discussion about all these budgetary issues, but I think, assuming for a minute just simply because it is only impacts what you characterize, I think, as 3 percent of the people, it does impact a tremendous amount of the income, business income in this country if you are going to start taxing half of that at a higher rate.

Secretary GEITHNER. I disagree with that. Again, I think it is very—I mean, you know this as well as anybody. You need to look at the effective tax rate. Now, it is true that under our proposal it will go up modestly. But it is really remarkably low now, relative to almost any other point in history, even for those past 2 percent of small businesses, you call small businesses will be affected by it.

So I guess what I keep trying to come back to is these things are about alternatives. The question is if you do not want to do that, who do you want to bear the burden of that, of the cost of those cuts? I think if you put that burden on other people, like below the 2 percent threshold, then I think that would be less fair. And I do not think it would be better for growth.

Senator THUNE. Well, it is—it may be 2 percent, but it is 750,000 small businesses who would be impacted. And if you think about what that means in terms of job creation in this economy, I do not know how you cannot conclude that it is not going to impact economic growth in a negative and adverse way.

Secretary GEITHNER. Relative to what, is the alternative? I think we both agree you cannot go borrow \$1 trillion to afford to extend those for 10 years. We cannot do that. Then the question is, the question is is who do you want to bear the burden of that and what impact would that have on economic growth?

The other alternatives available to us, I think, are again you cut infrastructure, you cut transfer payments, the biggest drivers of our deficits. I think you will more impact on demand, negative impact on demand, probably in a way that is worse, on balance, for those companies who are trying to get people buy their products.

That is the choice we face. And again, one more point, the effective tax rate, even with these proposals, I think looks pretty favorable compared to where it was in the late 1990s, which was a very good period for the small businesses you are seeking to—and again, using your definition, a lot of the people you capture in that definition are partners in law firms, in hedge funds, and lobbying firms because of the definition we use in that context. And a huge part of that 2 percent, half of the 2 percent of small business employers affected by this are small businesses who, after expenses, earn more than \$1 million a year.

So these are not—these are taxes that affect a small fraction, the people in the best position to absorb it. And if you do not do that, you are probably going to do something that is going to be worse for demand for their products.

That is the choice we face, I think.

Senator THUNE. It is a small portion of the 750,000 small businesses, all of whom have potential, I think, to create jobs and who, if faced with higher tax burdens at the Federal level because of increasing rates, are probably going to have less capital to invest in their businesses.

Secretary GEITHNER. But if you cut demand for their products—

Senator THUNE. Well, but I am not suggesting you cut demand. I think that you could, if you accompanied what— if we did entitlement reform and made reforms, you are assuming that is a dollar for dollar cut. And we do not assume that—if you get—one of the best things that we can do to get out of the mess that we are in is to get the economy expanding and growing again. And your assumptions on economic growth, which are in the 2.5 to 3 percent range, are much higher than what the CBO and a lot of outside forecasters are assuming is going to happen.

But I think that those assumptions about economic growth are at great risk and great jeopardy if they are accompanied by tax increases on the people who are going to create jobs out there.

Secretary GEITHNER. We disagree on that, but I think you are right to point out that the choice of how you reduce deficits should be significantly about what is a better outcome for growth. Of course, I understand and appreciate your views on that question.

Senator THUNE. Let me just ask you quickly—I do not have a lot of time left. But the current debt limit ceiling is \$16.394 trillion which, at the time that the Budget Control Act was passed, was expected to keep the government funded through November of this year. In the President's budget, Table 6.2 of analytical perspectives shows the government will be just \$60.1 billion below the debt ceiling at the end of the fiscal year in 2012, which will be September 30th.

So I guess the question is do you plan to institute extraordinary measures to avoid the debt limit being reached prior to the November elections? And how does the potential payroll tax holiday extension through the end of the year not being paid for affect that calculation?

Secretary GEITHNER. I think even with the agreement and prospect on the payroll tax, we still do not expect to hit the debt limit until quite late in the year, significantly after the end of the fiscal year but before the end of the calendar year. Now those estimates

have changed. It is a long way away and you know those estimates change a lot. We do, as you point out, still have or Congress has given us a set of extraordinary measures we can use to give Congress more time to act.

But we do try and do is update those estimates regularly, transparently, and we will keep doing that as we have in the past.

Senator THUNE. My time has expired. Thank you.

Chairman CONRAD. I thank the Senator. Senator Ayotte.

Mr. Secretary, I apologize to you. We are going to go a little over what I had promised you, but Senator Ayotte is here and she is on the list and I think, in fairness, we need to give her time.

Secretary GEITHNER. Happy to do that.

Senator AYOTTE. Thank you, Mr. Secretary, I appreciate it.

I wanted to ask you, why did the President ignore the Simpson-Bowles Commission? And why did he not take any steps to push Congress to act on it? It was his commission and I am certainly proud that my predecessor served on it.

Secretary GEITHNER. A good question, I am glad you raised it.

The President, in April of last year and then in September and now in the budget, has laid out a set of reforms on the spending side and the tax side that are very similar in broad magnitude.

We go deeper on discretionary—non-defense discretionary than Simpson-Bowles did. We are not as deep on defense as Simpson-Bowles was. We do not have Social Security in there and they went deeper on benefits than we are prepared to do. And we have a set of reforms on Medicare and Medicaid that are in the range of what they proposed.

But we did not, at the time Simpson-Bowles came out, because of the Social Security side of it and because of the defense piece of it, felt we could embrace it in its details to that point. But in the broad outlines of strategy, a balance between revenues and expenditures, the President's proposals are comfortably within that neighborhood.

Senator AYOTTE. But yet the President has taken a very different tax reform—he has not embraced, in my view, in the proposals he put forward, the type of tax reform that Simpson-Bowles embraced.

Secretary GEITHNER. Actually, that is not quite fair. What we did in the budget is say that if you need to get the revenues—like, for example, we propose about \$1.5 trillion on individuals over 10 years, 1 percent of GDP. Simpson-Bowles is \$2 trillion.

We say in the budget that if you want to do that in the current tax system we have, here is one way to do it. But we would prefer to do it, like in Simpson-Bowles, by lowering rates and broadening the base. But in the broad—

Senator AYOTTE. But that is not what is in this.

Secretary GEITHNER. No, we do not propose in the budget a comprehensive individual tax reform thing. But we say, as the President said in the State of the Union, that in broad principles, lower rates, broaden the base. We would support that basic approach.

What—

Senator AYOTTE. But here is—I do not want to interrupt you because I know we do not have a lot of time, but here is what—it is one thing to say something. It is another thing to do something, in terms of leadership. And certainly, the President can say a lot

of things. But in terms of putting forward a tax reform proposal that is one that broadens the base, obviously lower rates, he can talk about it but that is not what is in this budget.

Secretary GEITHNER. Maybe it would reassure you if I reminded you that we spent between two and four months last summer negotiating with the Republican leadership in the House on a broad comprehensive framework of tax reform and entitlement reform. And as we found the gap quite large, too large to bridge at that point.

Senator AYOTTE. Can I share something with you as just a member of the Senate? I never saw anything. Nobody ever gave me—I actually told my constituents I would read this stuff down here.

Secretary GEITHNER. Did you see what the Republicans proposed to us?

Senator AYOTTE. Well, where is the President's proposal?

Secretary GEITHNER. You have our proposals in the—that is why we are having this debate. You do not like them, I know, but you have the proposals in the budget.

Senator AYOTTE. It is not that I do not like them. It is just that you are saying that somehow he has embraced tax reform and that there were these two months of discussions last year about it, but we never saw a proposal on paper from those, from which we could judge it, the American people could judge it.

It is sort of like when he introduced his budget last year and then talked also about changing the budget. We never saw another budget introduced.

So it is very difficult, as a member of the Senate, to judge something that you have not seen on paper.

Secretary GEITHNER. You are right, Senator, that we have not proposed a comprehensive individual tax reform plan. You are absolutely right. We did not propose it last year. We have not proposed it this year. What we said is here are some broad principles, much like Simpson-Bowles did, and here are some specific proposals—

Senator AYOTTE. You cannot pass broad principles. You can only pass a written proposal. So if you want us to do tax reform, what I am saying to you is there seems to be people around here that are interested in tax reform, that leadership, it seems to me, would be putting it on paper rather than talking about broad principles.

Secretary GEITHNER. I welcome a chance to do that and maybe we can find some common ground. But I think we have to be able to answer—

Senator AYOTTE. Could we get that soon? Because it would be something I think that would be very interesting for this committee to take up.

Secretary GEITHNER. Maybe I can put it back this way, are you willing, on your side, to embrace the broad balance of Simpson-Bowles, revenues and expenditures? Because if you are, there is a lot of common ground.

Senator AYOTTE. Well, it takes leadership. It takes a President willing to put forward a written proposal. And I will tell you this, that if we are going to be in a position to look at something like Simpson-Bowles, then we cannot continue to spend more money

rather than apply the change in revenue to the debt. And I think that—

Secretary GEITHNER. I am touched by the affection you are showing for Simpson-Bowles but my understanding is, the last 12 months of this, is—

Senator AYOTTE. I think there is a lot for both parties not to like in Simpson-Bowles, let us be clear. But the bottom line is this: the President commissioned a group of talented individuals, including my predecessor, to serve on Simpson-Bowles. Simpson-Bowles came out with a report. You did not have to like everything in it. But we did not see any presidential leadership from him, in my view, of championing that report or modifying it and bringing it forward to Congress in a way.

What we saw was it sat there on the shelf.

Secretary GEITHNER. We tried to give them the best compliment we could, which is in April of last year, in September of this year, and in this budget, laying out a framework very, very similar in broad terms of the one they embraced.

Senator AYOTTE. Without fundamental tax reform, though, as you have admitted.

Secretary GEITHNER. I do not think that is fair. Now again, let us think about the difference. In the budget your side likes, you are \$2 trillion away from them on revenues. \$2 trillion. You are at zero and they are \$2 trillion more revenues. We are at \$1.5 trillion in additional revenues.

So if you can embrace that basic principle of balance—

Senator AYOTTE. The budget I have before me, of course, increases—it is amazing to me the budget I have before me because you manage to propose the largest tax increase in the history of the country, still run a \$1.3 trillion—

Secretary GEITHNER. Less than Simpson-Bowles.

Senator AYOTTE. You still manage, though, to run a \$1.3 trillion deficit this year, close to \$1 trillion deficit next year, and to bring our national debt up to \$26 trillion in the next 10 years—

Secretary GEITHNER. And we bring our deficit down—

Senator AYOTTE. Without, you know—essentially large with a large tax increase.

Secretary GEITHNER. And we bring—

Senator AYOTTE. You have managed to have the worst of both worlds in this proposal.

Secretary GEITHNER. No, we have substantial deficit reduction with more modest tax increases, higher levels of defense spending than in Simpson-Bowles. And if Congress were to embrace those reforms, we would be in a much better place today.

Senator AYOTTE. Well, I certainly do not agree that substantial deficit reduction would equate to bringing our national debt to \$26 trillion over the 10-year trajectory.

Secretary GEITHNER. Those numbers, they are the most misleading way to think about this problem. We are a \$14 trillion economy today. The right way to measure what is affordable and sustainable for the country is to say relative to all the income we produce each year, what is a sustainable deficit? And we achieve that with these proposals.

Now your side can say let us go deeper, faster, sooner and without revenues and I understand that, but we would not support that approach because we think it would be worse for growth and not necessarily better for fiscal sustainability. But it is not clear or accurate to say that what stands between us and more fiscal responsibility is the minor gaps between us and Simpson-Bowles.

Senator AYOTTE. With all respect, what I think stands between you and fiscal responsibility—the Administration meaning collectively—and fiscal responsibility is actually leadership and courage, particularly since we left most of the entitlements off the table.

And I know my time is up and we could have this debate for a while, but I understand—

Secretary GEITHNER. Okay, and we will.

Senator AYOTTE. —you have to go somewhere.

Secretary GEITHNER. We will. We will have this debate for a long time.

Chairman CONRAD. If you want to respond, feel free.

Secretary GEITHNER. No, I think I agree with the Senator that we are far apart on what the right strategy is but we would be much closer if you would be willing to embrace the balance in that plan that you show so much affection for. We would still have some differences in how we get there but it would be a start.

Chairman CONRAD. I think the Secretary.

Let me indicate to colleagues, when we return on February 28th, we will have Secretary Panetta here. I hope you will ask your staffs to prepare for that hearing because it is obviously a very important hearing. The first time the Secretary of Defense has been before this body in a very long time.

On February 29th, we will have a panel on health care. I hope colleagues will have their staffs prepare for that as well, because it is going to be critically important as we go into markup that we have options on health care.

On March 1st, a panel on tax reform, the issue that was just being raised. It is going to be obviously, as we go into markup, what are our options with respect to tax reform.

And finally, on March 6th, something we have added, a panel on defense to plumb down with respect to where we could get additional savings without endangering national security. And we will have a wide array of viewpoints on that day.

So I hope very much colleagues will ask their staffs to prepare now for those hearings so they can be as productive as possible.

With that—

Senator SESSIONS. Mr. Chairman, thank you. I think we have had a good hearing today. I wish it could have continued longer. I know the Secretary has got a lot to do.

I would like to just say that I do not think I haven't an answer yet as to did the budget you submit increase spending over the current law or did it decrease spending? Did it spend more than current law, that was passed last August, or spend less?

Secretary GEITHNER. Maybe we should do this some other time in more detail and I would be happy to respond in writing if you would like. But we have tried to meet a test that this country did not meet for a long time, which is to say that we are going to propose not just how to get the deficits down but how to make sure

where we think we need to do something more, like for example more infrastructure spending and for education, that we pay for it.

Senator SESSIONS. Well, I appreciate that and I would just say that you spend more, so far as I can tell, and it is disappointing that you are not willing to acknowledge that. So we cannot say to the American people we cut \$2.50 in spending for every dollar of tax increases when you do not have any spending reductions.

Secretary GEITHNER. Mr. Chairman—

Senator SESSIONS.—have spending increases.

Secretary GEITHNER. Could I spend one more minute on this? Because I think it is important. I think we are using slightly conflicting ways of thinking about how you judge deficits.

Let me try to respond this way. If you use what I think is your measure, if I understand it, if I understand the way you are approaching it—

Senator SESSIONS. Any fair measure and the budget you submitted.

Secretary GEITHNER. Let me try this way, if we use your measure, as I understand it, then let me say why I think that is misleading. It would mean that during the eight years of the Reagan Administration, spending increased by 70 percent. During the eight years of the Bush Administration, spending would have increased by 89 percent. Nobody, I think, in this committee or who served in that administration would have judged their spending records by that basic metric.

So the metric that we all use together is a way of looking at not just spending relative to current law or current policy but relative to GDP. And we propose to reduce spending quite substantially relative to GDP, in a different way than your side would. But I think we are using a conservative, accepted, responsible definition that I think is consistent with the way most people would judge things in the past.

Now we do some things significantly—

Senator SESSIONS. Mr. Secretary, you spend more money than we agreed to last year. That is all I asked. Did you spend more or less? I believe it is crystal clear you spend more. You undermined and gave away the cuts that were already in law just six months ago and you did not have any other cuts to wipe that out.

Secretary GEITHNER. No, I do not agree with that and I do not think it is a fair characterization.

Senator SESSIONS. Well—

Chairman CONRAD. Let me say this, we have kind of gone beyond. Senator Sessions made his point. You have made your point.

Let me just say this to you, I will make my point. The fact is we are spending now over 24 percent of GDP. Under this proposal, spending will be taken down to 22.8 percent of GDP. So the way I look at spending, I think the best measure, virtually every economist will say, is as a share of GDP. That factors out inflation.

We are, it is true, we are right now at almost a 60 year high on spending. We are almost at a 60 year low on revenue. Under the proposal before us, spending will be taken down from over 24 percent of GDP to 22.8 percent of GDP, I think is the point the Secretary is making.

The larger truth is, to me, the larger truth is we are on a course as a nation that is unsustainable. The Secretary has agreed with that. I think virtually every one of us believes that is the case.

Now the question is can we find a way to come together to actually get this debt threat under control? Every bipartisan group that has tackled this has come to the conclusion it is going to take more revenue and it is going to take entitlement reform, which means less in expenditure over time than is currently programmed.

And the question before us is do we have the collective courage to actually do something about it? You know what? I hope we do. And we are going to have a test. The test is going to start right here. I just say I hope we all show the courage that is required.

I thank the Secretary.

[Whereupon, at 11:59 a.m., the Committee was adjourned.]

United States Senate  
Committee on the Budget

Hearing: "President's FY 2013 Budget and Revenue Proposals"  
February 16, 2012

Post-Hearing Questions for the Record  
Submitted to Secretary Geithner

Senator Bill Nelson

**Question 1:**

Mr. Secretary, I believe the continued weakness in the housing market may just be the greatest headwind our economic recovery faces. By my count, the Administration has tried to wrap its head around this housing mess at least six times. First there was the Home Affordable Modification Program, also known as HAMP. Then you modified HAMP. Then you modified HAMP again.

There was also the Home Affordable Refinance Program, known as HARP. After several years of meager participation, you finally modified HARP to include underwater mortgages. And then we had the Hardest Hit Fund. Now we have a new plan released just this month, in which the Federal Housing Administration provides expanded refinancing opportunities and the incentives for principal reduction under HAMP are increased.

Mr. Secretary, when it came to Wall Street, the last two Administrations took an all-in, big bang approach. We effectively saved our banking system with shock therapy, a massive \$800 billion bailout. Yet for struggling middle class homeowners, we've been nickel and dime them with these piecemeal, overly complex and technocratic programs that seek to squeeze every last penny out of the homeowner before we give them a break.

First, do you consider HAMP and HARP a success? Second, what makes this new attempt to help homeowners different? Why didn't the Administration adopt a big bang, shock therapy approach to the housing crisis in the same way that it and the last Administration did for Wall Street and the big banks?

Before HAMP, there was little meaningful assistance available to struggling homeowners in the midst of the worst housing crisis in a generation. As we enter 2012, the housing market shows signs of recovery but is still fragile. The Making Homes Affordable (MHA) programs have proven to be critical foreclosure-prevention tools in the recovery process by providing vital assistance to struggling homeowners, which have in turn aided in the repair of the deep damage caused by the housing crisis, and set new standards for the mortgage industry to follow. To date, more than 1.1 million homeowners have received permanent assistance through HAMP, the Second Lien Modification Program (2MP), and the Home Affordable Foreclosures Alternatives Program (HAFA). We continue to see a need for assistance through the steady pace of

permanent modifications, unemployment forbearance plans, refinances and short sale agreements every month. These efforts have set the industry standard for successful modifications and have helped encourage private lenders to modify an additional 2.8 million mortgages. In addition, more than 1.1 million homeowners with mortgages owned or guaranteed by the GSE's have refinanced through the Home Affordable Refinance Program (HARP).

Over time, we have made important enhancements to the programs to get relief to struggling homeowners and set standards for the rest of the industry to follow. When MHA was first launched, the biggest obstacle facing most struggling homeowners was the prospect of resetting ARM interest rates. As the crisis accelerated, unemployment caused additional homeowners to default. The crisis has now become defined by mortgage affordability, home price declines, and the pressing need for more effective neighborhood stabilization.

In this environment, we believe it is important to enhance our existing programs in a manner that ensures the mortgage industry uses every tool available to help struggling families who are committed to remain in their homes while the housing market recovers from an unprecedented crisis.

For example, many homeowners who have an affordable first mortgage payment struggle beneath the weight of other debt such as second liens and medical bills. Recognizing that many homeowners in this situation are still struggling to make ends meet, the program has been expanded to offer another evaluation opportunity with more flexible debt-to-income criteria to expand modification assistance to borrowers with higher levels of secondary debt who otherwise meet program requirements.

Treasury has also expanded eligibility to include properties that are currently occupied by a tenant as well as vacant properties which the borrower intends to rent. This will provide critical relief to homeowners who live in their homes and will protect those who rent their homes from foreclosures over which they have no control, while further stabilizing communities from the blight of vacant and foreclosed properties.

MHA continues to offer homeowners some of the most sustainable assistance available and has established critical standards and protections for homeowners that we believe must continue as the housing market heals. The recently announced enhancements extend the reach of MHA to assist a broader pool of struggling homeowners, offer support for tenants at risk of displacement due to foreclosure and provide more robust relief to those who participate. Taken together, these enhancements will help the housing market recover faster from an unprecedented crisis.

**Question 2:**

**Mr. Secretary, as I am sure you know, there has been significant interest in Congress in moving towards a territorial tax system that exempts active foreign earnings from U.S. income tax. The argument is that a territorial system will make U.S.-based businesses more competitive in foreign markets, and this will translate into jobs and growth here at home. The Chairman of the Ways and Means Committee has a proposal for a territorial**

**tax system. I understand the Super Committee spent a considerable amount of time on this issue. The President's budget, however, pushes in the opposite direction. It seeks to tighten the tax noose on foreign earnings, and raises \$147 billion in the process. Could the Administration support a corporate tax reform plan that included a territorial tax system? Why do you believe the Administration's approach is better?**

The Administration's business tax reform framework addresses a number of significant distortions in the Tax Code that hurt productivity and economic growth and create incentives for U.S. businesses to base decisions on tax rules rather than economic returns. A key component of the Administration's business tax reform framework is that income earned by subsidiaries of U.S. corporations operating abroad should be subject to a minimum tax. This proposal reduces incentives for companies to shift profits and investment to low-tax countries, and puts a brake on the global race to the bottom in corporate tax rates. A minimum tax also promotes investment, economic growth, and job creation in the United States by helping to level the playing field between companies operating in the United States and those operating elsewhere around the world.

The Administration believes that a pure territorial system, under which all active foreign income of U.S. companies would either be taxed little or not at all in the United States could aggravate, rather than ameliorate, many of the problems of the current U.S. tax system. A system that does not subject foreign earnings of U.S. companies to any tax would only provide greater incentives to locate operations abroad or shift profits out of the United States. Further, such a system could exacerbate the global race to the bottom on corporate tax rates.

The Administration's business tax reform framework is intended to lay the foundation for a dialogue with Congress and stakeholders on tax reform. We are committed to working with Congress to enact comprehensive tax reform, as well as working with Congress on the details of how best to integrate the international minimum tax with the rest of the international tax system.

**Question 3:**

**Currently, for an individual taxpayer, dividends are taxed at the same reduced rate as long-term capital gains. This tax break for dividend income was adopted in 2003. Historically, dividends had been taxed as ordinary income. The President's budget drops a proposal included in the first three budgets, which would have permanently extended the tax break from dividend income. Under the budget release yesterday, income from dividends would once again be taxed as ordinary income beginning in 2013.**

**Can you explain why you made this change? Who is this provision most likely to affect? How would this affect income earned through 401(k) accounts, IRAs, and other retirement savings plans? What effect, if any, do you think this proposal would have on the economy?**

Restoring the ordinary income tax treatment of qualified dividends for high-income taxpayers would reduce the deficit by \$206 billion over ten years and make the tax system more

progressive. In addition, taxing qualified dividends at the same rates as other ordinary income would help simplify the tax code.

Only a small percentage of taxpayers, those with the highest incomes, would be affected. The vast majority of investors, including retired taxpayers who rely on dividend income and who have incomes below the applicable thresholds, e.g., \$250,000 for a married couple and \$200,000 for an individual, would not be affected by this change.

Income earned through 401(k) accounts, IRAs, and other retirement savings plans would not be affected by the proposal. Distributions from these accounts are currently taxed at ordinary income tax rates.

Raising the tax on dividends for upper-income families is unlikely to have a large effect on the economy or on the overall marginal effective tax rate on corporate investment. It will not affect the approximately 38 percent of corporate investment that is financed by debt. It will not affect the roughly 43 percent of corporate equity capital that is held by tax-exempt institutions, pensions, and in tax-preferred retirement accounts. It will not affect the almost 67 percent of the returns to corporate-equity financed investments that are taxed as a capital gain. All these facts limit the overall economic effect of greater tax liabilities for higher-income taxpayers who receive dividend income.

Senator Murray

**Question 4:**

**In May 2008, Treasury was ordered by the United States District Court for the District of Columbia to provide meaningful access to United States currency for blind and visually impaired persons. Not only is improving the accessibility of currency a requirement to comply with the Rehabilitation Act of 1973, it is a moral obligation we have to our service members and veterans who have lost their sight while serving their country,**

**A number of concerns have been raised about the accuracy and validity of claims by the banking and vending machine industries regarding the burden of adapting equipment and modifying practice for use with accessible currency. These concerns include the overestimation of the annual recurring cost of maintaining additional vault cash and equipment jam rates in the currency processing equipment. What has Treasury and the Bureau of Engraving and printing done to investigate these claims?**

In 2008, prior to submitting its recommendations for the best method(s) to provide meaningful access to U.S. currency, the Bureau of Engraving and Printing (BEP) commissioned a comprehensive study evaluate potential measures to provide meaningful access to U.S. currency. Part of the study's objective was to provide analysis on potential cost impacts of selected accommodations to the government, private sector businesses, and the public.

BEP's study presents the most comprehensive information on potential cost implications to the government and cash handling industries. The contractor met with, or received feedback from, numerous experts in various fields, including paper and ink manufacturers, the international banknote community, the United States Secret Service, the Federal Reserve Board, the Currency Technology Office of the Richmond Federal Reserve Bank (CTO), the National Council on Disability, cash handling organizations, cash machine manufacturers, and end users. Experts in tactility, ophthalmology, and optometry also contributed to the Study. The Study was able to provide BEP with a rough order of magnitude estimate for the various cost impacts that allows Treasury and BEP to evaluate relative costs.

- **Please describe the measures Treasury and the Bureau of Engraving and Printing is undertaking to improve the accessibility of currency for those with visual impairments.**
  - **Is high contrast the primary measure for meeting the needs of persons with visual impairment?**

Yes, high contrast numerals with unique colors for each denomination are the primary accommodation for those who are visually impaired, but not blind. It is one of the three primary measures for meeting the needs for the blind and visually impaired. These measures are: raised tactile features, high-contrast numerals, and a currency reader program.

- **Please describe the measures Treasury and the Bureau of Engraving and Printing are undertaking to improve the accessibility of currency for those who are blind.**
  - **What are the specific tactile features which are currently under consideration by the Bureau of Engraving and Printing for inclusion on banknotes?**

With the exception of one material that is currently under development by BEP personnel, the various forms of tactile features now under consideration for inclusion on U.S. currency are comprised of specialty proprietary materials that are being developed, and/or provided by private manufacturers or suppliers. All of the proposed materials that the BEP is considering can be applied to the surface of a note using various application methods or technologies, including screen printing, coating, ink-jet printing, or intaglio printing. Of these, the BEP currently has intaglio printing capabilities for production operations.

- **Has the Advance Counterfeit Deterrence Committee approved any specific tactile feature or features?**

No specific tactile features have been submitted to the ACD Steering Committee for its approval at this time.

- **Have any of the various proposed designs been printed at Bureau of Engraving and Printing's Product Development Center?**

The BEP's Product Development Center (PDC) has printed a number of samples with raised tactile features. One such feature uses a material that is being developed internally by BEP personnel and is applied using screen printing technology. Other samples have also been printed in the PDC that use traditional intaglio printing and corresponding ink to produce a raised tactile feature.

The PDC has limited capability to apply some of the specialty materials that are currently under consideration for use as a raised tactile feature. As a result, the PDC is directly and heavily engaged in overseeing and managing the development of several specialty materials that have been proposed by entities outside BEP. Samples of these features are currently printed by private printing companies under contract to BEP.

- **Canadian currency has raised tactile features; however the features disappear shortly after being placed in circulation. What measures are the Treasury and the Bureau of Engraving and Printing taking to ensure that a tactile feature in U.S. banknotes will not deteriorate rapidly?**

Durability is one of the criteria that BEP will use to select a raised tactile feature. Incorporated in the raised tactile feature development process are steps and

measures that are designed to evaluate the durability of the materials and corresponding features under consideration. Included in this process is extensive laboratory testing of the materials under consideration to ensure that they meet or exceed all of the durability standards and requirements that have been established for U.S. currency, as well as planned, extensive preliminary manufacturing and production trials to validate actual manufacturing and production conditions.

○ **What barriers prevent Treasury and the Bureau of Engraving and Printing from accelerating adoption and printing of accessible currency?**

There are several barriers that prevent Treasury and the Bureau of Engraving and Printing from accelerating adoption, and printing of accessible currency. These include:

- The most promising features to date require the acquisition and installation of new machinery and equipment, and could also require changes to our manufacturing processes to incorporate the feature into U.S. currency while still meeting the Federal Reserve Board's production demands and distribution requirements.
- The extensive amount of research and development work that is required to determine what material and system provide the most effective raised tactile feature.
- The extensive amount of information that needs to be obtained from stakeholders, including the blind and visually impaired community, the Federal Reserve, and cash handling machine manufacturers and users, in evaluating the effectiveness of the features under development.
- The extensive amount of manufacturing and production trials that will have to be accomplished to ensure that any feature adopted for use on U.S. currency can be manufactured efficiently and cost effectively.
- The extensive amount of testing that will be needed to integrate the raised tactile feature into the BEP's manufacturing system and to evaluate and minimize the potential negative impact incorporating the feature may have on manufacturing system as well as on cash handling equipment and systems around the world.

○ **What action has Treasury and the Bureau of Engraving and Printing undertaken to communicate plans with stakeholder groups, and receive feedback on these plans?**

Stakeholder dialogue has been a significant part of BEP's meaningful access program – first initiated in 2008 with the development of the comprehensive

Study to address options for improving the ability of the blind and visually impaired community to denominate U.S. currency.

BEP launched a Meaningful Access webpage on its website ([www.bep.gov](http://www.bep.gov)) to post the Study and continues to use the page to communicate information about the meaningful access program. In May 2010, BEP published a notice in the Federal Register identifying its recommendations on providing meaningful access to U.S. Federal Reserve notes and soliciting public comment. BEP received 65 comments. BEP has conducted open competition for a tactile feature usability studies at the American Council of the Blind and National Federation of the Blind conferences for the past four years. BEP has made presentations, discussed status, and engaged in dialogue with businesses and organizations including the Randolph-Sheppard Vendors of America, National Council on Disability, U.S. Access Board, National Council of State Agencies for the Blind, National Automatic Merchandising Association, American Bankers Association, Independent Community Bankers Association, Independent Armored Car Operators Association, National Armored Car Association, American Public Transportation Association, and National Retail Federation. The BEP sought stakeholder input in the development of its EyeNote® currency reading mobile application for the Apple iOS platforms, which launched in 2011.

- **What is the specific timetable for designing, testing, and printing accessible banknotes for each denomination?**

To stay ahead of counterfeiters, enhancing the design of U.S. currency has become an ongoing collaborative process. A decision has not been made regarding the next denomination to be redesigned. BEP, however, is not waiting for this decision to be made; the BEP is already exploring technologies and considering note designs.

- **What is the first denomination on which a tactile feature will be included?**

A decision has not been made on the next note to be redesigned. BEP, the Federal Reserve Board, and the United States Secret Service are collaboratively conducting a security threat assessment, defining other prioritization considerations, and identifying emerging technologies to address these issues. This information will help determine which notes are redesigned and when.

BEP, the Federal Reserve Board of Governors, and the United States Secret Service will present final recommendations to the Secretary of the Treasury, who has authority to determine the design of U.S. currency. BEP will continue to keep Congress and stakeholders informed throughout the process.

- **How many years does Treasury estimate before currency in circulation will be replaced with the new accessible currency?**

It takes several years before redesigned currency significantly replaces older-designed notes in circulation. As older notes reach the Federal Reserve from depository institutions, they are replaced as they become unfit by the newly designed notes. Historically, older and newly designed notes have circulated at the same time, and indefinitely, until the old designs return back to the Federal Reserve through the banking system.

Circulating bank notes are lasting longer in circulation than ever before. The life span of a note varies by denomination. For example, \$100 notes are often used as a store of value. This means that they pass between users less frequently than lower denominations that are more often used for transactions, such as \$10 notes. Thus, \$100 notes typically last longer than \$10 notes. The \$100 note is lasting approximately 17.9 years in circulation; and the \$10 note, with the shortest life span, is lasting about 3.6 years.

- **Following the retirement of Judge James Robertson, what court officer had been assigned to supervise the order?**

Judge Beryl A. Howell was assigned to this case on March 21, 2012.

**Senator Sessions**

**Question 5:**

**Table S-1 on page 205 of the President's Budget shows outlays increasing from \$3.796 trillion in 2012 to \$3.803 trillion in 2013, to \$4.532 trillion in 2017 and \$5.820 trillion in 2022.**

- 1. Are the outlay figures in your budget summary tables accurate?**
- 2. Does your budget spend more or less money over the next ten years?**

Total outlays are expected to rise by just over \$2 trillion from FY2012 to FY2022. However, as a share of the economy, total outlays are expected to decline from 24.3 percent in 2012 to 22.8 percent in FY2022.

Discretionary spending as a share of GDP is expected to fall from 8.5 percent in FY2012 to 5.0 percent in FY2022, well below the 50-year average of 9.4 percent. On the other hand, mandatory spending as a share of GDP is projected to be 14.4 percent in FY2022, unchanged from its expected FY2012 level, and well above the 50-year average of just over 9 percent. Social Security and Medicare programs combined will account for nearly 40 percent of total outlays in FY2022, up from their share of 33 percent in FY2012. The increase in costs of these two programs is being driven by the aging population and rise in health care costs.

Additionally, net interest payments are expected to more than double from 1.4 percent of GDP in FY2012 to 3.3 percent in FY2022. Excluding these net interest payments, Social Security, and Medicare spending, outlays as a share of the economy are expected to be 10.6 percent in FY2022, down from nearly 15 percent in FY2012.

**Question 6:**

**During a Finance Committee hearing on Tuesday, in response to a question from Sen. Hatch, you made the following statement: "I don't think it's fair to propose entitlement reform without asking people to pay their fair share."**

- 3. Your budget certainly contains a tax increase--\$1.9 trillion. So where is the entitlement reform?**
  - 4. Will this budget extend the solvency of Social Security?**
  - 5. Will this budget preserve Medicare in perpetuity?**
- The President's Budget includes approximately \$56 billion in reduced spending on Medicaid over 10 years.
  - The President's Budget includes proposals that build on initiatives included in the ACA to help extend Medicare's solvency while encouraging provider efficiencies and improved

patient care. These proposals save approximately \$300 billion over 10 years and would extend the solvency of the Hospital Insurance trust fund for an estimated two years.

- The President stated that Social Security is indispensable to workers, retirees, survivors, and people with disabilities. It is one of the most important and most successful programs ever established in the United States. Although current forecasts project that Social Security can continue paying full benefits through 2033, the President has stated that he is committed to making sure that Social Security is solvent and viable for the American people - now and in the future. The Administration looks forward to working on a bipartisan basis to preserve it for future generations and has put forward six principles for reform:
  - Any reform should strengthen Social Security for future generations and restore long-term solvency.
  - The Administration will oppose any measures that privatize or weaken the Social Security system.
  - While all measures to strengthen solvency should be on the table, the Administration will not accept an approach that slashes benefits for future generations.
  - No current beneficiaries should see their basic benefits reduced.
  - Reform should strengthen retirement security for the most vulnerable, including low-income seniors.
  - Reform should maintain robust disability and survivor benefits.
- The Budget also includes measures designed to enhance program integrity and reduce costs, and proposes reinstating demonstration authority in the Social Security Disability Insurance program to explore new areas for reform

**Senator John Cornyn**

**Question 7:**

**Mr. Secretary, last year I wrote a letter to you expressing my concerns with a proposed rule (REG-146097-09) that would extend current information reporting requirements to include bank deposit interest paid to investors who are residents of any foreign country. As you know, it is long-standing tax policy that deposit income belonging to foreign investors that is not connected to a U.S. business or trade is not taxed by the federal government. This policy helps attract capital investment, which is the fuel for job creation, to the United States.**

**I still have these same concerns and offered an amendment during the Senate Finance Committee's mark up of the transportation bill that would prevent the Treasury Department from moving forward on the proposed rule. News reports also indicate that community banks in Texas are already feeling the impact of the impending rule, with capital being withdrawn in anticipation of the rule being finalized.**

**Mr. Secretary, the proposed rule flies in the face of our nation's longstanding efforts to attract capital. In addition, many depositors have expressed fears that if the information is**

conveyed to their home countries, they could be subject to kidnappings and extortion because of the porous nature of their countries' political institutions.

1. **How do you respond to these concerns? What is the Department doing to alleviate them?**
2. **Because it appears your Department is moving forward with the proposed rule, does this mean that you do not believe it will cause much-needed capital from being withdrawn from community banks across Texas and across the country?**
3. **Has a benefit-cost analysis been conducted by the Department? If not, why not? If so, can you provide the analysis to the Committee?**

The final regulations requiring the reporting of interest paid on deposits held by nonresident aliens (T.D.9584, RIN 1545-01) are an important component of the U.S. strategy to combat offshore tax evasion by U.S. taxpayers. Addressing tax evasion through the use of offshore accounts and institutions requires a multi-faceted approach that includes not only domestic legislation and enforcement efforts, but also significant international cooperation through our network of treaties and tax information exchange agreements. Moreover, nonresidents depositing money in U.S. banks should not face lower standards of transparency than U.S. residents depositing money in U.S. banks. Under current law, banks must report information about the deposits of U.S. residents as a check on tax compliance. Nonresidents should not be shielded from such reporting.

In general, we believe predictions of capital flight that were based on the proposed regulations were based on misunderstandings of the effect of the proposed regulations. Prior final regulations require reporting of this information with respect to Canadian residents, and similar concerns were voiced when those rules were first proposed, but the predicted capital flight did not occur when the rules were implemented.

Foreign depositors should not be concerned that this information could be used improperly because there are very stringent controls governing when the IRS may exchange information. Section 6103 of the Internal Revenue Code prohibits the IRS from disclosing taxpayer information except in limited circumstances. The IRS cannot provide information to another country unless the United States has a tax treaty or tax information exchange agreement with that country. In addition, even such agreements in place, the IRS must be satisfied that the treaty partner adheres to strict confidentiality standards, will use the information only for purposes of enforcing or administering its tax laws, is willing and able to exchange information with the United States on a reciprocal basis, and can provide and receive information in a usable format. Thus, in general, only nonresidents who have underreported their income to their home country tax authority should be concerned about these regulations. In this regard, the United States should not be in the business of attracting deposits of nonresident aliens seeking to evade home country tax.

Nonetheless, to address the comments received and enhance awareness of existing protections of the reported information, the final regulations modify the proposed regulations in several significant ways. First, since the IRS can only exchange

information with a country with which the United States has a tax treaty or tax information exchange agreement that permits information exchange, the final regulations limit reporting to interest paid to nonresident alien individuals that are resident in such a country. These countries were identified in section 3 of Revenue Procedure 2012-24, which was published contemporaneously with the final regulations and which will be updated as appropriate. To address any potential concerns that reporting on a country-specific basis would be administratively burdensome for some financial institutions, the final regulations permit a financial institution to elect instead to report deposit interest payments to all nonresident alien individuals.

Second, as an additional measure to increase awareness regarding the IRS' use of deposit information collected under the final regulations, the Revenue Procedure also includes a second list identifying the countries with which the Treasury Department and the IRS have determined that it is appropriate to have an automatic exchange relationship with respect to deposit information (i.e., an arrangement under which deposit interest information relating to a country's residents is sent automatically to that country's tax authorities, rather than only on specific request). As explained in the preamble to the final regulations, a country will be added to this list only after further assessment of a country's confidentiality laws and practices and the extent to which the country is willing and able to reciprocate. The initial version of this list includes only Canada, because under the prior version of the final regulations the IRS already determined Canada to be an appropriate automatic exchange partner with respect to deposit interest. This list will be updated over time, however, as additional countries are evaluated and automatic exchange agreements are reached.

Finally, as a third measure to reduce concerns, the final regulations eliminate the requirement in the proposed regulations for financial institutions to inform the individual account holder that the information may be furnished to the government of the country where that individual resides.

During the course of finalizing these regulations, it was determined that the regulations are not covered by Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment, which generally includes a formal cost-benefit analysis, was not required.

The benefits of the final regulations are significant. The regulations are a key part of a multi-pronged effort to combat offshore tax evasion, which is a top priority of the Administration and Congress. The regulations will improve compliance with U.S. tax laws by allowing the IRS to cooperate with foreign governments to obtain information about U.S. taxpayers' overseas income.

This cooperation is particularly important for the implementation of provisions commonly known as the Foreign Account Tax Compliance Act, or "FATCA," enacted in 2010 as part of the Hiring Incentives to Restore Employment Act. FATCA requires foreign financial institutions to report information about U.S. accounts to the IRS. In many cases, implementing FATCA will require the cooperation of foreign governments

to address impediments under foreign law. The United States cannot expect foreign countries with confidentiality standards similar to ours to change their laws in order to accommodate sending information about U.S. accounts to the IRS, while refusing to even collect basic deposit interest information about nonresident accounts in the United States.

We believe the costs of the regulations on U.S. financial institutions will not be significant. U.S. financial institutions already report deposit interest information to the IRS with respect to U.S. citizens and residents and Canadian residents. Expanding this reporting to cover other depositors should not require new systems or new procedures

**Question 8:**

**Secretary Geithner, in your testimony you note that promoting a manufacturing innovation is one of three specific steps to boost growth and secure the United States' position as the most competitive economy in the world; specifically jumpstarting advanced manufacturing and creating well-paying jobs here at home.**

**Yet, one of the key factors for manufacturing is affordable energy. The National Association of Manufacturing pointed out this week that "...manufacturers still face a 20 percent cost disadvantage with our major trading partners, today's budget would make this hill even steeper with one job-killing tax increase after another. For example, raising taxes on energy producers, small businesses and other job creators will have a negative ripple effect across our economy."**

**1. How does the Administration anticipate new manufacturing can occur while making electricity from natural gas and coal more expensive through tax hikes and a preference toward higher-cost, renewable sources that still require backup generation?**

**2. How does this impact job creators?**

When considering the elimination of fossil fuel subsidies, the Administration carefully considered the impact that their elimination would have on the overall economy. Our analysis indicates that changes in domestic fossil fuel production costs resulting from loss of these subsidies would have little effect on U.S. energy prices. In 2009, Treasury's Office of Economic Policy estimated that the subsidies for the coal and natural gas industries amount to about one percent of average total revenues in these industries. Loss of the subsidies would increase U.S. coal and natural gas prices by approximately the same percentage. As a result, the final market impact on consumption and production of electricity is likely to be very small.

The fossil fuel tax preferences the Administration proposes to repeal distort markets by encouraging inefficient investment. To the extent these subsidies crowd out investments in other energy sources, they are detrimental to long-term energy security and are also inconsistent with the Administration's policy of reducing greenhouse gas emissions and encouraging the use of renewable energy sources. Moreover, the inefficient investments generated by these subsidies result in underinvestment in other, potentially more productive, areas of the economy.

**Question 9:**

**The Internal Revenue Service recently released an advance notice of proposed regulations titled “Determination of Government Plan Status.” As currently written, the regulations appear to prohibit charter school teachers from participating in state retirement systems, even though twenty-four states mandate charter school participation in the state-sponsored retirement system. In the other eighteen states that authorize public charter schools, state laws permit but do not require participation in the state-sponsored retirement system.**

**1. Was it the Department’s intent to single out charter school teachers with this proposed regulation?**

No. The Advance Notice of Proposed Rulemaking (ANPRM) is designed to outline possible factors relevant to determining the types of entities that may establish or participate in governmental plans (which are exempted from many requirements, including Pension Benefit Guaranty Corporation (PBGC) insurance coverage, that protect plan participants) and to solicit public comments before issuing proposed regulations for further comment. The ANPRM does not specifically include or exclude charter schools as governmental entities. Rather it provides elaboration of facts and circumstances test to determine whether an entity is a governmental entity and may establish or participate in a governmental plan. The factors in the guidance under consideration are generally a compilation of factors from various revenue rulings and court cases dating back to 1957. Of necessity, the test depends on all relevant facts relating to the particular entity in question. The preamble to the guidance under consideration specifically provides that no one factor will determine whether an entity is a governmental entity.

**2. If not, then what assurance can you provide that the Department will clarify the proposed regulation in favor of charter school teacher participation in the state pension plan?**

The ANPRM has not been finalized, and there will be ample opportunity for comment before the issuance of any final regulations. In cooperation with the Department of Labor and PBGC, the Department of Treasury and the IRS will review comments received in response to the ANPRM, as well as input at public hearings and town hall meetings. After evaluating the comments, a notice of proposed rulemaking (NPRM) will be prepared. The public will have another opportunity to submit comments after the NPRM is issued. Recognizing that we have never issued regulations on the definition of governmental plans within the meaning of section 414(d) of the Internal Revenue Code, we anticipate that, once issued, the regulations will have transition rules. The ANPRM specifically requests comments on transitional relief. We also anticipate that any regulations would not be effective any earlier than the plan year beginning after the date of publication of the Treasury decision adopting the rules as final regulations.

**Question 10:**

**A record amount of U.S. household income went to paying for gas and electricity in 2011. This fact can partly attribute to the Administration’s hostile policies towards oil, gas, coal and nuclear energy, which compromise 90 percent of U.S. energy consumption.**

**1. The President's budget proposes raising taxes in oil, gas and coal production by \$41 billion over ten years, which would especially hit domestic production. Won't this only further discourage domestic energy production, lead to fewer well-paying American jobs, and increase our reliance on foreign sources of energy?**

When considering the elimination of fossil fuel subsidies, the Administration carefully considered the impact that their elimination would have on the overall economy. Our analysis indicates that changes in domestic fossil fuel production costs resulting from loss of these subsidies would have little effect on U.S. energy prices. Regarding oil, the domestic price of oil is determined by global supply and demand because oil is an internationally traded commodity. The U.S. contribution to world oil supply is relatively small, and thus any changes likely will not significantly affect the world oil price. Accordingly, U.S. consumers would see little impact from the removal of oil tax preferences. In 2009, Treasury's Office of Economic Policy estimated that the enactment of similar proposals would increase total oil finding and lifting costs by less than 2 percent and would decrease domestic production by less than one-half of one percent. The subsidies for the coal and natural gas industries amount to about one percent of average total revenues in these industries. As a result, the final market impact on consumption and production is likely to be very small.

The fossil fuel tax preferences the Administration proposes to repeal distort markets by encouraging inefficient investment. To the extent these subsidies crowd out investments in other energy sources, they are detrimental to long-term energy security and are also inconsistent with the Administration's policy of reducing greenhouse gas emissions and encouraging the use of renewable energy sources. Moreover, the inefficient investments generated by these subsidies result in underinvestment in other, potentially more productive, areas of the economy.

**2. Substantial income comes to the government from rents, royalties and bonuses from oil and gas development on federal lands. Still more income comes from taxes on these activities. What is the Administration doing to reverse the dramatic drop of oil and gas development on federal lands since 2009?**

The Administration is committed to an all-of-the-above approach that develops every available source of American energy. This commitment includes the safe and responsible production of our oil and natural gas resources. Today, American oil production is at the highest level in eight years, and last year we relied less on foreign oil than in any of the past 16 years. In 2009, we became the world's leading producer of natural gas.

Expediting safe and responsible development of our domestic oil and gas resources is a key component of our comprehensive strategy to grow America's energy economy, and doing so will help us continue to reduce our dependence on foreign oil and create jobs here at home. The Proposed Outer Continental Shelf Oil and Gas Leasing Program for 2012–2017 (Proposed Program) will advance safe and responsible domestic energy exploration and production by offering substantial acreage for lease in regions with known potential for oil and gas development. The Proposed Program is consistent with the Obama Administration's Blueprint for a Secure Energy Future, which aims to promote domestic energy security and reduce oil

imports by a third by 2025 through a comprehensive national energy policy. The Proposed Program is informed by lessons learned from the Deepwater Horizon incident and reforms that have been implemented to make offshore drilling safer and more environmentally responsible, and to ensure that we are better prepared in case a blowout or oil spill occurs. The Proposed Program includes 15 lease sales in six offshore areas where there are currently active leases and exploration and where there is known or anticipated hydrocarbon potential. This strategy makes more than 75% of the undiscovered technically recoverable oil and gas resources estimated on the OCS available for development. The Department of the Interior (DOI) is also streamlining its permitting process to accelerate drilling permits and leases on Federal lands.

DOI has taken administrative steps to reform the terms of offshore oil and gas leases to include a range of incentives that encourage prompt development and ensure a fair return to taxpayers. These measures to incentivize prompt exploration and development include escalating rental rates and tiered durational terms with relatively short base periods followed by additional time under the same lease if the operator drills a well during the initial period. DOI can provide more details on how the Administration is encouraging safe and responsible domestic energy production on public lands and on the Outer Continental Shelf.

**3. Despite such notable failures as Solyndra, the President's budget proposes spending billions more to further his green energy agenda. How can the Administration claim fiscal responsibility when, rather than eliminating wasteful green programs, it recommends pouring billions of more into them and creating new ones?**

The Administration believes we need to expand the use of clean energy in the United States. Transitioning to cleaner sources of energy will enhance our national security, protect the environment and public health, and grow our economy and create new jobs. The centerpiece of the Administration's strategy is a Clean Energy Standard -- a flexible approach that harnesses American ingenuity and innovation, and channels it toward a clean energy future. By creating a market here at home for innovative clean energy technologies, we will unleash the ingenuity of our entrepreneurs and ensure that America leads the world in clean energy.

The Administration supports renewing and extending a number of proven and successful provisions that are crucial to the continued growth of the domestic clean energy sector. This includes tax incentives for clean energy manufacturing, and the renewable electricity incentives to support investment in the deployment of clean energy technologies like wind and solar.



**Opening Statement of Senator Sheldon Whitehouse  
Senate Budget Committee  
February 16, 2012**

I want to thank Secretary Geithner for testifying here today and for his work in crafting the President's FY 2013 budget request. As I've discussed a number of times in this Committee, I believe the foreclosure crisis continues to impede our economic growth, ultimately to the detriment of the federal budget. Secretary Geithner and I have exchanged a number of letters on federal foreclosure mitigation efforts and on the poor participation record of the nation's largest loan servicers. I ask consent to place those letters into the record of this hearing. I look forward to continuing to work with the Administration to keep families in their homes.

SHELDON WHITEHOUSE  
RHODE ISLAND

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November 19, 2009

The Honorable Timothy Geithner  
Secretary of the Treasury  
Department of the Treasury  
1500 Pennsylvania Avenue  
Washington, DC 20220

Dear Mr. Secretary:

This is a "report from the field," if you will. I met recently with a number of realtors and recent homebuyers to discuss the state of the housing market in Rhode Island. I am only one Senator, and Rhode Island is only one state, but I hope that this information will be a useful data point as you make your decisions.

Here is what I heard:

There are three individual real estate markets now. One is the market for foreclosed homes. This market is essentially closed to regular homebuyers by the sellers' preference for cash purchases and impatience for the credit approval steps for any buyers requiring loans. With rare exceptions, this market is now the exclusive province of speculators.

Next is the "short-sale" market. The administrative incompetence of the banks weights this market with two to six month delays and inconsistent decisions, such that the realtors have begun advising clients not even to bother in that market.

Bank of America was singled out for particular incompetence, with comments like the following:

"If I see B of A is the lender, I run."

Despite being a "major" part of the market, they are "awful to deal with on short sales."

The "last thing you want to hear" is that Bank of America is the lender.

"I gave up on short sales with Bank of America."

"Nobody wants to deal with them."

Obviously this compromises the short-sale market. Because Bank of America's performance figured so prominently in the distaste the realtors felt for the short-sale market, I am copying this letter to Barbara Desoer, President of Bank of America's "Home Loans and Insurance" division.

Third, the "arm's-length" market is doing well. However, because most buyers are limited to the arm's-length market, and excluded from the foreclosure and short-sale markets, the imbalance of supply and demand causes prices to be artificially higher in that market, and a potential misconception that home prices have recovered.

The two pieces of advice they had were this:

1. Force short sale lenders to give an answer in a fixed period of time, perhaps 30 or 45 days. Yes or no, at least the buyer will know.
2. Keep pushing programs like HUD's 203(k) rehabilitation mortgage insurance which allows homebuyers to borrow additional funds to improve or repair a home before they move into it. For a segment of buyers willing to undertake those repair projects on a foreclosed house, repair loans make all the difference.

On a final note, the HAMP is not well-regarded, and I continue to believe that allowing bankruptcy courts to reset the principal on primary home mortgages, at least those *that were sold off in strips*, will help break through the continuing bureaucratic nightmare the servicers present to distressed homeowners.

Sincerely,



Sheldon Whitehouse  
United States Senator

Cc: Hon. Chris Dodd, Chairman, Senate Committee on Banking, Housing, and Urban Affairs;

Hon. Shaun Donovan, Secretary, U.S. Department of Housing and Urban Development;

Barbara Desocr, President, Home Loans & Insurance, Bank of America Corporation



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 22, 2009

The Honorable Sheldon Whitehouse  
United States Senate  
Washington, D.C. 20510

Dear Senator Whitehouse:

Thank you for your letter of November 19, 2009, regarding the state of the housing market in Rhode Island, including the foreclosure sale market, short-sales market, and "arms-length" home purchasing market.

The Administration's broad range of housing initiatives, including the Home Affordable Modification Program (HAMP) and broad support for Fannie Mae and Freddie Mac, are targeted at maintaining mortgage finance availability and affordability across the market.

As part of HAMP, we recently posted specific guidance for our Foreclosure Alternatives Program, which provides incentives to servicers participating in HAMP to process as quickly as possible short sales or deeds-in-lieu of foreclosure for borrowers unable to stay in their homes. Your letter suggests that short sale lenders should provide an answer within a fixed period of time – and the guidance in our Foreclosure Alternatives Program does exactly that. In the guidance for the program posted at [www.hmpadmin.com](http://www.hmpadmin.com), we provide the following required timelines for servicers providing the short sale option to homeowners:

"Within three business days following receipt of an executed purchase offer, the borrower or the listing broker must deliver to the servicer a completed Request for Approval of Short Sale describing the terms of the sale transaction... Within ten business days of receipt of the Request and all required attachments, the servicer must indicate its approval or disapproval of the proposed sale by signing the appropriate section of the Request and mailing it to the borrower."

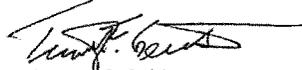
In its role as compliance agent, Freddie Mac will audit the timeliness of servicers' responses.

You also indicate your support for allowing bankruptcy courts to reset the principal on primary home mortgages. President Obama has long been a supporter of balanced bankruptcy reform. The Administration agrees that judges should have the power to modify mortgages for borrowers who have run out of other options, and to put in place a responsible payment plan so that debtors in bankruptcy can return to financial solvency.

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Thank you again for your attention to these important issues. We look forward to working with you on making the Administration's housing initiatives as effective as possible.

Sincerely,



Timothy F. Geithner

SHELDON WHITEHOUSE  
RHODE ISLAND

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## United States Senate

WASHINGTON, DC 20510-3905

November 1, 2010

The Honorable Timothy Geithner  
Secretary of the Treasury  
Department of the Treasury  
1500 Pennsylvania Avenue  
Washington, DC 20220

Dear Mr. Secretary:

I write to respond to your recent comment on the Charlie Rose Show that a national foreclosure moratorium would be "very damaging to exactly the kind of people we're trying to protect." With only 500,000 loan modifications in the first eighteen months of the Administration's Home Affordable Modification Program (HAMP), it is clear that it is falling far short of its target of three to four million modifications. Foreclosure rates continue at historic levels in many areas of the country, including my state of Rhode Island, and we must do more fix a system that has become broken and distorted.

The system is simply not working logically when it cannot answer the question, "why is the bank throwing me out of my house, to sell it to someone else who'll pay less than I'm willing and able to pay right now?" Slicing and dicing these mortgages into securities, and selling them to the four winds, has fractured the marketplace and introduced shards of perverse incentive. Misaligned fee structures have led loan servicers to reject mortgage modifications that would benefit both the homeowner and the mortgage holders. When a homeowner is "underwater" and willing and able to make payments on a rewritten mortgage with reduced principal, why would the loan servicer decline, and throw the home into a foreclosure that decimates its value? Present practices are injurious not only to the homeowner, but often to the owners and investors in the mortgage. That is a nonsensical result, but it is the result the present system produces regularly. Why? In part because of conflicts of interest you seem to overlook.

In explaining your opposition to a national moratorium, you stated, "[we] want to make sure that we're not going to make the problem worse." It would be hard to argue this to homeowners who have toiled for months or longer to try to get sensible modifications from reluctant servicers. I have heard from constituents being ignored and abused as they try to get modifications under the HAMP: documents repeatedly lost, inconsistent advice, hours trapped on the phone, and common sense turned on its head to reject fair modifications in favor of foreclosure. This is not episodic; it is epidemic. The major

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loan servicers have a dismal record of modifying mortgages and maintaining the status quo should not be an option. As a piece of administrative hardware, the system is defective. It is shameful, and nonsensical.

The simplest failure of all is the present system's inability to get the homeowner in contact with anyone who has authority on behalf of the lender. It just doesn't happen, and sensible results are sacrificed to the remorseless structure of the present "system." I would challenge you to keep your composure, with your family home at stake, being put through the relentless nonsense: mortgage servicer employees with no last names and no answers, and constant hoops to jump through, that are the standard ordeal for Americans seeking mortgage modifications.

A national foreclosure moratorium would force loan servicers to look at the broader economic realities of foreclosure. Far from "delaying the inevitable" as some commentators have suggested, a national moratorium on foreclosures would force loan servicers to reevaluate their practices, and clean up the bureaucratic nightmare they now run, to the ultimate benefit not just of American homeowners trapped in the system, but also the banks and investors who will do better with a successful modification than a foreclosure.

The present system has created nightmare, agony and frustration and too often turns a blind eye to a more reasonable path forward for our struggling homeowners and their lenders. I hope you will reconsider your position on a foreclosure moratorium, and I look forward to working with you to keep families in their homes.

Sincerely,



Sheldon Whitehouse  
United States Senator

*This is not a form letter. There are serious  
system malfunctions happening that you  
should not be glossing over. Please take  
a second look. Thank you.*

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SHELDON WHITEHOUSE  
RHODE ISLAND

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December 1, 2010

The Honorable Timothy Geithner  
Secretary of the Treasury  
Department of the Treasury  
1500 Pennsylvania Avenue  
Washington, DC 20220

Dear Mr. Secretary:

Further to our attached correspondence from last year, I write to update you on the state of the short sale market in Rhode Island.

According to a group of realtors with whom I met last week, progress over the past year has been negligible. The bureaucracies of the large loan servicers continue to frustrate the realtors. At my meeting, I heard the following:

“It’s an awful system”;  
“You have to plan to be on hold for hours”;  
“Like a train without an engineer”; and  
“The banks are actually compounding their losses because they’re stuck in their own bureaucracy.”

The realtors report once again that: (1) repeated demands for the same records are a virtually universal commonplace – they are constantly “lost”; (2) HAMP is not working; and (3) short sales are often handled so badly that the property ends up in foreclosure at a lower price. Everyone present had a sale approved by one division of a servicer, only to find that “the other hand” of the servicer foreclosed on the property, presumably unaware of the pending sale.

The realtors argue for a simple solution. To quote one of them: “All we need is somebody that the consumer can talk to make an intelligent decision.” Such a person is virtually impossible to get to, unfortunately. This is consistent with a recent hearing I held in which a consumer had been working a mortgage modification for 19 months, and had yet to reach a human being with authority to make a decision. Beyond short sales, the problem extends to all mortgage settlements including HAMP modifications. Stories that constituents have told me include common elements: hours on the phone, “lost” paperwork and redundant requests; and inconsistent answers from different divisions of the same servicer.

In the event that you are hearing differently from the bank CEOs, I wanted to share with you the frustrations of Rhode Island's local realtors. Your letter from last December evinced a confidence that is not consistent with the experiences of the realtors in the field. I hope that you will consider their dissatisfaction and implement common sense reforms to the HAMP modification and short sale systems.

In addition to broader reforms to HAMP, I ask that you consider supporting bankruptcy court pre-trial loss mitigation programs. These programs, which are up and running in several states, including Rhode Island, simply require the servicer to sit down with the homeowner and negotiate in good faith. While no settlement is required, as the realtors have suggested the mere act of bringing the homeowner together with a person who can make an intelligent decision for the bank cuts through the bureaucracy and produces mutually-beneficial modifications and short sales. I hope that you will consider supporting the attached legislation which would clarify and support the courts' authority in this area. I would be happy to discuss with you the bill or the situation on the ground in Rhode Island.

Sincerely,

A handwritten signature in black ink, appearing to read 'Sheldon Whitehouse', written in a cursive style.

Sheldon Whitehouse  
United States Senator



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 23, 2010

The Honorable Sheldon Whitehouse  
United States Senate  
Washington, DC 20510

Dear Senator Whitehouse:

Thank you for your thoughtful letters regarding foreclosure rates, the short sale market, and the difficulties families are encountering both in Rhode Island and across the nation. I share your concerns and appreciate the time you took to convey them.

In your November 1 letter, you suggest that a nationwide foreclosure moratorium is the appropriate solution to the problems that homeowners face in obtaining modifications. We agree that the foreclosure rate is too high, and we are also aware of the difficulties that homeowners often face in contacting and negotiating with their servicers and lenders. Foreclosure is painful for homeowners; it also dislocates families, disrupts communities, and destabilizes local housing markets. However, we do not believe a nationwide foreclosure moratorium is the best response to these problems.

One out of every four homes purchased today is a foreclosed property. For that reason, a moratorium – even a targeted one – could prevent tens of thousands of families from buying legally and appropriately processed foreclosed homes. These purchases are an integral part of continuing to stabilize the housing market. A moratorium could also increase the number of vacant and abandoned homes, properties that are estimated to be three times as destructive to neighboring property values as occupied homes at the beginning of the foreclosure process. Not only would new families be prevented from moving in, but communities already suffering from blight and declining home values would face further challenges.

Treasury believes that we should continue to focus on reducing the number of foreclosures through mortgage modifications and other alternatives, including short sales. We created the Making Home Affordable (MHA) program to help struggling homeowners avoid foreclosure by providing them with an affordable mortgage modification. As we have learned in implementing MHA's first lien modification program, the Home Affordable Modification Program (HAMP), servicers were historically structured and staffed to perform a limited role—primarily collecting payments. They did not have the systems, staffing, operational capacity or incentives to engage with homeowners on a large scale and offer meaningful relief from unaffordable mortgages. We have repeatedly pressed the servicers to expand their capacity and improve their procedures in

order to be more responsive to homeowners and the need to modify mortgages. I agree their performance is not adequate, and they will continue to have to do more.

Additionally, Treasury has required servicers to follow certain procedures to ensure that homeowners are offered alternatives to foreclosure. A fact sheet that outlines these efforts is enclosed.

Although we have not achieved as many modifications as we would like, we believe the HAMP program is producing sustainable modifications that deliver important economic benefits. Of the nearly 1.4 million homeowners that have entered into HAMP trial modifications, almost 520,000 homeowners have converted to permanent modifications. These homeowners are experiencing a 36 percent median reduction in their mortgage payments – averaging more than \$500 per month – amounting to a total, program-wide savings of nearly \$3.7 billion annually for homeowners.

The recent allegations of widespread foreclosure documentation irregularities underscore the importance of trying to avoid foreclosure through mortgage modifications and other alternatives. In September, the Administration formed a foreclosure task force – a group of 11 federal agencies, including seven voting members of the Financial Stability Oversight Council as well as the Federal Trade Commission, the Department of Housing and Urban Development, and the Department of Justice, with specific expertise on housing and mortgage processing issues to assess the extent of the issues through reviews of the nation's largest mortgage servicers and other entities. The main objectives of the task force are to determine the scope of the foreclosure problems, hold banks accountable for fixing these problems, protect homeowners, and mitigate any long-term effects this misconduct could have on the housing market. The interagency task force is working in close coordination with state attorneys general as well.

As you mentioned in your December 1 letter, the short sale process is another circumstance in which servicers lacked the capacity to address the needs of the housing crisis in a timely manner. Treasury responded by creating the Home Affordable Foreclosure Alternative (HAFA) program, which provides incentives and clear timelines to make it easier for eligible homeowners to sell their homes through a short sale or arrange for a deed-in-lieu of foreclosure. HAMP-participating servicers must evaluate a homeowner for HAFA within 30 days after the homeowner requests a short-sale or after it is determined that the homeowner did not successfully complete or does not qualify for a modification under HAMP.

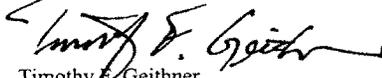
Treasury is currently evaluating ways to change and improve the HAFA program guidelines to expand the population of eligible borrowers and to further shorten the time servicers have to respond to a request to enter into a short sale agreement. Treasury will keep you and your staff informed of our progress on these improvements.

Thank you, also, for sharing your draft legislation to limit investor and homeowner losses in foreclosure. The Obama Administration supports loss mitigation programs that encourage servicers and homeowners to work out solutions in which the borrower avoids foreclosure. Treasury is happy to provide technical assistance with the details of your bill.

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Thank you again for sharing your thoughts and your constituents' experiences, and your efforts in service of our common goals.

Sincerely,



Timothy E. Geithner

Enclosure

**Holding Servicers Accountable: Treasury's Guidance to Protect Homeowners in the Home Affordable Modification Program**

**FACT SHEET**

**HAMP includes a number of safeguards to help homeowners avoid foreclosure. Servicers may not proceed to foreclosure sale unless and until they have tried these alternatives first. Servicers must issue a written certification to their foreclosure attorney or trustee stating that "all available loss mitigation alternatives have been exhausted and a non-foreclosure option could not be reached."**

MHA Supplemental Directive 10-01 became effective on June 1, 2010 and requires participating servicers of non-GSE loans to:

- Proactively reach out to all recently delinquent homeowners and evaluate them for HAMP modifications before referring them to foreclosure;
  - The focus here is on early intervention. Servicers must attempt to contact all potentially eligible borrowers when they are only two months delinquent and there is still a viable opportunity to save the loan.
- Suspend foreclosure sales against homeowners who have applied for HAMP modifications, while their applications are pending;
- Stop all pending foreclosure actions when a borrower makes the first payment on a fully verified trial plan (applies to all HAMP trial modifications after June 1, 2010);
- Evaluate whether homeowners who do not qualify for HAMP (or who have fallen out of HAMP) qualify for alternative loss mitigation programs (which may include a short sale or deed-in-lieu of foreclosure) or private modification programs; and
- Provide a written explanation using plain language denial explanations to any borrower who is not eligible for modification and delay foreclosure for at least 30 days to give the homeowner time to appeal.

Servicers may not proceed to foreclosure sale unless and until they have tried to implement these safeguards. Additionally, participating servicers may not conduct a foreclosure sale until they have issued a written certification to their foreclosure attorney or trustee stating that "all available loss mitigation alternatives have been exhausted and a non-foreclosure option could not be reached." On October 6, 2010, Treasury reminded participating servicers in writing of this pre-foreclosure certification requirement.

Treasury also recently instructed its compliance agent to increase compliance reviews of the internal policies and procedures developed by the ten largest servicers for completing the written pre-foreclosure certifications. Though the results of these reviews are not yet available, if incidents of non-compliance with the certification requirement are found, Treasury will insist

that servicers take appropriate corrective action, which may include suspending or reversing foreclosure proceedings and re-evaluating the affected homeowners for HAMP.

On November 3, 2010 Treasury issued guidance to servicers designed to enhance servicer responsiveness to borrowers who have inquiries or disputes related to MHA. Among the new requirements, servicers must:

- Establish in-house MHA case escalation teams staffed with individuals who are independent of the original underwriting decision-makers;
- Provide to borrowers a response within 30 calendar days;
- Fully cooperate with representatives of Treasury's borrower support centers so that disagreements can be resolved; and
- Suspend scheduled foreclosure sales until an escalated case is resolved.

If homeowners believe that they have been inappropriately denied a HAMP modification or wrongly placed in foreclosure while participating in an MHA program, Treasury, through the HOPE Hotline and MHA Help call centers, provides free foreclosure prevention resources. Homeowners are encouraged to call the 24-hour HOPE Hotline at 1-888-995-HOPE (4673) and ask to escalate their case with a specialist at MHA Help. The MHA Help call center has trained housing counselors dedicated to working exclusively with homeowners and servicers to resolve escalated cases. Additionally, our [MakingHomeAffordable.gov](http://MakingHomeAffordable.gov) website contains overviews of our modification programs, FAQs, links to counseling organizations, contact information for HAMP servicers, and other resources in both English and Spanish for homeowners who may be in need of assistance.

SHELDON WHITEHOUSE  
RHODE ISLAND

COMMITTEES:  
AGING  
BUDGET  
ENVIRONMENT AND PUBLIC WORKS  
INTELLIGENCE  
JUDICIARY

## United States Senate

WASHINGTON, DC 20510-3905

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February 8, 2011

The Honorable Timothy Geithner  
Secretary of the Treasury  
Department of the Treasury  
1500 Pennsylvania Avenue  
Washington, DC 20220

Dear Mr. Secretary:

It is with deep and continuing concern that I write you about the foreclosure crisis in Rhode Island and across the nation. Almost two full years after the establishment of the Home Affordable Modification Program (HAMP), foreclosures continue at historically-high levels. According to the Mortgage Bankers Association, 8.7% of first lien mortgages nationwide were either seriously delinquent or in foreclosure at the end of the third quarter of last year – a total of over 3.8 million homes. What's more, the Congressional Oversight Panel projects a total of 8 million to 13 million foreclosures before the crisis begins to abate. Many of these foreclosures can be avoided, and the HAMP performance to date has been lackluster at best.

I first shared with you my constituents' frustrations about HAMP modification and short-sale requests in a letter dated November 19, 2009 (see attached for a full record of our correspondence on this topic). After meeting with a group of Rhode Island realtors, I reported in that letter that "[t]he administrative incompetence of the banks weighs this market with two to six month delays and inconsistent decisions, such that the realtors have begun advising clients not to even bother in [the short-sale] market." I then passed along their advice that the Treasury Department – through the HAMP – require lenders to answer short-sale applications within a fixed period of time.

In a written reply dated December 22, 2009, you apprised me of recent guidance you posted as part of the HAMP program that "[w]ithin ten business days of receipt of the Request and all required attachments, the servicer must indicate its approval or disapproval of the proposed [short] sale by signing the appropriate section of the Request and mailing it to the borrower."

Mirroring the bureaucratic maze that continues to cripple the short-sale market, my constituents report few if any improvements in the HAMP modification process. In both systems, the homeowner may be continuously bounced from one servicer representative to another, never reaching someone who actually has the authority to decide on their application. One constituent recently testified at a Judiciary Committee hearing on his

nearly two-year ordeal trying to get an answer to his HAMP modification request from his servicer. The excruciating application process included the servicer frequently misplacing paperwork and dozens of long phone conversations with representatives who refused to disclose their full names. Even though this constituent was ultimately approved for a mortgage modification, the inexcusably long process ruined his credit and nearly drove him to bankruptcy.

I wrote you once again in a letter dated November 1, 2010 about the broken system bedeviling the modification, short-sale, and foreclosure processes. Following reports of fraudulently-executed mortgage documents and “foreclosure mills,” I suggested a national foreclosure moratorium while the servicers “reevaluate their practices, and clean up the bureaucratic nightmare they now run.” I summed up the problem saying, “[t]he simplest failure of all is the present system’s inability to get the homeowner in contact with anyone who has authority on behalf of the lender.”

Two weeks later, in a letter dated December 1, 2010, I reported to you that the realtors in my state rated progress in the short-sale market over the previous twelve months as “negligible.” I passed along their experience that “(1) repeated demands for the same records are a virtually universal commonplace – they are constantly ‘lost’; (2) HAMP is not working; and (3) short sales are often handled so badly that the property ends up in foreclosure at a lower price.”

In a letter dated December 23, 2010, you responded to my previous two correspondences, saying that Treasury has “repeatedly pressed the servicers to expand their capacity and improve their procedures in order to be more responsive to homeowners and the need to modify mortgages.” You went on to say that you “agree their performance is not adequate, and they will continue to have to do more.”

Despite your acknowledgment of inadequate servicer performance, you addressed my short-sale concerns by highlighting HAMP short-sale requirements that many servicers seem to ignore. In particular you said, “HAMP-participating servicers must evaluate a homeowner [under HAMP requirements] within 30 days after the homeowner requests a short-sale or after it is determined that the homeowner did not successfully complete or does not qualify for a modification under HAMP.”

The view from Rhode Island is that the HAMP servicers have failed to comply with both modification and short-sale requirements and guidelines. In a recent decision by the Bankruptcy Court for the District of Rhode Island, Judge Arthur N. Votolato summed up his experience with foreclosure cases saying “at hearings on motions for relief from stay, debtors were routinely advising the Court that they had been seeking out of court loan modifications, forbearance agreements, or similar relief regarding their home mortgages, but that lenders’ responses were virtually impossible to come by, despite multiple requests made to the mortgage holder or servicer. The stories were familiar and nearly identical. Creditors’ counsel regularly stated that they were either unaware of such requests, or had no information to share – not even the name of a contact person.”

Under his Bankruptcy Code Section 105(d) authority to convene "status conferences as are necessary to further the expeditious and economical resolution of the case," Judge Votolato implemented a program under which he may require the servicer to sit down with the homeowner and try in good faith to arrive at a settlement mutually preferable to foreclosure. In its first year, the pre-trial loss mitigation program has already produced 123 mortgage modifications. While the bankruptcy court program is impressive and I have introduced legislation to support it (S. 222), homeowners should not need to file for bankruptcy in order to get a straight answer on their modification and short-sale requests.

Clearly, where a federal judge says that "lenders' responses were virtually impossible to come by," the system is failing.

I once again ask you to use the leverage of the HAMP program to require servicers to give timely answers to modification and short-sale applications. Servicers not in compliance with HAMP guidelines should be held accountable through meaningful financial penalties. Simply "shaming" these profit-driven companies as the Administration has repeatedly attempted is clearly ineffective against the weight of bureaucratic ineptitude and (often) conflict of economic interest. In working to reform the HAMP process, I recommend that you consider: (1) ensuring that each homeowner has a single point of contact at his or her servicer – a real person with a first and last name; (2) prohibiting "dual-tracking," the system under which foreclosures proceed while modification requests are under review; (3) requiring a third-party review before HAMP-participating servicers proceed with foreclosures; and (4) establishing and enforcing strict deadlines for modification and short-sale answers. These improvements, along with consistent enforcement of existing requirements, would help to end the nightmare that is currently the modification and short-sale process.

I thank you for your prompt attention to these recommendations. I would be happy to meet with you to discuss any or all of them. I look forward to working with you to minimize avoidable foreclosures.

Sincerely,



Sheldon Whitehouse  
United States Senator

United States Senate  
WASHINGTON, DC 20510

March 9, 2011

The Honorable Timothy Geithner  
Secretary of the Treasury  
Department of the Treasury  
1500 Pennsylvania Avenue  
Washington, DC 20220

Dear Mr. Secretary:

Thank you for reaching out to us and briefing us on your ongoing work to alleviate the foreclosure crisis. We greatly appreciated the candid discussion. In Rhode Island, Oregon, and across the country, millions of homeowners continue to struggle through the HAMP and the Administration's other mortgage modification and resolution programs. We were pleased to hear that you take seriously the frustrations of these homeowners and the poor customer service record of some of the nation's largest mortgage servicers.

We were also pleased to learn that you favor requiring servicers to provide homeowners with a single point of contact – a real person with a first and last name – with whom to work on mortgage modifications or other settlement requests. In addition to including this requirement in the servicing standards that are under development, we ask that you require all HAMP servicers to adopt this practice for all mortgages. Having a single point of contact can spare homeowners hundreds of hours of paperwork and call center frustrations, and can save the servicers administrative costs as well.

As we discussed last Tuesday, we also ask that you take steps to enforce prohibitions on so-called "dual tracking" – the all-too common practice of proceeding with foreclosure while a modification or short-sale request is pending. It is our understanding that HAMP already prohibits this practice once a trial modification has been approved and the borrower's initial payment has been received by the loan servicer. We ask that you extend the prohibition on dual tracking to pending applications as well. Should you believe new authority is needed to address this issue on a more comprehensive basis, we urge you to work with us on legislation we have introduced to accomplish this goal.

We also ask that you formulate a process that requires an independent third party to review a case prior to foreclosure. Foreclosure should be the very last option, to be engaged only in circumstances in which modification, short-sale, and other settlements do not prove to be economically feasible. Given the high costs of foreclosure to the homeowner, the servicer, the mortgage holders, and the local community, foreclosures should be rare.

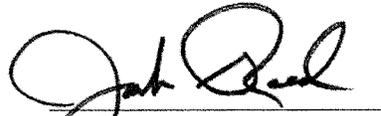
Once again, we thank you for your time and attention and look forward to working with you to end the foreclosure crisis and restore stability to the housing market.

Sincerely,



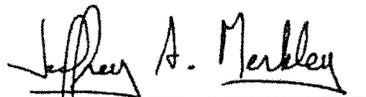
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Sheldon Whitehouse  
United States Senator



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Jack Reed  
United States Senator



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Jeff Merkley  
United States Representative

SHELDON WHITEHOUSE  
RHODE ISLAND

COMMITTEES:  
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November 9, 2011

The Honorable Timothy Geithner  
Secretary of the Treasury  
Department of the Treasury  
1500 Pennsylvania Avenue  
Washington, DC 20220

Dear Mr. Secretary:

Last March, you kindly visited my office to brief me on the Administration's efforts to stem the foreclosure crisis. At that meeting we discussed proposals to improve the Home Affordable Mortgage Program (HAMP) and the often inefficient processes servicers use to evaluate modification requests and foreclosure actions. I write today about another Treasury program that is sadly falling fall short of its potential to help homeowners.

As you know, Rhode Island Housing – our state housing finance agency – has received about \$80 million from the Hardest Hit Fund to help homeowners stay in their homes. The Hardest Hit Fund Rhode Island program (HHFRI), which the Department of Treasury approved, was designed to provide both temporary assistance and permanent mortgage modifications. Rhode Island Housing reached out to the major national loan servicers before it designed the program and incorporated many of their ideas into it. Unfortunately, due to a lack of cooperation from some of those same servicers, the use of these funds has been severely constrained.

According to Rhode Island Housing, the major national loan servicers will accept HHFRI funds to help homeowners in temporary distress make their full payments, but have thus far refused to approve any permanent loan modifications. In contrast, Rhode Island-based loan servicers have already approved 85 HHFRI-supported modifications. With a large portion of mortgages in Rhode Island serviced by major national companies, their unwillingness to approve HHFRI-supported mortgage modifications has greatly limited the reach of the program. In fact, of the \$80 million approved for the HHFRI, only \$7.5 million had been used to help homeowners as of September 30.

While I am encouraged to hear that the largest national loan servicers have agreed to meet with Rhode Island Housing and other state housing finance agencies in Dallas on November 15, their attention to the HHFRI and similar programs to date has been severely lacking. I respectfully ask you take any steps necessary under your authority to compel the cooperation of the large national mortgage servicers. Hardest Hit Fund money around the country has the potential to prevent thousands of foreclosures, and it

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would be shameful if it continues to be tied up due to bureaucratic intransigence,  
particularly after local officials reached out to design the programs with their advice.

Sincerely,

A handwritten signature in black ink, appearing to read 'Sheldon Whitehouse', written in a cursive style.

Sheldon Whitehouse  
United States Senator

SHELDON WHITEHOUSE  
RHODE ISLAND

COMMITTEES:  
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November 22, 2011

The Honorable Timothy Geithner  
Secretary of the Treasury  
Department of the Treasury  
1500 Pennsylvania Avenue  
Washington, DC 20220

Dear Mr. Secretary:

As I have done in the past, I write to share with you views from Rhode Islanders on the foreclosure crisis. Attached please find an editorial printed this past Saturday in the *Providence Journal Bulletin* – our largest local newspaper. I agree with the editors' assertion that the HAMP and other federal efforts to help homeowners have come up short. I also agree that "[i]t will take more than another narrowly tailored program to set things right." To that end, I ask you to continue exploring ways in which you can hold mortgage servicers accountable for failing to abide by the rules and spirit of the HAMP, HARP, and other foreclosure mitigation programs. Their failure to participate responsibly is a continuing problem.

Sincerely,



Sheldon Whitehouse  
United States Senator

**Modest mortgage help: Providence Journal Editorial**

November 19, 2011

Since early 2009, the Obama administration has made a series of attempts to help struggling homeowners. But all have been modest, in scope and effect, and the latest plan is little different. By expanding opportunities to refinance, the plan, unveiled last month, could help up to a million homeowners save on their monthly payments, according to officials.

The savings — as much as \$2.5 billion — would help stimulate the economy, though probably not at the hoped-for level. Not every household that refinances will spend all its savings. And investors who held the original loans will find themselves earning (and presumably spending) less. More importantly, even if the program works as envisioned, it will help only a fraction of those in need.

Reviving the housing market remains stubbornly difficult, for several reasons. Joblessness is slowing the formation of new households as young people move back home. Some potential buyers fear another downturn, or simply another decline in prices, so are sitting on the sidelines. And millions of foreclosed properties have flooded the market, dampening prices. Finally, lenders' new, stricter standards often make borrowing too difficult.

Meanwhile, a nationwide probe of shoddy lending practices, set in motion last year by the robo-signing scandal, has slowed but hardly ended the foreclosure process. Clearing the supply of foreclosed homes from the market has, in turn, slowed, stalling the recovery further.

Perhaps the greatest challenge is still the number of homeowners who owe more on their mortgages than their houses are worth. Around 8 million of these "underwater" borrowers, the great majority, are paying above-market rates, according to The Wall Street Journal. Though they could benefit from refinancing, most will not qualify for the new program. Talks between several large banks and state attorneys general could bring a new infusion of funds. But the two sides seem far apart on both the final dollar amount and the extent of future legal protection for the banks.

It would be easy to leave the whole mess to the markets to work out (a position Congress now seems to favor). And, indeed, the real hope for Americans is that the economy improves and housing values climb. But in agreeing to bail out the banks in 2008, Congress insisted that some money should go toward preserving home ownership.

Thanks to timidly structured remedies, virtually nonexistent enforcement and continuing problems in the housing market, no one has delivered on that promise very well. In many cases, borrowers who leaped through every hoop lost their homes anyway, and lenders suffered no penalties for failing to prop them up. It will take more than another narrowly tailored program to set things right.



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

December 14, 2011

The Honorable Sheldon Whitehouse  
U.S. Senate  
Washington, DC 20510

Dear Senator Whitehouse:

Thank you for your letter of November 9, 2011 to Secretary Geithner regarding the Hardest Hit Fund Rhode Island program (HHFRI). We appreciate your support for the program and your desire to see that it reaches its full potential. Please allow me to respond on the Secretary's behalf.

We share your concern regarding the difficulties Rhode Island Housing has experienced in obtaining cooperation from some of the largest servicers to fully participate in HHFRI. Limited servicer participation is an issue for many states participating in the Hardest Hit Fund (HHF). Because servicer participation is key to the success of the program, we have been working with the state housing finance agencies (HFAs) to address this concern. As you know, we met with large servicers, Fannie Mae, Freddie Mac, the Department of Housing and Urban Development, the Federal Housing Finance Agency, and the HFAs, including Rhode Island Housing, on November 15. Increasing servicer participation for modification programs was a primary topic of conversation at this meeting.

To date, across all HHF participating states, including Rhode Island, almost all program volume has been in unemployment and reinstatement programs. This is largely because these programs are far easier for servicers to implement. For these types of programs, a homeowner works directly with his or her HFA, and the HFA then makes payments on the homeowner's behalf directly to the servicer. Additionally, many servicers have automated these processes, enabling quicker and more streamlined assistance to a larger number of homeowners.

On the other hand, modification, short sale and principal reduction programs require considerably more resources from servicers. The servicers need to evaluate and interact with each homeowner (or with the HFA on their behalf) and each modification is a unique transaction. Unlike unemployment and reinstatement programs, modification programs are operationally complex and require servicers to devote resources to augment their systems and train personnel to implement programs that vary by state. Because the large servicers service loans across most of the states, they are reluctant to dedicate resources and infrastructure to accommodate state-specific platforms.

While we will fully encourage servicer participation, we are limited in our ability to compel servicer participation. As you are aware, Treasury is not a regulator and we have no contractual relationship with servicers to mandate participation in the HHF programs. However, we provide ongoing advice and other technical support to Rhode Island Housing and have facilitated

numerous meeting with national servicers to discuss participation in their modification program. As a follow-up from the November 15 meeting, we formed a working group comprised of servicers and several states, including Rhode Island, to identify solutions that would result in greater servicer participation.

Additionally, thank you for your letter of November 22 containing the *Providence Journal Bulletin* editorial. We are continuously working to improve Treasury's housing programs so that they will reach as many homeowners as possible. You suggested that Treasury take additional steps to increase servicer accountability. We have taken important action in this regard. Treasury began publishing quarterly Servicer Assessments for each of the 10 largest servicers participating in the Making Home Affordable (MHA) Program in June. These assessments contain information on servicer compliance with specific program guidelines as well as program results data, which reflect how timely and effectively servicers assist eligible homeowners. The assessments provide more transparency to the public about servicer performance to hold servicers accountable. In addition, Treasury has taken remedial actions against servicers that are not in compliance with MHA guidelines, such as requiring servicers to correct identified instances of non-compliance and withholding incentive payments owed to the servicers. Treasury is committed to increasing servicer accountability for MHA, and we appreciate and agree with your suggestion. For your reference, I have included a copy of our latest Servicer Assessments.

I would be happy to discuss these issues in more detail with you or your staff. We will continue to work closely with Rhode Island Housing and mortgage servicers to better deliver assistance to struggling homeowners. I look forward to continuing to work with you in support of Rhode Island homeowners.

Sincerely,



Timothy G. Massad



**THE PRESIDENT'S FISCAL YEAR 2013 BUDGET  
REQUEST FOR THE U.S. DEPARTMENT OF  
DEFENSE**

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**TUESDAY, FEBRUARY 28, 2012**

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

The Committee met, pursuant to notice, at 9:34 a.m., in Room SD-608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Murray, Wyden, Nelson, Sanders, Whitehouse, Warner, Begich, Sessions, Grassley, Enzi, Graham, Thune, Portman, Johnson, and Ayotte.

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's hearing will examine the President's defense budget request. Our witnesses today are the Secretary of Defense, Leon Panetta; General Martin Dempsey, the Chairman of the Joint Chiefs of Staff; also joining them at the witness table is the Under Secretary and Comptroller of the Department of Defense, Robert Hale.

I want to particularly thank Secretary Panetta for being here today. It has been some time since the Secretary of Defense has appeared before the Senate Budget Committee. As a former OMB Director and a former House Budget Committee Chairman, Secretary Panetta understands the important role of the Budget Committee, and we especially appreciate his willingness to appear here today.

Secretary Panetta gave me a commitment that he would come, and I very much appreciate his keeping that promise. We look forward to his testimony as well as that of General Dempsey and Comptroller Hale. We also very much understand the time constraints that you are under. We recognize that you have many issues on your plate, especially with what is happening in Syria and Iran and the Middle East, and, of course, North Korea and China and Russia, and on and on it goes. So we do recognize the heavy burden that is on your shoulders, and we will keep our commitment to get you out of here as expeditiously as possible.

I want to begin by highlighting the budget crisis facing the country. Despite the progress in last summer's Budget Control Act, we remain on what is fundamentally an unsustainable course. Admiral

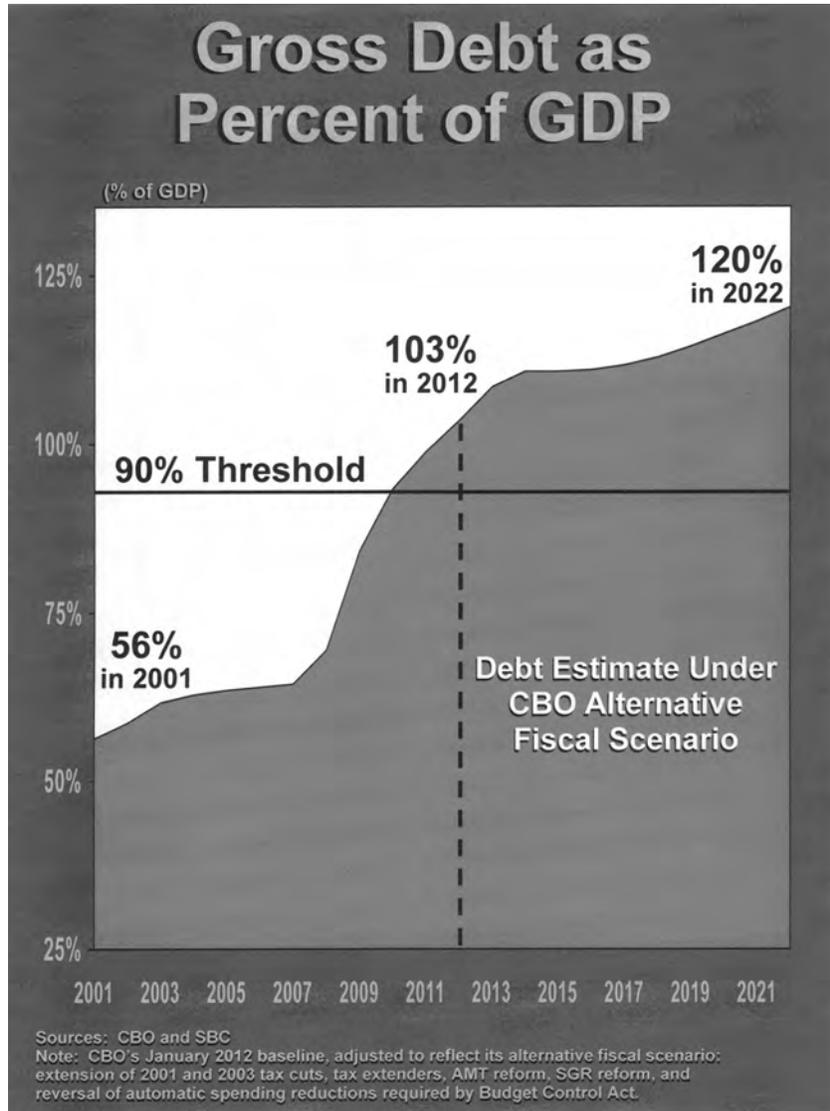
Mullen, General Dempsey's predecessor as Chairman of the Joint Chiefs of Staff, described the national debt as our "biggest national security threat." I understand General Dempsey may not share that exact assessment but I think, nonetheless, recognizes this is a key challenge facing the country.

## Admiral Mullen on Debt Threat

**"Our national debt is  
our biggest national  
security threat."**

—Admiral Mike Mullen, Former  
Chairman of the Joint Chiefs of Staff  
"Tribute to the Troops" Breakfast  
June 24, 2010

We simply will not be able to remain a global superpower if we fail to stop the explosion of debt, and we are now at a gross debt 100 percent of GDP. What is of even greater concern is where we are headed, because the Congressional Budget Office tells us if we stay on our current course, we are headed for a debt well over 230 percent of GDP.

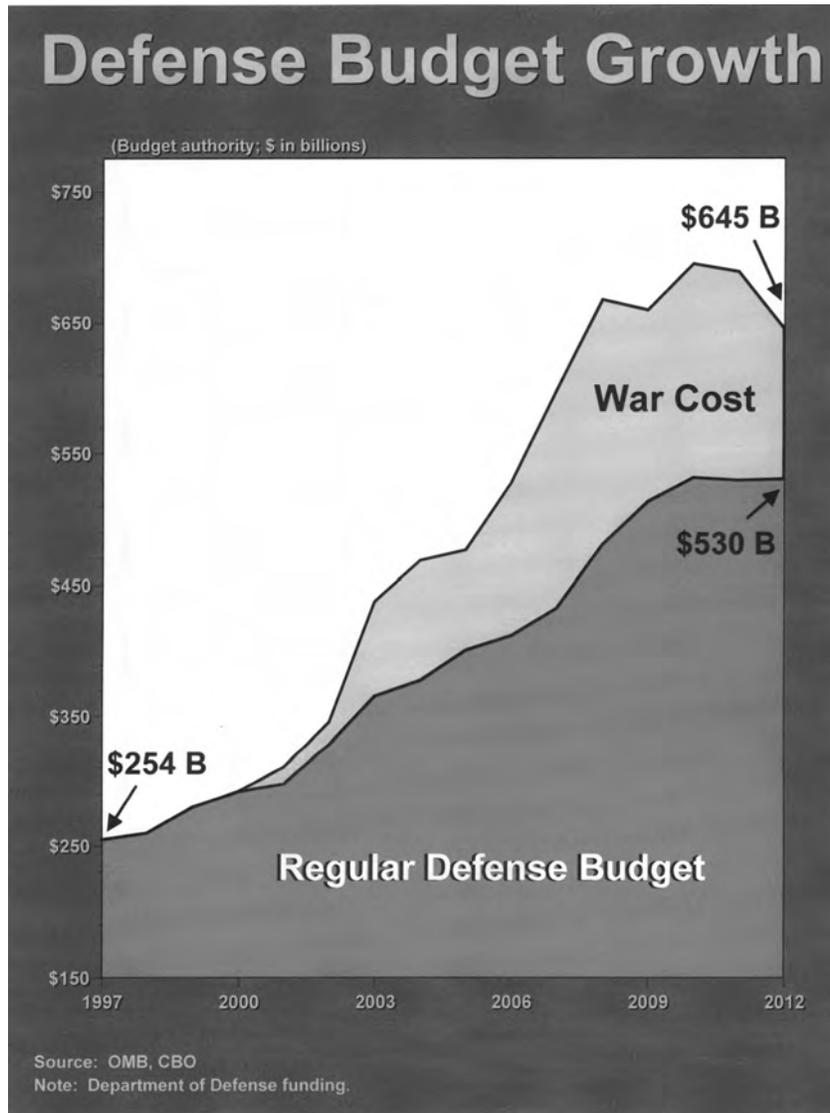


Under CBO's alternative fiscal scenario, gross Federal debt will reach 103 percent of GDP this year, well above the 90-percent threshold that many economists believe is the beginning of the danger zone. And it will continue rising to 120 percent by 2022 and well beyond that in the years beyond 2022.

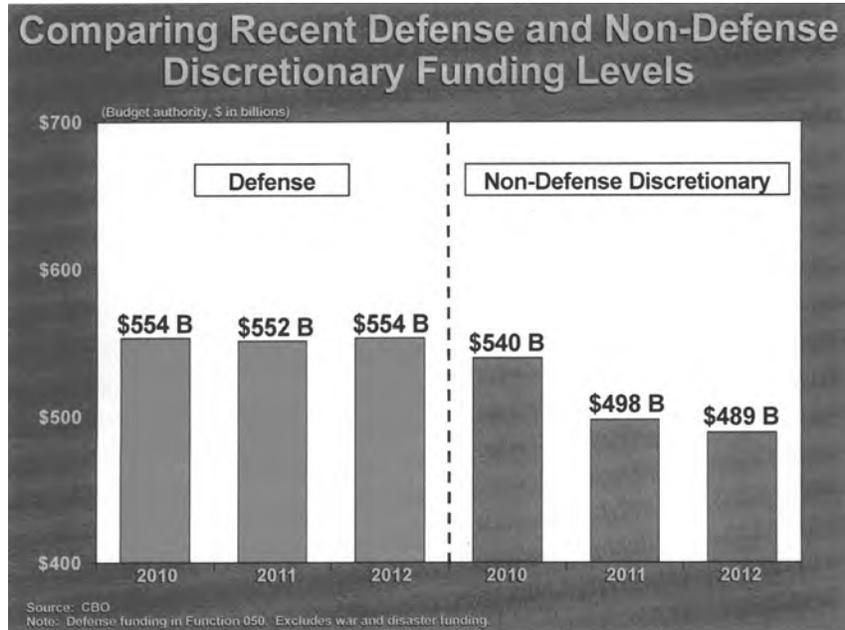
The reality is that defense spending, both in the core defense budget and in war costs, has grown dramatically and has been a factor in contributing to recent deficits.

In 1997, we spent \$254 billion on the Department of Defense. In 2012, when we include war costs, we will spend about \$645 billion on the Department, which is down slightly from the peak in 2010.

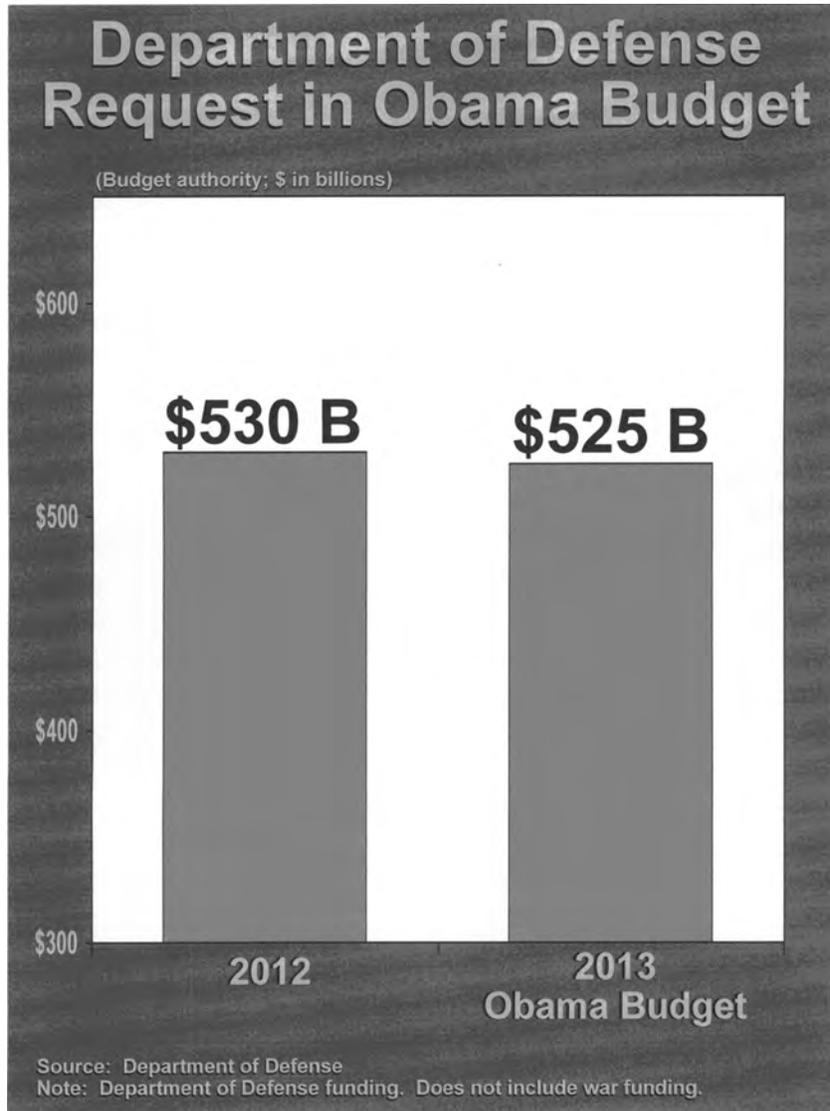
All of the decline from 2010 to 2012 came from a reduction in war costs. The core Department of Defense budget has been about flat since 2010 but remains at a very high level.



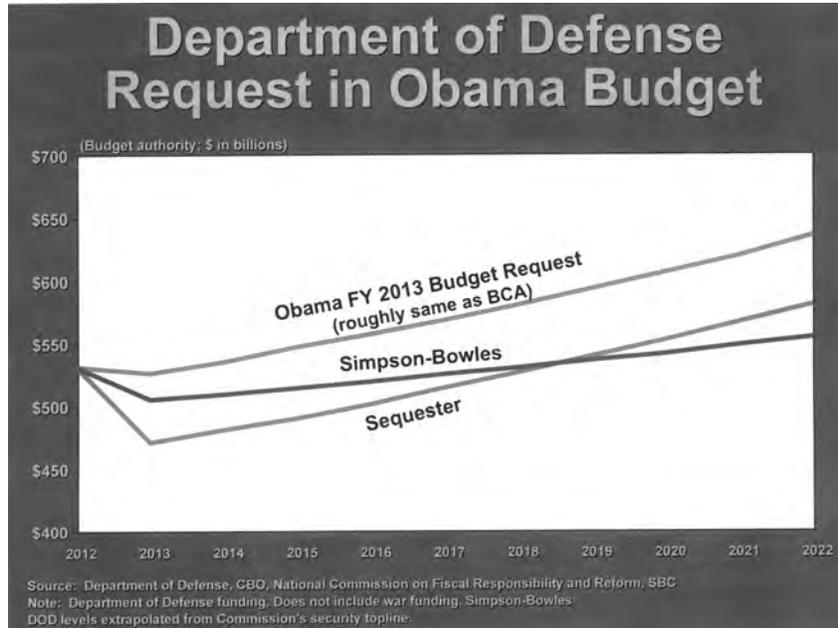
If we compare recent overall defense spending in budget function 050 to recent nondefense discretionary spending, we can see that overall defense funding has remained at about \$554 billion since 2010, not including war costs, while nondefense funding has fallen from \$540 billion to \$489 billion in 2012. So of the discretionary pot, basically defense is level, nondefense down slightly.



Looking forward, the President is proposing a small reduction in Department of Defense funding in 2013, bringing it down from \$530 billion in 2012 to \$525 billion in 2013.



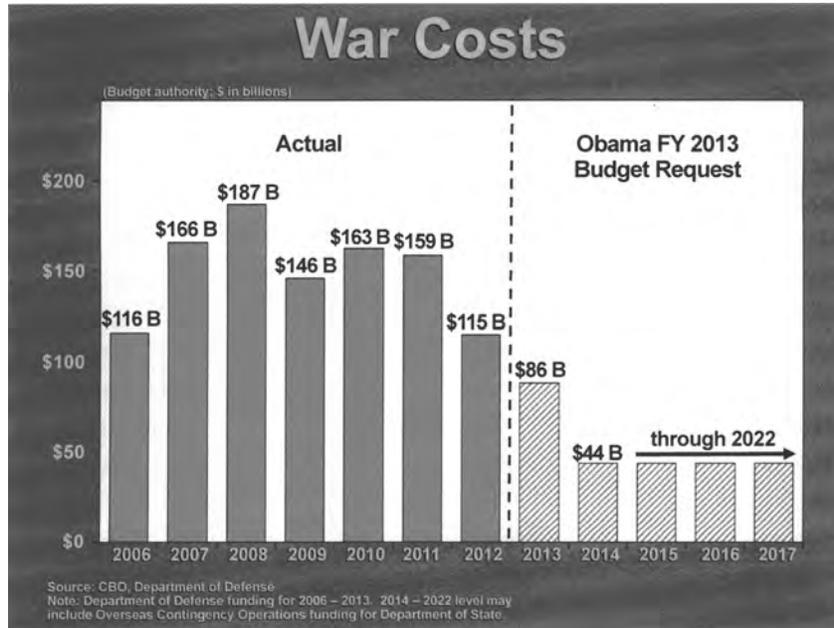
Over the next 10 years, the President's Department of Defense request would roughly match the levels set in the Budget Control Act, not including the sequester. As we can see from the blue line on this chart, the President's request would provide a steady increase in the defense budget from 2013 on. The red line on this chart shows what would happen to Department of Defense funding if the sequester were implemented. We would see a much steeper drop in 2013, but then steady growth after that. I believe the steep drop in 2013 required by a sequester would be a mistake, but I also believe further reductions beyond the Budget Control Act levels must be considered.



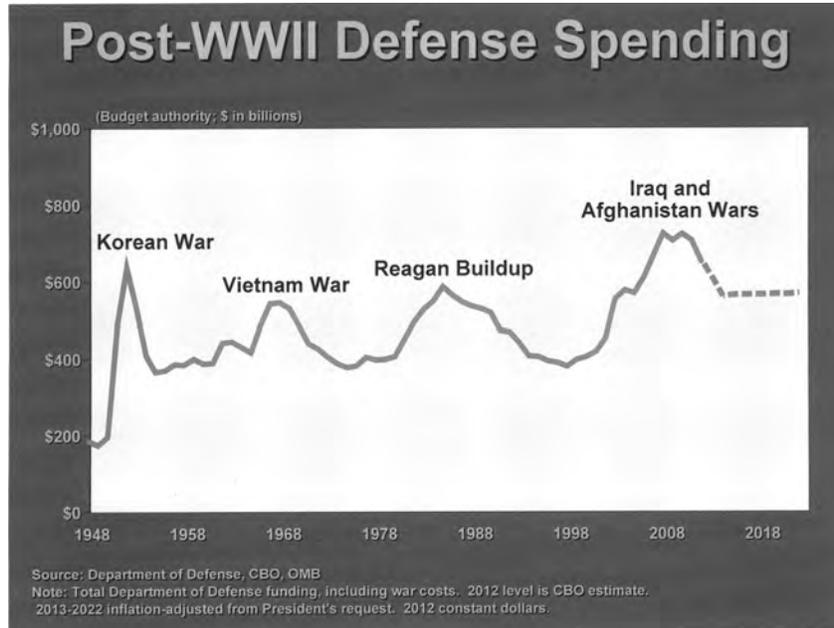
The green line represents the proposed Department of Defense funding under the so-called Simpson-Bowles plan, which would provide a smaller drop in 2013 than the sequester, but slower growth in funding after that.

Obviously, all of these have to be reviewed in light of the defense threat that we face at the time decisions are made. All of us understand budgets are taken at a point in time, and we all understand that there are threats facing this country that are unpredictable.

As I noted, war costs have started to come down. Overall war funding dropped from \$159 billion in 2011 to \$115 billion in 2012. The President's budget provides \$86 billion in 2013 for war costs and then includes a plug number of \$44 billion a year for the remainder of the 10 years.



This next chart puts our defense spending in a historical perspective. We can see that even with the drop in war costs included in the President's budget, defense spending would remain very high by historical standards, near the peaks of the Korean War, the Vietnam War, and the Reagan defense buildup during the Cold War. Defense spending came down more dramatically following those conflict periods.



Now, we all understand none of these periods can just be easily compared because we face a different threat environment now than we faced after those conflicts.

I want to conclude with a quote from the former Defense Secretary Robert Gates. In an interview on CBS' "60 Minutes" last year, he said this: "The budget of the Pentagon almost doubled during the last decade, but our capabilities did not particularly expand. A lot of that money went into infrastructure and overhead and, frankly, I think a culture that had an open checkbook."

## Former Defense Secretary Gates on Defense Funding

“...[T]he budget of the Pentagon almost doubled during the last decade. But our capabilities didn’t particularly expand. A lot of that money went into infrastructure and overhead and, frankly, I think a culture that had an open checkbook.”

—Former Secretary of Defense Robert Gates  
Interview on CBS’s *60 Minutes*  
May 15, 2011

Well, we cannot afford an open checkbook anymore. I recognize the administration has already taken steps to eliminate some inefficiencies in the Defense Department and to end some unnecessary or wasteful programs, and we applaud that. But we know that we are going to have to do more.

I have always been a very strong supporter of defense spending because I believe providing for the national defense is the Government’s core responsibility. And make no mistake, Congress will continue to provide our troops everything they need to complete the missions that they are assigned and to keep them safe.

And we have to, of course, recognize that we still face very serious potential new threats. I mentioned some earlier. I want to focus on Iran, Syria, the Middle East, Pakistan. These are all of deep concern to members of this Committee. I know they are of deep concern to you, Secretary Panetta, and your entire defense team.

But given the fiscal crisis that we confront, we are going to have to find more savings in the core defense budget. We cannot rely solely on declining war costs for savings, and we need to ensure that every dollar going to defense is essential to promoting the country’s national security.

With that, we will turn to Senator Sessions for his opening statement. Then we will go directly to the Secretary for his remarks, and then we will open it to questions.

### OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Mr. Chairman.

Secretary Panetta, we are honored to have you with us today. And, General Dempsey, it is a pleasure to see you again. I had the

opportunity and honor to visit you as you were deployed in Iraq on more than one occasion and to work with you in your new position here. Mr. Hale, we are delighted to have you.

America is blessed with the greatest military the world has ever seen. We must ensure that it remains so. I know you are honored, Mr. Secretary, to lead such a magnificent force. Defense is a core function of Government, and the continued dominance of our military deters threats and encourages peaceful resolution of conflict.

I fear, however, that the Budget hearing today may not be a good use of your time. The Senate Democratic leadership is refusing for the third straight year to bring a budget plan to the floor. Has the Democratic majority forgotten the warning that Admiral Mullen gave us, our former Chairman of the Joint Chiefs, who told us that the debt is the greatest threat to our national security? How will we be able to defend this country when we are broke?

General Dempsey, the sequester I know you feel is too draconian on the Defense Department. I agree. But it is a direct result of unsustainable debt, and it does threaten our national security if we do not break that cycle.

America leads the Western world in per person Government debt. Amazing. At \$44,000 for every man, woman, and child, America's per capita Government debt is worse than Greece. But the President has submitted a budget plan that will continue the unsustainable course and increase our gross Federal debt by another 75 percent over the next 10 years, from about \$15 trillion to \$26 trillion in 2022.

The President's budget also raises taxes by almost \$2 trillion, those taxes not to reduce the deficit but to pay for a \$1.6 trillion spending increase above that that we just projected above what we reduced spending just a few months ago. In other words, he is spending \$1.6 trillion more than the level we agreed to in the August debt deal.

Almost as shocking is the administration's unwillingness to tell the truth about our situation to the country. I sent a letter to the President's budget chief, Jeffrey Zients, asking him once again whether their budget plan increases spending relative to current law—a very simple question. I received a response last night that once again refused to answer this simple fact, this simple matter.

If the administration thinks they can sweep this under the rug, they are wrong. Congress and the White House committed \$2.1 trillion in spending reductions, about a 3-percent reduction in the expected growth, not a reduction in spending but a reduction in expected growth over the next 10 years, resulting in \$45.5 trillion spending through 2022, total spending. This is the new ceiling on how much we can spend and the starting point for much needed reductions.

Now, after just a few months, the President is proposing abandoning even those small cuts. This does not mean we should not reorganize where the initial \$2.1 trillion in cuts falls. Under the Budget Control Act, the defense spending—one-sixth of the budget defense spending is—we will experience a 20-percent reduction in real dollars over 10 years. If this sequester stays in real adjusted-for-inflation dollars, the Defense Department will take a 20-percent reduction over the President's budget over 10 years. Nondefense

spending, the other five-sixths of the budget, will experience a 50-percent real-dollar increase over that same 10-year period.

So it is critical that we reorganize the Budget Control Act, but also we must not reduce the size of the total cut we promised the country just a few months ago, thereby increasing spending over the modest reduction that was agreed to. Instead, we should be taking thoughtful actions to place this Nation on a sound fiscal path. The first step in the process is to dispense with some common myths about the defense budget.

Senator Conrad made some points, and they provide insight. I would like to provide some points that I think also provide insight into where we are.

Myth one: The defense spending is at an all-time high. The truth: During the war on terror, it has averaged about 4 percent of GDP, around half the post-World War II average. Fifty years ago, national defense made up 48 percent of the budget while entitlement spending accounted for 26 percent. Next year, entitlements will be 60 percent and defense will amount to 19 percent of the total budget.

Myth two: We can balance the budget by steep cuts to the Pentagon. The truth: Over time, entitlement obligations will consume an ever larger share of Federal spending. In 2030, amazingly—this is just 8 years outside our budget window. In 2030, entitlement obligations will be as much as 6 times greater than defense spending, rising from there. Even eliminating defense in its entirety would not come close to balancing the budget if you eliminated it entirely.

Myth three: Defense spending has seen the fastest growth of any item in our budget. The truth: While the Pentagon's base budget has increased 10 percent since 2008, 3 years—it has increased 3 percent a year—nondefense discretionary spending increased 24 percent, not counting the stimulus, during just the first 2 years of President Obama's Presidency. So the cuts that showed in the non-defense discretionary are impacted, the part of the Budget Control Act agreement that are projected out there, but it is from accelerated levels of spending that surge.

Over the last 3 years, Medicaid has increased 37 percent while the Defense Department has increased 10 percent. Spending at the Department of Education grew 70 percent over 2009 through 2011 compared to the previous 3 years of education spending. Food stamps have seen a 300-percent increase since 2001.

Myth four: The wars in Iraq and Afghanistan have been leading contributors to the deficit. While the war on terrorism has imposed substantial costs, this year's deficit alone, \$1.3 trillion, equals the entire cost of the wars in Afghanistan and Iraq. War spending represents only 4 percent of the total Government outlays in the last 10 years.

So I share these numbers because it is essential that Washington engage in fact-based budgeting. Every department, every agency, every part of Government will have to experience reductions, including defense. I know you are working on that now, and it is a very important priority for

you and for the United States Congress.

But these decisions should be guided by an honest assessment of facts, and the fact is that the only thing the President seems will-

ing to cut significantly is defense. The rest of the budget will continue to surge out of control. By the year 2030, nearly every penny of revenue the Government receives will go to the entitlement and interest payments, leaving no money outstanding for defense, education, highway, and other matters.

So we should chart a different course: Control the growth of Government and empower the private sector and maintain a strong, cost-effective national defense. If we do this, we will create growth, good-paying jobs, reduce surging health care and energy costs, and pass a better future to our children.

Thank you, gentlemen, for your service to your country, and I look forward to an important discussion today.

Chairman CONRAD. Let me just say, in the interest of, I think, providing balance, I agree with many of Senator Sessions' observations. I think that was very useful; going through some of the things that people think about defense spending and providing an additional perspective, I think that was very useful. But I think we should also remind ourselves the Budget Control Act passed Congress. We all voted for it to have almost \$500 billion of savings out of defense. That was passed in the Budget Control Act. I understand some did not vote for it, but the fact is the vast majority of the Senate did: 74 votes in the Senate for that. The House passed it. It was signed by the President.

The Budget Control Act also provided for special powers to the special committee to deal with entitlements, to deal with revenue. They did not succeed.

So that leaves us with the sequester, which was also passed as part of the Budget Control Act, that says we have to cut an additional, General Dempsey tells me, \$535 billion, or roughly that amount, over the next 10 years on top of the other almost \$500 billion of savings out of defense.

The other thing I think we should remind ourselves is when we talk about cuts in Washington, cuts relate to a baseline. I think this is sort of the point that you were—part of the point that you were getting at, Senator Sessions. Cuts relate to a baseline. A baseline is inflated by historic experience. And so, I think most people, when they think about cuts, think that you are going to get less money than you got the year before. Other than this next year, what we are seeing is increases are being slowed, increases in spending being slowed rather than actually getting less money than you got the year before.

Now, in the case of defense, for the next year we actually do see a \$5 billion reduction in the President's proposal, \$5 billion less than they got the previous year.

So, with that, Mr. Secretary, welcome back to the budget wars. I know you have spent a lot of time in this room. I have spent a lot of time in this room. I do not think anybody has given more distinguished service to this country in so many different roles than have you. I think you were outstanding as the Chairman of the House Budget Committee. You were outstanding at the Office of Management and Budget. You were outstanding as the President's Chief of Staff, President Clinton, played a key role in getting us to balanced budgets in those days—the last time we have had any balanced budgets around here was when you were at the helm and

I was a very willing ally in your efforts—and then at the CIA where you did really such an outstanding job and now here. We have a lot of confidence in you, but we also know you have tremendous challenges facing you. Please proceed.

Senator SESSIONS. Mr. Chairman, just if you would not mind, I think you gave a nice summary of what the situation is that we are facing. The Defense Department is looking at almost \$500 billion in cuts. They are working hard to achieve that. They saluted, yes, sir, we are going to do this. And that would put you in the leading part of the entire Government in reducing spending.

However, the sequester, the language that was put in at the last minute without any real debate, driven by the President, I guess, the Democratic negotiators, added another \$500 billion in cuts, as you noted, to it. It is that cut that I think is risky, and I believe the Secretary believes it would be devastating, as he said, to the defense budget.

And what I would say is we agreed to the cuts. There was really no debate about where they would occur. I just truly believe that we should not give those up and say just because they cannot be placed additionally on the Defense Department that the remaining five-sixths of the Government—about half of it totally protected from any cuts—I do think we need to look at maintaining the level of spending we agreed to in the Budget Control Act and not back away from that.

So maybe we are in agreement, maybe we are not, but I see that as the challenge we face today.

Chairman CONRAD. You know, I think, Senator Sessions, you and I, we may not be in agreement exactly how to accomplish it, but I think we are very much in agreement that we have to maintain that level of savings. We have to find that level of savings.

All right. Mr. Secretary, please proceed.

**STATEMENT OF THE HONORABLE LEON E. PANETTA, SECRETARY, U.S. DEPARTMENT OF DEFENSE, ACCOMPANIED BY ROBERT F. HALE, UNDER SECRETARY OF DEFENSE (CONTROLLER), AND CHIEF FINANCIAL OFFICER, U.S. DEPARTMENT OF DEFENSE**

Secretary Panetta. Mr. Chairman, Senator Sessions, members of the Committee, I want to thank you for the opportunity to have a chance to appear before you to discuss the President's budget request for fiscal year 2013 for the Department of Defense.

As pointed out, as a former Chairman of the House Budget Committee and a former OMB Director, I have a very deep appreciation for the important role that is played by this Committee, having spent a lot of time in this room on budget conferences over the years. And your basic role is to try to achieve fiscal discipline and help set the Government's overall spending priorities.

As you know and as you pointed out, Mr. Chairman, I had the honor of working on most of the budget summits and proposals during the 1980s and 1990s that ultimately helped produce a balanced Federal budget. Believe me, I know firsthand what a very tough and critical job you have, particularly given the size of the deficits that, unfortunately, face our country again.

It is no surprise that there is a vigorous debate in Washington about what steps should be taken to try to confront these challenges. We went through many of the same debates in the 1980s and the 1990s. Thankfully, the leadership of both parties were willing to make the very difficult decisions that had to be made in order to reduce the deficit.

Today you face the same difficult choices, and while I understand the differences, there should be consensus on one thing: that the leaders of both the legislative and executive branches of Government have a duty to protect both our national and fiscal security. I know that as elected Members of Congress, particularly the members of this Committee, you take that duty seriously, as I do as Secretary of Defense.

I do not believe, I fundamentally do not believe that we have to choose between fiscal discipline and national security. I believe we can maintain the strongest military in the world and be part of a comprehensive solution to deficit reduction. The defense budget that we present to the Congress and the Nation seeks to achieve those goals.

The fiscal year budget request for the Department of Defense was the product of a very intensive strategy review conducted by senior military and civilian leaders of the Department under the advice and guidance of the President. The reasons for this review are clear: First, we are at a strategic turning point after a decade of war and after substantial growth in defense budgets. And, second, Congress did pass the Budget Control Act of 2011, imposing spending limits that reduced the defense base budget by \$487 billion over the next decade.

We made the decision that the fiscal situation that was presented to us also gave us the opportunity to establish a new defense strategy for the future. We developed a strategic guidance before making any budget decisions to make sure that budget choices reflected the new strategy. We were driven by strategy, not simply by budget reductions. We agreed that we are at a key inflection point. The military mission in Iraq has ended. We are still in a very tough fight in Afghanistan, but 2011 did mark significant progress in trying to reduce violence and transitioning to an Afghan-led responsibility, and we and our NATO allies have made a strong commitment to continue this transition through the end of 2014.

Last year, there were successful NATO operations that led to the fall of Qadhafi, and we have had very targeted counterterrorism efforts that significantly weakened al Qaeda and decimated its leadership.

But even though we have had these successes, unlike past drawdowns when threats receded, we still face an array of security challenges. The Chairman referred to a number of those. We are still at war in Afghanistan; we still confront terrorism, if not in the Fatah, in Somalia, in Yemen, in North Africa, and elsewhere. There is still a proliferation of weapon of mass destruction in the world. Iran and North Korea continue to undermine stability in the world. There is continuing turmoil in the Middle East. Any one of those events in the Middle East could be thrust upon us in the future. There are rising powers in Asia and growing concerns about

cyber intrusions and attacks. We must meet these challenges, we must meet these threats if we are to protect the American people.

And at the same time as we try to protect the American people, we have a responsibility to fiscal discipline. This is not an easy task. We made the decision that we did not want to repeat the mistakes of the past. We have gone through drawdowns in the past in the defense budget. We decided to be guided by these guidelines:

Number one, we wanted to maintain the strongest military in the world.

Number two, we did not want to hollow out the force, and in the past when defense cuts were made across the board, in effect what you did was you weakened every area of defense, and that is what resulted in hollowing out the force.

To not have that happen, we have to take a balanced approach to budget cuts and look at every area in the defense budget and put everything on the table.

And, lastly, of course, we did not want to break faith with the troops and their families, those that have had to be deployed time and time and time again over 10 years of war.

The President's budget requests \$525.4 billion in fiscal year 2013 for our base budget and \$88.5 billion to support the war efforts. In order to be consistent with Title I of the Budget Control Act, our budget request had to be roughly \$45 billion less than we had anticipated under last year's budget plan. Over the next 5 years, defense spending will be \$259 billion less than planned for that we had in the fiscal year 2012 budget, a difference of nearly 9 percent. And over the 10 years starting in fiscal year 2012, it will be reduced by \$487 billion.

To meet these new budget targets and our national security responsibilities, we had to fundamentally reshape our defense spending priorities based on our new strategy.

The Department of Defense has stepped up to the plate to meet its responsibilities under the Budget Control Act, but with these record deficits, no budget can be balanced on the back of defense spending alone. For that matter, no budget can be balanced on the back of discretionary spending alone.

Based on my own budget experience, I strongly believe that all areas of the Federal budget must be put on the table, not just discretionary but mandatory spending and revenues. That is the responsible way to reduce deficits and the responsible way to avoid sequester provisions contained in Title III of the Budget Control Act. The sequester meat ax, as pointed out, would cut another roughly \$500 billion over the next 9 years. These cuts would, in fact, hollow out the force and inflict severe damage to our national defense.

The President's budget does put forward a plan to try to avert sequestration and reduce deficits by \$4.3 trillion over the next decade. Whether you agree or disagree with these proposals, I encourage this Committee to look closely at the President's approach and to hopefully adopt a large balanced package of savings that de-trigger sequestration, reduce the deficit, and maintain the strongest national defense in the world.

The \$487 billion in 10 years savings that we have proposed come from four areas of the defense budget: efficiencies, force structure

reductions, procurement adjustments, and compensation. Let me, if I can, summarize each of those areas.

First of all, efficiencies, more disciplined use of defense dollars. On top of the \$150 billion in efficiencies that were proposed by my predecessor as part of the fiscal year 2012 budget, we added another \$60 billion, primarily from streamlining support functions, consolidating IT enterprises, re-phasing military construction programs, consolidating inventory, and reducing service support contractors. As we reduce force structure, something that Secretary Gates pointed out has increased as a result of large budgets over the last 10 years, we have a responsibility to provide the most cost-efficient support for the force that we are going to need. For that reason, the President will request the Congress to authorize the Base Realignment and Closure process for 2013 and 2015.

Now, look, as somebody who has been through the BRAC process and I had it happen in my district in California; we lost Fort Ord, the Fort Ord Reservation, which constituted 25 percent of our local economy. So I have been through BRAC. I know what it means and the impact it has on people as well as your local communities. At the same time, I do not know of any other effective way to achieve infrastructure savings in the long term, and that is the reason we ask you to consider that.

Achieving audit readiness is another key initiative that will help the Department achieve greater discipline in the use of defense dollars. As I have directed the Department to achieve audit readiness by the end of calendar year 2014.

But efficiencies are not enough to achieve the necessary savings that were mandated. Budget reductions of this magnitude require significant adjustments to force structure, to procurement investments, and, yes, to compensation. The choices we made reflected five key elements of the defense strategic guidance that we developed at the Department with the support of the Service Chiefs, the Under Secretaries, and the Secretaries.

Let me describe the key elements of that strategy and the decisions that followed—some of the decisions.

One, the force of the future will be smaller and it will be leaner. That is a fact. But at the same time, it should be agile, it should be flexible, it should be ready, and it should be technologically advanced. We knew coming out of these wars that the military would be smaller. We would be doing a drawdown in the military.

But in order to ensure an agile force, we made a conscious choice not to maintain more force structure than we could afford to properly train and properly equip. We are implementing force structure reductions consistent with the new strategic guidance for a total savings of about \$50 billion over the next 5 years. We are gradually resizing the active army. We are going from 562,000 to 490,000 by 2017. That is a level that is slightly higher than where we were prior to 9/11. We are doing the same thing with the Marine Corps, going from about 202,000 to 182,000 marines by 2017.

We are reducing and streamlining the Air Force's airlift fleet. In addition, the Air Force will eliminate seven tactical air squadrons but retain a robust force of about 54 combat fighter squadrons and enough to, obviously, maintain air superiority and strategic airlift that we need.

The Navy, while it will maintain and protect some of our highest-priority and most flexible ships, it will retire seven lower-priority Navy cruisers that have not been upgraded with ballistic missile defense capability.

The second area in our strategy was that we wanted to rebalance our global posture to focus on emphasizing Asia-Pacific and the Middle East. Those are the two areas where obviously we could confront challenges in the future.

The strategic guidance made clear that we have to do everything to project power in the Asia-Pacific region and in the Middle East. So to this end, the budget does maintain our current bomber fleet. It maintains our aircraft carrier fleet. It maintains the big-deck amphibious fleet that we need. And we do enhance our Army and Marine Corps force structure presence both in the Pacific as well as in the Middle East.

Thirdly, we have to with our responsibilities elsewhere in the world as well, so to do that, we recommend building innovative partnerships and strengthening key alliances and partnerships in Europe, in Latin America, and in Africa. This strategy makes clear that even though Asia-Pacific and the Middle East represent areas of growing strategic priority, the United States must work to strengthen its key alliances, to build partnerships, and one of the things we are doing and recommending is the development of innovative ways to have rotational deployments by the Army, by the Marines, and by Special Operations to sustain a U.S. presence elsewhere in the world.

Fourthly, we wanted to ensure, as we must, that we can confront and defeat aggression from any adversary anytime, anywhere. This fourth area means that we have to have the capability to defeat more than one enemy at a time. In the 21st century, we have to recognize that our adversaries are going to come at us using 21st century technology. This is the world we live in, and we have to be able to respond with 21st century technology as well. So we must invest in space, in cyberspace, in long-range precision strike capabilities, and in special operations forces to ensure that we can still confront and defeat multiple adversaries even with the force structure reductions that I outlined earlier.

Even with some adjustments to force structure, this budget sustains a military that is the strongest in the world, that is capable of quickly and decisively confronting aggression wherever and whenever necessary.

And, lastly, our strategy was to protect and prioritize key investments. This cannot just be about cuts. It has to be in what do we want to invest in for the future and our capacity to be able to grow, to adapt, and to mobilize. So we have made recommendations to invest in science and technology and basic research, in special operations forces and unmanned air systems, and in cyber. At the same time, we recognize that we have to be able to look at our modernization needs and make decisions about those that can be delayed. This budget identifies about \$75 billion in savings resulting from canceled or restructured programs. They include \$15.1 billion from restructuring the Joint Strike Fighter, \$13.1 billion by stretching investment in the procurement of ships, \$2.5 billion from terminating what we considered one expensive version of the Glob-

al Hawk, \$2.3 billion from terminating a redundant weather satellite program.

The key to this strategy is making sure that as we do this we maintain a very strong Reserve and a strong National Guard. They have been one of the very important factors in our ability to conduct war over the last 10 years. The National Guard and the Reserve have fought right alongside the active duty, and they have done a great job. They have gained tremendous experience. I want to be able to maintain that for the future so that we can mobilize quickly if we have to, and I also want to maintain a strong and flexible industrial base.

Finally, the most fundamental element of our strategy and our decision-making process is not our technology or our weapons systems or our force structure. It is our people. They, far more than any weapons system or technology, are the great strength of our military. We are determined to sustain the programs that help our families, that help the troops, that help our wounded warriors and that meet their needs. And yet to build the force needed to defend this country under existing budget constraints, cost growth in military pay and benefits has to be put on a sustainable course.

That part of the defense budget, by the way, has grown by nearly 90 percent since 2001. So for that reason, we felt an obligation to look at how could we control costs in this area.

Well, on military pay there are no pay cuts, and we will provide pay raises these next 2 years. We will try to limit those pay raises in the out-years. We have also looked at ways to try to increase fees to pay for TRICARE costs. Health care in the military is costing me close to \$50 billion right now. There have to be ways to try to control those costs as well.

And as we have recommended a retirement commission to look at that area for savings, although we do want to grandfather those that are serving so that they do not lose the retirement benefits that were promised to them.

So that, in summary, is the package. This has not been easy. This is a tough process, and obviously we need your support to review the proposals we have made and to give us your best guidance as well. I am a believer, as someone who comes from the Congress, that we need your partnership in order to try to implement this strategy. And as this Committee in particular, this is a zero-sum game. If you are going to restore cuts, you have to find places to cut it. And there is a very narrow margin here for mistakes. If you are going to restore funding in one area, then you have to cut more in force structure. If you are going to restore compensation, you have to cut more in weapons systems. That is the process we went through.

Also, make no mistake. There is no way I can reduce the defense budget by half a trillion dollars and not have it impact on all 50 States. That is a reality. In addition to that, I cannot reduce the budget by half a trillion dollars and, frankly, not increase risk. The bottom line is we think these are acceptable risks, but there are risks. We are going to have a smaller force. We are going to depend on mobilization. We are going to depend on the development of new technologies. But we have to meet the needs of troops as they return home, find jobs, find support systems in their communities.

So as I said, there is no margin for error here, but Congress mandated, as has been pointed out, on a bipartisan basis that we reduce the defense budget by \$487 billion, and that is what we have done. In many ways, this is going to be a test. Everybody talks a good game about deficit reduction. Everybody talks about cutting costs. This is a test of whether or not this is about talk or about action and whether or not we do this right or whether we walk away from that responsibility.

Mr. Chairman and members of the Committee, as a former member and Chairman of the Budget Committee, this Committee must never cease being the conscience of the Congress when it comes to fiscal responsibility and doing what is right for this Nation. I look forward to working with all of you closely in the months ahead to do what the American people expect of their leaders: to be fiscally responsible in developing the force of the future, a force that can defend the country, a force that will support our men and women in uniform, but, more importantly, a force that is and always will be the strongest military in the world.

Thank you, Mr. Chairman.

[The prepared statement of Secretary Panetta follows:]

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**SECRETARY OF DEFENSE LEON E. PANETTA  
DEFENSE BUDGET REQUEST – SUBMITTED STATEMENT  
SENATE BUDGET COMMITTEE  
TUESDAY, FEBRUARY 28, 2012**

Chairman Conrad, Senator Sessions, members of the committee. Thank you for the opportunity to appear before you to discuss the President's budget request for Fiscal Year 2013 (FY13) for the Department of Defense.

As a former Chairman of the House Budget Committee and Director of the Office of Management and Budget, I have a deep appreciation for the important role played by this committee in helping set the federal government's overall spending priorities. It is a tough job, but it is a critical responsibility, particularly given the significant challenges we are facing as a country. Our economy is still recovering from an historic recession. We are grappling with very large debt and deficits that over the long-term threaten our nation's fiscal solvency. Meanwhile, we remain a nation at war, and we are confronting a complex range of security challenges that threaten global stability and our homeland.

I recognize that there are vigorous debates in Washington about the proper role of government in confronting these challenges. But if there is consensus on one thing, it is that one of the fundamental duties of the federal government is to protect our national security. This is a responsibility for both political parties, and all branches of government. And I know that as members of Congress you take this duty as seriously as I do as Secretary of Defense.

In order to protect our national security, I believe that we must maintain the strongest military in the world, and I am committed to sustaining our military strength as Secretary of Defense. But that is not enough. Our national security also depends on strong diplomacy, it also requires strong intelligence efforts. Above all, protecting the nation requires a strong economy, fiscal discipline and effective government.

As someone with a lifetime of experience developing and implementing budgets, I do not believe that we must choose between fiscal discipline and national security. I believe we can maintain the strongest military in the world, and be part of a comprehensive solution to deficit reduction.

**Defense Strategy Review**

We were able to achieve that balance because the FY13 budget request for the Department of Defense was the product of an intensive strategy review conducted by the senior military and civilian leaders of the Department under the advice and guidance of President Obama. The reasons for this review are clear: first, the United States is at a strategic turning point after a decade of war and substantial growth in defense budgets. Second, given the size of our debt and deficits, Congress passed the Budget Control Act of 2011, imposing limits that led to a reduction in the defense base budget of \$487 billion over the next decade.

We at the Department decided that the fiscal situation presented us with the opportunity to establish a new strategy for the force of the future, and that strategy has guided us in making the decisions contained in the President's budget. These decisions reflect the fact that we are at an important turning point that would have required us to make a strategic shift under any circumstances. The U.S. military's mission in Iraq has ended. We still have a tough fight on our hands in Afghanistan, but 2011 marked significant progress in reducing violence and

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transitioning to Afghan-led responsibility for security – and we are on track to complete that transition by the end of 2014, in accordance with our Lisbon commitments. Last year, the NATO effort in Libya also concluded with the fall of Qadhafi. And successful counterterrorism efforts have significantly weakened al-Qaeda and decimated its leadership.

But despite what we have been able to achieve, unlike past drawdowns when threats have receded, the United States still faces a complex array of security challenges across the globe: We are still a nation at war in Afghanistan; we still face threats from terrorism; there is dangerous proliferation of lethal weapons and materials; the behavior of Iran and North Korea threaten global stability; there is continuing turmoil and unrest in the Middle East; rising powers in Asia are testing international relationships; and there are growing concerns about cyber intrusions and attacks. Our job is to meet these challenges and at the same time, meet our responsibility to fiscal discipline. This is not an easy task, but is one that I believe is within our grasp if we all do our part for the American people.

To build the force we need for the future, we developed new strategic guidance that consists of five key elements:

- First, the military will be smaller and leaner, but it will be agile, flexible, ready and technologically advanced.
- Second, we will rebalance our global posture and presence to emphasize Asia-Pacific and the Middle East.
- Third, we will build innovative partnerships and strengthen key alliances and partnerships elsewhere in the world.
- Fourth, we will ensure that we can quickly confront and defeat aggression from any adversary – anytime, anywhere.
- Fifth, we will protect and prioritize key investments in technology and new capabilities, as well as our capacity to grow, adapt and mobilize as needed.

#### **Strategy to FY13 Budget**

We developed this new strategic guidance before any final budget decisions were made to ensure that the budget choices reflected the new defense strategy.

While shaping this strategy, we did not want to repeat the mistakes of the past. Our goals were: to maintain the strongest military in the world, to not “hollow out” the force, to take a balanced approach to budget cuts, to put everything on the table, and to not break faith with troops and their families. Throughout the review we also made sure this was an inclusive process. General Dempsey and I worked closely with the leadership of the Services and Combatant Commanders, and consulted regularly with members of Congress.

As a result of these efforts, the Department is strongly united behind the President’s budget request for fiscal 2013, and the Future Years Defense Plan.

#### **Defense Topline**

The President’s budget requests \$525.4 billion in FY13 for the base budget of the Department of Defense and \$88.5 billion to support the war efforts. In order to be consistent with Title I of the Budget Control Act, our FY13 base budget request had to be roughly \$45 billion less than we had anticipated it would be under last year’s budget plan. Over the next five years, defense spending under the FY13 budget will be \$259 billion less than we had planned for

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in the FY12 budget – a difference of nearly nine percent. Over the ten years starting in FY12, it will be reduced by \$487 billion. This represents a significant change to our defense spending plans, and in order to meet these new budget targets and our national security responsibilities, we had to fundamentally reshape our defense spending priorities, based on our new defense strategy.

Whereas under last year's budget we had planned for several years of modest real growth in the defense base budget, the \$525.4 billion base budget request for FY13 represents a decline of more than two percent over last year's enacted level in real dollar terms.

At the same time, we expect total defense spending, which includes war-related costs, to be reduced significantly over the next five years. Given the drawdown in Iraq and the ongoing transition in Afghanistan, funding requests for overseas contingency operations have already begun to decrease sharply. After adjustment for inflation, we expect total defense spending to be down by more than 20 percent, mostly because of the drop in war costs. This decline is roughly consistent with the size of the drawdowns after Vietnam and the Cold War – although we are determined to implement these reductions in a manner that avoids a hollow force and other mistakes of the past.

While the defense base budget will not be significantly reduced over the next five years – in fact, it will remain above 2008 levels after adjusting for inflation – the Department has historically required modest real growth in force structure and modernization accounts in order to maintain our force structure without hollowing out the force. That means that even with a defense base budget that is roughly flat in real dollar terms, we will have to get smaller in order to maintain a ready, agile, and deployable force.

I believe that this pattern of defense investment is both appropriate and sustainable within the overall federal budget. Spending on the defense base budget has increased by about 30 percent in real terms since 2001, and by fiscal 2013, it will make up 45 percent of all Federal discretionary budget authority. That said, the defense base budget will represent only 3.2 percent of GDP in 2013 – and as our economy continues to grow, we project that percentage will fall to 2.8 percent by 2017.

Ultimately, we need to base our investment in national defense not on numbers but on strategy, and a clear-eyed assessment of the risks and threats that exist to our national security. Given the complex and dangerous world we continue to inhabit, the President's proposal for spending on the defense base budget represents the investment we need to provide an adequate defense for the nation.

There is no doubt that our budget deficits are too high and that, as the economy recovers, we need to reduce deficits in order to strengthen our long-term economic outlook and protect our national security. The Department of Defense has stepped up to the plate with its share of the cuts needed to meet the original caps enacted under the Budget Control Act. But with these record deficits, no budget can be balanced on the back of discretionary spending alone.

Based on my own budget experience, I strongly believe that Congress and the Administration need to put all areas of the federal budget on the table and work together to achieve sufficient deficit reduction, in a balanced way, to avoid the sequester provisions contained in Title III of the Budget Control Act. Sequester would subject the Department to another roughly \$500 billion in additional cuts over the next nine years, and in FY13, these cuts would have to be implemented with limited flexibility. These changes could hollow out the force and inflict severe damage to our national defense and programs that are vital to our quality of life.

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I understand that sequester is designed to force the Congress to confront the hard choices that must be made in any serious effort to deal with the deficit. We all recognize what those hard choices are. They involve dealing with mandatory spending, which represent almost two-thirds of the federal budget, and additional revenues. It's a matter of simple arithmetic that discretionary spending, which accounts for only one-third of the federal budget, cannot be expected to contribute 100 percent to our deficit reduction efforts.

History has made clear that real deficit reduction only happens when everything is on the table – discretionary, mandatory spending, and revenues. That has been true for every major deficit reduction plan enacted by the Congress in recent history.

We still have time to avert sequestration, and the President's FY13 budget represents a path to doing so. The President's FY13 budget proposes a balanced plan to produce about \$4 trillion in savings, including the \$1.0 trillion in deficit reduction already generated by the Budget Control Act's discretionary caps. The President's plan would add mandatory savings and revenue increases to the already enacted discretionary cuts. If enacted, this proposal would provide a basis for halting sequestration, while ensuring the maintenance of a strong national defense.

#### **Accommodating Defense Budget Cuts**

Let me turn now to the changes we made to accommodate the reductions required to be consistent with the Budget Control Act. I believe that these changes offer convincing evidence that we have made tough choices in the Department of Defense, and that we are doing our part to help achieve the national security imperative of deficit reduction while making decisions that fit within our overall defense strategy.

The \$259 billion in five year savings from defense that are part of this plan come from three broad areas:

- First, efficiencies – we redoubled efforts to make more disciplined use of taxpayer dollars, yielding about one quarter of the target savings;
- Second, force structure and procurement adjustments – we made strategy-driven changes in force structure and procurement programs, achieving roughly half of the savings;
- Finally, compensation – we made modest but important adjustments in personnel costs to achieve some necessary cost savings in this area, which represents one third of the budget but accounted for a little more than 10 percent of the total reduction.

The remaining reductions reflect economic changes and other shifts. Let me walk through these three areas, beginning with our efforts to discipline our use of defense dollars.

#### **More Disciplined Use of Defense Dollars**

If we are to tighten up the force, I felt we have to begin by tightening up the operations of the Department. This budget continues efforts to reduce excess overhead, eliminate waste, and improve business practices across the department. The more savings realized in this area, the less spending reductions required for modernization programs, force structure, and military compensation.

As you know, the FY12 budget proposed more than \$150 billion in efficiencies between FY 2012 and FY 2016, and we continue to implement those changes. This budget identifies

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about \$60 billion in additional savings over five years. Across the military services, new efficiency efforts over the next five years include:

- The Army proposes to save \$18.6 billion through measures such as streamlining support functions, consolidating IT enterprise services, and rephasing military construction projects;
- The Navy proposes to save \$5.7 billion by implementing strategic sourcing of commodities and services, consolidating inventory, and other measures;
- The Air Force proposes to save \$6.6 billion by reducing service support contractors and rephasing military construction projects;

Other proposed DoD-wide efficiency savings over the next five years total \$30.1 billion, including reductions in expenses in the Office of the Secretary of Defense and the Defense Agencies.

As part of these initiatives, we are continuing the initiative to improve the Department's buying power by seeking greater efficiency and productivity in the acquisition of goods and services. We are strengthening acquisition support to the warfighter, executing acquisitions more efficiently, preserving the industrial base, and strengthening the acquisition workforce. This budget assumes that these policies produce savings of \$5.3 billion over the next five years.

In terms of military infrastructure, we will need to ensure that our current basing and infrastructure requirements do not divert resources from badly needed capabilities.

As we reduce force structure, we have a responsibility to provide the most cost efficient support for the force. For that reason, the President will request that Congress authorize the Base Realignment and Closure process for 2013 and 2015. As someone who went through BRAC, I realize how controversial this process can be for members and constituencies. And yet, it is the only effective way to achieve infrastructure savings.

Achieving audit readiness is another key initiative that will help the Department achieve greater discipline in its use of defense dollars. The Department needs auditable financial statements to comply with the law, to strengthen its own internal processes, and to reassure the public that it continues to be a good steward of federal funds. In October 2011, I directed the Department to emphasize this initiative and accelerate efforts to achieve fully auditable financial statements. Among other specific goals, I directed the Department achieve audit readiness of the Statement of Budgetary Resources for general funds by the end of calendar year 2014, and to meet the legal requirements to achieve full audit readiness for all Defense Department financial statements by 2017. We are also implementing a course-based certification program for defense financial managers in order to improve training in audit readiness and other areas, with pilot programs beginning this year. We now have a plan in place to meet these deadlines, including specific goals, financial resources, and a governance structure.

These are all critically important efforts to ensure the Department operates in the most efficient manner possible. Together, these initiatives will help ensure the Department can preserve funding for the force structure and modernization needed to support the missions of our force.

#### **Strategy-driven Changes in Force Structure and Programs**

But it is obvious that efficiencies are not enough to achieve the required savings. Budget reductions of this magnitude require significant adjustments to force structure and procurement

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investments. The choices we made reflected five key elements of the defense strategic guidance and vision for the military.

*1. Build a force that is smaller and leaner, but agile, flexible, ready and technologically advanced*

We knew that coming out of the wars, the military would be smaller. But to ensure an agile force, we made a conscious choice not to maintain more force structure than we could afford to properly train and equip. We are implementing force structure reductions consistent with the new strategic guidance for a total savings of about \$50 billion over the next five years.

These adjustments include:

- Gradually resizing the active Army to 490,000 soldiers;
- Gradually resizing the active Marine Corps to 182,100 Marines;
- Reducing and streamlining the Air Force's airlift fleet. The Air Force will maintain a fleet of 275 strategic airlifters and 318 C-130s – a fleet more than capable of meeting the airlift requirements of the new strategy. In addition, the Air Force will eliminate seven Tactical Air squadrons but retain a robust force of 54 combat-coded fighter squadrons, maintaining the capabilities and capacity needed to meet the new strategic guidance;
- The Navy will retire seven lower priority Navy cruisers that have not been upgraded with ballistic missile defense capability or that would require significant repairs, as well as two dock landing ships.

*2. Rebalance global posture and presence to emphasize Asia-Pacific and the Middle East*

The strategic guidance made clear that we must protect capabilities needed to project power in Asia-Pacific and the Middle East. To this end, this budget:

- Maintains the current bomber fleet;
- Maintains the aircraft carrier fleet at a long-term level of 11 ships and 10 air wings;
- Maintains the big-deck amphibious fleet;
- Restores Army and Marine Corps force structure in the Pacific after the drawdown from Iraq and as we drawdown in Afghanistan, while maintaining a strong presence in the Middle East.

The budget also makes selected new investments to ensure we develop new capabilities needed to maintain our military's continued freedom of action in face of new challenges that could restrict our ability to project power in key territories and domains.

Other key power projection investments in FY13 include:

- \$300 million to fund the next generation Air Force bomber (and a total of \$6.3 billion over the next five years);
- \$1.8 billion to develop the new Air Force tanker;
- \$18.2 billion for the procurement of 10 new warships, including two Virginia-class submarines, two Aegis-class destroyers, four Littoral Combat Ships, one Joint High Speed Vessel, and one CVN-21-class aircraft carrier. We are also investing \$100 million to increase cruise missile capacity of future Virginia-class submarines;

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*3. Build innovative partnerships and strengthen key alliances and partnerships*

The strategy makes clear that even though Asia-Pacific and the Middle East represent the areas of growing strategic priority, the United States will work to strengthen its key alliances, to build partnerships and to develop innovative ways such as rotational deployments to sustain U.S. presence elsewhere in the world.

To that end, this budget makes key investments in NATO and other partnership programs, including \$200 million in FY13 and nearly \$900 million over the next five years in the NATO Alliance Ground Surveillance system.

The new strategy also envisions a series of organizational changes that will boost efforts to partner with other militaries. These include allocating a U.S.-based brigade to the NATO Response Force and rotating U.S.-based units to Europe for training and exercises; and increasing opportunities for Special Operations Forces to advise and assist partners in other regions.

*4. Ensure that we can confront and defeat aggression from any adversary – anytime, anywhere*

This budget invests in space, cyberspace, long range precision-strike and the continued growth of special operations forces to ensure that we can still confront and defeat multiple adversaries even with the force structure reductions outlined earlier. It also sustains the nuclear triad of bombers, missiles and submarines to ensure we continue to have a safe, reliable and effective nuclear deterrent.

Even with some adjustments to force structure, this budget sustains a military that is the strongest in the world, capable of quickly and decisively confronting aggression wherever and whenever necessary. After planned reductions, the FY17 joint force will consist of:

- An Army of more than one million active and reserve soldiers with 18 Divisions, approximately 65 Brigade Combat Teams, 21 Combat Aviation Brigades and associated enablers.
- A Naval battle force of 285 ships – the same size force that we have today –that will remain the most powerful and flexible naval force on earth, able to prevail in any combat situation, including the most stressing anti-access environments. Our maritime forces will include 11 carriers, 9 large deck amphibious ships, 82 guided missile cruisers and destroyers, and 50 nuclear powered attack submarines.
- A Marine Corps with 31 infantry battalions, 10 artillery battalions and 20 tactical air squadrons.
- An Air Force that will continue to ensure air dominance with 54 combat coded fighter squadrons and the current bomber fleet. Our Air Force will also maintain a fleet of 275 strategic airlifters, 318 C-130s and a new aerial refueling tanker.

*5. Protect and prioritize key investments, and the capacity to grow, adapt and mobilize*

The force we are building will retain a decisive technological edge, leverage the lessons of recent conflicts and stay ahead of the most lethal and disruptive threats of the future.

To that end, the FY13 budget:

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- Provides \$11.9 billion for science and technology to preserve our ability to leap ahead, including \$2.1 billion for basic research.
- Provides \$10.4 billion (base and OCO) to sustain the continued growth in Special Operations Forces;
- Provides \$3.8 billion for Unmanned Air Systems. We slowed the buy of the Reaper aircraft to allow us time to develop the personnel and training infrastructure necessary to make full use of these important aircraft.
- Provides \$3.4 billion in cyber activities. We are investing in full spectrum cyber operations capabilities to address the threats we see today and in the future;

At the same time, the strategic guidance recognizes the need to prioritize and distinguish urgent modernization needs from those that can be delayed – particularly in light of schedule and cost problems. Therefore this budget identifies about \$75 billion in savings over five years resulting from canceled or restructured programs. Key modifications and associated savings over the next five years include:

- \$15.1 billion in savings from restructuring the Joint Strike Fighter by delaying aircraft purchases to allow more time for development and testing;
- \$13.1 billion by reducing investment in procurement of ships, while continuing to focus on the higher-capability vessels most needed to carry out our defense strategy;
- \$1.3 billion in savings from delaying development of the Army’s Ground Combat Vehicle due to contracting difficulties;
- \$4.3 billion in savings from delaying the next generation of ballistic missile submarines by two years for affordability and management reasons;

We will also terminate selected programs, including:

- The Block 30 version of Global Hawk, which has grown in cost to the point where it is no longer cost effective, resulting in savings of \$2.5 billion; and
- The weather satellite program, because we can depend on existing satellites, resulting in savings of \$2.3 billion;

We have also invested in a balanced portfolio of capabilities that will enable our force to remain agile, flexible and technologically advanced enough to meet any threat. To that end, ground forces will retain the key enablers and know-how to conduct long-term stability operations, and the Army will retain more mid-grade officers and NCOs. These steps will ensure we have the structure and experienced leaders necessary should we need to re-grow the force quickly.

Another element is to maintain a capable and ready National Guard and Reserve. The Reserve Component has demonstrated its readiness and importance over the past ten years of war, and we must ensure that it remains available, trained, and equipped to serve in an operational capacity when necessary.

Another key part of preserving our ability to quickly adapt and mobilize is a strong and flexible industrial base. This budget recognizes that industry is our partner in the defense acquisition enterprise.

#### **Ensuring Quality of the All-Volunteer Force**

Now to the most fundamental element of our strategy and our decision-making process: our people. This budget recognizes that they, far more than any weapons system or technology, are the great strength of our United States military. All told, the FY13 budget requests \$135.1

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billion for the pay and allowances of military personnel and \$8.5 billion for family support programs vital to the well-being of service members and their families.

One of the guiding principles in our decision making process was that we must keep faith with our troops and their families. For that reason, we were determined to protect family assistance programs, and we were able to sustain these important investments in this budget and continue efforts to make programs more responsive to the needs of troops and their families. Yet in order to build the force needed to defend the country under existing budget constraints, the growth in costs of military pay and benefits must be put on a sustainable course. This is an area of the budget that has grown by nearly 90 percent since 2001, or about 30 percent above inflation – while end strength has only grown by three percent.

This budget contains a roadmap to address the costs of military pay, health care, and retirement in ways that are fair, transparent, and consistent with our fundamental commitments to our people.

On military pay, there are no pay cuts. We have created sufficient room to allow for full pay raises in 2013 and 2014 that keep pace with increases in the private sector. However we will provide more limited pay raises beginning in 2015 – giving troops and their families fair notice and lead time before changes take effect. Let me be clear: nobody's pay is cut in this budget nor will anyone's pay be cut in the future years of this proposal.

This budget devotes \$48.7 billion to health care costs – an amount that has more than doubled over the last decade. In order to continue to control the growth of these costs, we are recommending increases in health care fees, co-pays and deductibles to be phased in over four to five years. None of the fee proposals in the budget would apply to active duty service members, and there will be no increases in health care fees or deductibles for families of active duty service members under this proposal. Those most affected will be retirees – with the greatest impact on working-age retirees under the age of 65 still likely to be employed in the civilian sector. Even with these changes, the costs borne by military retirees will remain below levels in most comparable private sector plans – as they should be.

Proposed changes include:

- Further increasing enrollment fees for retirees under age 65 in the TRICARE Prime program, using a tiered approach based on retired pay that requires senior-grade retirees with higher retired pay to pay more and junior-grade retirees less;
- Establishing a new enrollment fee for the TRICARE-for-Life program for retirees 65 and older, using a tiered approach;
- Implementing additional increases in pharmacy co-pays in a manner that increases incentives for use of mail order and generic medicine; and
- Indexing fees, deductibles, pharmacy co-pays, and catastrophic caps to reflect the growth in national health care costs.

We also feel that the fair way to address military retirement costs is to ask Congress to establish a commission with authority to conduct a comprehensive review of military retirement. But the President and the Department have made clear that the retirement benefits of those who currently serve must be protected by grandfathering their benefits. For those who serve today I will request there be no changes in retirement benefits.

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**A Balanced Package**

Members of the committee: putting together this balanced package has been a difficult undertaking and, at the same time, an important opportunity to shape the force we need for the future. I believe we have developed a complete package, aligned to achieve our strategic aims.

As a result, the FY13 request is a carefully balanced package that keeps America safe and sustains U.S. leadership abroad. As you take a look at the individual parts of this plan, I encourage you to do what the Department has done: to bear in mind the strategic trade-offs inherent in any particular budget decision, and the need to balance competing strategic objectives in a resource-constrained environment. The best example of this balancing act is the size of the budget itself, which in my view strikes the right balance between both the fiscal and security responsibilities of the Department to the nation.

But we will need your support and partnership to implement this vision of the future military. I understand how tough these issues can be, and that this is the beginning and not the end of this process. Make no mistake: the savings we are proposing will impact all 50 states. But it was this Congress that mandated, on a bi-partisan basis, that we significantly reduce discretionary funding, which realistically leads to substantial cuts in the defense budget. We need your partnership to do this in a manner that preserves the strongest military in the world. This will be a test of whether reducing the deficit is about talk or action.

My hope is that now that we see the sacrifice involved in reducing the defense budget by almost half a trillion dollars, Congress – and this Committee in particular – will be convinced of its important responsibility to make sure that we avoid sequestration.

The leadership of this department, both military and civilian, is united behind the strategy that we have presented, and this budget. Like all strategies and all defense budgets, there are risks associated with this spending plan. I cannot reduce the defense budget by almost half a trillion dollars and not incur additional risks. In our judgment these risks are acceptable, but nevertheless these additional risks do exist. Those risks primarily stem from the fact that we will be a smaller military. Will our forces be able to mobilize quickly enough to respond to crises? Will we be able to compensate with more advanced technology? Can we ensure the continued health of the all-volunteer force and meet our obligations to transitioning service members so they don't become part of the unemployment rolls?

We believe we can deal with these risks, and that the budget plan we have presented has an acceptable level of risk because it was developed based on our defense strategy. But there will be little room for error. If this Congress imposes more cuts in the defense budget, that will increase the risk and could make it impossible for us to execute the strategy we have developed. And if sequester is triggered, this strategy will certainly have to be thrown out the window and the result will be risks that are unacceptably high. So I really urge you to try to confront this issue and try to do everything you can to avoid that outcome, and to give us the opportunity to implement the strategy we have developed with the necessary and appropriate level of spending.

I look forward to working closely with you in the months ahead to do what the American people expect of their leaders: be fiscally responsible in developing the force for the future – a force that can defend the country, a force that supports our men and women in uniform, and a force that is, and always will be, the strongest military in the world.

# # #

Chairman CONRAD. Thank you, Mr. Secretary.

I understand, General Dempsey, that you have a statement. We would welcome you to make that statement at this point, and then we will go to questions. First of all, I want to thank you, General Dempsey, for your service. It is distinguished service. I very much appreciated the visit you paid to me several weeks ago. I think that was about as frank and forthcoming a discussion as could be had, and that is what has to happen. We are all going to have to be part of a solution if we are going to actually produce one.

So, welcome, General Dempsey, and please proceed.

**STATEMENT OF GENERAL MARTIN E. DEMPSEY, USA,  
CHAIRMAN, JOINT CHIEFS OF STAFF**

General DEMPSEY. Thank you, Chairman Conrad and Senator Sessions, and I assure you that it is a great honor to put the uniform of our nation on every day, and I do commit to you to continue to have those frank conversations as we collectively try to do what is right for our nation.

This budget represents a responsible investment in our nation's security. It strikes a purposeful balance between succeeding in today's conflicts and preparing for tomorrow's. It also keeps faith with the nation and with the source of our military's greatest strength, which as you heard Secretary Panetta say moments ago, are America's sons and daughters who serve in uniform.

As we sit here, they are out there well beyond our shores doing everything that our nation asks them to do. In just this past year, our soldiers, sailors, airmen, and marines further crippled our enemies, al-Qaeda. They shifted more responsibility onto Afghan shoulders. They protected the Libyan people from near certain slaughter. They helped Japan recover from a tragic disaster. And they brought to a close more than 20 years of military activities over and in Iraq. And behind the scenes, they defended against cyber threats, sustained our nuclear deterrent, and partnered globally to prevent conflict.

What is even more remarkable is that they have been doing this for the past ten years—is the way they have been doing this for the past ten years during what I think we would agree has been one of the most searing periods in our nation's military history. They do it with uncommon professionalism and pride. They do it with moral courage backstopped by unsurpassed skill. And they do it with the unassailable support of their families, so it really is truly a privilege to serve with each and every one of them. They are our nation's pride and it is our responsibility to keep faith with them, and I think our budget does that.

One way the budget keeps faith is by being strategy-based. Our new defense strategy draws on the lessons of the past ten years of war. It also acknowledges a new fiscal reality. It anticipates a dangerous and competitive security environment. And it affirms our need for a joint force that is always ready and always dominant.

This budget helps us build just such a military. It restores versatility at an affordable cost. It retains our conventional overmatch while mainlining emerging capabilities like cyber. It puts us on a path for a joint force in the year 2020 that is global and

networked, versatile and responsive, and that preserves options for the nation.

We also keep faith by reducing risk. Risk is inherent in all strategies and in all budgets that resource them. In my judgment, the risk here lies not in what we can do, but how much we can do and how often we are asked to do it. This budget helps buy down that risk. It does this in part by preserving a strong reserve component and developing the joint capabilities we need for an uncertain future.

More importantly, this budget continues to invest in our people. It ensures our troops have the best equipment, the best training, and the best leadership. To me, this is a non-negotiable strategic imperative for the nation. It is how we win wars.

In order to do all this, we had to achieve the right balance among force structure, modernization, operations, training, pay, and benefits, not just within each service, but overall. So what I want you to know is that this budget is a budget for a joint force, not the aggregate of individual service budgets. Changes not informed by this joint context risk upending that balance and could compromise the entire force. And indiscriminate changes, such as the cuts looming on the horizon through sequestration, would cause self-inflicted and potentially irrevocable wounds to our national security.

Finally, this budget honors our commitments by providing our military family with the compensation and care they deserve. There are no freezes or reductions in pay, as the Secretary mentioned. There is no lessening in the quality of health care for active duty members and in particular for our medically retired and wounded warriors. Family support and child care are safeguarded.

But we cannot ignore hard realities. Pay and benefits are now roughly one-third of defense spending. We simply had to act to slow this growth. So pay raises slow over time and retirement reform gets a look, and we adopt modest increases in health care fees for retirees. We must act now to make our health care system sustainable. If we do not, its very viability will soon come into question.

I know there are concerns about these changes and about others, and believe me, I have heard those concerns. Our troops, our veterans, their families, and you have my personal commitment to continue to work on these, to keep looking for ways to be more innovative, affordable, and equitable, to make sure we recruit and retain the very best.

In closing, I offer my sincere thanks to this committee and to the entire Congress. Thank you for keeping our military strong. Thank you for continuing to take care of our military family. Thank you for supporting those who serve, who have served, and, importantly, who will serve. I know you share my pride in them and I look forward to answering your questions.

[The prepared statement of General Dempsey follows:]

SENATE COMMITTEE ON THE BUDGET

STATEMENT OF  
GENERAL MARTIN E. DEMPSEY, USA  
CHAIRMAN  
JOINT CHIEFS OF STAFF  
BEFORE THE  
SENATE COMMITTEE ON THE BUDGET  
FY13 DEPARTMENT OF DEFENSE BUDGET  
FEBRUARY 28, 2012

Chairman Conrad, Senate Sessions, and distinguished members of the Committee, it is my privilege to update you on the state of the United States' Armed Forces and to comment on the President's budget proposal for fiscal year 2013. The context for this year's posture testimony is unique. Our military has transitioned many of our major operations, and we have new strategic guidance that sets priorities. We are also facing real fiscal constraints and an increasingly competitive security environment. The President's proposed fiscal year 2013 defense budget accounts for these realities. It provides a responsible investment in our nation's current and future security.

### **Global Military Operations**

Today our Armed Forces stand strong. We are proud of the performance and accomplishments of our men and women in uniform over the past year. They have carried out far-ranging missions with much success. They have defended our homeland, deterred aggression, and kept our Nation immune from coercion. And despite a decade of continuous combat operations, our troops and their families remain resilient.

U.S. Forces-Iraq recently completed its mission. More than twenty years of military operations in and over Iraq came to conclusion. The security of Iraq is now the responsibility of the Iraqi people, leaders, and security forces. We have transitioned to a normal military-to-military relationship. Diplomats and civilian advisors are now the face of the United States in Baghdad. To be sure, Iraq still faces challenges to the country's future. But as we look to that future, we will continue to build ties across Iraq to help the people and institutions capitalize on the freedom and opportunity we helped secure.

In Afghanistan, we are seeing the benefits of the surge in combat forces begun in early 2010. The security situation is improving. By nearly every measure, violence has declined. The Taliban are less capable, physically and psychologically, than they were two years ago. Afghan and ISAF forces have

maintained persistent pressure on insurgent groups and have wrested the initiative and momentum from them in much of the country. But these groups remain determined, and they continue to threaten the population and the government. Combat will continue.

Key to long-term stability in Afghanistan is the development of the Afghan National Security Forces (ANSF). In 2011, the Afghan National Army grew by 18 percent. The Afghan National Police grew by 20 percent. These forces, combined with the nascent but ever more capable Afghan Local Police, are steadily assuming responsibility for Afghan security. The process of transition began in July, and today, after nearly completing the second of five “tranches” of transition, Afghan security forces are now responsible for the day-to-day security of almost half of Afghanistan’s population. Developing the ANSF, degrading insurgent capabilities, and turning over responsibilities have allowed us to begin a measured draw down of our forces in Afghanistan. We have withdrawn over 10,000 of the surge troops and will withdraw the remaining 23,000 by the end of this summer. By that time, we expect the ANSF to achieve their initial operating capability and to be responsible for securing nearly two-thirds of the Afghan population. They are on track to meet the goal of assuming full lead for security by the end of 2014.

Sustaining progress in Afghanistan requires dealing with some significant challenges. The ANSF and other national and local government institutions require further development. Corruption remains pervasive and continues to undermine the capacity and legitimacy of government at all levels. Insurgent sanctuaries in Pakistan remain largely uncontested. And ultimately, much more work remains to achieve the political solutions necessary to end the fighting in Afghanistan.

Our military has been vigilant and active in other areas and with other missions to keep America and our partners safe. We decapitated al-Qa’ida and pushed this terrorist network decidedly closer to strategic defeat through the

successful special forces operation targeting Osama Bin Laden. We supported NATO in its UN mission to protect civilians in Libya allowing them to end Muammar Qaddafi's tyrannical rule. We responded quickly to the devastating earthquakes and tsunami that struck Japan, saving lives and acting on our commitment to this key ally. We fended off cyber intrusions against our military's computer networks and systems. And we helped counter aggression and provocation from Iran and North Korea.

### **A Time of Transition**

While our military continues to capably and faithfully perform this wide array of missions, we are currently in the midst of several major transitions. Any one of them alone would be difficult. Taken together, all three will test our people and our leadership at every level.

First, we are transitioning from a war-time footing to a readiness footing. With the end of our operations in Iraq and Libya and the ongoing transition of security responsibilities in Afghanistan, our troops are steadily returning home. From a peak of more than 200,000 troops deployed to combat two years ago, we have fewer than 90,000 today. This shift cannot lead us to lose focus on on-going combat operations. But, it does mean we must give attention to restoring our readiness for full spectrum operations. We need to reset and refit, and in many cases replace, our war-torn equipment. We need to modernize systems intentionally passed over for periodic upgrading during the last decade. We must retrain our personnel on skills used less often over the last decade. And we will have to do all of this in the context of a security environment that is different than the one we faced ten years ago. We cannot simply return to the old way of doing things, and we cannot forget the lessons we have learned. As described in the Department's recently released strategic guidance, we should adjust our missions, our posture, and our organizational structure in order to adapt to ever evolving challenges and threats.

Second, our military is transitioning to an era of more constrained resources. The days of growing budgets are gone, and as an institution we must become more efficient and transparent. We must carefully and deliberately evaluate trade-offs in force structure, acquisition, and compensation. We must make the hard choices, focus on our priorities, and overcome bureaucratic and parochial tendencies. In sum, we must recommit ourselves to being judicious stewards of the Nation's resources.

Third, tens of thousands of our veterans—and their families—are facing the transition to civilian life. Many enlistments are coming to their normal conclusion, but we are also becoming a leaner force. As we do this, we must help our veterans find education opportunities, meaningful employment, and first-class health care. We must pay particular attention to those bearing the deepest wounds of war, including the unseen wounds. We must help those who have given so much cope with—and where possible, avoid—significant long-term challenges such as substance abuse, divorce, depression, domestic violence, and homelessness. Addressing these issues is not the exclusive responsibility of the Services or veterans organizations. How we respond, as a military community and as a Nation, conveys our commitment to our veterans and their families. It will also directly affect our ability to recruit and retain our Nation's best in the future.

I have outlined several priorities for the Joint Force to help us anticipate and navigate the challenges these transitions present. We will maintain focus on achieving our national objectives in our current conflicts. We will begin creating the military of our future—the Joint Force of 2020. We will also confront what being in the Profession of Arms means in the aftermath of war. And above all else, we will keep faith with our Military Family. In doing all these things, we will provide an effective defense for the country and strengthen the military's covenant of trust with the American people.

**A Responsible Investment**

The President's Fiscal Year 2013 Department of Defense base budget of \$525 billion and overseas contingency operations (OCO) budget of \$88 billion represent a responsible investment in our Nation's security. The decisions underlying them flow from the strategic guidance the Department of Defense issued last month. This guidance set priorities for assessing our programs, force structure, and spending in the context of a persistently dangerous and increasingly competitive security environment. With those priorities in mind, the budget proposal strikes an appropriate and necessary balance between succeeding in today's conflicts and preparing for tomorrow's challenges. It accounts for real risks and real fiscal constraints, marrying versatility with affordability.

The tradeoffs were complex, and the choices were tough. They will produce \$259 billion in savings over the next five years and a total of \$487 billion over the next ten years. They will not lead to a military in decline. Rather, this budget will maintain our military's decisive edge and help sustain America's global leadership. It will preserve our ability to protect our vital national interests and to execute our most important missions. Moreover, it will keep faith with the true source of our military's strength—our people.

The merits of this budget should be viewed in the context of an evolving global security environment and a longer term plan for the Joint Force. Coming on the heels of a decade of war, this budget begins the process of rebalancing our force structure and our modernization efforts and aligns them with our strategy. Essentially, we are developing today the Joint Force the Nation will need in 2020, and our plans to build this force will unfold over the course of several budget cycles. This budget is the first step—a down payment. If we fail to step off properly, our recovery will be difficult, and our ability to provide the Nation with the broad and decisive military options will diminish.

It is worth addressing head-on some of the major changes we are planning as we adapt to changing global opportunities and challenges. And just as this budget must be viewed in the context of a broader plan, these changes must be viewed in the context of our evolving force. They represent a comprehensive, carefully devised package of decisions that strikes a fine balance. They are not, and cannot be viewed as, individual, isolated measures. In all cases, needed capabilities are preserved or, when necessary, generated, through one or several programs.

This budget will make critical investments in our future force. Certain specialized capabilities, once on the margins, will move to the forefront. Networked special operations, cyber, and Intelligence, Surveillance, and Reconnaissance will become increasingly central. The results will be a Joint Force that is global and networked, that is versatile and innovative, and that is ably led and always ready. This force will be prepared to secure global access and to respond to global contingencies. We will be a military that is able to do more than one thing at a time—to win any conflict, anywhere.

Particular attention will be placed on our anti-access/area-denial capabilities. The proliferation of technology threatens our unfettered access to the global commons—access that is fundamental to global commerce and security. As we rebalance our global posture to emphasize the Asia-Pacific region and the Middle East, we are adjusting our operating constructs and the systems we employ. This includes divesting some outdated ships, planes, and equipment as well as investing in new programs. We will also commit to our partnerships and to helping develop our partners' security capabilities.

Similarly, this force will place added focus on our military's cyber defense capabilities. The threats to the average American's day-to-day life and our military capabilities that emanate from cyber space have evolved faster than many could have imagined. We must adapt to these threats with similar adroitness and capacity. This budget allows for us to expand many of our

nascent cyber capabilities and to better protect our defense networks. Similarly, bipartisan cyber legislation being introduced in Congress is a good first step in developing protection for our Nation's critical infrastructure. With much work to be done, we look forward to working with agencies across the government and with our allies and partners to confront this broad range of emerging threats.

While some additional capabilities for our Joint Force will be needed, others will not. The Joint Force of the future will be leaner than today's. We will no longer be sized for large scale, prolonged stability operations. As a result, we expect to draw down the Army from 562,000 to 490,000 by the end of fiscal year 2017, and the Marine Corps from over 202,100 to 182,100 by the end of fiscal year 2016. Some of this reduction was planned several years ago when Congress authorized temporary end strength increases to support our operations in Iraq and Afghanistan.

But in making ourselves leaner, we will not make the mistakes of previous draw downs. We will not retain organizational structures that lack the people, training, and equipment necessary to perform the tasks we expect from them. We will be realistic about the organizations we keep, while also maintaining our ability to reconstitute and mobilize forces. We will still be able to respond to any large scale mobilization against us. To do this, the Joint Force will retain capacity in our reserve components and our industrial base should they be required to surge. We will maintain the Army Reserve end-strength at 205,000 and reduce the Army National Guard by only 5,000 down to 353,200. The Marine Corps reserves will be retain their current strength.

Another major concern among our troops, their families, retirees, and with the American public is military compensation and benefits. I want to make it clear that cuts in spending will not fall on the shoulders of our troops. There are no proposed freezes or reductions in pay. There is no change to the high quality health care our active duty members and medically retired

Wounded Warriors receive. But we cannot ignore some hard realities. Pay and benefits are now roughly one third of defense spending. Pay will need to grow more slowly in the future. We are also proposing a commission to review of military retirement. And to control the growth of healthcare costs, we are also recommending changes to TRICARE. These adjustments include modest, new or phased-in increases in health care fees, co-pays, and deductibles largely for our retirees—but not our active duty service members. Even with these increases, TRICARE will remain one of the finest medical benefits in the country.

Overall, these proposed changes value both the demands of military service and our duty to be good stewards of the Nation's fiscal resources. They will sustain the recruitment, retention, and readiness of the talented personnel we need. Most importantly, they will sustain our enduring commitment to our troops and their families—we must never break faith with them. I want to note, however, that keeping faith with our service men and women is not just about pay and benefits. It is also about ensuring we remain the best trained, best equipped, and best led force on the planet.

The last, and perhaps most critical issue, is risk. This budget and the strategy it supports allow us to apply decisive force simultaneously across a range of missions and activities around the globe. They mitigate many risks, but they accept some as well, as all strategies must. The primary risks lie not in what we can do, but in how much we can do and how fast we can do it. The risks are in time and capacity. We have fully considered these risks, and I am convinced we can properly manage them by ensuring we keep the force in balance, investing in new capabilities, and preserving a strong reserve component. We can also compensate through other means, such as effective diplomacy and strong partnerships. I believe that these risks are acceptable and that we will face greater risk if we do not change from our previous approaches.

**Conclusion**

In the upcoming year, our Armed Forces will build on the past year's achievements, adapt to emergent challenges, seize new opportunities, and continue to provide for our common defense. We will continue to face threats to our security, whether from aggressive states or violent terrorist organizations. But our military will be ready for them, and our response will be a source of pride for the American people. In all of our efforts, we will aim to maintain strength of character and professionalism—at the individual and institutional level—that is beyond reproach.

As we embark on this critical new course, we will need Congress' support to help us build the Joint Force the Nation needs and to strengthen our relationship with the American people. As I stated before, this budget and the choices that underlie it should be understood in the context of the comprehensive, carefully balanced, multi-year plan they support. These choices were tough. Some decisions will be controversial. But they call for an investment that allows our force to take the steps necessary to ensure our Nation's defense for years to come. We ask Congress to support this budget and, more importantly, to avoid the deep and indiscriminant cuts that sequestration would impose.

I thank this Committee, and the entire Congress, for all you have done to support our men and women under arms and their families. Your resolute attention to their needs and to our security has been both invaluable and greatly appreciated.

Chairman CONRAD. Thank you very much for that excellent statement.

We are going to go to questions. We are going to do five-minute rounds today, given the number of people and given the need for the Secretary and the Chairman to leave here at an appropriate hour.

First of all, this is a challenge for all of us. We face a circumstance in which we are borrowing 40 cents of every dollar we spend. Our revenue is at or near a 60-year low in terms of share of the economy. Our spending is at or near a 60-year high in terms of a share of our spending. Our gross debt is now 100 percent of our Gross Domestic Product. These are hard facts.

Secretary Panetta, having worked with you before, as I indicated earlier, being an ally in your efforts to get a balanced budget before, and the last time we have actually seen success in accomplishing that, I think better than almost anyone in this town, maybe almost better than anyone in this country, how really hard it is to get the job done. What is always interesting to me is how many speeches are given, how many brave statements are made, when the hard choices are made, how few people are left at the table because it is not popular. I mean, the hard reality is doing what has to be done to reform entitlements—it is not popular, to reform the revenue system—that creates its own challenges, and to face up to costs in every part of the Federal Government. There is a constituency for every dollar. Nobody knows that better than you do.

So let us start with this question. The Budget Control Act asked for \$487 billion of savings over ten years. That is in the President's budget. That is in train. The Budget Control Act also called for a sequester if the Special Committee did not come up with a specified level of savings. The Special Committee failed. That is the hard reality we are left with. They did not succeed. And so we are left with a sequester which calls on additional savings out of defense of—I think General Dempsey used the number of \$535 billion. Our number is slightly different than that, but almost the same.

The question is this. And we have heard you loud and clear, sequester goes too far. Is there a place in between? And I say this, and I know you do not want to negotiate against yourself. I understand that. I was part of the Simpson-Bowles Commission. It had overall savings almost as big as the sequester amount in addition to the other savings in the Budget Control Act. Other bipartisan commissions, in trying to bell this cat, have called for a similar level of savings. And I understand, again, loud and clear, we hear you, that that, from your perspective, goes too far.

But let me understand, is there no additional savings that can be derived beyond those that are imposed in the first tranche of the Budget Control Act requirements?

Secretary PANETTA. Mr. Chairman, having been through this process a great deal, the \$487 billion, almost a half-trillion dollars, is the largest amount ever included in any budget agreement or summit that I have ever worked on, and it is a big number, and yet I thought it was very important to be able to work with the service chiefs and others to develop a strategy that would be able to implement those savings in a way that would still protect the

kind of force we need for the future, and I think we have done that. We have tried to do this in a responsible way.

And I guess what I need to have in order to make this work, frankly, is a degree of stability with regards to the defense budget and as to where we are going over the next ten years, particularly in light of the threats that we are confronting. I mean, this is not like the past. We have some very significant threats that are still out there in the world, any one of which could have us immersed in a new conflict, and any one of which demands that we have a presence in the world.

So my view is that what we have presented here is a strong budget. It is fiscally responsible. It sets the right path for the future. If at some point in the future threat is reduced, if there are areas of efficiencies that we could gain additional savings, of course, we will look at those additional savings. But for now, what we have put in place, I think, represents an important step that we should stick to.

Chairman CONRAD. All right. Let me just say to you, I mean, I want to be very honest and direct, I do not know how to write a budget that achieves the kind of deficit and debt reduction that we need—and by the way, I would go further than what the President has presented. I actually would go further than Simpson-Bowles. I tried to convince Simpson-Bowles to do \$6 trillion of deficit reduction because we could balance the budget with that amount. There was not support on that Commission for going that far. So I think you know where I am coming from.

I would very much like to achieve a balanced budget at the end of ten years, given the level of debt that we have. And I do not know a way to do that without fundamentally reforming entitlements, without fundamentally reforming the tax system and asking those who are the best off among us who enjoy certain tax preferences to give them up. And I do not know any way to do it without asking for additional defense savings.

Let me ask this. Before the Simpson-Bowles Commission, top defense analysts appeared. I asked them about their assessment. One of the things they reminded us of is 51 percent of all Federal employees are at the Department of Defense. And they also reminded us that did not count contractors. When we asked them how many contractors there are, they said, well, we cannot give you a number. I said, well, what is the range? And they said, one to nine million—one to nine million. Can you give us a better assessment today of how many contractors there are at the Department of Defense?

Mr. HALE. Yes. I am not sure where the one to nine came from, Mr. Chairman. We do have limited data on the number of full-time equivalents, but it is more like 300,000 contractor full-time equivalents. I am not sure where the—the one to nine may be including multiplier effects in the budget. I am not sure. But that is our rough estimate now.

Chairman CONRAD. Can you tell us, what is the cost per soldier to maintain a soldier for a year in Afghanistan?

Mr. HALE. Right now, about \$850,000 per soldier. And I would be careful with that number because there are some fixed costs

that are built into that number and the decisions you make about those fixed costs are going to affect it. But it is—

Chairman CONRAD. No, we understand that. I just say this to you. When people back home ask me and when I give—the number I have had previously was \$600,000, so it kind of takes my breath away when you tell me it is \$850,000. When I tell them \$600,000, it takes their breath away. Can you help us understand why that cost is so—you are talking about \$850,000 a year per soldier?

Mr. HALE. Let me try. The major component of the extra costs in Afghanistan are higher operating costs for our weapons. When you are in a war, you are operating at a much higher tempo. That is a good part. That is probably 50 percent of the budget. There are some special pays and allowances. And then there are all these enabler costs, for example, the JIEDDO costs for improvised explosive devices. We have some coalition support payments. All of those are amortized into the \$850,000. The \$600,000 might be closer to a variable cost if you just looked at an operating cost. It is mainly you are operating at a very high tempo in a war zone and we need to support that.

Chairman CONRAD. I think it did reflect the variable cost.

Let me just say, I have gone over the five minutes, but we will go to Senator Sessions. I just want to conclude this round on my part by saying I think at the end of the day, before we are done, it is not going to be possible, absent some other thing happening, and goodness knows that could happen tomorrow, so we all understand that, but budgets have to be based on what we know at the time we write them, that we are going to have to have additional savings if we are really going to deal with the debt threat confronting the country.

Secretary PANETTA. Mr. Chairman?

Chairman CONRAD. Mr. Secretary.

Secretary PANETTA. Could I just comment on that? Look, this Congress proposed as part of the Budget Control Act a trillion dollars in savings off the discretionary budget. You cannot meet the challenge that you are facing in this country by continuing to go back at discretionary spending. That is less than a third of Federal spending. Now, if you are not dealing with the two-thirds that is entitlement spending, if you are not dealing with revenues, and you keep going back to the same place, frankly, you are not going to make it—

Chairman CONRAD. Well, I—

Secretary PANETTA. —and you are going to hurt this country. You are going to hurt this country's security, not only by cutting defense, but very frankly, by cutting discretionary spending that deals with the quality of life in this country.

Chairman CONRAD. I could not agree with you more. I mean, I do not know what could be more clear. And, of course, Leon, you understand it because you have actually written budgets around here, as have I, and it is not possible. In fact, it is almost bizarre, is it not, what the strategy has been so far. The strategy so far is to go after discretionary spending that is the part of spending that is going down as a share of GDP. And we do not go after the part of spending that is going up as a share of GDP, and going up markedly. Those are the entitlements. We have to be honest with people

and we have to help them understand what is the place where spending over time is really rising dramatically. It is in the entitlement accounts. And on the revenue side, the fact is, the revenue is the lowest it has been in 60 years. This is reality talking. I am glad you gave a dose of it here.

Senator SESSIONS.

Senator SESSIONS. Thank you.

Mr. Secretary, thank you, as we wrestle with these challenges. I would just say that the discretionary spending this country has embarked on, non-defense has grown substantially. It grew 24 percent in the first two years of the President's tenure, and not counting the stimulus package that was almost a trillion dollars in addition to that. We are over a trillion in the other stimuluses we have since. So we are spending a lot of money there.

I would also note that Food Stamps is an entitlement. It has increased 300 percent. There is a lot of fraud, abuse, and waste in that program. Medicaid increased 37 percent in three years. The Defense Department base budget is up ten percent while the war costs have been dropping over those years. Medicaid is a huge growing program. Medicaid, Social Security, Medicare increasing at almost eight percent a year, whereas our economic growth is projected to be about three percent over the next ten years. That is why that is unsustainable.

Would you agree, Mr. Panetta, that is an unsustainable path?

Secretary PANETTA. There are a lot of unsustainable paths—

Senator SESSIONS. It is an unsustainable path. So I guess what I would say to my colleagues, and I hope that we understand this, that Food Stamps, Medicare, Medicaid, Social Security were exempted from any cuts under the sequester, not a dime. So the cuts fell dramatically on other discretionary and the defense. And defense has not had as much increase prior to these cuts taking place as the other discretionary did. So I think, defense being a core function of government, this is a dangerous path for us to be in. We have to get off of it.

Mr. Secretary, we talk about the money shortfall. Admiral Mullen has said that threatens our national security inevitably, just as crunching it down as we—do you agree that it does threaten our national security?

Secretary PANETTA. I do.

Senator SESSIONS. With regard to the sequester and the situation we are in, the President's budget calls for almost \$2 trillion in new taxes. As a reality, that is not going to happen. He also basically abandons the sequester and increases spending about \$1.6 trillion over where we were with the sequester in place. So I am worried that we may not reach a conclusion of this satisfactorily before you face a financial challenge of great significance.

Do you have plans now to deal with the eventuality that perhaps an agreement will not be reached and you might have to go forward with the sequester reductions?

Secretary PANETTA. Senator, we are not and we have not made any plans with regards to sequester. The problem is this, that sequester has this kind of "meat-axe" approach and formula for cuts across the board that, frankly, you cannot do a hell of a lot of planning for. Secondly, it would truly be a disaster. I would have to

take the strategy I just presented to you and throw it out the window if a sequester did happen. And for that reason, I urge the Congress to come together. We will work with you to try to develop some approach that can de-trigger sequester before it happens.

Senator SESSIONS. I will work with you on that. I believe that is what we have to do. We have multiple threats around the world. I just returned from a trip with Senators McCain, Blumenthal, Graham, and Hoenes on Afghanistan, Egypt, Libya, Tunisia, Israel, and you never know what danger will break out next. There is still a lot of tension in that area of the world. Then we have our obligations in the Pacific. That is very significant. There are just things that a core defense budget, I believe, has to be maintained sufficient to meet the challenges we face.

And I do believe that the remaining five-sixths of the budget, almost half of it not touched at all with any reduction in spending, have to be—a little more than half—that is really just a challenge to us. We just cannot balance this budget on the back of the Defense Department. And if we break faith with those fabulous men and women who have been deployed repeatedly, away from their families, placing their lives at risk, if they see what we have done as disproportionately targeting them for the wasteful Washington spending that has been going on, we would have broken faith with the best people this country has produced.

I hope and pray, somehow, Mr. Chairman, we can work this out. I know you share those concerns.

Chairman CONRAD. Thank you.

Senator SANDERS.

Senator SANDERS. Thank you, Mr. Chairman, and Mr. Secretary and General Dempsey and Mr. Hale, thanks very much for being with us today.

I am going to pick up on a slightly different tangent than my friend from Alabama and suggest to you that everybody understands that our country faces huge economic challenges. Our middle class is collapsing. We have more people living in poverty than probably any time in the modern history of this country, which is one of the reasons that Medicaid is up, one of the reasons that Food Stamps are up. We have 50 million people who have no health insurance and millions of families are struggling to send their kids to college or to pay for child care. So how we deal with every aspect of the budget, including the military, impacts on every other.

Now, the reality is, as I understand it, and somebody correct me if I am wrong, military spending has tripled since 1997—tripled. Not exactly ignoring the military. And we now spend more on defense, as I understand it, than the rest of the world combined. So I want to start off by asking you, Mr. Secretary, my understanding is that the United States still operates 268 military installations in Germany and 124 in Japan. Now, in Germany, people all have health care. In Germany, their kids go to college, without having to pay for it, as a matter of fact. So I am kind of interested to know why we have 268 military bases defending Germany when I thought that war was won a few years ago. Can somebody help me out on that one?

Secretary PANETTA. I will also yield to General Dempsey on this. First of all, that 268 number sounds very high. We have cut almost 140 bases out of Europe over the last few years, and as a result of bringing down to additional brigades out of Europe, we will bring down that infrastructure even more.

Senator SANDERS. Mr. Secretary, I may be wrong, but that is the best information we have. But by the way, why are we—World War II has been over for a few years. Why are we—who are we defending? The Soviet Union does not exist. Why do we have that kind of presence in Germany when we have 50 million people in this country who have no health insurance?

General DEMPSEY. Well, I cannot answer the latter part of your question, Senator, but I will say that I am an advocate of maintaining our relationship with NATO. NATO gets maligned on occasion. They have done some great work around the world. They have a \$300 billion budget in the aggregate. If we go to war tomorrow, who are the first people we are going to ask—

Senator SANDERS. But who are we going to war with in Europe, do you think?

General DEMPSEY. No, no. That is not the point, Senator. If we go to war tomorrow, the first people we will ask to go with us are Europeans.

Senator SANDERS. But does that answer the question why we have that type of—268 military installations—

General DEMPSEY. Well, Senator, I will have to give you the—I will get you the data. I have spent 12 years in Germany. I cannot imagine—I have never counted up anywhere near 268 installations, but we will take that one for the record.

[The information follows:]

The Department currently operates 14 installations\* in Germany.

Each installation is comprised of one or more discrete sites (parcels of land), of which there are a total of 202 in Germany. Sites are grouped together under a single installation for administrative purposes and can range in size from communications relay stations of less than one acre to maneuver training ranges of over 50,000 acres.

US Army Garrisons Heidelberg and Mannheim are in the process of closing and consolidating at US Army Garrison Wiesbaden. Upcoming force reductions in Europe will likely lead to additional closures.

U.S. global defense posture is the fundamental enabler of U.S. defense activities overseas. It is central to both communicating our strategic interests to Allies, partners, and rivals, and to projecting power globally in support of U.S. foreign policy objectives.

\*

1. Ramstein Air Base.
2. Spangdahlem Air Base.
3. US Army Garrison Ansbach.
4. US Army Garrison Bamberg.
5. US Army Garrison Baumholder.
6. US Army Garrison Grafenwoehr.
7. US Army Garrison Heidelberg.
8. US Army Garrison Hohenfels.
9. US Army Garrison Kaiserslautern.
10. US Army Garrison Mannheim.
11. US Army Garrison Schinnen.
12. US Army Garrison Schweinfurt.
13. US Army Garrison Stuttgart.
14. US Army Garrison Wiesbaden.

Senator SANDERS. I want to pick up on another question, a question that the Chairman asked about defense contractors. My understanding is that, in the past, the DOD has estimated that we have some 500,000 to 600,000 people who are military contractors, and that the GAO has estimated that number at 900,000.

Mr. HALE. You know, I think I would need to see the definitions of what we are including. Are we including private sector contractors who are supporting others, the multiplier effects—

Senator SANDERS. I suspect we are.

Mr. HALE. The numbers I am giving you, and I will agree they are rough in number, are the portion—the full-time equivalents that we believe we are paying, and it is around 300,000.

Senator SANDERS. I had an interesting experience. I was in Afghanistan maybe a year and a half ago and we were being taken around by two fellows in an armored car. One was with the U.S. military. One was a private contractor. They were both doing basically the same work, but the guy who was the contractor was making substantially more than the fellow who was in the Army. Does that make sense? Could you talk about that?

Secretary PANETTA. Let me just say, Senator, that the area you have pointed out is an area that, frankly, needs attention at the Defense Department. One of the reasons we are looking at \$60 billion in trying to make the place more efficient is going after contractors and trying to reduce those numbers. So I just wanted to assure you that I am aware of the problem.

Secretary Gates at one point basically said he did not know how many contractors he had at the Defense Department. It is a large number. Frankly, it is too large and we need to do what we can to reduce it.

Senator SANDERS. I appreciate that answer.

The last question I would ask, Mr. Chairman. My office has gotten involved a little bit in terms of fraud. You are dealing—you have a huge budget dealing with thousands and thousands of defense contractors, et cetera. My understanding is that the top three defense contractors—that is Boeing, Lockheed, and Northrop Grumman—paid over a billion dollars of fines over this ten-year period to settle fraud allegations. That is just the top three. There is massive amounts of fraud going on in terms of defense contractors dealing with the DOD. Are we moving aggressively to try to address that issue?

Secretary PANETTA. That is part of our effort to—two ways. One, to be able to go after those kinds of fraudulent activities in the various contracts that we have to try to achieve savings there, but in addition to that, the auditing—I mean, we are a Department that still cannot audit all of our books. That is crazy.

Senator SANDERS. That is crazy.

Secretary PANETTA. We need to do that and—

Senator SANDERS. I would just say—and I thank you for raising that point. We hear people talking about we need more money, and what you have just told us is we do not even know what we are spending and how we are spending it.

Secretary PANETTA. Well, we do not have auditability, and that is, frankly, something we owe the taxpayer.

Senator SANDERS. I would think so. My last—

Chairman CONRAD. No, we have to stop there because we are a minute over, and with the number of Senators we have, if we do not impose that discipline, we will not get done in time for the Secretary to meet his requirements.

Senator ENZI.

Senator ENZI. Thank you, Mr. Chairman, and I want to congratulate you on this historic hearing. I think this is one of the few times that the Secretary of Defense has appeared before the Budget Committee, and I really appreciate you doing that. I know you have been here in a number of other capacities. And, of course, I come from Wyoming, which is a very patriotic State. It probably has the highest percentage of people that are serving or have served in the military. And there is a rumor—it is attributed to the President—that there would be one base in each State eliminated. In Wyoming, we only have one base. It is by Cheyenne, and it is an integral part of the—that is our biggest city of 56,000, so it is a big part of that city, and the two work together. And I appreciate the military doing a number of tests of intra-military cooperation there, which have been very successful.

So I appreciated your comments that you would be going through a BRAC process. We have no problem with the BRAC process and know that it has been difficult but fair in the past, and those people—so I just want your reassurance that that is the process you will be using.

Secretary PANETTA. That is correct.

Senator ENZI. Thank you very much.

Also, as a co-founder of the Air Force Caucus and a former member of the Air National Guard, I noted your comments about the reduction in strategic airlift. Am I correct in assuming that that will rely more on Air National Guard units than who are very efficient at providing that? Would that be a fair assumption?

General DEMPSEY. The Chief of Staff of the Air Force, of course, who is responsible for two of the legs of the triad, are looking at the balance of capabilities, both active Guard and Reserve. I do not have the answer committed to memory on how it will affect the Guard, but I am sure we can get you that answer, sir.

[The information follows:]

Senator Enzi, thank you for your question. The new DoD Strategic Guidance "Sustaining US Global Leadership: Priorities For 21st Century Defense" directs the services to build a force that will be smaller and leaner, flexible, ready and technologically advanced. Analysis consistent with the scenarios in the new DoD Strategic Guidance demonstrated that the Air Force could reduce some strategic airlift with acceptable risk. As such, the Air Force has asked that the strategic airlift floor be reduced to 275. Of the 27 C-5A's, 11 aircraft are assigned to the Air National Guard and 16 aircraft belong to the Air Force Reserve. The affected Air Force Reserve unit will be backfilled with more advanced C-5M aircraft, while the affected Air National Guard unit will receive C-17 aircraft. The Air Force will continue to use its Total Force assets in the most effective manner possible to optimize the movement of cargo and personnel via strategic airlift in support of Joint warfighter.

Senator ENZI. Again, I hope you will take a look at the cooperative efforts that we have had of combining regular Air Force and Air National Guard in Wyoming.

My third concern, I mentioned that we only have one base in Wyoming. It happens to be a missile base, and Senator Conrad and I share another caucus that worries about the nuclear capability of this country, and we are wondering if—there are rumors that the

Department is preparing unilateral reductions in nuclear force beyond the requirements of START. So is that what the future is for the ICBM force? And are there really any significant budget savings from ICBM reductions?

Secretary PANETTA. Senator, one of the things in our budget is to maintain the triad, the nuclear triad, and the deterrence that we have. We think we need to maintain our missiles, we need to maintain our submarines, we need to maintain our bombers that are part of our deterrent, and we will continue to do that.

The one thing you are referring to is a review that was being conducted, I think pursuant to legislation from the Congress, to review our nuclear stockpile and nuclear issues, and there were, a number of options that were discussed. There have been no decisions on that, and, frankly, one of the options that was presented was maintaining the status quo.

Senator ENZI. I appreciate that. Particularly in light of what is happening in Iran right now, some deterrent may be absolutely necessary.

My final area of concern, because I got a letter just this week from a man in the military who is about to retire, and his family has been a part of TRICARE and he appreciates that, but he has heard these comments about how the cost for TRICARE, the participation, was going to have to go up. And the reason he wrote me is because he has a sister that is on welfare, and his sister pays nowhere near the costs that he does, and so he is not sure that the military is such a good deal compared to welfare. That seems to me to be a terrible comparison.

Is that something that is going to be taken into consideration as you are looking at these additional costs?

Secretary PANETTA. Well, in the recommendations we do base it on income levels with regards to retirees and what they are asked to provide in additional fees. The problem we have, Senator, is that the costs in health care have grown dramatically, as they have elsewhere. I have about \$50 billion in the defense budget that goes for health care. So we were looking for ways to try to see if we could provide some additional cost control, and increasing these fees is one of the recommendations that we have made. And we do it still recognizing that the TRICARE program is a much more—in terms of cost, is much less in cost than the private sector in terms of those same health care benefits. So it is still a pretty good deal that we provide for retirees, even those we are asking for these additional fees.

Senator ENZI. I appreciate the brevity of your answers and the clarity of them.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator NELSON?

Senator NELSON. Mr. Secretary, thank you for your long and distinguished record of public service, even when I had the privilege of serving with you when we were both young Congressmen, and you were the head of reconciliation in the Budget Committee in the House. And nobody understood what reconciliation was, and you were trying—and here we are some three decades later still talking about reconciliation. So thank you.

I want to call to your attention a subject matter not directly in your jurisdiction, but I have filed what the administration has requested, a Veterans Conservation Corps for unemployed veterans to bring them into the Federal employ for 1 year—these are veterans coming home that are unemployed—to do projects helping the environment, teachers' aides, et cetera, and give these veterans a chance to get over the hump. And that indirectly affects you, certainly, even though it is going to be run through the Department of the Interior, and with the concurrence of the Department of Veterans Affairs.

I wanted to ask you about this sequester. Now, let us remember what the sequester was. It was an attempt to try to create a guillotine that would hang over the heads of the super committee so that the super committee would have a significant incentive in order to come to agreement. And, of course, the super committee did not, on a vote of 6–6, and now we are having to deal with a sequester which is law unless we change the law.

And so what do you do? You talk about what you need is certainty in budgeting for the Defense Department, and yet you have this guillotine hanging over the head of the Defense Department that would go into effect in January of 2013.

How do you deal with this in your budgetary planning?

Secretary PANETTA. Well, Senator, it is very unfortunate because, frankly, it sends a very dark cloud over the Defense Department and, frankly, our Defense Department contractors that worry about the possibility of sequester and what it means for their employment force as well. So there are a lot of very concerned people looking at the prospect that it may happen, and for us, as I said, obviously, we are not planning—we have made no plans for sequester because it is a nutty formula and it is goofy to begin with, and it is not something, frankly, that anybody who is responsible ought to put into effect.

Senator NELSON. Thank you.

Secretary PANETTA. It was designed as a gun to the head.

Senator NELSON. Yes, it was.

Secretary PANETTA. And I was disappointed that the super committee failed in its job.

I have to tell you, having been in the budget process for a long time, there was a time when we had to be in a room negotiating with the administration on budget reductions, and, frankly, we were not allowed to leave that room until we had resolved the issue, and that is what should have happened here.

Senator NELSON. It should have and—

General DEMPSEY. Chairman, could I add my voice to that? I know I am taking up your time, sir, and I apologize. But I feel that, we showed—Chairman Conrad, you showed the chart—or maybe it was Senator Sessions—at times in the past when we have done drawdowns, and you mentioned a moment ago we should plan for what we know. Well, one of the things we know is that this drawdown is occurring not in an era of peace and stability following conflict but in an era that is actually more dangerous than the era we are just leaving. That is a big difference in terms of how we deal with this.

Secondly, on sequestration and our ability to plan for it, we would have to change the strategy, without question.

And, third, the thing you need to understand is some of the variables that we can affect are fixed, so our manpower, we are already off-ramping 120,000, 125,000, notably, soldiers and marines. We cannot speed that up much, so that is a fixed variable. Infrastructure is fixed because even if Congress decides on another round of BRAC, it will take some time to implement. Therefore, there are four places we are going to go for money if we have to go for more money: operations, maintenance, training, and modernization. That is it. There is no place else to go.

And so were you to ask me, "Can I go back and look for more money in those four accounts?" no, sir, not in this environment.

Senator NELSON. A quick question, Mr. Chairman, on another subject. Mr. Secretary, your Secretary of the Navy has stated the policy of the Defense Department given the fact of the lessons of Pearl Harbor, how you need to spread the assets of ships, that there be the spreading of those assets, as they have always been of the carriers on the Atlantic coast, just like they are spread in three home ports on the Pacific coast. Is that what you understand to be the policy of spreading the carrier assets on the Atlantic to two ports?

Secretary PANETTA. That is correct.

Senator NELSON. Thank you.

Chairman CONRAD. Senator Johnson?

Senator JOHNSON. Thank you, Mr. Chairman. And, General Dempsey, Secretary Panetta, Mr. Hale, thank you for your service, and I mean that sincerely.

I would like to reinforce a couple points that Senator Sessions made earlier with a couple graphs. The first one, I think it is—I would like to dispel the notion, contrary to popular belief, that the wars in Iraq and Afghanistan have been the primary cause of our deficits. It is just not true. Over the last 10 years, we have spent a total of about \$1.3 trillion, and this graph just shows the spending on the wars in blue and the deficit is in red. Just to make that point because I think, so many people believe that it is the war spending that has caused our deficits and it is simply not the case. Last year, we spent about \$115 billion on those wars, and we had a \$1.3 trillion deficit. So that is the first point.

Secondly, I am new to town here, and I am an accountant, and I do like looking at history and numbers, and I was really surprised when you take a look at the average spending on defense over the last number of decades during my lifetime how it has declined. We have gone from an average of about 8 percent in the 1960s down to 5.6 percent in the 1970s and 1980s, to 3.8 percent in the 1990s, 3.6 percent the last decade—really a record low during my lifetime. And now the last 3 years it has been about 4.8 percent as well as if you take a look at defense spending as a percentage of the total budget that went from 43 percent in the 1960s to 28, 25 percent, basically in the last few decades it has been 18, 18, and 19 percent, and now the fiscal year 2013 budget would have it at 16 percent.

So to me, I believe—and it just makes common sense—that the defense of the Nation is really the top priority of Government, and

it looks like that our Federal Government has changed its focus from really defending the Nation to really protecting entitlements.

Let me just start out first by asking, why is it the case that President Obama—and it just seems like, an awful lot of Democrats pick out defense first for adjusting the fiscal situation. I mean, that is the first thing they want to cut. I do not understand that. Do you have any explanation on that?

Secretary PANETTA. Well, Senator, first of all, that is not true. The fact is that it was the Congress through the Budget Control Act that mandated the reductions in defense that I am implementing. I am following the law, and the Congress passed that law.

Senator JOHNSON. Weren't the defense cuts really pushed by the Democratic side and by the President? I mean, let us face it, that was the hammer over the Republicans' head to come to the table, was defense sequestration, which, by the way, you referred to as "mindless" and I agree with that.

Secretary PANETTA. My understanding is that you came up, however you did it, with about \$1 trillion in discretionary savings. The Congress made a decision that you were going to fence those funds for national security as well as nondefense discretionary. That automatically established a number of close to \$500 billion that we would have to reduce defense. So I think it is unfair to say that somehow the Democrats were pushing for it. It was basically a bipartisan deal.

Senator JOHNSON. Next question, then. I think as the Chairman pointed out and I think you agreed with, the entitlement spending is really what is driving our deficits, especially long term. Can you explain why the President has not proposed any kind of reform for saving Social Security and Medicare? There has just been no proposal whatsoever. Secretary Geithner even admitted there is absolutely no plan to try and save Social Security. Why is that?

Secretary PANETTA. Well, if I was an OMB Director, I could engage with you on that, but I am the Defense Secretary, and that is what I focus on. But I am sure that the President has indicated that if there is a willingness to come together and look at all elements of Federal spending, including entitlements, that there would be a willingness to be able to put together the kind of comprehensive solution that I have always been a part of in my budget history that needs to happen now.

Senator JOHNSON. Okay. I understand comprehensive, I understand balance, but the fact is everybody recognizes it is Social Security and particularly Medicare that is driving our deficit problem, and there has been no proposal—it is just used as a political football. That is basically true, correct?

Secretary PANETTA. Well, it is the old game. You know, on the one hand—

Senator JOHNSON. And that is the problem. It is a game. That is the problem.

Secretary PANETTA. That is unfortunate. It is a game, because on one side people, will defend not touching revenues, which need to be part of the deal. On the other side, there are those that will defend not touching entitlements, which have to be part of the deal.

If you want to deal with the size deficits that this country is facing, you better put everything on the table.

Senator JOHNSON. One just quick question. When we are asking the military to increase their contribution to TRICARE, we are not asking any other Government employee to do that. Why is that? Why ask the military and not maybe, I guess, unionized members of the Federal workforce?

Secretary PANETTA. Well, I mean, look, I am dealing with the defense budget. I am not dealing with other elements of the budget. And we felt that in order to control our health care costs, this was one way to try to do that.

Senator JOHNSON. Okay, Thank you, Mr. Chairman.

Chairman CONRAD. Senator Begich.

Senator BEGICH. Mr. Chairman, thank you very much. Before I ask my questions or comment, I always like to give a little bit of good news. I do this on a regular basis because we get intense around here.

You know, where we were 3 years ago, where we are today, I will just read you headlines from just yesterday: U.S. stock rises on home sales data. Housing trends make Home Depot a buy. Why? Because people are now remodeling, spending in the homes they live in. Pending home sales rise to a new 2-year high. Economy moving in the right direction. The National Association for Business Economics say forecasters have raised their expectations for employment, new home construction, and business spending. Why? Again, because the economy is moving in the right direction. Consumer confidence up in February for the sixth straight month.

Along with that, today, if I recall the numbers, unemployment claims are at the lowest level—or most consecutive level—lowest level since March 2008.

Why I like to do that is because this is a Budget Committee meeting and we want to talk about not only cuts but where we are in this economy.

Is it where we want it to be? No. Can it be better? Yes. Is it better? Absolutely. So I want to put that into context here.

I do want to say, to my colleague on the other side, I can answer your question on insurance premiums. Not that I want to see any military premiums increase, but they pay a lower premium, a lower co-pay than folks who work in the Federal Government as a civilian worker. That is just a fact. That is why there is probably an adjustment. But I do not—without the chart, I just want to make sure that is clear.

The other thing I want to make a point, the chart was interesting about the military expenditure, but we have to include the State Department, the CIA, Ag, and, oh, by the way, VA—the VA—which will be trillions to the expense of these wars. We cannot forget that. I know I serve on the Veterans' Committee. I know a couple of my other members here do. That is an ever growing cost to us that we must bear, and we are responsible to do. They served our country. They did it at our call. We can argue over the wars, but the VA must be taken care of, and the veterans must be taken care of. So I want to make sure when we talk about these numbers everything is included today and into the future, because it is important that the public who watches us or who are subjected to watch us in this opportunity here, they get the facts.

I want to ask you specifically—I want to be a little parochial, but I do want to follow up on one question that was asked earlier, and it leads to my question about Eielson Air Force Base in Alaska. But first, before I do that, I cannot have the details. I know there was some debate over how many bases in Japan, how many bases in Germany and so forth, but there are over 600 military bases overseas, and I guess my concern is as we look at the realignment, especially now that we have identified Asia-Pacific as an important asset that we need to protect and be engaged in—of course, I am biased here. Alaska by air and by sea is the closest, other than Hawaii, despite how they put Alaska down by California all the time, no disrespect to your State, but they get a little confused on the map. But we are closer in a lot of ways.

So I am a little confused on why we have these 600-plus bases with limited—I understand now you are thinking about two brigades now. Two years ago we asked for this. I know you were not there 2 years ago. We asked for this. Now there is some discussion. Eielson Air Force Base, which seems to be in the right location, the F-16s they are planning to move, was the same debate we had when we did the BRAC—the exact same debate. We are not doing the BRAC now. The folks are just doing it.

So the first question is: Did the Department of Defense's Legal Counsel look at this and how it conforms or not conforms to what BRAC may require, if there is a BRAC? In other words, this seems to be kind of going around the system.

Secretary Panetta. Senator, I think the reason the President would be requesting a BRAC is to basically go through the process of what infrastructure should we reduce in this country, and so that is the process that I would expect we would go through.

Senator BEGICH. But Eielson is already—here is what they have done. This is what gets me very concerned. They have said we are going to move these F-16s, and now the Air Force is now doing the analysis if it is going to save money, versus the Army, which I will use Fort Wainwright and other forts in Alaska, they are actually going through a process before they determine what they are going to do. I do not get this, to be very frank with you. It is almost like they have picked a location—many locations, I will say, some of my colleagues here in their States, but they are now starting the analysis. Does that seem—and yet this is the same debate we had on BRAC on the same location.

Secretary PANETTA. I strongly urge that you talk with the Air Force Chief and—

Senator BEGICH. We have.

Secretary PANETTA. —the Air Force Secretary.

Senator BEGICH. General Schwartz—we have had him up in Alaska, and I still have the same questions. That is why you are here today, and that is why I am asking you today.

Secretary PANETTA. Well, and I guess I have to ask him the same question.

Senator BEGICH. Okay. So can I look forward to having a response back on that.

[The information follows:]

The Air Force must achieve spending reductions in the current budget cycle regardless of whether additional Base Realignment and Closure (BRAC) rounds may

ultimately be authorized. The Air Force is therefore making adjustments to its force structure, and the transfer of the Aggressor squadron from Eielson Air Force Base (AFB) to Elmendorf AFB is among them. The BRAC round provided that action does not trigger the thresholds established in 10 U.S.C. 2687. Section 2687 specifies that the Department cannot take any action to effect or implement the closure of any military installation at which at least 300 civilian personnel are authorized to be employed, or the realignment of any such installation involving a reduction of more than 1,000, or by more than 50 percent of the number of civilian personnel, whichever is less, unless and until certain requirements set out in the statute are met.

The actions at Eielson do not trigger the thresholds specified in section 2687. Specifically, Eielson AFB is not being closed, and the realignment will not relocate either 1000 or 50 percent of the permanent DoD civilian positions at Eielson to Elmendorf AFB. Were the triggering thresholds of the statute to be exceeded, the Air Force would have to report on the proposal, provide certain specified analyses, and wait a prescribed period of time before implementing the action.

Finally, it is important to note that if Congress does authorize the requested BRAC rounds, the Air Force's currently proposed force structure changes do not presuppose and will not prejudice an installation during a BRAC analysis.

Secretary PANETTA. Yes, indeed.

Senator BEGICH. That would be very important.

The last thing I will just say, I would—and we will put it in for the record, on MEADS, it was in this Committee a year ago and it was through the work of the Chair bringing folks here in front of us that we discovered some expenditure that we think is not the best use of the money. I need more definition of why you are funding that again. And I have some other questions. I will submit them to the record in keeping with my time as the Chair restricted us.

[The information follows:]

The Administration has requested funding in the FY2013 budget not only to complete our international obligations under the Medium Extended Air Defense System (MEADS) Design and Development Memorandum of Understanding (MOU) as agreed with the other participants - the German Federal Ministry of Defense and the Italian Ministry of Defense - but also to obtain the meaningful data and results of the 9-year Design and Development effort for the U.S. DoD and our partners. FY2012 and FY2013 funds from the U.S. DoD and the balance of the the German and Italian funds are required to complete development and testing of MEADS elements, which would provide the program participants with a useful data package for future missile defense activities.

In accordance with the requirements of section 235 of the National Defense Authorization Act for FY2012, the Department has consulted with the German and Italian participants regarding development of a plan to restructure the program further in the event that Congress does not authorize or appropriate FY2013 funding for these purposes. We have informed the German and Italian participants that there is significant risk that FY2013 funding may not be made available by the Congress. In response, the German and Italian participants have informed the Department that they remain fully committed to their MOU obligations and expect that all three participants will provide funding in 2013 to complete ongoing MEADS Proof of Concept efforts. Although we have engaged with the other MOU participants to seek to complete MEADS MOU efforts using only FY2012 funding, we cannot force them to agree to this course of action.

More broadly, although the Department shares your commitment to ensure that we are careful stewards of taxpayer funds, we also note that failure to meet our MEADS MOU funding obligations for FY2013 could negatively affect our Allies' implementation of other current transatlantic projects and multinational cooperation efforts in which we are engaged with them - as well as their willingness to join future cooperative endeavors with the United States - that are strongly supported by the Administration and Congress. In fact, we are concerned that the ramifications of failing to provide funds for this program after FY2012 could affect our relationship with our Allies negatively and on a much broader basis than just future cooperative projects.

Secretary PANETTA. No, I appreciate that, and we will get a full response back to you. But I think the problem with MEADS is if we do not meet our funding requirement, the obligation that we made, we will incur an even larger fine for not putting up that money, and that is a problem.

Senator BEGICH. Except I will end on this: Every contract you sign, any department signs, is subject to appropriation. That is how the contractor signs it, knowing that this body, meaning the Senate—

Secretary PANETTA. I understand that.

Senator BEGICH. —could not appropriate—we never exercise that. It is like a fake clause. Well, let us just not give the money. No fines then, because they signed the contract with that obligation.

Secretary PANETTA. I understand, and Appropriations ultimately makes those decisions. You know, one way or another, we will pay a price here if we do not meet that obligation.

Senator BEGICH. Okay. I will leave it at that.

Chairman CONRAD. Senator Ayotte.

Senator AYOTTE. Thank you, Mr. Chairman. Thank you, Mr. Secretary. Thank you, Chairman. Thank you Secretary Hale.

Chairman Dempsey, I have great respect for you and your service to the country and the important role that you play, but I have to ask you about the interview that you gave with CNN because I need to understand it.

When you were asked by Fareed Zakaria about what we were counseling our Israeli partners with respect to Iran, you said that you were counseling them not to attack Iran, and then you also said that you believed that—the administration believes, I assume, that the Iranian regime is a rational actor. Can you help me understand, why you would have said that, particularly in a public interview, about one of our closest allies? And I am really concerned that in doing that, we are sending the wrong signal to Iran. Can you help me with that?

General DEMPSEY. Actually, thanks for asking, Senator, and you beat Senator Graham to the punch. No, honestly, I want to clear up some things.

First of all, I did not counsel Israel not to attack. We have had a conversation with them about time, the issue of time, and that will require a much longer conversation. But on the issue of rationality, look, I agree that Iran is a regime that is dangerously misguided. Look at its behavior. It protects itself. It loathes its neighbors. It interferes with its neighbors. It threatens its neighbors, and it disregards its own citizens.

So, none of that is acceptable to us or to our way of thinking and our way of being rational, but it does fit their pattern of thinking and a 30-year history of conduct.

So my view of this is we cannot afford to underestimate our potential adversaries by writing them off as irrational. That is kind of the juxtaposition of the phrase. And I personally do not mistake Iran's rhetoric for a lack of reason. I think the issue here for us all is that we have to decide what global pressure, including the

use of force if and when necessary, can turn that regime away from its nuclear ambitions, its nuclear weapons ambitions.

So thanks for letting me clear that up.

Senator AYOTTE. But as I understand your testimony, you would not take force as an option off the table.

General DEMPSEY. Absolutely not.

Senator AYOTTE. And one of the things I am concerned about when you think about with the description as the way it came across in the interview with CNN is describing Iran as a “rational actor” is this issue that if they acquire a nuclear weapon, it is not just about their using it, but also the possibility they are a great state sponsor of terrorism that they could provide that nuclear weapon to let others use it on their behalf. Is that not a real risk with Iran?

General DEMPSEY. That is a real risk, as is the risk of nuclear proliferation among others who, feeling threatened, would seek to acquire their own nuclear weapons.

Senator AYOTTE. And I think when we hear those types of possibilities, when we have just heard today that that is a real risk if Iran acquires a nuclear weapon, that most of us think that cannot be a rational act from our perspective of terms of looking at it and the world and the number of innocent lives that could be lost if a terrorist group acquires a nuclear weapon and Iran provides it to a terrorist group. You would agree with me that I understand that maybe by their calculations it is rational, but by ours it would not be?

General DEMPSEY. I think that is exactly the point, and as we seek to influence their behavior, we have to understand their way of thinking. That was the only point I was making.

Senator AYOTTE. Okay. I appreciate your testifying about that today.

I would ask you, Secretary Panetta, just a follow-up to the question that Senator Johnson asked, it really is this, the bigger question: In the President’s budget, you are recommending increases to our active duty and veterans in terms of health care costs. But it does not seem the President is proposing really any increases, as I can see it, effectively none to the civilian workforce. I think that is a hard ask of our military when they are already making so many sacrifices when we are not making sacrifices on the civilian side, too. Do you think that is fair? And do you think that really we should also—including myself, by the way. Members of Congress have what the civilians have. I think all of us should be sacrificing. I worry that we are asking them to go first, understanding that I know that health care costs are a big issue.

Secretary Panetta. Senator, again, if I was an OMB Director, I think I would give you an answer that dealt with the entire budget that the President presented. But as Defense Secretary, I had to deal with what I was responsible for, and that is why we approached it based on where we thought savings could be achieved.

Senator AYOTTE. I just worry about your ability to go to our military and to ask them to do this, to make the sacrifice, when civilian employees of the Federal workforce, including Members of Congress because we have the same health plan, are not making a similar sacrifice, and you as the leader of the Department of De-

fense, I just worry about what message we are sending to our military with that. So that is where I worry, and I worry about you as a leader and having to go and sell that.

Secretary Panetta. I understand, but, one of the great things about our men and women in uniform is they go where they are told to go and they do what they are supposed to do and they salute and do the job. And that is what they are doing here.

Senator AYOTTE. But we have a responsibility—

Chairman CONRAD. Senator.

Senator AYOTTE. —for them.

Chairman CONRAD. Senator.

Senator Whitehouse?

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Mr. Secretary, welcome. We are gearing up towards another BRAC round, maybe two, I gather. The last BRAC round, as I understand it, only addressed American bases. You have just said that the question in the upcoming BRAC round would be what infrastructure should we reduce in this country.

Is there a way to and should we include in the next BRAC round both domestic and overseas bases, particularly given the extent to which so much of what is done can now be done from a remote location because of our electronic capabilities? We fly aircraft from remote locations far away from theaters of operation, for instance.

Secretary Panetta. Senator, we have the authority that we need to close bases abroad. We have closed about 140 bases in Europe. We are looking at another 40 to 50 bases that will be closed. So we do have the authority to look at the infrastructure abroad and try to reduce that. When it comes to this country, the only way we can do it, obviously, is with the approval of the Congress and that is why the BRAC process was developed.

Senator WHITEHOUSE. And I get that. There is a political difference between your executive ability to close an offshore base and the requirement that Congress approve of or tolerate a decision to close a domestic base. But nevertheless, when you are looking at our posture as a military and trying to figure out where the most effective basing is, is it not a bit artificial to have the BRAC process only look at American bases and not overseas bases? Should it not include, to an effect, a global BRAC?

Secretary Panetta. Well, I think Congress certainly, if it proceeds with a BRAC process, has every right to ask the administration and this Department to present our rationale for what we are doing with regards to infrastructure abroad and how that fits the larger picture. I agree with that.

Senator WHITEHOUSE. Okay. Let me jump to cyber security. If I understand it, your testimony says there is \$3.4 billion for cyber command, which I applaud, which I think is necessary. I think, frankly, we are a little bit behind the curve and we are in a race and the threat vector is developing at a far greater rate than our defense capability is growing against it.

Could you speak a little bit about military supply chain security against planted cyber threats? We have supply chain security for textiles, thank God, for Rhode Island industries, and yet we have aircraft flying around that have components that are built overseas. Do you need more resources, now that this cyber threat has

become more great, to make sure that our supply chain is protected against cyber intrusion?

Secretary Panetta. You know, it has been pointed out, we are seeing increasing attacks, cyber attacks, not only in the public sector, but the private sector, as well, and I think this country has a responsibility to develop the defenses that have to be there in order to ensure that this country is not vulnerable to those kinds of attacks.

The money that we dedicated in our budget tries to improve our technologies, our capabilities within the Defense Department, within NSA, but I would suggest that part of that consideration has to be, what do we need to do to make sure that the equipment, the technology that we are getting, all of that has adequate protections against cyber attack.

Senator WHITEHOUSE. Let me make a request for the record, if I may, since my time is starting to run out—two requests for the record. One is that if you could break out for me what in your budget is related to supply chain security—

Secretary Panetta. Sure.

Senator WHITEHOUSE. —and to the extent that you can make that specific to cyber attacks and specifically from the Chinese, if you go that far—

Secretary Panetta. We will do that.

[The information follows:]

The Department's FY2013 budget request includes \$24.4 million dedicated to supply chain risk management efforts. This includes supply chain threat analysis and institutionalization of supply chain security practices across the DoD.

DOD's supply chain security program, called Trusted systems and Networks, does not single out threats from any particular country, but incorporates this aspect of risk through supply chain threat information. Accordingly, we cannot break out a specific portion dedicated to China.

Senator WHITEHOUSE. —I would like to get that.

The second thing I would like to do is to have a discussion with whoever in the Department of Defense is focusing on health care reform for the Department of Defense. You are a very big buyer. I think you said \$50 billion in health care. A lot of that gets delivered overseas, but a lot of it gets delivered here. That is the kind of money that can make a difference in how people behave, and there is a significant reform movement that is taking place and I just want to be connected with whoever is engaged in that for the Department of Defense.

Secretary Panetta. Yes. No, I will have our Under Secretary responsible for the health care area get in touch with you and go through the issues that we are dealing with there to try to—

Senator WHITEHOUSE. That would be great. I appreciate it. Thank you, Mr. Secretary. Thank you three gentlemen for your service.

Chairman CONRAD. Thank you.

Senator PORTMAN. Thank you, Mr. Chairman. I am going to start with Under Secretary Hale. I do not know if he has gotten too many questions today, but first to thank him for working with us on ensuring that CFOs around government have the standing they deserve. I appreciate his conversations with me in that regard and

ensuring that that legislation kept them as confirmed individuals in their various departments and agencies, including DOD.

Auditing—as we begin this downsizing, it seems to me the most critical thing is to make sure we are doing it right, whether it is this first \$487 billion or whether we have to go to something beyond that, and I am concerned that we still do not have the kind of sound audit that we would like to have of the Department. Can you give us a status report on that and what you are doing to accelerate the auditability of DOD, given the huge sacrifices that DOD is being asked to make.

Mr. HALE. I can. First, thank you for your help on the CFOs. I appreciate it.

We have a plan that we set up a couple of years ago to move toward auditable statements in a cost effective manner. We are focusing first on the information the Department most uses to manage, particularly budgetary information and accounts and location of our assets. At Secretary Panetta's direction, we have accelerated particularly the budget statement portion of it because it is a key one, seeking audit readiness by 2014, with all of the statements being audit-ready by 2017 as the law requires.

We have set aside a fair amount of resources. We have a governance process. As I mentioned, we have a plan and we have some near-term successes. The Air—the Marine Corps, I should say, is going through an audit process now for its budget statement. They are close in terms of getting an opinion, and a variety of other appropriations receive, which is our funds distribution process, got a clean opinion last year. We are trying to do near-term things that show progress both, frankly, to ourselves and to the Congress.

We are not there yet, but we are committed to it. I think Secretary Panetta's support is a golden opportunity for us and I want to leverage it in every way I can to move forward in this important area.

Senator PORTMAN. Great. Thank you. I appreciate it, and just know we are watching and I appreciate your efforts, and having a former OMB Director as head kind of helps to get some attention on it.

By the way, finally, one OMB Director made good. Congratulations, Leon, for continuing to exceed expectations of OMB Directors.

Quickly on this whole issue of the sequester, this first stage, you said, and I was here earlier listening to your testimony, that it creates risks, and that is the \$487 billion. You also said those were acceptable risks and explained why. This must mean that there are additional steps with step two, which was an additional \$535 billion. How would you describe those risks that would be entailed should we move forward with a sequester as currently planned?

Secretary Panetta. They would be devastating because the cuts would be made, as according to that formula across the board. So it would come out of force structure. It would come out of readiness. It would come out of, I assume compensation would be on the table, as well, and it would come out of every area of the defense budget. And the danger is that when you do it that way, you automatically hollow out the force because what you are doing is you are weakening every area of the defense budget by some kind of

blind formula, and it means that even though we will have a smaller force structure as a result of those cuts, they will be ill-equipped, ill-trained, and ill-prepared to be able to—

Senator PORTMAN. Mr. Secretary, when do you need to start making the changes? In other words, January 1 next year is when a sequester goes into effect, but when would you have to start making changes at DOD?

Secretary Panetta. I am waiting for OMB guidance on that, but I would assume sometime in the summer, we would have to do that.

Senator PORTMAN. In the summer. So you are looking for at least something from Congress prior to the summer.

Secretary Panetta. That is correct.

Senator PORTMAN. We are now into the spring and we would need to act very quickly.

You talked about health care earlier. Let me give you a statistic that I have. I hope it is not right, because it is scary. Seventeen-point-four billion is what you spent on health care in 2000, and you said earlier they are spending \$50 billion today. Is that correct?

Secretary Panetta. That is right.

Senator PORTMAN. So you have seen a huge increase in your health care expenses—

Secretary Panetta. True—

Senator PORTMAN. —and it is the biggest increase in your budget, as I understand it. Do you think you are doing enough on health care in this first stage, and what more can be done?

Secretary Panetta. It is the first step. I think there are probably other steps that we have to look at as we look at kind of health care costs generally. But we thought that probably the first step would be to try to increase these TRICARE fees and then continue to kind of look at health care delivery in the future.

Mr. HALE. May I add to that?

Senator PORTMAN. Yes, sir.

Mr. HALE. We are actually doing a number of things in the health care area. It is not just the TRICARE fees. Trying to improve the quality, and again, I think our Under Secretary of Personnel and Readiness could address this better, but we have looked at provider costs. We sought and received authority, for example, to use Federal pricing schedules for pharmaceuticals, which has significantly reduced our cost, to use Medicare payment rates for our outpatient payments, which also significantly reduced our cost.

We really did a number of those things before we looked at the TRICARE fees last year, and in this proposal we have made this year. So we are looking across the board at health care and trying to hold down costs while maintaining the quality of the care, which is critical.

Senator PORTMAN. General.

General DEMPSEY. Could I just add one thing on sequester, please, Mr. Chairman. It is already beginning to have an effect on our defense industrial base. Although we can wait until the summer, there are some corporations in our defense industrial base who with the specter of sequestration hanging over them are already making some decisions about their workforce. And so this is

an immediate problem for them that will become a problem for us eventually.

Senator PORTMAN. Well, I thank you, and I know my time is up, but the audits are critical as we are downsizing to make sure it is done right. We have to be sure we are dealing with these health care costs because that takes away from readiness and operations. I know the Chairman has talked about putting a budget together. We would have to do something pretty quickly here, it sounds like, to avoid eroding further the industrial base and having DOD making decisions that would be detrimental and as devastating as the Secretary said.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Murray.

Senator MURRAY. Thank you, Mr. Chairman.

Secretary Panetta, as I spent a lot of time

last year on the Joint Select Committee on Deficit Reduction working with Democrats and Republicans to tackle some of the issues that you are talking about today. All of us went into that committee knowing that sequestration would be a terrible outcome and we understood that across-the-board cuts to these programs, as well as middle-class families and most vulnerable Americans depend on, would be bad policy. That was really the point of the bipartisan triggers that Senator Reid and Speaker Boehner agreed to. They were supposed to be painful to push us towards a compromise.

So I was really disappointed that despite the fact that we put a lot on our side, some pretty painful cuts out, we could not get to an agreement because we could not come to that shared sacrifice moment. I am still willing to make those compromises needed to get to that. I hope everyone on both sides are because I think we are all really concerned about where that is going to go.

But I did not want to focus on that today on my time. I wanted to ask you a question about an issue that has become very important and recently come to light. At Madigan Army Medical Center in my home State of Washington, a number of soldiers had their behavioral health diagnosis changed from PTSD to other behavioral health disorders that did not come with the same level of benefits. However, following, as you may know, an independent review at Walter Reed, a number of those diagnoses were then changed back to PTSD. Obviously, this is really troubling. But what is even more troubling to me and to many service members and their family members in my home State and a lot of people I have been talking to is the allegation that the decision to strip those soldiers of a PTSD diagnosis came from a unit at Madigan that seems to have been taking the cost of a PTSD diagnosis into account when they were making their decision.

Now, there is an investigation going on into this, but really, to me, one of the things that is clear is that oversight within the Army and then at the departmental level allowed this break from standard diagnosis process to go unchecked. So I am really concerned about how the services handle non-PTSD behavioral health conditions like adjustment disorder, where service members are administratively separated instead of going through the physical disability process, and I wanted to ask you, given that an adjustment

disorder is compensable by VA and DOD is required to use the VA's rating schedule, what is the reason for DOD treating adjustment disorder differently?

Secretary Panetta. Well, I was very concerned when I got the report about what happened at Madigan and I think it reflects the fact that, frankly, we have not learned how to effectively deal with that and we have to. We need to make sure that we have the psychiatrists, the psychologists, and the medical people who can make these evaluations because these are real problems.

I have met with men and women who have suffered this problem. I just met with a couple last night. And they had to go through hell in order to be able to get the diagnosis that was required here, and that should not happen.

So we are investigating, obviously, what took place, but I have directed our Personnel Under Secretary to look at this issue and to correct it because it is unacceptable now to have the process we have in place.

Senator MURRAY. Well, I appreciate the attention given to this. It is going to take a lot of work, and I am deeply concerned. When someone comes home from war and they have to go through a diagnosis like this, it is hard enough after you have been told to "man up" during your time of service to then face the fact that you have PTSD, and then to have that reversed and changed back and then told there is nothing wrong with you is just devastating to these men and women and their families. So this is something I am going to be following very closely. I want your personal attention on it. And I think that the issue that was raised at Madigan really needs to have a more—shows us that we need to have a more clear, consistent guideline for clinical practices for diagnosing and treating PTSD.

Secretary Panetta. I agree with that. Absolutely. You are absolutely right.

Senator MURRAY. And I never want to hear anybody in any service say, we are not going to give you a diagnosis of PTSD because we have a budget problem.

Secretary Panetta. That is for sure.

Senator MURRAY. Okay. Thank you very much.

Chairman CONRAD. Senator Thune.

Senator THUNE. Thank you, Mr. Chairman. Mr. Secretary, thank you for being us. General, Mr. Hale, thank you for being here, and I also want to recognize Colonel Toliver, who commanded one of the finest bases in the country, Ellsworth Air Force Base in Rapid City, South Dakota.

Mr. Secretary, I think you have touched on this once already, but I just want to maybe put a fine point on it. But you recommend in your budget that Congress enact two more BRAC rounds and it seems like that a lot of that excess capacity among domestic bases could be filled by closing overseas bases, particularly in Europe, and bringing troops home from bases back to bases back in the continental U.S., and particularly given the fact that it seems that we have had a military presence in Europe for a long time, obviously, but it seems to make abundant good sense to get some of these folks home. So if you could just kind of elaborate on why you have not recommended closing overseas bases in this budget, especially

in parts of the world where it is perhaps no longer necessary to have that kind of military footprint.

Secretary Panetta. Well, we have made recommendations with regards to reduced infrastructure abroad. It is an area where we have the authority to be able to make those reductions, and as I pointed out, we have closed about 140 bases abroad. We are going to close additional bases, particularly as a result of reducing the number of brigades in Europe from four down to two.

But at the same time, I do have to tell you that operations, particularly in the Middle East, have required some of the key bases in Europe to be important launching points for our Air Force and for travel and for supplies to that area. So there is a need, A, to try to maintain those basic areas, and in addition to that, obviously, our NATO requirements and our partnership require that we engage in exercises and in a rotational presence there to work with NATO so that we can build up that partnership to make it capable of dealing with its responsibilities, as well.

But having said that, we are in the process of looking at additional reductions abroad. When it comes to the United States and the kind of infrastructure reductions that have to take place here, frankly, there is no other way to do it than through the BRAC process.

Senator THUNE. Mr. Secretary, the President has said that he would veto any attempt by Congress to prevent the effects of sequestration on military spending, and I want to share with you some things that you said, for example, at the Munich Security Conference last month, that you and the President, quote, "are not paying attention to sequester," "sequester is crazy." You also said that you "strongly urge Congress to be able to come forward and try to detriquer that amount because, frankly, it is not the amount, it is also the way it would be done. The formula is built in the sequester. It would cut across the board, and as I said, it would certainly virtually devastate our national defense," end quote.

Now, so essentially—I am trying to figure out, because a conflicting message is coming out. You are urging the Congress to do away with the sequester at the same time the President has said that he would—he has threatened to veto legislation that would do away with it. So how do you sort of reconcile or square those—

Secretary Panetta. Senator, I think what the President stated was that if there were just an effort to detriquer the defense part of sequester, that he would oppose that, that he thinks that sequester across the board, both on defense and non-defense, is severe enough that both areas ought to be addressed in trying to detriquer sequester.

Senator THUNE. There is a question, too, about whether or not, if there were a sequester in the defense, how it would be applied, and Section 302 of the Budget Control Act speaks of sequestration of budget enforcement in terms of accounts. It does not dictate that sequester cuts must be applied in equal percentages to each program, project, and activity, as you claimed in a letter November 14 to Senators McCain and Graham on the effects of sequestration. For example, you could choose to apply the amount to be sequestered from the Navy procurement account entirely to one activity within that account.

So how would you approach this issue in terms of the flexibility? You are suggesting that this would be applied in a very—

Secretary Panetta. Across the board.

Senator THUNE. —indiscriminate way across the board.

Secretary Panetta. Let me ask our Comptroller to—

Mr. HALE. We are trying to work with OMB to understand. This is an arcane law. It goes back to the 1985 Budget Impoundment and Control Act. Our lawyers believe that it would be at that low level of detail that would be in that letter. I think that we need to work with the OMB lawyers to see exactly what would be the case. But make no mistake, I do not think anybody questions that at the account level, Army O&M, Navy shipbuilding, that would have to be equal in percentage terms, and I think that fits the meat-axe description pretty well if you have to do it every account by the same percent. So this is a bad idea. It is bade policy and I really hope that the Congress will take the steps to detriger it.

Senator THUNE. All right. I see my time has expired. I am getting the gavel, so thank you, Mr. Chairman. Thank you all.

Chairman CONRAD. I thank the Senator. We are trying to adhere closely to the five because we promised the Secretary to get him out of here by noon.

Senator WYDEN.

Senator WYDEN. Thank you, Mr. Chairman, and thank you, Mr. Secretary and your colleagues, and let me get right to it.

I wanted to talk, Mr. Secretary, first about the Guard and Reserve. You and I have talked about this in the past. In my view, their unique expertise and particularly their ability to adapt rapidly to mission requirements is one of the reasons we ought to be especially careful in this time of making touch choices with respect to what happens with the Guard and Reserve.

Now, this year, you all are going to get four separate studies that are going to provide in-depth analysis of the cost comparison between Reserve component military members and those on active duty. And what the studies are going to find—all of them, because we had a chance to hear about them—is strong evidence about how much less expensive the Guard is compared to the active duty.

So the question, Mr. Secretary, for you this morning is would it not make more sense to wait until you have an accurate model to compare costs before you go forward with disproportionate cuts to the Air Guard. What we have tried to do is look at the Air Force, tried to look at the Guard, and it just seems to me, while all the choices you have in front of you are tough ones, I mean, there is not an easy one there, would it not make more sense to hold off until you get those four studies before there would be disproportionate cuts made to the Air Guard?

Secretary Panetta. Senator, first of all, I strongly agree that we have to depend on a strong Reserve and a strong National Guard to assist us, particularly when it comes to mobilization. And as we reduce the force, frankly, we are going to need to have that backup. And that is why, frankly, when it comes to numbers in the National Guard and in the Reserve, we pretty much maintain the force that we have now and will continue to maintain it.

The one area where there were reductions was in the Air Guard Reserve and it was done pursuant to the recommendations of the

Air Force Chief, and the basis for that was, in the past, we have reduced airlift in the active force, but we did not touch the Reserve force, and he felt in order to achieve the savings that we had to achieve under this Budget Control Act that there were areas in the Reserve where he could achieve some savings by reducing some of the airlift capability that was not multi-mission, and that is why the decision was made to reduce those areas.

Now, at the same time, I have to tell you, I met with the Governors yesterday. They have the same concerns you have. And I indicated to them that we would work with them to determine whether we can try to do this in a way that can achieve the same savings but provide some ability to relieve some of the impact that some of this would have.

Senator WYDEN. Well, thank you on that point, Mr. Secretary. Just if you will stay open on that and we can continue to have some discussion on that, I think as we look at those four separate studies—and that, frankly, Mr. Secretary, what you have done on this is to try to make this a data-driven debate. That is what has really swung us. If we can continue that discussion, I would appreciate it.

One area I want to get into, and that is energy. You all at the Department of Defense are one of the largest single users of energy in our country, and sometimes it just takes your breath away when you think through the implications. On a recent tour when we were in Afghanistan, we heard about the fact that it costs in some instances hundreds of dollars, in effect, to get a gallon of gas out to some of the forward operating kind of bases. So what do you envision, Mr. Secretary, in this budget as actually getting accomplished in terms of making us more energy independent?

Secretary Panetta. I am going to have General Dempsey speak to the particulars of what you just pointed out. Energy is a very important element in driving our national defense. But at the same time, we have made strong improvements in trying to develop energy efficiency, particularly in the Navy as well as in other elements, and here, the goal is to try to continue the investment in energy efficiencies because it does save money in the long run to be able to do that. But let me ask General Dempsey.

General DEMPSEY. Yes. I mean, we are seized of this, Senator. For me, it is part efficiency and part effectiveness. The better we can do it, becoming self-sustaining at the point of need, the less we put soldiers and sailors, airmen and marines on road networks. So there is a real operational requirement here. I mean, look, there are places in Afghanistan where you cannot get anything by way of resupply except by air dropping it. That kind of drives the cost of that commodity up when that is the condition in which we place our armed forces.

So to the Secretary's point, we are seized with it. We have a commitment in the budget. We have some plans, milestones, and we are working toward it.

Senator WYDEN. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Grassley.

Senator GRASSLEY. Senator Wyden brought up the issue that I was going to start with on the Air Guard, so I do not expect you to say any more than what you said to him, but I would like to

make a little comment about your answer, and that would be this, that you probably correctly quoted the Secretary of the Air Force that it was—that the active duty had taken probably as much as they can and so something had to come from the Guard. But we got the distinct impression with our meeting of the Iowa delegation in regard to the Des Moines 132nd Fighter Wing being removed that—well, the last time they went through cuts, the Air Force did it and now it was the Guard's turn, as opposed to being what Senator Wyden said, having data driven.

So we asked for a lot of this data but we are not getting anything. And we heard from the National Guard Bureau of which fighter wing to cut after the decision had been made to take the cut out of the Air National Guard. So we are looking for the statistical basis, the data basis, whatever it is, and we are having a hard time getting it and we would like to have it, and not just Chuck Grassley but the whole delegation.

My second point would be to read a statement and not have you comment because I gave you a letter that is going to have the basis of what I want to talk about, but just so you know that this is not something that I give little concern to. For the last three years, we have—in my office, we have read each year 120 audits done by the Inspector General, and you want to remember, we pay about \$100 million a year in this area. So my letter is about just 16 of the 120 audits of the last year.

We have uncovered egregious waste and misconduct at DOD. These reports were issued by the Office of Inspector General last year. I discovered them during the course of my ongoing oversight review of audit quality, where I am about to issue my third annual report. If I had to use two words to characterize what I found in these 16 reports, these words would be “scandalous” and “disgraceful.” This is some of the worst that I have ever seen. These 16 reports tell me two things. First, all the wasted money needs to be recovered, and second, responsible persons held accountable.

You have said that you want to save \$500 billion. Well, the Acting Inspector General is serving up some savings on a silver platter, close to a billion dollars' worth. Unfortunately, without high-level intervention, I fear all the good audit work and all potential savings will go for naught. I fear the accountability and recovery of wasted money not likely to happen any time soon.

All the information I see tells me the hard-hitting recommendations contained in these reports are being slowly and quietly ground down to nothing by Pentagon bureaucracy. So I respectfully ask that you take a moment, read the summaries of those 16 reports that I picked out of the 120, which you will find in my letter, and then tell me whether you are disturbed or angered by what you read.

If you see what I see, then please initiate a top-level review of all allegations laid out in these reports. Please urge those assigned that task to search for a reasonable path forward on all the unresolved recommendations. For audits, recommendations are a point of the spear. They are the bottom line and they are about to fall through the cracks.

May I remind you that these audits cost, as I said, \$100 million. Given the strength of the evidence that I presented, I believe it is

incumbent upon all of us to act on the waste, and I will just use one example and only one sentence from my letter.

One of these reports calls for a review of the actions of officials responsible for approving PV projects that were not cost effective and take administrative action as needed. Now, this is what the Navy's response was to it in e-mail of January 17 this year. It stated, quote, "It is not necessary to take administrative action against officials responsible for selecting the projects and considers the recommendations closed."

I will close with this. I want to compliment—on another issue, I want to compliment the Defense Department for reopening the Project Flicker investigation. Project Flicker was supposed to examine allegations that government employees, including DOD personnel, have perused child pornography on government computers. Some of those involved were reported to have sensitive security clearances. After learning that the Defense Criminal Investigation Service had arbitrarily shut down this investigation, I wrote your predecessor, Secretary Gates, on November 5, 2010. I wanted to raise questions about why the Flicker investigation was allowed to go dead. I have recently learned that, after review, cases are now flowing from DCIS to the courts for prosecution. That is very good news and I hope DOD employees purchasing child pornography while on the job are held accountable.

Thank you.

Secretary Panetta. Senator Grassley—

Senator GRASSLEY. You can respond if you want to, but you do not have to.

Secretary Panetta. No, I understand, but I would like to. First of all, I want to thank you for your leadership on these issues. You and I have known each other a hell of a long time, going back to our days on the Agriculture

Committee on the House side, and I have always respected your work in going after waste in the Federal Government.

I want you to know a couple things. Number one, on those IG reports, I do not take those lightly. I think they are seriously done and my direction to my Department is that we will implement the recommendations contained in those reports. And I get a report on that, and I am happy to share that with you, as to what progress we are making in implementing those recommendations. I have required, when an IG makes that kind of report, makes those recommendations, we do not just put it in a drawer. We have to implement those recommendations. That is something I believe in.

Secondly, our ability to develop our own audit capability, I hope, will give us the ability to get ahead of this game rather than behind it, where we are now.

Senator GRASSLEY. Well, I thank you very much and I know you are very sincere about it and I appreciate your following through.

Chairman CONRAD. Thank you, Senator.

Let me put this chart up because, Secretary Panetta, you gave a serious charge to this committee in your earlier testimony, saying that we have to be the conscience of the Congress in these committees in the House and the Senate. You certainly were that when you were Chairman. I have tried. I must say, I do not feel I have had great success in convincing my colleagues to face up to these

matters. I was proud to be part of the Fiscal Commission. I was proud to be part of the Group of Six. I think we made serious, responsible suggestions to do things on a—in a balanced way. Yes, discretionary spending has to be addressed. Yes, we have to reform the entitlements. Yes, we have to address revenue, as well.

But as I have listened here this morning, I hope the conclusion is not that there is no additional savings that can be derived from defense, not another nickel, because I do not believe it. I mean, I have spent a great deal of time looking at places we could save responsibly and I do not think we are going to, at the end of the day, have an alternative here. In fact, if we do not find a way to come together around a comprehensive plan, to have additional savings, what is ultimately going to happen here, it is going to be forced on us. And it will be forced on us at the worst possible time, when we are in crisis. I cannot think of a worse outcome for this country.

About the only thing they support on the spending side is cutting foreign aid. Well, Mr. Chairman, Mr. Secretary, former Mr. Chairman, you know that is not going to do it. That is less than one percent of the budget. And about the only thing they support on the revenue side is taxing those who have incomes of over a million dollars, and there is no question in my mind, we are going to have to ask some of them to do more.

But when I look at—here it is. Here is the spending in dollar terms. Under the President's budget, there is this little dip, but then it goes up over the remainder of the budget period. So when people say, well, it is being cut to the bone, really? It is being cut to the bone? There is more spending every year beyond this next year than we have had. Every year, more spending.

And I compare it to the sequester. Boy, that is harsh. I do not think this is a wise course. Certainly not. I absolutely agree with you that this trajectory under the sequester is too sharp a cut, and the means of doing it—across-the-board cuts, by the way, we share your view, if that is what would have to be done, that really does not make sense.

Simpson-Bowles, that is the only place we have had a bipartisan agreement around here, more savings initially and more savings overtime than the President's budget, but not the kind of abrupt cut that we see in the sequester.

So I would just say this to you: I hope that we do not conclude or that it is not your testimony here today that there is not another dime of savings to be derived in defense. I just had an analyst briefing that was talking about the way we manage our Navy and that we keep crews tied to ships, and that means when a ship is deployed and the crew comes back, the ship comes back. There has been analysis done that if we kept the ship deployed and shared crews, that we could derive significant savings.

I do not know if that level of detail is something, Mr. Secretary, you have looked at, but I would be very interested. Do you believe

or have you looked at the notion of having crews share ships so that we would not have to, when a crew returns, return the ship?

Secretary Panetta. Mr. Chairman, I am not sure that is the case anymore because I think there was a concern about just what you have pointed out, and let me get back to you to make sure that that is the case. But I agree that that is an area that we need to review.

[The information follows:]

We currently rotate crews on our Mine Countermeasures and Patrol Coastal class ships. We also plan to employ rotating crews for Littoral Combat Ships as the force grows. We have recently initiated a study on the benefits and costs of expanding the use of rotational crewing.

Chairman CONRAD. All right. Contracting. Last year, the Department's testimony here was, "We do have a contracting issue. We do have to better manage our contracting. We do have to derive savings there." Is that still the view of the Department, that we have legitimate savings that could be derived from better managing of contracting.

Secretary Panetta. Yes.

Chairman CONRAD. All right. Senator Graham has returned. Senator Graham has been trying to get his questions in. He has another hearing going on. That is why he has had to shuttle back and forth. I am going to stop right now to give him a chance so that he has his opportunity.

Senator GRAHAM. Thank you very, very much. This is not a budget question, but it does relate to what is going on in Afghanistan. There are 3,044 prisoners under American control under the Law of Armed Conflict, General Dempsey, Secretary Panetta. I am going to ask of you today to provide a detailed analysis of what they are being held for, how many of them are IED makers, how many of them engaged in violent attacks against American troops. And do you believe that the Afghan legal system has the capacity to administer justice in these cases by March 7th?

General DEMPSEY. No, sir, I do not believe they do, and as General Allen has a plan to build their capacity over time.

Senator GRAHAM. Right, but do you agree with me, General Dempsey, if we released these prisoners to the Afghan legal system as it exists today, a lot of them would go back out on the streets and try to kill Americans?

Secretary Panetta. That is trouble.

Senator GRAHAM. That is trouble. Do you agree with me, Secretary Panetta, that of all the military strategies we have employed in Afghanistan, night raids produced a lot of good results?

Secretary Panetta. Absolutely.

Senator GRAHAM. And they have been reformed, and the Afghans are more in the lead than ever?

Secretary Panetta. That is correct.

Senator GRAHAM. But from a military point of view, they need to continue?

Secretary Panetta. Correct.

Senator GRAHAM. Okay. Do you support a strategic partnership agreement with the Afghan Government?

Secretary Panetta. I do.

Senator GRAHAM. And they need to step it up if they want one. Do you agree with that?

Secretary Panetta. That is correct.

Senator GRAHAM. Okay. Now, when it comes to the budget, you were asked about TRICARE premiums. General Dempsey, when you retire, would you be willing to pay more in premiums for your TRICARE?

General DEMPSEY. Yes, and I have made that clear in other testimony.

Senator GRAHAM. Well, I keep asking you, so I know your wife probably would like me to stop. But the reason I do that is because we have not had a premium adjustment since 1995. If a means test is to be applied, I think that is smart.

Secretary Panetta, the entitlement part of the DOD budget health care cost is competing with the guns and weapons systems. Is that correct?

Secretary Panetta. Correct.

Senator GRAHAM. And you cannot sustain this. This is what you are telling the Congress.

Secretary Panetta. That is correct.

Senator GRAHAM. If we do not like the way you have adjusted the premiums, I would just ask the Congress, because we have not done anything with Social Security, we should, I am for means testing. I am for a longer retirement age. I would support working until you are 70 for younger workers, but giving you plenty of notice. I am willing to do the hard things, but when it comes to the Department of Defense budget, because we have not done these other things is no reason to put DOD in such a bind. It is absolutely essential you get control of your health care costs. Is that correct, Secretary Panetta?

Secretary Panetta. That is correct.

Senator GRAHAM. If you have a better way of adjusting premiums, let me know, but it has to change.

Secretary Panetta. I am open.

Senator GRAHAM. This is a better deal than you will ever get in the private sector. It should be a good deal, but it is an unsustainable deal.

Now, when it comes to BRAC, I am in the camp that if we are going to look at trying to save \$480 billion, whatever the number is, we should put everything on the table. Do you believe it would be prudent to take another look at our basis?

Secretary Panetta. You are in the right camp because you have to look at everything.

Senator GRAHAM. Well, I just think we cannot say not in my back yard.

Now, when it comes to sequestration, you say it is the dumbest idea you have heard lately, right?

Secretary Panetta. That is right.

Senator GRAHAM. And you are competing against a lot of dumb ideas, so that is really—

[Laughter.]

Senator GRAHAM. So that is really a big prize. So would you be willing to consider resigning if you were ordered to implement sequestration in protest?

Secretary Panetta. Well, I am not going to go there because I—  
 Senator GRAHAM. Well, I would not want you to. I would not want you to because I think you have been one heck of a Secretary of Defense. But the way you communicate—General Dempsey, much to your credit, you are telling us, without any nuance, we will destroy the military if we cannot fix this problem, and I promise you, we are not going to let the military be destroyed.

Now, when it comes to budget threats, budgets and threats, do you believe the Iranians are trying to develop a nuclear weapon? Secretary Panetta?

Secretary Panetta. I think they are developing nuclear capability. Our intelligence makes clear that they have not made the decision to develop a nuclear weapon itself.

Senator GRAHAM. Do you feel confident that we have the ability, if necessary, militarily to deal with the threat that Iran faces?

Secretary Panetta. Yes.

Senator GRAHAM. Okay. And if we implemented sequestration, that ability would be greatly reduced?

Secretary Panetta. That would hurt us.

Senator GRAHAM. Okay. Now, at the end of the day, General Dempsey, you are being tasked to take \$450 billion out of the military budget. We are being pushed to do that. But if you do more, \$600 billion on top of that, that would be a no-go for you?

General DEMPSEY. We would have to go back and look at—we would have to redo our strategy, and we would not any longer be a global power.

Senator GRAHAM. Okay. When it comes to Afghanistan, Secretary Panetta and General Dempsey, is it worth it? What is winning? What are the benefits of winning? What is the cost of losing? Could you describe that as briefly as possible?

Secretary Panetta. The reason we are there, Senator, is because our mission is to dismantle, destroy, and defeat al Qaeda and their terrorist allies. And that means that our ultimate goal here has to be an Afghanistan that can control and secure itself and make sure that it can never again become a safe haven where terrorists can plan attacks—

Senator GRAHAM. Do you think that is possible?

Secretary Panetta. I do.

Senator GRAHAM. That would be winning?

Secretary Panetta. That is correct.

Senator GRAHAM. What is the cost of losing?

Secretary PANETTA. The cost of losing is that the Taliban, without question, would regain control there, that terrorist allies would again come together, and their sole goal is to attack this country.

Chairman CONRAD. I thank the Senator. I thank the witnesses. I especially thank—we are a little beyond time. I apologize for that. You have been extremely generous with your time. This is an important hearing for this Committee. We are delighted, Mr. Secretary, that you were here in person. General Dempsey, thank you very much for your testimony and for your service. Thank you, Secretary Hale, for yours as well, and we will—

Senator SESSIONS. Mr. Chairman, just let me thank the witnesses also for your testimony and for your service to your country, and we know—and the military has accepted larger cuts already

and are working diligently to achieve those in the most effective way than other departments have been asked to achieve. In fact, many of them have been asked to achieve not any cuts, zero, and I think that is important.

With regard to the chart that you were showing, Mr. Chairman, I think that is probably not—that is probably in dollars not adjusted for inflation. Adjusted for inflation, I think if we continued, you would not see a growth. I think the relative growth pattern you showed in that chart is probably accurate between the three different proposals.

Chairman CONRAD. Yes, well, you are right. It is in

Senator SESSIONS. But you adjust it for inflation, and energy costs go up, material costs go up somewhat over the years.

So I think that sequester represents a greater threat than we would like to admit, and the way to fix it is not to give up the reductions in the total number, but to look at the other aspects of the Government, as Senator Graham mentioned, and see if we can maintain a healthy Defense Department, making sure that our men and women in uniform know that, yes, they had to take some cuts and reductions, but we affirm them, we believe in them, and we are not breaking faith with them. That can be done, and I think we share that common ideal.

Chairman CONRAD. Yes, we share that view. I think that is a very good summary statement for what we have to try to achieve here. I think one thing that should go out as a message clear from this hearing on both sides here, we do not believe the sequester ought to go forward. It is terrible policy, certainly for the national defense of our country. So let us not have that be a result.

At the same time, we understand we have to deal with this deficit and debt threat, as difficult as it is. And, Senator Graham, thank you for your questions. Right on point.

We will stand in adjournment.

[Whereupon, at 12:08 p.m., the Committee was adjourned.]

CHARRTS No.: SB-01-001

Senate Budget Committee

Hearing Date: February 28, 2012

Subject: The President's Fiscal Year 2013 Department of Defense Budget Request

Member: Senator Ayotte

Witness: HON Panetta

Question: #1

Audit Readiness

Question: The Department of Defense (DoD) is one of the few cabinet-level agencies in the federal government that is not prepared to undergo an audit. Secretary Panetta has reiterated his commitment to achieve audit readiness of the Statement of Budgetary Resources for general funds by the end of calendar year 2014 and to meet the legal requirements to achieve full audit readiness for all DoD financial statements by 2017. The Air Force in particular confronts some serious challenges in the effort to achieve audit readiness. Are there concerns that the Air Force will not be able to meet the audit readiness goals, and how can the Senate assist in ensuring that the Air Force meets the audit timelines and requirements? Will the Office of the Secretary of Defense keep members of Congress informed as to the Pentagon's progress toward these important intermediate goals and, where possible, let Congress know how where it can help to expedite progress toward full auditability?

Answer: The Air Force's earlier plan reflected a dependency on multiple ERP implementations. These system modernization initiatives are still important to our long-term business process improvements as well as cost-effective sustainability of audit readiness. The Air Force has adjusted their plan to address processes and controls as well as improving interfaces between its current systems. Improving controls and interfaces around the systems will be an investment that aids the implementation of the future systems and improves the likelihood of successful system implementation. The Air Force will also consider cost-effective upgrades to existing systems to meet the new timeline. An example of this would be improving the ledger posting logic.

My staff will continue to keep all interested Congressional parties fully informed about our progress. The May 2012 FIAR Plan Status Report will provide the detail of the Department's plans for achieving the accelerated timelines, including intermediate goals. Future FIAR Plan Status Reports will also report on our progress towards meeting these goals. Congress should continue to review these status reports and hold hearings to ensure satisfactory progress.

CHARRTS No.: SB-01-002  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Ayotte  
Witness: USA GEN Dempsey  
Question: #2

Reset Costs

Question: Years of war in Iraq and Afghanistan has worn down military hardware and equipment. Last year, Congress provided \$13 billion for equipment reset and the Department of Defense requested \$9.3 billion in OCO funding for FY13. How much funding has been provided to cover reset costs in the past? What is DoD projecting for future reset costs? What is the readiness impact if we fail to fully fund equipment reset?

Answer: Through fiscal year 2012, approximately \$190 billion was provided for the replenishment, replacement, and repair of worn, damaged, or expended equipment.

We have a large wave of recapitalization and reconstitution coming our way. Even if the war ended today, the next two to three years would be spent resetting the force. Unfortunately, precise reset requirements are difficult to estimate – dependent on many variables including equipment condition upon return – and we cannot predict exactly what those costs will be at this point. However, we do know that the high operating tempo and harsh environments of Afghanistan and Iraq have a substantial deteriorating effect on equipment.

If we fail to fully fund equipment reset, we would have serious equipment shortfalls as inventories are used up, expended, damaged, or worn out, and not replaced and repaired in a timely manner. These shortfalls would have a direct impact on unit readiness levels.

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CHARRTS No.: SB-01-003  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Ayotte  
Witness: USA GEN Dempsey  
Question: #3

U.S. Nuclear Force

Question: According to the Associated Press, the Obama administration is considering new cuts to the U.S. nuclear force, including reducing the number of deployed weapons by up to 80 percent. What is the minimum number of nuclear weapons the Department of Defense considers necessary to maintain a credible nuclear deterrent?

Answer: The Department is currently in the process of completing a post Nuclear Posture Review (NPR) analysis to determine our requirements for future levels of nuclear weapons and delivery platforms. This analysis, when completed, will inform subsequent guidance from the Secretary, which in turn will be followed by my issuance of new nuclear guidance to the Services and combatant commanders. This process will conclude with a revision of STRATCOM's annual nuclear plan. This overall process, when complete, will identify our future nuclear weapons requirements to maintain a credible nuclear deterrent.

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CHARRTS No.: SB-01-004  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Cornyn  
Witness: USA GEN Dempsey  
Question: #4

Attacks on NATO personnel in Afghanistan

Question: The recent attacks on NATO personnel in Afghanistan were deeply troubling. Specifically, in DoD's FY13 budget request, I note that the Afghan National Security Forces budget request has been cut by 50%; at the same time we are telling the Afghans and our NATO partners that we are transitioning to an Afghan National Security Forces lead. You and others have stipulated the drop-off is primarily due to a reduction in front-loaded costs, such as equipment and facilities. This sounds logical, but reading the request shows a 50% reduction in funding, from \$1.1B to \$570M, for "training and operations" of the Ministry of Interior forces, which includes the Afghan National Police. I worry that we will undermine our stated strategy being pennywise and pound foolish, potentially undercutting our ability to train and advise the Afghan forces while relying on those same forces to take the lead role in security operations. Is such a dramatic cut wise, especially when by all accounts fielding an Afghan police force that is sufficient in size and capabilities is key to U.S. transition plans and the long-term security of Afghanistan?

Answer: The budget is adequate to support the continued growth and development of the ANP while we transition security lead to the ANSF. The FY 13 budget requests for support of the ANSF were developed based off of the input from our commanders in the field. The Commander of the International Security Assistance Force (ISAF) and his subordinate commands assessed all aspects of ANSF development. Critical elements of their analysis included determining the resources required to recruit, train and sustain a capable ANSF. This allowed the commanders in the field to identify cost savings while developing ANP capacity.

CHARRTS No.: SB-01-004  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Cornyn  
Witness: SecDef Panetta  
Question: #4

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Answer: The Afghan National Security Forces (ANSF), including the Afghan National Police (ANP), are growing in capability. It is this growth in capability which in fact is reducing the cost to develop the ANP. Growth in capability is covered by two distinct phases: "Build ANP" capabilities and "Sustain ANP" capabilities. During fiscal year 2012, the ANP is on track to achieve their planned end strength of 157,000 personnel. Once they achieve their target endstrength, the ANP enters into the "Sustain" phase in fiscal year 2013 and subsequently would reduce their requirement for initial entry training to focus on sustaining the force level. Another mission in fiscal year 2013 and thus significantly reducing DoD's reliance upon mentor and trainer contacts to meet these needs. The ANP is growing in overall strength and in capability, including the capability to train new recruits. This process will be reflected in both their operating and generating forces. For clarification, the funding decrease for training and operations for the ANP is from \$1.1 billion in fiscal year 2012 to \$570 million in fiscal year 2013 for a reduction of 48 percent.

CHARRTS No.: SB-01-005  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Enzi  
Witness: HON Panetta  
Question: #5

Voluntary Protection Programs (VPP)

Question: The Voluntary Protection Programs (VPP), a collection of workplace safety programs overseen by the Occupational Safety and Health Administration (OSHA) at the Department of Labor (DOL) is a good example of employers, employees and the federal government working together to improve safety conditions and reduce injuries. VPP worksites develop, implement and carry out safety plans specifically designed for each worksite. In January, 2012, OSHA reported 2,395 active VPP sites across the country, covering over 950,000 employees. As you know the Department of Defense (DOD) is a major participant in the program, with 39 VPP sites and more than 200 additional sites that are in the process of becoming certified. According to a recent OSHA white paper, DOD VPP sites saw a 41% reduction in lost day rates since 2002. VPP not only saves lives, but it also saves tax dollars. Estimated cost savings because of the lower injury rate save between \$73,000 and \$8.8 million per DOD VPP site, according to OSHA. In meeting DOD's own goal of reducing workplace injuries by 75%, VPP is instrumental, wouldn't you agree? Yet, there is an ongoing effort to undermine the effectiveness of the program by approving fewer sites. The current Administration even sought to defund the program two years ago; a request which this Committee rejected by unanimously approving an amendment I offered. Have you communicated the important benefits of this program to your counterpart at the Department of Labor? What is the status of the more than 200 additional DOD sites you are attempting to get approved? Have any of the site approvals been pending for longer than 12 months?

Answer: We agree that VPP is instrumental in DoD's effort to reduce workplace injuries. Those working VPP within the Department of Defense routinely meet with their counterparts in the Department of Labor on common issues and interests. Specifically, we have met with OSHA several times over the 7-year period of our VPP journey, and they have directly supported our VPP efforts. This dialogue continues today with discussions to explore new ways to further improve our mishap prevention results through VPP.

The Department continues to support more than 320 additional sites in the implementation of VPP. In fact, over 45 DoD sites have now achieved OSHA's "Star" status. Our goal is to continue adding 40 new DoD sites every year, targeting those sites with higher than average mishap and lost work day rates. We have also started a campaign to show how VPP can help DoD sites meet the metrics established in President Obama's POWER initiative.

As to site approvals, we have had 4 DoD sites that have submitted applications for VPP Star status more than 12 months ago. This delay in recognition does slow the momentum in the push

for VPP within the military components. However, we fully understand OSHA's constraints and we will continue to work with them for solutions to this challenge.

CHARRTS No.: SB-01-006

Senate Budget Committee

Hearing Date: February 28, 2012

Subject: The President's Fiscal Year 2013 Department of Defense Budget Request

Member: Senator Enzi

Witness: SecDef Panetta

Question: #6

Renewable Energy

Question: The President's budget calls for significant military investment in renewable energy sources and includes a significant amount of money to make our military more energy efficient. While I support strong investment in our renewable energy portfolio and making our military more energy efficient, I am concerned that the budget ignores one of our nation's most abundant energy sources - coal. Coal has the potential to be turned into jet fuel, which could help make us less dependent on foreign oil, and yet, it seems to be an energy source that receives little attention from the President. How do you plan to integrate coal-to-jet fuel into the military's energy portfolio so we don't ignore this reliable, abundant, and inexpensive American energy source?

Answer: The Air Force, which is DoD's largest user of fuel, has just completed certification of its entire fleet to operate on 50/50 blends of Fischer-Tropsch fuels, which can be derived from coal or biomass, and conventional fuels. In compliance with section 526 of the Energy Independence and Security Act of 2007, the Department does not enter into contracts that specifically require fuels that have greater lifecycle greenhouse gas emissions than conventional petroleum products, except for research and testing purposes. However, section 526 does not preclude the purchase of fuels that are mixed with or comprised of coal-based alternatives when they are part of the petroleum commodity market.

Carbon capture and storage technologies, currently being pursued by the private sector and the Department of Energy, may eventually allow DoD to specifically contract for the purchase of these fuels, in compliance with section 526. In fact, DoD itself is also supporting research in this area.

CHARRTS No.: SB-01-007  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Murray  
Witness: SecDef Panetta  
Question: #7

Senior Oversight Committee (SOC)

Question: Secretary Panetta, DoD and VA recently decided to incorporate the Senior Oversight Committee (SOC) into the Joint Executive Committee. At this point, it is very important that the Departments continue to make progress on a wide range of joint initiatives. The TAP redesign, implementation of my VOW to Hire Heroes legislation, coordination of care, and the integrated electronic health record and the virtual lifetime electronic record are just a few of the major initiatives on which we cannot afford to lose momentum.

- A. How will you ensure that all of the functions of the SOC are carried on effectively under the new JEC structure?
- B. What is your plan to ensure that the most appropriate leaders are in place to guide the JEC?

Answer: The Senior Oversight Committee (SOC) and Joint Executive Council (JEC) were consolidated into one JEC forum with the guidance to clearly articulate Wounded, Ill, and Injured Service member issues, including the appropriate level of senior leader membership and to maintain SOC Wounded, Ill and Injured programs.

To ensure all the functions of the SOC are carried on effectively in the new JEC structure, all the current SOC working groups were realigned within the JEC, current in-process SOC issues, programs and initiatives have been identified and appropriately handed off to the JEC or to JEC sub-forums for continued oversight and support, a joint Wounded, Ill and Injured Committee was created under the JEC to specifically oversee Wounded Warrior issues and emerging Wounded Warrior issues will be addressed bi-monthly at JEC meetings and quarterly with the Department Secretaries.

A revised membership has been established to maintain the most senior level decision makers from the both Departments. The JEC will ensure subject matter experts are available to provide senior leaders with most current and relevant information to identify issues provide initiative updates and drive decisions. The meetings will maintain senior level focus, and program/project management will be the responsibility of working group co-leads and functional offices of primary responsibility. Specifically, the Under Secretaries and Vice Chiefs of all the Services, Vice Chief of the Joint Chief of Staff and Deputy Secretary and Under Secretaries of VA are members of the new JEC structure.

CHARRTS No.: SB-01-008  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Murray  
Witness: SecDef Panetta  
Question: #8

Oversight of the Disability Evaluation Process

Question: What will the Department do to improve the oversight of the disability evaluation process to ensure servicemembers are treated fairly and to make the system more efficient?

Answer: DoD has been on a continuous process improvement journey relative to disability for years now and we do not plan on stopping anytime soon.

We continue to oversee the correct implementation of DoD policy in several ways, including periodic reports on disability evaluation issues to the DoD-VA Joint Executive Council, by requiring the Military Secretaries to certify their compliance with general disability evaluation law and policy, and through continual discussion in the disability evaluation community, including the Disability Advisory Council and Disability Improvement Working Group.

I intend to add disability evaluation issues to a standing requirement for the Service IGs to review compliance in their Departments with law and DoD policy. We are also implementing a requirement that the Service Secretaries expressly certify compliance with law and policy on these issues in their Departments. The reviews will address ensuring requirement compliance, specifically those diagnoses which distinguish personality disorders from compensable disabilities (such as post-traumatic stress disorder), and are rendered by a psychiatrist or PhD-level psychologist utilizing the Diagnostic and Statistical Manual of Mental Disorders. Additionally, for Service members who have served or are currently serving in imminent danger pay areas, a peer or higher-level mental health professional, endorsed by the Surgeon General of the Military Department concerned, must corroborate personality disorder diagnoses prior to administrative discharge without disability benefits. These diagnostic requirements help DoD ensure no Service member is erroneously, administratively discharged for a personality disorder when he or she should receive a discharge for a service-related disability.

We also are taking a number of steps to improve the efficiency of the disability evaluation system, including conducting site visits to identify areas for improvement, assistance and training, and the implementation of best practices. We are focused on near-term IT enhancements, including increasing our ability to transfer disability case files electronically and enhancing the joint DoD-VA case file tracking system.

Finally, we consistently ask the Military Departments concerned to review and ensure the proper resolution of cases where instances of possible unfair treatment may have occurred.

CHARRTS No.: SB-01-009  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Murray  
Witness: SecDef Panetta  
Question: #9

Policy for Discharging Servicemembers with an Adjustment Disorder

Question: Please provide a history of the policy of administratively discharging servicemembers diagnosed with an adjustment disorder. Please include the basis for the decision at the time the policy was developed, its relationship to the definition of adjustment disorder used at the time the policy of administrative discharge was originally enacted, changes to the diagnostic criteria in the Diagnostic and Statistical Manual of Mental Disorders made since the original decision and whether or not such changes warrant reconsideration of the administrative discharge policy.

Answer: While DoD believes there is no reason to reconsider the administrative discharge policy for acute adjustment disorder, the potential classification of chronic adjustment disorder as a disability is under review.

Background:

DSM-IV (1994) revised the description and classification of adjustment disorder into acute, with disturbance lasting less than 6 months, and chronic, with disturbance lasting 6 months or longer from initiation of the stressor. Diagnoses of adjustment disorder include a subtype designation, such as disturbances of conduct or emotions, depressed mood, or anxiety.

There have been no changes to the DSM-IV since it was issued in 1994. Using the DSM IV definition, classifying simple adjustment disorder as a disability does not seem warranted. Adjustment disorder meets the administrative separation criteria for discharge as a medical condition bearing on the suitability for service. The Department's basis for that determination was that adjustment disorder appropriately describes anxiety, mood or conduct problems that stem from preexisting conditions or stressors which were not service-connected.

The potential classification of chronic adjustment disorder as a disability is under review. However, it is unlikely that many cases will be seen, as inability to weather the routine vicissitudes of military life without evidencing unsatisfactory performance or psychiatric dysfunction is usually a cause for separation early in the military training process. While a person's inability to adjust to military life and requirements may be solved to the benefit of both the individual and the Service through administrative separation, in civilian life, removal of environmental stressors (e.g. poverty, chronic medical care, unemployment) is often not possible. This may explain why the VA confers chronic adjustment disorder diagnoses upon veterans more frequently.

One rationale for adjustment disorder being a basis for non-compensable separation is that adjustment disorder is a minor, but manifest, mental deficiency. Disorders not constituting a disability based on the VASRD are: "Mere congenital or developmental defects, absent, displaced or supernumerary parts, refractive error of the eye, personality disorder and mental deficiency are not diseases or injuries in the meaning of applicable legislation for disability compensation purposes."

The pertinent legal and legislative history with respect to VA determining chronic adjustment disorder a disability at VA is as follows, the legal developments occurred from 1996-1998:

Smith v. West, 1998 U.S. Vet. App. LEXIS 333 (Vet. App. Mar. 17, 1998)

"Furthermore, the US Court of Veterans Appeals has specifically found Adjustment Disorders to be compensable. "However, the same separation examination also diagnosed "adjustment disorder with depressed mood." The Secretary has determined that "adjustment disorder" is a ratable disability. 38 C.F.R. § 4.132, Diagnostic Code 9405 (1996). (The Secretary has revised the rating codes, but "chronic adjustment disorder" remains a ratable disability. See 38 C.F.R. § 4.130, DC 9440 (1997)).

Recent legislative developments and instruction changes:

On August 28, 2008, DoD Directive 1332.14 was "cancelled" and reissued as DoD Instruction 1332.14. Enclosure 3, paragraph 3.a.(8)(d) and (e) of this instruction expanded policy on personality disorder administrative separations as follows:

(d) Separation for personality disorder is not appropriate nor should it be pursued when separation is warranted on the basis of unsatisfactory performance or misconduct. [Note: it is quite appropriate, after a thorough psychiatric examination, to diagnose service members who are evidencing misconduct in the face of stressors that are otherwise successfully negotiated by their peers with "Adjustment Disorder with disturbance of conduct, or adjustment disorder with mixed disturbance of emotions and conduct"] In such circumstances, the member should not be separated under this paragraph regardless of the existence of a personality disorder. Unless found fit for duty by the disability evaluation system, a separation for personality disorder is not authorized if service-related PTSD is also diagnosed.

(e) Nothing in paragraph 3.a.(8) of this enclosure precludes separation of a Service member who has a personality disorder or other designated physical or mental conditions under any other basis set forth in paragraph 3 of this enclosure (convenience of the Government) or for any other reason authorized by this Instruction.

Change 1 to DoD Instruction 1332.14, issued on March 29, 2010, only modified DoD enlisted administrative separation policy related to homosexual conduct.

Change 2 to DoD Instruction 1332.14, issued on September 20, 2011, completely removed DoD enlisted administrative separation policy related to homosexual conduct.

Change 3 to DoD Instruction 1332.14, issued on September 30, 2011:

- Added Encl 2, paras 2.C. (5)(b) 1- 3: enlisted administrative separation policy required by public law 111-84 § 512, concerning medical examinations for Service members being considered for administrative separation under a characterization of other than honorable, who deployed to a contingency operation during the previous 24-months, and is diagnosed with post traumatic stress disorder or a traumatic brain injury, and is not being separated under courts-martial or other Uniformed Code of Military Justice proceeding.
- Added Encl 3, para 3.(8)(a): policy required by public law 111-383 § 534 and public law 112-81 § 527, pertaining to administrative separation and reenlistment denial of service members for the same reason they were found fit for duty by a Physical Evaluation Board.
- Changed Encl 3, par 3.(8)(c): inserts: “or other mental condition not considered a disability” as a qualifier (in addition to or in lieu of a diagnosis of personality disorder) that requires peer or higher-level mental health professional corroboration and Military Department Surgeon General endorsement of the administrative separation of a Service member who has served or is serving in an imminent danger pay area.

CHARRTS No.: SB-01-010  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Murray  
Witness: SecDef Panetta  
Question: #10

DoD Physical Disability Evaluation

Question: Secretary Panetta, the DoD Physical Disability Evaluation instructs the services not to treat Adjustment Disorder as a disability, but may be the basis for administrative action. In contrast, the Department of Veterans Affairs compensates veterans for service connected 'Chronic Adjustment Disorder'. Can you explain why DoD treats adjustment disorder differently than the VA? Moreover, can you differentiate why adjustment disorder is provided in lieu of anxiety (NOS) for servicemembers who are no longer recruits? Can you tell me how many servicemembers were separated administratively for adjustment disorder and later diagnosed with another mental condition by the VA or received a disability rating and compensation for Chronic Adjustment Disorder? Is DoD considering changing their regulations to treat Chronic Adjustment Disorder as disability like VA does?

Answer: Disability ratings are conferred by the VA, using the VA Schedule for Rating Disabilities (VASRD). While chronic adjustment disorder may be used by VA providers, in DoD, individuals who are impaired enough from a psychiatric condition to be deemed medically unfit for service are receiving diagnoses that more specifically describe their illnesses, such as PTSD and other anxiety disorders, psychotic disorders, or mood disorders. In accordance with DSM-IV, DoD excludes adjustment disorder from compensable disabilities because it is defined as a condition that recedes when the stressor is removed. The Department's basis for that determination is that adjustment disorder appropriately describes anxiety, mood or conduct problems that stem from stressors, which were not service aggravated.

Chronic adjustment disorder uses a specific and rare "specifier," to an adjustment disorder diagnosis in DSM-IV parlance. Data in regard to how many service members were separated administratively for adjustment disorder and later had their diagnoses changed or received chronic adjustment disorder were not available, but a discussion with the Senior Medical Officer at a combined VA-DoD facility (Lovell FHCC) suggests that the existence of chronic adjustment disorder in veterans is rare among VA patients receiving treatment there.

There is no evidence that DoD is conferring the diagnosis of Chronic adjustment disorder with any regularity. Classifying simple adjustment disorder as a disability is not warranted. However, it does meet criteria for administrative separation as a medical condition bearing on unsuitability for service. The potential classification of chronic adjustment disorder as a disability is under review; however, it is unlikely that many cases will be seen, since the condition is rare among mentally disabled patients seen in DoD for the reasons cited above., and service members unable to weather the routine vicissitudes of military life without evidencing unsatisfactory performance or psychiatric dysfunction are usually separated early in the training

process.

While a person's inability to adjust to military life and requirements may be solved to the benefit of both the individual and the Service through administrative separation, in civilian life, removal of environmental stressors (e.g. poverty, chronic medical care, unemployment) is often not possible. This may explain why the VA confers chronic adjustment disorder diagnoses upon veterans more frequently.

CHARRTS No.: SB-01-011

Senate Budget Committee

Hearing Date: February 28, 2012

Subject: The President's Fiscal Year 2013 Department of Defense Budget Request

Member: Senator Murray

Witness: HON Panetta

Question: #11

FY13 Strategic Guidance

Question: General Dempsey, the concept of "reversibility" and creating a "continuum of service" has been discussed with the release of the Secretary's Strategic Guidance and the release of the FY13 budget. I understand the need to avoid the hollow force created by the last military drawdown and continue to maintain an operational Guard and Reserve to build back forces quickly when needed. However, I am concerned that it can be difficult to move from the Reserve Component back to Active Duty as well as moving between different Reserve Component forces. Have you identified what the barriers are that would enable the services to be able to activate the Reserve Component more quickly? Or allow servicemembers to move more easily between the different Reserve Components?

Answer: The Department of Defense currently has the ability to rapidly activate Reserve Component members. With the support of Congress, recently passed legislation in NDAA 12 further enhances that capability. In HR1540, 12304a allows for the Secretary of Defense to call up Army Reserve, Navy Reserve, Marine Corps Reserve or Air Force Reserve units and members for up to 120 days in response to a major disaster or emergency to respond to a Governor's request for Federal assistance. In addition, recently added 12304b legislation authorizes the Service Secretaries to order up to 60,000 Reserve Component members to active duty for preplanned missions in support of the combatant commands. These members can be called up for a period of not more than 365 days. Finally, Reserve Component units will remain in the services' force generation models and will continue to train in order to maintain the operational experiences they have gained over the last decade plus of combat.

CHARRTS No.: SB-01-012

Senate Budget Committee

Hearing Date: February 28, 2012

Subject: The President's Fiscal Year 2013 Department of Defense Budget Request

Member: Senator Murray

Witness: HON Panetta

Question: #12

#### Behavioral Health Diagnostic Tools

Question: How does the Department of Defense evaluate and monitor the type of behavioral health diagnostic tools used and care provided to servicemembers to ensure accountability by all the services?

Answer: The Department evaluates and monitors the type of diagnostic tools by supporting the use of clinically validated diagnostic instruments. These tools are in widespread use nationwide for behavioral health testing and can be crucial in addition to data garnered in clinical histories, laboratory assays, and neuroimaging. Instruments, such as the Mini Mental Status Examination (MMSE), help clinicians evaluate how patients are thinking, and whether baseline thought processing is within established norms. Some instruments are used for specific types of screening, such as the Alcohol Use Disorders Identification Test (AUDIT-C) for alcohol abuse or the Patient Health Questionnaire (PHQ-9) for depressive illness. Finally, some instruments are used for diagnostic clarification, such as the Minnesota Multiphasic Personality Inventory (MMPI-2).

The Department ensures that the accountability in the Services by ensuring that the fidelity of administration of these tools is monitored in ongoing peer review of clinicians which is done at all Military Treatment Facilities. The department supports the use of evidence-based clinical practice guidelines for all clinicians. This equilibrates practice patterns not only between military providers, but also standardizes practices between DoD and civilian treatment entities. DoD also maintains and develops practice-specific "core credential," requirements. These include adherence to standardized practice parameters such as diagnostic testing to which healthcare providers are accountable for achieving and maintaining their competence regardless of service affiliation.

Although some Service members have pointed out that testing instruments lead to inappropriate diagnoses, or alternatively, that their use at the time of intake histories to assist with diagnosis should not be part of a routine psychiatric evaluation, these tests (such as the MMPI-2) have strong psychometric properties, meaning that tests give similar results between clinicians and over time, and that the tests accurately measure the psychological traits they purport to measure. An additional benefit of these tests is validity scaling, which allows clinicians to assess the sincerity and veracity of responses. American courts accept the psychometric properties of clinically indicated, well-researched, and validated psychological tests as evidence of high reliability.

CHARRTS No.: SB-01-013  
Senate Budget Committee  
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Member: Senator Murray  
Witness: HON Panetta  
Question: #13

Post-Traumatic Stress Disorder (PTSD)

Question: Does the Department of Defense develop and release guidelines that comply with currently accepted best practices for the treatment of PTSD?

Answer: Yes, the Department of Defense (DoD) and Department of Veterans Affairs (VA) jointly develop Clinical Practice Guidelines (CPGs). These efforts include the recently revised 2010 VA/DoD CPG for the Management of Post-Traumatic Stress. The VA/DoD PTSD CPG serves as a means of communicating the state of the evidence to clinical providers in the field. VA/DoD CPGs are also publically available through either Army Medical Command Quality Management Division's website (<https://www.qmo.amedd.army.mil/pguide.htm>) or the VA's Office of Quality and Safety website (<http://www.healthquality.va.gov/>).

An expert multidisciplinary panel of VA and DoD providers developed the VA/DoD CPG recommendations by conducting comprehensive and rigorous reviews of the currently available studies on psychotherapy and medication. The PTSD CPG concludes that there are several psychotherapies and medications that have the strongest evidence of efficacy.

CHARRTS No.: SB-01-014  
Senate Budget Committee  
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Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Murray  
Witness: HON Panetta  
Question: #14

Seamless Transition

Question: I remain committed to ensuring our men and women in uniform have a seamless transition to civilian life. Having an integrated electronic health record shared by the Defense Department and VA will ensure a clean hand-off when it comes to health care for our veterans. In December, Congress approved \$100 million to support the development of this health record, and now we're being asked to spend millions more for its development. Please provide me with a firm timeline for delivery of the iEHR. Also, do the Defense Department and VA have the right project plan and requirements in place to ensure that the millions of dollars we're asking the taxpayers to spend on this project will be put to good use? Please provide me with a copy of the project plan and any related materials.

Answer: The Secretary of Defense and the Secretary of Veterans Affairs met February 27, 2012 and committed to having the Interagency Program Office (IPO) identify additional sites to implement initial iEHR capabilities by 2014.

The iEHR program is in the Planning State. As part of its focused effort to establish Program Management discipline and standards, the content of the Program Plans and related documents will be contained in program documentation which is currently in development. As program documentation becomes available, we commit to sharing final versions with the Committee. The iEHR FY12 Execution Plan and Program Management Plan are in development. These documents will serve as a basis for the iEHR organizational Concept of Operations.

iEHR will be subject to the programmatic requirements of both the DoD Business Capability Lifecycle (BCL) and the VA Program Management Accountability System (PMAS). The IPO, DoD, and VA are identifying areas where process differences may exist, and are collaboratively engaging in efforts to ensure that any impediment that may arise is resolved in an efficient manner.

The IPO will leverage BCL and PMAS to create a Capability Development Life Cycle Framework which will capture the required documentation and milestone decisions for each phase, to include funding and investment decisions. Given the complexity of the iEHR effort and the need to merge two acquisition lifecycles, the Departments have acknowledged the need to optimally align their processes to ensure agile and cost efficient delivery of capabilities to the clinical community.

CHARRTS No.: SB-01-015  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Toomey  
Witness: SecDef Panetta  
Question: #15

Clean Energy

**Question:** President Obama pledged to spur on energy innovation and the development of clean energy in his 2012 State of the Union address. A critical element of this pledge was that the Department of Defense, as the world's largest consumer of energy, would "make one of the largest commitments to clean energy in history." As part of these efforts, the Navy has purchased 450,000 gallons of biofuel and the Air Force has 131 renewable energy projects in operation on 56 bases and an additional 50 under construction. During these difficult budget times, the long-term push for green energy for the Department of Defense leads to the following questions: How much has been spent at the Department of Defense on green energy initiatives since President Obama took office? How much funding is included in the budget request for FY 2013 and the Future Years Defense Program (FYDP) period of FY2013-2017 for green energy efforts? What analysis has been done regarding the potential costs and savings from these green energy efforts? What are the estimated costs and savings under the current FYDP, the current budget window ending in FY 2022, and the long-term?

**Answer:** The Department of Defense (DoD) divides its energy use and investments into two broad areas: Operational Energy and Installation Energy.

Operational Energy is the energy "required for training, moving and sustaining military forces and weapons platforms for military operations..." It is crucial to understand that our investments in this area are not in order to be "green" or "clean." Instead, they are to improve our military capabilities and reduce the risks to and burden on our Forces from moving energy to and around the battlefield. They are aimed at creating a more effective fighting force. On December 11, 2011, General John Allen directed all U.S. Forces in Afghanistan to take steps to improve the energy security of the mission. "Operational energy," he wrote, "is about improving combat effectiveness. It's about increasing our forces' endurance, being more lethal, and reducing the number of men and women risking their lives moving fuel." General Allen's memorandum and the Department's May 2011 Operational Energy Strategy send a consistent message: improvements in military energy security provide the Department with a unique opportunity to improve efficiency while increasing operational effectiveness.

For FY 2013, DoD budgeted approximately \$1.4 billion for operational energy initiatives and approximately \$16.3 billion for fuel purchases. The FYDP budget total for operational energy initiatives is approximately \$8.6 billion. Approximately 89 percent of the funding, \$7.6 billion for FY 2013 – FY 2017, is focused on initiatives to reduce demand for energy from warfighting equipment, and approximately 10 percent, \$886.3 million for FY 2013 – FY 2017, is for supply expansion initiatives. The remaining one percent is allocated to planning for strategic

energy use.

Army initiatives for improving Energy Performance and Efficiency in Operations and Training include generators and microgrids improvements, combat vehicle improvements, an improved rotary-winged aircraft engine, Aviation Simulators Ground Soldier Systems, and new, more efficient Force Provider modules and associated equipment. Army Operational Energy Innovation initiatives include combat vehicle and automotive technologies, aviation technologies, Warfighter (Soldier) technologies, and Defense Research Sciences (e.g., basic research efforts).

Navy initiatives for improving Energy Performance and Efficiency in Operations and Training include the Hybrid Electric Drive Development and Implementation, Electric Ships Office Efficiency Initiatives, and Simulator Upgrades along with on-going Shipboard Incentivized Energy Conservation Program and the newly established Air Energy Conservation Program. Navy Operational Energy Innovation initiatives include both demand reduction and supply expansion. Demand reduction innovation efforts include Naval Variable Cycle Engine Technology, Electric Ship Research and Development Consortium, Ship Hydrodynamics, and the Turbine Engine Technology Demonstration. Supply expansion innovations include Unmanned Undersea Vehicle initiatives, Energy Efficiency and Alternative Energy Technologies, and Power and Energy Materials Research. The U.S. Marine Corps demand reduction includes programs such as Advanced Power Sources, Family of Shelters and Shelter Equipment, Family of Expeditionary Water Systems, Family of Mobile Electric Power Equipment, and Medium Tactical Vehicle Replacement.

Air Force Operational Energy Innovation initiatives include Aerospace Propulsion and Power Technologies, Aerospace Vehicle Technologies, ADVENT Technology Maturation, Materials Technologies, and alternative fuels technology development. Air Force initiatives for improving Energy Performance and Efficiency in Operations and Training include procurement and sustainment of Basic Expeditionary Airfield Resources sets, KC-10 drag reduction efforts, and the Automatic Dependent Surveillance – Broadcast technology insertion.

Installation or facility energy refers to the traditional energy sources (largely electricity and natural gas) used on DoD's 500-plus fixed military installations here in the United States and overseas. The Department's facility energy strategy is designed to reduce costs and improve the energy security of our fixed installations. DoD is increasing the supply of renewable and other distributed (on-site) sources of energy on our installations. On-site energy is critical to making our bases more energy secure. Together with smart microgrid and storage technologies, it allows a military base to maintain its critical operations "off-grid" for weeks or months if necessary.

Large-scale renewable energy projects are being developed through third-party financing mechanisms. By leveraging private sector capital, DoD receives the benefits of renewable power (to meet congressionally mandated goals) and, more importantly, improved energy security of our military installations. The Department is also pursuing small-scale distributed renewable energy (rooftop solar, solar heaters, ground source heat pumps) using appropriated funds. Since FY 2009, the Department has funded approximately \$320 million for renewable energy initiatives. In the FY 2013 President's Budget, the Department requested \$34.5 million for

renewable energy projects under the Energy Conservation Investment Program (ECIP). On average, small-scale renewable energy projects funded through the ECIP have a savings to investment ratio of 1.7, meaning for every dollar invested, ECIP renewable energy projects have historically obtained on average about \$1.70 in savings over the lifetime of the project. The average payback for these projects is less than 12 years.

CHARRTS No.: SB-01-016

Senate Budget Committee

Hearing Date: February 28, 2012

Subject: The President's Fiscal Year 2013 Department of Defense Budget Request

Member: Senator Sessions

Witness:

Question: #16

Marine Corps Installations West (MCI West)

Question: Marine Corps Installations West (MCI West) has devoted significant effort to green energy production and renewable fuels. Please provide the actual cost of green energy production and renewable fuels for MCI West for the period 2002 through 2011 (ten years) including solar, wind, geothermal, methane and alternative fuel vehicles, alternative fuel and other energy production projects. Please provide an estimate of the cost of displaced fuel or electricity that was avoided by these alternative sources of fuel or power over the same ten year period. Finally, please provide an estimate of the net savings (or cost) over the next ten years (2012 through 2021) resulting from green projects completed during the ten year time period (2002 through 2011) using the latest published cost estimates of fuel and electricity forecast by the US Energy Information Administration and a discount rate consistent with the rate recommended by OMB Circular A-94 to be used for cost-effectiveness analysis.

Answer: The attached spreadsheet provides the actual cost of green energy and renewable fuels production and an estimate of the cost of displaced fuel and other energy production for MCI-West. Additionally, we have included the estimated future net savings resulting from green projects built in the last 10 years. All USMC investments in green energy and primarily driven by NDAA/10 USC 2911(e), EPLA 2005, and Energy Independence and Security Act (EISA) 2007.

CHARRTS No.: SB-01-017  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Sessions  
Witness: HON Panetta  
Question: #17

Department-Wide Force Structure Reviews

Question: Each of the Services are conducting reviews of their force structure and manning that will inform them on how they will execute their budget cuts. What are all of the reviews being conducted across the entire department that will inform how the budget reductions will be executed, and what other budgetary impacts will these reviews have?

Answer: While cost savings are part of the decision-making process, the most important factor is the Air Force's ability to provide the capabilities required by the new Defense Strategic Guidance, "Sustaining US Global Leadership: Priorities for 21st Century Defense." This new strategy directs the Services to build a leaner, more flexible, and technologically advanced force. The strategy began to evolve over a year ago, and analysis was conducted in parallel, informing the Air Force Corporate Structure. The analytical review of warfighting scenarios consistent with the new strategic guidance informed the size of the force, the balance of risk across the Air Force Core Functions, and the force mix across the components. The Air Force Corporate Structure, which is chaired by the Under Secretary of the Air Force and the Vice Chief of Staff of the Air Force, conducted a deliberate and collaborative review resulting in tough choices that best balanced the Total Force to meet the strategy. The Air Force position presented in the FY13 President's Budget was vetted through the Office of the Secretary of Defense's Program and Budget Review process.

Additionally, the Air Force formed a General Officer-led team of Active Duty and Reserve Component experts that determined force structure changes at various locations. Each course of action was assessed using specified criteria to include manpower composition, location of the installation, Reserve Component presence in the state, and how well a replacement mission is suited for a given location (e.g., facilities suitability, MILCON needed, etc.). The team's recommendations were reviewed by the Air Force Corporate Structure and ultimately approved or disapproved by the Secretary and Chief of Staff of the Air Force.

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CHARRTS No.: SB-01-018  
Senate Budget Committee  
Hearing Date: February 28, 2012  
Subject: The President's Fiscal Year 2013 Department of Defense Budget Request  
Member: Senator Sessions  
Witness: HON Panetta  
Question: #18

313 Ship Navy

Question: When will we see the analysis behind forthcoming changes to the Navy's 313 plan?

Answer: : The Navy is in the process of conducting a Force Structure Assessment based on the new Defense strategy.

The Force Structure Assessment will evaluate the capabilities needed to execute the defense strategic guidance, the ships and aircraft needed to deliver these capabilities and the resulting inventory requirements.

Senior DoD leaders will conduct a series of seminars on Joint Force warfighting requirements over the next several months. I have also directed the Combatant Commanders to validate their Operational Plans. I anticipate these efforts will inform the Force Structure Assessment and subsequent analysis.

Results of the Force Structure Assessment will be available following final approval by my office.

CHARRTS No.: SB-01-019

Senate Budget Committee

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Subject: The President's Fiscal Year 2013 Department of Defense Budget Request

Member: Senator Sessions

Witness: HON Panetta

Question: #19

Air Force Re-Missioning Cost

Question: What is it going to cost in terms of dollars and readiness to perform the re-missioning that the Air Force is planning on executing?

Answer: The Air Force programmed approximately \$600 million dollars across the Future Years Defense Plan to enable the re-missioning and relocation of aircraft. The \$600M funds aircraft flying hours for training, depot maintenance for aircraft, manpower authorizations to meet prescribed crew ratios/new missions, minor construction, and military construction projects. Over the next several months, the Major Commands, Air National Guard (ANG), and Air Force Reserve Command are poised to conduct site surveys to identify any facility and non-facility requirements that we may not have anticipated so they can be addressed in the FY14 Program Objective Memorandum.

The Air Force re-missioning timeline is executed across the Future Years Defense Program, enabling the Reserve Component to recruit and train personnel on new weapon systems prior to divesting older aircraft. For example, the ANG will assume the MC-12W mission in FY14; however, the RC-26B (aircraft the MC-12W will replace) will not be divested until FY15. Additionally, the Air Force will establish associations where needed to ensure sufficient trained operations and maintenance personnel. The Air Force anticipates no readiness impacts due to re-missioning.

CHARRTS No.: SB-01-020  
Senate Budget Committee  
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Member: Senator Sessions  
Witness: HON Panetta  
Question: #20

Acquisition Program Disruptions

Question: What will the disruptions be to the large amount of acquisition programs that are affected by the cuts in this year's Defense budget, and has the Department had enough time to consider all the factors and ensure we are getting the most value out of our investment without causing serious harm by the 2<sup>nd</sup> and 3<sup>rd</sup> order effects of these decisions?

Answer: The proposed FY 2013 budget is aligned to strategic priorities we have identified to keep America safe and maintain the strongest military in the world. It is also a signal of the Department's commitment to our men and women in uniform and their families. The FY 2013 budget reflects decisions to make better use of the taxpayers' defense dollars and meet our fiscal responsibilities.

The proposed budget will ensure U.S. Armed Forces will remain capable across the spectrum of missions, fully prepared to deter and defeat aggression and to defend the homeland and our allies in the world's complex security environment. It results from an intensive strategic review conducted by the Department's senior military and civilian leaders under the leadership and guidance of the President. The proposed budget makes more disciplined use of defense dollars to maintain the world's finest military and sustain U.S. global leadership. It applies strategic guidance to force structure and investment.

For our acquisition programs, as with other elements of the budget, the Department has implemented a number of proposals resulting in a more disciplined use of our defense dollars. These include termination of lower-priority programs, reductions in contract funding, and implementation of Better Buying Power (BBP) initiatives. We have undertaken a number of efforts in the BBP area, including: setting goals for weapons systems early in their development; more use of "should" cost as well as the "will" cost numbers based on the history to which we budget; better management of service contracts; and improving financial information. We are committed to a balanced acquisition process that supports the execution of affordable programs, improves efficiency in acquisition execution, and strengthens the industrial base.

The Defense budget, including our acquisition programs, underwent a thorough and disciplined Program and Budget review prior to inclusion in the President's Budget. The Department devoted necessary and adequate time to minimize disruptions and to consider the effects of its decisions on other aspects of the budget, including other effects as a result of reductions (e.g., industrial base concerns).

CHARRTS No.: SB-01-021

Senate Budget Committee

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Subject: The President's Fiscal Year 2013 Department of Defense Budget Request

Member: Senator Sessions

Witness: HON Panetta

Question: #21

Sequestration

Question: With sequestration pending, when will disruptions to the industrial base and the Defense Department start occurring, and what will the initial costs be for slowing production lines and cancelling programs?

Answer: The defense industrial base is complex, and industrial capabilities in different sectors and at different tiers of the supply chain are in very different states today, even before sequestration. The Department's Office of Manufacturing and Industrial Base Policy, through its Sector-by-Sector, Tier-by-Tier assessment of the industrial base, has uncovered evidence of some industrially critical niches that are already fragile and require intense monitoring, even at pre-sequestration levels of defense spending. On the other hand, other niches are more robust, and the Department increasingly buys products and services from flexible suppliers or from commercial components makers for whom defense revenue is not critical to their long-term survival or investment. In a time of fiscal austerity, the Department needs to focus its limited resources on the critical, unique parts of the defense supply chain and on meeting critical Warfighter needs. The non-targeted, non-strategic defense cuts that would be imposed under sequestration are sure to threaten damage to at least some critical industrial niches.

The initial costs will be felt both by current production workers and in defense companies' investment activities. Across the industrial base, companies may already be holding back on research and development and capital investments because they are waiting to find out whether sequestration will reduce future acquisition spending, thereby reducing the potential payoff to their investments. However, the really strong impact of sequestration would be felt when Government acquisition funds stopped flowing. Work at the lower tiers of the supply chain will stop sooner than final assembly by the prime contractors who deliver systems directly to the Department. In many cases, it is the product and service niches at the lower tiers that are already the most fragile parts of the industrial base because some of those niche companies have less diverse portfolios of business. However, because sequestration would impose across-the-board cuts, even companies that participate in a diverse range of defense acquisition programs may struggle if their business is truly defense-oriented and provides unique, specialized capabilities to support our Warfighters.

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CHARRTS No.: SB-01-022

Senate Budget Committee

Hearing Date: February 28, 2012

Subject: The President's Fiscal Year 2013 Department of Defense Budget Request

Member: Senator Sessions

Witness: HON Panetta

Question: #22

Depot Core Workloads

Question: As funding reductions are made in depot maintenance, will the Department ensure that core workloads at our depots are maintained?

Answer: Yes, the Department's policies and actions support the preservation of core workloads at organic depots. Reductions in depot maintenance funding will inevitably decrease depot workloads across the national industrial base. As a result, core workloads will also be reduced. However, the Department will continue to assign sufficient workload to ensure cost efficiency and protect technical competence at the organic depot facilities.

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Question: #23

911th Wing (USAFR) and Air Refueling Wing PAANG

Question: Since February 3rd, my staff and I have received a number of briefings from the Air Force on its intent to close the 911th Wing (USAFR) and reduce the number of aircraft in the 171 ~ Air Refueling Wing PAANG). I look forward to the Air Force's response to a list of related questions that I provided to the Vice Chief of Staff of the Air Force when he briefed me on February 9th. In follow-up to a briefing which the Air Force provided to my staff on February 16th, I would very much appreciate the following information. My purpose is to gain clarification on the applicability of the statutory congressional reporting requirements in 10 USC 2687 to the Air Force's intent to close the 911th Airlift Wing/Pittsburgh International Airport Air Reserve Station. Specifically I request a list of the full time civilian personnel positions at the installation by type, e.g. dual status military technicians, Active Guard and Reserve, etc. Additionally I request that the list include an annotation as to whether or not each position counts towards the reporting threshold described above. In the case of those positions which do not count towards this threshold, please note the reason why.

Answer: Title 10 USC § 2687(a)(1), Base Closures and Realignment, states that, "...no action may be taken to effect or implement closure of any military installation at which at least 300 civilian personnel are *authorized to be employed*." The Air Force used a multi-step process to determine the number of civilian positions *authorized to be employed* at Pittsburgh Air Reserve Station (ARS). The Air Force determines civilians authorized to be employed at an installation by adding to the funded authorized end-strength, from the Air Force Unit Manning Document (UMD), the number of overhires that exceed the number of UMD vacancies. Because of the statutory definition of "civilian personnel," only direct-hire, permanent Department of Defense (DoD) civilian employees are counted; contractor employees, and temporary and term employees are not included. In the case of the Pittsburgh ARS, the installation has 283 civilian authorizations, 30 overhires, and 33 vacancies. Additionally, there are 4 DoD civilians employed at the Defense Contract Management Agency (DCMA) with zero vacancies. Applying 10 USC § 2687(a)(1) guidance, Pittsburgh ARS' civilian positions *authorized to be employed* is 287. Our Air Force UMD for Pittsburgh ARS is attached for your information.

Attachment:  
Pittsburgh Air Reserve Station UMD

CHARRTS No.: SB-01-024

Senate Budget Committee

Hearing Date: February 28, 2012

Subject: The President's Fiscal Year 2013 Department of Defense Budget Request

Member: Senator Wyden

Witness: HON Panetta

Question: #24

Domestic Air Alert

Question: I understand the budget proposal for this year proposes ending the 24-hour domestic air alert mission at two U.S. locations. I'm deeply concerned that the risk you're proposing we accept is not worth the small savings these changes might produce. Reducing the number of alert sites directly affects our response time, and increases the exposure of US citizens to the very real threat of another domestic attack. When your primary mission is to defend our territory, how can you justify increasing the risk to our homeland for such a relatively small savings?

Answer: In line with the President's Budget Request for FY13 and U.S. Air Force budget decisions and force structure changes, the North American Aerospace Defense Command (NORAD) identified a reduction in the 24-hour Aerospace Control Alert (ACA) requirement at two ACA sites in the Continental United States, Duluth, MN and Langley, VA. This decision was based on a comprehensive risk analysis completed by NORAD and in deliberation with the U.S. Air Force. This decision is not a base closure or deactivation of an Air Force Fighter Wing, but a removal of the 24-hour ACA requirement at these two sites. NORAD does retain the authority to conduct ACA operations at these sites should national security threats elevate and higher levels of readiness are implemented by the NORAD Commander.

The decision-making process was extensive and included many partners within the Department of Defense. In 2010, NORAD staff conducted a thorough risk analysis of the ACA mission based on a Government Accountability Office (GAO) recommendation. This study considered a number of factors, to include current threats to impacted regions; redundancy with geographical basing in relation to other ACA sites; the impact to the aerospace warning and control, air sovereignty and air defense mission; historical data detailing intercepts, scrambles and tracks of interest; coverage of our critical infrastructure; and commercial aviation routing.

The NORAD ACA mission is vital to the security and defense of our nation and although a reduction in the 24-hour ACA requirement has been identified at these two particular sites, NORAD will continue to maintain the ability to meet the nation's defense requirements to protect our homeland.

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ADDITIONAL MATERIALS SUBMITTED

MCIWEST ENERGY PRODUCTION FROM RENEWABLE POWER  
2002-2011 AND FORECAST 2012-2021

Investor/Owner	Project	Solar PV		Solar Thermal		Wind		Conventional		Methane		Vehicle		Captive		Storage		Residential Storage	
		Size (MW)	Cost (\$)	Size (MW)	Cost (\$)	Size (MW)	Cost (\$)	Size (MW)	Cost (\$)	Size (MMBtu)	Cost (\$)								
MCA-Minamit	Various	1,146	11,106							4.1	5,500	385,840	348	0.75	4,565	1,130	351.0	364,027	7,190.2
MCB Camp Pen	Various	3,810	21,280	28.4	2,109							4,823,000	11,883			26,128	3,657.9	72,794	8,522.3
MCA Camp Pen	Various	0.457	4,066	241	126							241,150	594			513	142	6,878	762.0
MCA Yuma	Various	0.297	1,732									385,840	948			462	154	2,692	2,427.2
MCA GCC 29 Palms	Various	5.95	47,936									434,070	1,070	7.2	11,700	502,936	40,363	640,733	51,476
MCLB Barstow	Various	0.195	1,560			1.5	4,600					289,380	802			6,000	876	33,000	4,360
MCRD	Solar PV	0.725	4,725									96,000	235			2,232	321	12,268	1,801
MCIWEST		11,960	\$ 93,423	269	\$ 2,235	2	\$ 4,600	0	\$ -	5	\$ 5,500	6,655,280	\$ 16,480	8	\$ 16,263	539,491	\$ 45,864	1,132,422	\$ 76,536

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Unit Manpower Document

MPES UMD Quick Query Search for Snapshot: UMD\_CURRENT (17 February 2012)

Search Terms

CID Equals OM  
 AND MNTI Equals X  
 AND ILC Equals ILSS  
 AND RIC Equals 0160/0163

Summary of All Units

CAT	RIKC	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	282	283	283	283	283	283	283	283	283
CIV	ACT	0160	CIVILIANS USDH	126	127	127	127	127	127	127	127	127
CIV	ART	0163	AFR TECHS (MEMO)	156	156	156	156	156	156	156	156	156
Total				282	283	283	283	283	283	283	283	283

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Unit Manpower Document

GCID: 0M CID: 0M 0 HQ AF RESERVE COMMAND OL: A70P (FIMY) PITTSBURGH INTL JAF PA SUB: A MPF: RX CPO: 6T MOF: RX ARR: 0

Unit Summary -- FIMY

CAT	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	01600	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
<b>Total</b>			<b>1</b>								

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Unit Manpower Document

GCID: 0M CID: 0M 0 AFR EAST RECRUIT SQUADRON OL: 000Z (F3DC) PITTSBURGH INTL JAP FA SUB: F MPF: RX CPO: 6T MOF: W1 ARR: 0

Unit Summary - F3DC

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ACT	0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
<b>Total</b>				1	1	1	1	1	1	1	1	1

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Unit Manpower Document

GCID: 0M CID: 0M 0 AFR EAST RECRUIT SQUADRON OL: 000Z (F3DC) PITTSBURGH INTL JAP PA SUB: F MPF: RX CPO: 6T MOF: W1 ARR: 0

OSC RSOR - RESERVE RECRUITING

POS	0670311600	0XXXXX	RSOR N	0160	OSC	LDR RIC	GRD AFSC	AFSC TITLE	SEIT	OCC PEC	RP	IL	ASF N	1	2	CRK1	CRK2	Y	2	3	4	5	6	7	8	9	Start	End
								KNOWLEDGE OPERATIONS MANAGEMENT		0000	5816007	7	J														11/01/2009	12/31/4712
								JOURNEYMAN																				

Position Summary for PAS F3DC OSC RSOR - RESERVE RECRUITING

CAT	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
Total			1	1	1	1	1	1	1	1	1

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Unit Manpower Document

GCID: JL CID: 0M 911 MAINTENANCE GROUP OL: 0000 (FC91) PITTSBURGH INTL JAP PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

Unit Summary -- FC91

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	7	7	7	7	7	7	7	7	7
CIV	ACT	0160	CIVILIANS USDH	2	2	2	2	2	2	2	2	2
CIV	ART	0163	AFR. TECHS (MEMO)	5	5	5	5	5	5	5	5	5
Total				7	7	7	7	7	7	7	7	7

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Unit Manpower Document

GCID: 1L-CID-0M 911 MAINTENANCE GROUP OL: 0000 (FC91) PITTSBURGH INTL JAF PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

OSC CC - COMMANDER

POS	S	MNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	A	P	SEI	OCC	PEC	RP	ILL	ASF	N	I	2	CRK1	CRK2	Y	2	3	4	5	6	7	8	9	Start	End
007159440M	0	XXXXX	CC	N	0163	GS-13	42000	LOGISTICS GP CMDR			1601	54343F	5	J																	10/01/1999	12/31/4712
007389520M	0	XXXXX	CC	N	0160	CIV	-3D07	KNOWLEDGE OPERATIONS MANAGEMENT CRAFTSMAN			0318	54343F	7	J																	11/01/2009	12/31/4712

Position Summary for PAS FC91 OSC CC - COMMANDER

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	2	2	2	2	2	2	2	2	2
CIV	ACT	0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
CIV	PART	0163	AFR TECHS (MEMO)	1	1	1	1	1	1	1	1	1
<b>Total</b>				<b>2</b>								

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Unit Manpower Document

GCID: 1L CID: 0M 911 MAINTENANCE GROUP OL: 0000 (FC91) PITTSBURGH INTL JAP PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

OSC MXQ - QUALITY ASSURANCE

POS	P	S	MNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	A	SEI	OCC	PEC	S	P	M	A	R	M	R	R	M	M	T	Start	End
007020250M	0	XXXXX	MXQ	N	0163	WG-11	2A571	AEROSPACE MAINT CRAFTSMAN				8852	54343R	7	J	D	D	E7							04/01/1998	12/31/4712
007020260M	0	XXXXX	MXQ	N	0163	WS-11	2A590	AEROSPACE MAINT SUPERINTENDENT				8801	54343R	7	J	D	D	E8							04/01/1998	12/31/4712
007020640M	0	XXXXX	MXQ	N	0163	WG-12	2A573M	INTEGRATED AVN SYS (HEA VV)				2610	54343R	7	J	D	F4	E7							01/01/2004	12/31/4712
007021450M	0	XXXXX	MXQ	N	0160	CIV	3D051	KNOWLEDGE OPERATIONS MANAGEMENT				0303	54343P	7	J	RR									11/01/2009	12/31/4712
007093390M	0	XXXXX	MXQ	N	0163	WG-11	2A671	AEROSPACE PROPULSION CRAFTSMAN				8602	54343R	7	J	D	D	E6							04/01/1998	12/31/4712

Position Summary for PAS FC91 OSC MXQ - QUALITY ASSURANCE

CAT	RICK	RIC	TITLE	Totals	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	5	5	5	5	5	5	5	5	5
CIV	ACT	0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
CIV	ART	0163	AFR TECHS (MEMO)	4	4	4	4	4	4	4	4	4
Total				5	5	5	5	5	5	5	5	5

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Unit Manpower Document

GCID: 1L CID: 0M 911 MISSION SUPPORT GROUP OL: 0000 (FC96) PITTSBURGH INTL JAV PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

Unit Summary -- FC96

CAT	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV		Civilians	5	5	5	5	5	5	5	5	5
CIV	0160	CIVILIANS USDH	3	3	3	3	3	3	3	3	3
CIV	0163	AFR TECHS (MEMO)	2	2	2	2	2	2	2	2	2
<b>Total</b>			<b>5</b>								

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MPES Unclassified

Unit Manpower Document

GCID: IL CID: 0M 911 OPERATIONS GROUP OL: 0060 (FC9Z) PITTSBURGH INTL JAP PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

Unit Summary - FC9Z

CAF	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
			Civilians	6	6	6	6	6	6	6	6	6
CIV	ACT	0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
CIV	ART	0163	AFR TECHS (MEMO)	5	5	5	5	5	5	5	5	5
<b>Total</b>				<b>6</b>								

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Unit Manpower Document

GCID: 1L CID: 0M 911 LOGISTICS READINES SQUADRON OL: 0000 (FH6W) PITTSBURGH INTL JAP PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

Unit Summary -- FH6W

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	11	11	11	11	11	11	11	11	11
CIV	ACT	0160	CIVILIANS USDH	5	5	5	5	5	5	5	5	5
CIV	ART	0163	AFR TECHS (MEMO)	6	6	6	6	6	6	6	6	6
<b>Total</b>				<b>11</b>								

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Unit Manpower Document

GCID: 1L CID: 0M 911 LOGISTICS READINES SQUADRON OL: 0000 (FH6W) PITTSBURGH INTL JAP PA SUB: B MPF: WI CPO: 6T MOF: WI ARR: 1

OSC LGRV -- VEHICLE MANAGEMENT

POS	P	S	MNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	SEI	I	OCC	PEC	S	P	J	H	CRK1	CRK2	Start	End
007064470M	0	XXXXX	LGRV	Y	0160	CIV	421R3	LOGISTICS READINESS				2101	55542P							11/07/2002	12/31/4712

Position Summary for PAS FH6W OSC LGRV -- VEHICLE MANAGEMENT

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ACT	0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
Total				1	1	1	1	1	1	1	1	1

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Unit Manpower Document

GCID: IL CID: 0M 911 CONTRACTING FLIGHT OL: 0000 (FH6Y) PITTSBURGHINTL JAP PA SUB: B MPF: WI CPO: 6T MOF: WI ARR: 1

Unit Summary -- FH6Y

CAT	RIC	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ACT	0160	CIVILIANS USDH	9	10	10	10	10	10	10	10	10
<b>Total</b>				<b>9</b>	<b>10</b>							

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Unit Manpower Document

GCID: JL CID: 0M 911 OPERATIONS GROUP OL: 0000 (FC9Z) PITTSBURGH INTL JAP PA SUB B MPF WI CPO 6T MOF WI ARR: 1

Unit Summary - FC9Z

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	6	6	6	6	6	6	6	6	6
CIV	ACT	0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
CIV	ART	0163	AFR TECHS (MEMO)	5	5	5	5	5	5	5	5	5
Total				6	6	6	6	6	6	6	6	6

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GCID: 1L CID: 0M 911 LOGISTICS READINES SQUADRON OL: 0000 (FH6W) PITTSBURGH INTL JAP PA SUB: B MPE: W1 CPO: 6T MOF: W1 ARR: 1

Unit Summary -- FH6W

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	11	11	11	11	11	11	11	11	11
CIV	ACT	0160	CIVILIANS USDH	5	5	5	5	5	5	5	5	5
CIV	ART	0163	AFR TECHS (MEMO)	6	6	6	6	6	6	6	6	6
Total				11	11	11	11	11	11	11	11	11

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Unit Manpower Document

GCID: 1L CID: 0M 911 LOGISTICS READINES SQUADRON OL: 0000 (FH6W) PITTSBURGH INTL JAP PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

OSC LGRV -- VEHICLE MANAGEMENT

POS	S	MINT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	SEI	A	P	2101	5554EP	J	H	CRK1	CRK2	Start	End
00706470M	0	XXXXX	LGRV	Y	0160	CIV	021R3	LOGISTICS READINESS										11/07/2002	12/31/4712

Position Summary for PAS FH6W OSC LGRV -- VEHICLE MANAGEMENT

CAT	TRK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ACT	0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
<b>Total</b>				<b>1</b>								

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GCID: 1L CID: 9M 911 CONTRACTING FLIGHT OL: 0000 (FH6Y) PITTSBURGH INTL JAP PA SUB: B MFF: W1 CPO: 6T MOF: W1 ARR: 1

Unit Manpower Document

Unit Summary -- FH6Y												
CAT	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019	
CIV	0160	CIVILIANS USDDH	9	10	10	10	10	10	10	10	10	
Total			9	10	10	10	10	10	10	10	10	

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Unit Manpower Document

GCID: 1L CID: 0M 911 AIRCRAFT MAINT SQUADRON OL: 0000 (FH70) PITTSBURGH INTL JAP PA SUB: B MPF: WI CPO: 6T MOF: WI ARR: 1

Unit Summary -- FH70

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ART	DIG3	AER TECHS (MEMO)	16	16	16	16	16	16	16	16	16
<b>Total</b>				<b>16</b>								

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Unit Manpower Document

CCID: 1L CID: 0M 9111 AIRCRAFT MAINT SQUADRON DL: 0000 (FH70) PITTSBURGH INTL JAP PA SUB: B MPF: WI CPO: 6T MOF: WI ARR: 1

OSC MXA - AIRCRAFT MAINTENAN

POS	0070203300M	0 XXXXX	MXA N	0163	IBD	2A600	SYSTEMS CEM	AFSC	AFSC TITLE	SEL	OCC	PEC	8852	54343R	7	J	D	E4	E8	CRK1	CRK2	23	4	5	6	7	8	9	Start	End
	007179200M	0 XXXXX	MXA N	0163	WS-10	2A590	AEROSPACE MAINT SUPERINTENDENT						8801	54343R	7	J	D	D	E8			1	1	1	1	1	1	1	04/01/1998	12/31/4712

Position Summary for PAS FH70 OSC MXA - AIRCRAFT MAINTENAN

CAT	RUC	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ART	0163	AFR TECHS (MEMO)	2	2	2	2	2	2	2	2	2
<b>Total</b>				<b>2</b>								

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Unit Manpower Document

GCID: 0M 911 FORCE SUPPORT SQUADRON OL: 0000 (F14R) PITTSBURGH INTL JAP PA SUB: B MFF: W1 CPO: 6T MOF: W1 ARR: 1

Unit Summary - FJ4R

CAT	RIC	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ACT	0160	Civilians	37	37	37	37	37	37	37	37	37
CIV	ART	0163	CIVILIANS USDH AFR TECHS (MEMO)	25	25	25	25	25	25	25	25	25
<b>Total</b>				<b>37</b>								

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Unit Manpower Document

GCID : IL CID: 0M 911 FORCE SUPPORT SQUADRON OL: 0000 (F14R) PITTSBURGH INTL IAP PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

OSC CC - COMMANDER

POS	SMINT	OSC LDR	RIC	GRD	AFSC	AFSC TITLE	SEI	OCC	PEC	S P M A A R S E R P I L	R M M S K K	CRK	CRK2	Start	End
007033520M	0	XXXXX	CC	N	0160	CIV -038FE3		0301	55530P	7	T			10/01/2010	12/31/4712
007145660M	0	XXXXX	CC	N	0163	GS-13 -038FE3		0301	54343R	7	J			10/15/2010	12/31/4712
007145850M	0	XXXXX	CC	N	0160	CIV -3D951		0318	55560P	8	J			10/15/2010	12/31/4712

Position Summary for FAS EJAR OSC CC - COMMANDER

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	3	3	3	3	3	3	3	3	3
CIV	ACT	D160	CIVILIANS USDH	2	2	2	2	2	2	2	2	2
CIV	ART	D163	AFR TECHS (MEMO)	1	1	1	1	1	1	1	1	1
Total				3	3	3	3	3	3	3	3	3

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Unit Manpower Document

GCID: 1L CID: 0M 911 FORCE SUPPORT SQUADRON OL 0000 (F14R) PITTSBURGH INTL JAP PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

OSC FSV -- SUSTAINMENT SERVICES

POS	P S MNT	OSC LDR RIC GRD AFSC	AFSC TITLE	A P	SEI	OCC	PEC	S P M A A R S E R P I L A S F N I 2	R R M M S K K N I 2	CRK J CRK 2	Start	End
007141210M	0 XXXXX	FSV N 0160 CIV -3D051	KNOWLEDGE OPERATIONS MANAGEMENT JOURNEYMAN			1101	55530P 7	T	RR		10/01/2010	12/31/4712
007518990M	0 XXXXX	FSV N 0160 CIV -3M071	SERVICES CRAFTSMAN			0188	55530P 7	T	B		10/01/2007	12/31/4712
007519000M	0 XXXXX	FSV N 0160 CIV -3M051	SERVICES JOURNEYMAN			0000	55530P 8	T	B		10/01/2007	12/31/4712

Position Summary for PAS F14R OSC FSV -- SUSTAINMENT SERVICES

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ACT	0160	CIVILIANS USDH	3	3	3	3	3	3	3	3	3
Total				3	3	3	3	3	3	3	3	3

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Unit Manpower Document

GCID: IL CID: 0M 911 OPERATIONS SUPPORT SQUADRON OL: 0000 (FJ74) PITTSBURGH INTL IAP PA SUB: B MPF: WI CPO: 6T MOP: WI ARR: 1

Unit Summary - FJ74

CAT	RIC	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
GIV	ART	0163	AFR TECHS (MEMO)	10	10	10	10	10	10	10	10	10
Total				10	10	10	10	10	10	10	10	10

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Unit Manpower Document

GCID: 1L CID: 0M 911 OPERATIONS SUPPORT SQUADRON OL: 0000 (EJT4) PITTSBURGH INTL JAP PA SUB: B MPF: WI CPO: 6T MOF: WI ARR: 1

OSC OSL -- AIRCREW FLIGHT EQUIPMENT

POS	P	S	MNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	SEI	A	OCC	PEC	S	P	M	A	R	R	M	M	A	R	M	M	A	R	R	M	M	A	R	M	M	A	End		
007020410M	0	XXXXXX	OSL	N	0163	WG-10	IP071		AIRCREW FLIGHT EQUIPMENT CRAFTSMAN			4818	54343R	7	J			D	E7																02/01/2008	12/31/4712		
007020420M	0	XXXXXX	OSL	N	0163	WG-09	IP071		AIRCREW FLIGHT EQUIPMENT CRAFTSMAN			4818	54343R	7	J			D	E5																	02/01/2008	12/31/4712	
007020700M	0	XXXXXX	OSL	N	0163	WS-09	IP091		AIRCREW FLIGHT EQUIPMENT SUPERINTENDENT			4818	54343R	7	J			D	E8																	02/01/2008	12/31/4712	
007020710M	0	XXXXXX	OSL	N	0163	WG-10	IP071		AIRCREW FLIGHT EQUIPMENT CRAFTSMAN			4818	54343R	7	J			D	E6																		02/01/2008	12/31/4712
007020720M	0	XXXXXX	OSL	N	0163	WG-09	IP051		AIRCREW FLIGHT EQUIPMENT JOURNEYMAN			4818	54343R	7	J			D																			02/01/2008	12/31/4712
007093460M	0	XXXXXX	OSL	N	0163	WG-09	IP051		AIRCREW FLIGHT EQUIPMENT JOURNEYMAN			4818	54343R	7	J			D	E5																		02/01/2008	12/31/4712
007448380M	0	XXXXXX	OSL	N	0163	WG-09	IP071		AIRCREW FLIGHT EQUIPMENT CRAFTSMAN			4818	54343R	7	J			D	E6																		02/01/2008	12/31/4712

Position Summary for PAS EJT4 OSC OSL -- AIRCREW FLIGHT EQUIPMENT

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ART	0163	AFR TECHS (MEMO)	7	7	7	7	7	7	7	7	7
Total				7	7	7	7	7	7	7	7	7

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Unit Manpower Document

GCID: 1L CID: 0M911 OPERATIONS SUPPORT SQUADRON OL: 0000 (EJ4) PITTSBURGH INTL JAP PA SUB: B MPF: WI CPO: 6T MOF: WI ARR: 1

OSC OSX -- OPERATIONS PLANS

POS	P	S	MINT	OSC LDR	RIC	GRD	AFSC	AFSC TITLE	SEI	A	P	OC	PEC	2183	56343R	7	J	S	P	M	A	R	P	I	L	ASF	N	1	2	CRK1	CRK2	Start	End
007160880M	0	XXXXX	OSX	N	0163	TBD	201M3B	MOBILITY PILOT, C-130EH																								05/01/2004	12/31/4712

Position Summary for PAS EJT4 OSC OSX -- OPERATIONS PLANS

CAT	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ART	AFR TECHS (MEMO)	1	1	1	1	1	1	1	1	1
Total			1	1	1	1	1	1	1	1	1

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Unit Manpower Document

GCID: 1L CID: 0M911 MAINTENANCE OPS FLIGHT OL: 0000 (FTT6) PITTSBURGH INTL JAP PA SUB: B MPE: W1 CPO: 6T MOF: W1 ARR: 1

Unit Summary - FJT6

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	13	13	13	13	13	13	13	13	13
CIV	ACT	0160	CIVILIANS USDH	3	3	3	3	3	3	3	3	3
CIV	ART	0163	AFR TECHS (MEMO)	10	10	10	10	10	10	10	10	10
<b>Total</b>				<b>13</b>								

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Unit Manpower Document  
 GCID: 1L CID: 9M 911 AIRLIFT WING OL: 0000 (FLJL) PITTSBURGH INTL JAP PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

Unit Summary -- FLJL

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	31	31	31	31	31	31	31	31	31
CIV	ACT	0160	CIVILIANS USDH	23	23	23	23	23	23	23	23	23
CIV	ART	0163	AFR TECHS (MEMO)	8	8	8	8	8	8	8	8	8
Total				31	31	31	31	31	31	31	31	31

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Unit Manpower Document

CCID: 1L CID: 0M 911 AIRLIFT WING OL: 0000 (FLJL) PITTSBURGHINTL JAP PA SUB: B MPF: WI CPO: 6T MOF: WI ARR: 1

OSC IP - INFORMATION PROTECTION

POS	S	MNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	A	P	SEI	OCC	PEC	S	P	M	A	R	M	R	R	2016	2017	2018	2019	End
				Y																						
007132420M	0	XXXXX	IP	N	01600	CIV	-3P071	SECURITY FORCES CRAFTSMAN				0080	55539P	S	J											02/01/2009
007132940M	0	XXXXX	IP	N	01600	CIV	-3P051	SECURITY FORCES JOURNEYMAN				0080	55539P	S	J											02/01/2009

Position Summary for PAS FLJL OSC IP - INFORMATION PROTECTION

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ACT	01600	CIVILIANS USDH	2	2	2	2	2	2	2	2	2
Total				2	2	2	2	2	2	2	2	2

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Unit Manpower Document

GCID: 1L CID: 0M 738 AIRLIFT SQUADRON OL: 0000 (FLJM) PITTSBURGH INTL JAP PA SUB: B MPF: WI CPO: 6T MOF: WI ARR: 1

Unit Summary - FLJM

CAT	RIEK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ART	0163	AFR TECHS (MEMO)	14	14	14	14	14	14	14	14	14
<b>Total</b>				<b>14</b>								

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Unit Manpower Document

GCID: 1L CID: 0M 738 AIRLIFT SQUADRON OL: 0000 (FLJM) PITTSBURGH INTL JAF PA SUB. B MPF: WJ CPO: 6T MOP: WJ ARR: 1

OSC DOJA -- A FLIGHT AIRCREWS

POS	P S MNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	SEI	A P I	OCC	PEC	S P M A A R S E R P I L	R M M S K K N 1 2	C R K 1 C R K 2	T o d a y v	2 0 1 5	2 0 1 6	2 0 1 7	2 0 1 8	2 0 1 9	Start	End	
007020740M	0	XXXXX	DOJA	N	0163	TBD	412M3B MOBILITY CSO, C-130E/H	2181		54343R	7	J	D		1	1	1	1	1	1	05/01/2004	12/31/4712	
007020750M	0	XXXXX	DOJA	N	0163	YA-02	-012M3B MOBILITY CSO, C-130E/H	2183		54343R	7	J	D	05	1	1	1	1	1	1	1	05/01/2004	12/31/4712
007042060M	0	XXXXX	DOJA	N	0163	GS-13	-011M3B MOBILITY PILOT, C-130E/H	2181		54343R	5	J	D		1	1	1	1	1	1	1	05/01/2004	12/31/4712
007058640M	0	XXXXX	DOJA	N	0163	GS-13	-011M3B MOBILITY PILOT, C-130E/H	2181		54343R	7	J	D		1	1	1	1	1	1	1	05/01/2004	12/31/4712
007448360M	0	XXXXX	DOJA	N	0163	GS-13	-011M3B MOBILITY PILOT, C-130E/H	2181		54343R	7	J	D	F4	1	1	1	1	1	1	1	05/01/2004	12/31/4712

Position Summary for PAS FLJM OSC DOJA -- A FLIGHT AIRCREWS

CAT	RTIC	RTIC	TITLE	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ART	0163	AFR TECHS (MEMO)	5	5	5	5	5	5	5	5
Total				5	5	5	5	5	5	5	5

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Unit Manpower Document

GCID: 1L CID: 0M 911 AEROMED STG SQUADRON OL: 0000 (FLJO) PITTSBURGH INTL JAP PA SUB: B MPE: W1 CFO: 6T MOF: W1 ARR: 1

Unit Summary -- FLJO													
CAT	RIKC	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019	
CIV			Civilians	5	5	5	5	5	5	5	5	5	
CIV	ACT	0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1	
CIV	ART	0163	AFR TECHS (MEMO)	4	4	4	4	4	4	4	4	4	
Total				5	5	5	5	5	5	5	5	5	

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Unit Manpower Document

GCID: 1L CID: 0M 911 AEROMED STG SQUADRON OL: 0000 (FLJO) PITTSBURGH INTL JAP PA SUB: B MPF: WJ CPO: 6T MOF: WI ARR: 1

OSC SGGF -- FLIGHT/MISSILE MED

POS	SPMNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	SE	A	P	OC	PEC	RP	IL	ASFN	1	2	CRK1	CRK2	Y	2	3	4	5	6	7	8	9	Start	End
007057510M	0	XXXXX	SGGF	N	0160	CIV	-3D051 KNOWLEDGE OPERATIONS MANAGEMENT		0303	58211P	7	J																11/01/2009	12/31/4712	
007099920M	0	XXXXX	SGGF	N	0163	GS-10	-4A091 HEALTH SERVICE MGT SUPERINTENDENT		0301	58211R	7	J																04/01/1998	12/31/4712	

Position Summary for PAS FLJO OSC SGGF -- FLIGHT/MISSILE MED

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	2	2	2	2	2	2	2	2	2
CIV		0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
CIV		0163	AFR TECHS (MEMO)	1	1	1	1	1	1	1	1	1
Total				2	2	2	2	2	2	2	2	2

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Unit Manpower Document

GCID: 1L CID: 0M 32 AERIAL PORT SQUADRON OL. 0000 (FLIR) PITTSBURGH INTL JAP PA SUB. B MPE. W1 CPO. 6T MOF. W1 ARR. 1

Unit Summary -- FLJR

CAT	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	0163	AFR TECHS (MEMO)	4	4	4	4	4	4	4	4	4
<b>Total</b>			4	4	4	4	4	4	4	4	4

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Unit Manpower Document

GCID: 1L CID: 0M 911 AEROMED EVAC SQUADRON OL 0000 (FLR3) PITTSBURGH INTL JAP PA SUB B MPF, W1 CPO: 6T MOF: W1 ARR: 1

Unit Summary -- FLR3

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ART	0163	APR TECHS (MEMO)	5	5	5	5	5	5	5	5	5
Total				5	5	5	5	5	5	5	5	5

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Unit Manpower Document

GCID: JL CID: 0M 911 COMMUNICATIONS SQUADRON OL: 0600 (FMZB) PITTSBURGH INTL IAF PA SUB: B MPF: WI CPO: 6T MOF: WI ARR: 1

Unit Summary -- FMZB

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
			Civilians	17	17	17	17	17	17	17	17	17
CIV	ACT	0160	CIVILIANS USDH	15	15	15	15	15	15	15	15	15
CIV	ART	0163	AFR TECHS (MEMO)	2	2	2	2	2	2	2	2	2
<b>Total</b>				17	17	17	17	17	17	17	17	17

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Unit Manpower Document

GCID: IL CID: 0M 911 COMMUNICATIONS SQUADRON OL: 0000 (FMZB) PITTSBURGH INTL JAP PA SUB: B MPF: W1 CPG: 6T MOF: W1 ARR: 1

OSC SCOK - KNOWLEDGE OPERATIONS

POS	007405150M(0)	XXXXX	SCOK N	LDR	RIC	GRD	AFSC	AFSC TITLE	SEI	A	0000	55550P7	R	D	CRK1	CRK2	2	3	4	5	6	7	8	9	Start	End
								KNOWLEDGE OPERATIONS MANAGEMENT																	10/01/2010	12/31/4712
								CRAFTSMAN																		

Position Summary for PAS FMZB OSC SCOK - KNOWLEDGE OPERATIONS

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV <td>ACT</td> <td>0160</td> <td>CIVILIANS USDH</td> <td>1</td> <td>1</td> <td>1</td> <td>1</td> <td>1</td> <td>1</td> <td>1</td> <td>1</td> <td>1</td>	ACT	0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
<b>Total</b>				<b>1</b>								

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Unit Manpower Document

GCID: 0M 911 COMMUNICATIONS SQUADRON OL: 0000 (FMZB) PITTSBURGH INTL JAP PA SUB: B MPF: WI CPO: 6T MOF: W1 ARR: 1

OSC SCX - PLANS AND RESOURCES

POS	P	S	MNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	SEI	A	P	I	OCC	PEC	R	P	I	L	ASF	N	1	2	CRK1	CRK2	2016	2017	2018	2019	End		
00715750M4	0	XXXXX	SCX	Y	0160	CIV	017DDB	CYBERSPACE OPS, CYBER CONTROL						0000	5550P	7	R														04/01/1998	12/31/4712

Position Summary for PAS FMZB OSC SCX - PLANS AND RESOURCES

CAI	ACT	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
		0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
Total				1	1	1	1	1	1	1	1	1

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Unit Manpower Document

GCID: 1L CID: 0M 911 MAINTENANCE SQUADRON OL: 0000 (FNW6) PITTSBURGH INTL JAP FA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

Unit Summary - FNW6

CAT	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ART	AFR TECHS (MEMO)	50	50	50	50	50	50	50	50	50
Total			50	50	50	50	50	50	50	50	50

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Unit Manpower Document

GCID: 1L CID: 0M 911 MAINTENANCE SQUADRON OL: 0000 (FNW6) PITTSBURGH UNTL JAP PA SUB: B MPF: W1 CPO: 5T MOF: W1 ARR: 1

OSC MXMC -- ACCESSORIES

POS	P	SMNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	SEI	A	P	OCC	PEC	RP	IL	ASFN	1	2	CRK1	CRK2	3	4	5	6	7	8	9	Start	End
007020490M	0	XXXXX	MXMC	N	0163	WG-10	2A690	AIRCRAFT SYS SUPERINTENDENT	8801	54343R	7	J	D	D	D	D	D	D	D	D	D	D	D	D	D	D	01/01/2004	12/31/4712	
007020520M	0	XXXXX	MXMC	N	0163	WG-11	2A674	AIRCRAFT FUEL SYS CRAFTSMAN	8268	54343R	7	J	D	D	D	D	D	D	D	D	D	D	D	D	D	D	01/01/2004	12/31/4712	
007020630M	0	XXXXX	MXMC	N	0163	WG-10	2A674	AIRCRAFT FUEL SYS CRAFTSMAN	8268	54343R	7	J	D	D	D	D	D	D	D	D	D	D	D	D	D	D	01/01/2004	12/31/4712	
007020640M	0	XXXXX	MXMC	N	0163	WG-10	2A675	AIRCRAFT HYDRAULIC SYS CRAFTSMAN	8268	54343R	7	J	D	D	D	D	D	D	D	D	D	D	D	D	D	D	01/01/2004	12/31/4712	
007020650M	0	XXXXX	MXMC	N	0163	WG-11	2A676	AIRCRAFT HYDRAULIC SYS CRAFTSMAN	8268	54343R	7	J	D	D	D	D	D	D	D	D	D	D	D	D	D	D	01/01/2004	12/31/4712	
007020660M	0	XXXXX	MXMC	N	0163	WG-10	2A656	AIRCRAFT ELECTRICAL & ENVIRONMENTAL SYS CRAFTSMAN	2892	54343R	7	J	D	D	D	D	D	D	D	D	D	D	D	D	D	D	01/01/2004	12/31/4712	
007093430M	0	XXXXX	MXMC	N	0163	WG-10	2A656	AIRCRAFT ELECTRICAL & ENVIRONMENTAL SYS JOURNEYMAN	2892	54343R	7	J	D	D	D	D	D	D	D	D	D	D	D	D	D	D	01/01/2004	12/31/4712	

Position Summary for PAS FNW6 OSC MXMC -- ACCESSORIES

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ART	0163	AFR TECHS (MEMO)	8	8	8	8	8	8	8	8	8
<b>Total</b>				<b>8</b>								

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Unit Manpower Document

GCID: 1L CID: 0M 911 MAINTENANCE SQUADRON OL: 0000 (FNW6) PITTSBURGH INTL JAP PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

OSC MXMT -- MAINTENANCE SUPPORT

POS	P S MNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	SEP	A P	SEP	I	OCC	PEC	R P I L	S P M A	R P I L	A R S E	R P I L	A S F N	R R	R M M	S K K	CRK1	CRK2	CRK3	Start	End
007020340M	0 XXXXX	MXMT N	0163	WG-11	-2A571	AEROSPACE MAINT CRAFTSMAN		8852	54343R	7	J	D														01/01/2004	12/31/4712
007020350M	0 XXXXX	MXMT N	0163	WG-10	-2A571	AEROSPACE MAINT CRAFTSMAN		8852	54343R	7	J	D														01/01/2004	12/31/4712
007020360M	0 XXXXX	MXMT N	0163	WS-09	-2A590	AEROSPACE MAINT SUPERINTENDENT		8852	54343R	7	J	D														01/01/2004	12/31/4712
007020590M	0 XXXXX	MXMT N	0163	WG-10	-2A571	AEROSPACE MAINT CRAFTSMAN		8852	54343R	7	J	D														01/01/2004	12/31/4712
007020510M	0 XXXXX	MXMT N	0163	WG-10	-2A571	AEROSPACE MAINT CRAFTSMAN		8852	54343R	7	J	D														01/01/2004	12/31/4712
007093440M	0 XXXXX	MXMT N	0163	WG-10	-2A551	AEROSPACE MAINT JRNYMN		8852	54343R	7	J	D														01/01/2004	12/31/4712
007127810M	0 XXXXX	MXMT N	0163	WG-10	-2A551	AEROSPACE MAINT JRNYMN		8852	54343R	7	J	D														01/01/2004	12/31/4712
007127820M	0 XXXXX	MXMT N	0163	WG-10	-2A571	AEROSPACE MAINT CRAFTSMAN		8852	54343R	7	J	D														01/01/2004	12/31/4712

Position Summary for PAS FNW6 OSC MXMT -- MAINTENANCE SUPPORT

CAT	RICK	RIC	TITLE	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ART	0163	AFR TECHS (MEMO)	8	8	8	8	8	8	8	8
Total				8	8	8	8	8	8	8	8

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Unit Manpower Document

GCCD: 1L CID: 0M 91J MAINTENANCE SQUADRON OL: 0000 (FNW6) PITTSBURGH INTL JAP PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

OSC MXMV -- AVIONICS

POS	P S MNT	OSC	LDR RIC GRD	AFSC	AFSC TITLE	A P SET I	OCC PEC	S P M A A R S E	R R R M M S K K	CRK2	CRK1	Start	End
007020580M	0 XXXXX	MXMVN	0163 WS-11	-2A573A	INTEGRATED AVN SYS (HEAVY) CRAFTSMAN, COMM/NAV/MISSION	2610	54343R 7 J		D	E7		01/01/2004	12/31/4712
007020590M	0 XXXXX	MXMVN	0163 WG-12	-2A573A	INTEGRATED AVN SYS (HEAVY) CRAFTSMAN, COMM/NAV/MISSION	2610	54343R 7 J		D	E6		01/01/2004	12/31/4712
007020600M	0 XXXXX	MXMVN	0163 WG-12	-2A553A	INTEGRATED AVN SYS (HEAVY) JOURNEYMAN, COMM/NAV/MISSION	2610	54343R 7 J		D	E5		01/01/2004	12/31/4712
007020610M	0 XXXXX	MXMVN	0163 WG-12	-2A573A	INTEGRATED AVN SYS (HEAVY) CRAFTSMAN, COMM/NAV/MISSION	2610	54343R 7 J		D	E6		01/01/2004	12/31/4712
007020620M	0 XXXXX	MXMVN	0163 WG-12	-2A573A	INTEGRATED AVN SYS (HEAVY) CRAFTSMAN, COMM/NAV/MISSION	2610	54343R 7 J		D	E6		01/01/2004	12/31/4712
007020630M	0 XXXXX	MXMVN	0163 WG-12	-2A573B	INTEGRATED AVN SYS (HEAVY) CRAFTSMAN, INSTR/FLIGHT CONTROLS	2610	54343R 7 J		D	E5		01/01/2004	12/31/4712
007041990M	0 XXXXX	MXMVN	0163 WG-13	-2A573B	INTEGRATED AVN SYS (HEAVY) CRAFTSMAN, INSTR/FLIGHT CONTROLS	2610	54343R 7 J		D	E7		01/01/2004	12/31/4712
007042000M	0 XXXXX	MXMVN	0163 WG-12	-2A573B	INTEGRATED AVN SYS (HEAVY) CRAFTSMAN, INSTR/FLIGHT CONTROLS	2610	54343R 7 J		D	E6		01/01/2004	12/31/4712
007083930M	0 XXXXX	MXMVN	0163 WG-12	-2A553C	INTEGRATED AVN SYS (HEAVY) JOURNEYMAN, ELECTRONIC WARFARE	2610	54343R 7 J		D	E5		01/01/2004	12/31/4712
007083940M	0 XXXXX	MXMVN	0163 WG-12	-2A573C	INTEGRATED AVN SYS (HEAVY) CRAFTSMAN, ELECTRONIC WARFARE	2610	54343R 7 J		D	E7		01/01/2004	12/31/4712
007103170M	0 XXXXX	MXMVN	0163 WS-12	-2A590	AEROSPACE MAINT SUPERINTENDENT	2610	54343R 7 J		D	E8		01/01/2004	12/31/4712

Position Summary for PAS FNW6 OSC MXMV -- AVIONICS

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ART	0163	AFR TECHS (MEMO)	11	11	11	11	11	11	11	11	11
Total				11	11	11	11	11	11	11	11	11

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Unit Manpower Document

GCID: 1L CID: 0M 911 CIVIL ENGINEER SQUADRON OL: 0000 (FTFS) PITTSBURGH INTL JAP PA SUB: B MPF: W1 CPO: 6T MOF: W1 ARR: 1

Unit Summary -- FTFS

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	24	24	24	24	24	24	24	24	24
CIV	ACT	0160	CIVILIANS USDH	22	22	22	22	22	22	22	22	22
CIV	ART	0163	AFR TECHS (MEMO)	2	2	2	2	2	2	2	2	2
Total				24	24	24	24	24	24	24	24	24

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Unit Manpower Document

GCID: 1L CID: 0M 911 CIVIL ENGINEER SQUADRON OL 0000 (PTFS) PITTSBURGH INTL JAP PA SUB B MPF: W1 CPO: 6T MOF: W1 ARR: 1

OSC CEC -- ENGINEERING

POS	S	MNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	AP	SEL	OCC	PEC	REP	IL	ASF	N	1	2	CRK1	CRK2	Y	2	3	4	5	6	7	8	9	Start	End		
007005330M	0	XXXXXX	CEC	Y	0160	CIV	-032E3E	CIVIL ENGINEER, ELECTRICAL ENG			0801	52578F	7	J		RR					1	1	1	1	1	1	1	1	1	1	06/01/2001	12/31/4712	
007005340M	0	XXXXXX	CEC	N	0160	CIV	-032E3C	CIVIL ENGINEER, CIVIL ENG			0801	52578F	7	J		RR					1	1	1	1	1	1	1	1	1	1	1	06/01/2001	12/31/4712
007005360M	0	XXXXXX	CEC	N	0160	CIV	-3E571	ENGINEERING CRAFTSMAN			0802	52578F	7	J		RR					1	1	1	1	1	1	1	1	1	1	1	06/01/2001	12/31/4712
007007670M	0	XXXXXX	CEC	N	0160	CIV	-032E3F	CIVIL ENGINEER, MECHANICAL ENG			0801	52578F	7	J		RR					1	1	1	1	1	1	1	1	1	1	1	06/01/2001	12/31/4712
007018380M	0	XXXXXX	CEC	N	0160	CIV	-032E3C	CIVIL ENGINEER, CIVIL ENG			0801	52578F	7	J		RR					1	1	1	1	1	1	1	1	1	1	1	06/01/2001	12/31/4712
007175140M	0	XXXXXX	CEC	N	0160	CIV	-032E3A	CIVIL ENGINEER, ARCHITECT/ARCHITECTURAL ENG			0801	52578F	7	J		RR					1	1	1	1	1	1	1	1	1	1	1	06/01/2001	12/31/4712
007175150M	0	XXXXXX	CEC	N	0160	CIV	-3E571	ENGINEERING CRAFTSMAN			0802	52578F	7	J		RR					1	1	1	1	1	1	1	1	1	1	1	06/01/2001	12/31/4712
007175160M	0	XXXXXX	CEC	N	0160	CIV	-3E591	ENGINEERING SUPERINTENDENT			0802	52578F	7	J		RR					1	1	1	1	1	1	1	1	1	1	1	06/01/2001	12/31/4712

Position Summary for PAS PTFS OSC CEC -- ENGINEERING

CAT	TRICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV	ACT	0160	CIVILIANS USDH	8	8	8	8	8	8	8	8	8
Total				8	8	8	8	8	8	8	8	8

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Unit Manpower Document

GCID: 1L CID: 0M 911 CIVIL ENGINEER SQUADRON OL 0000 (F1F5) PITTSBURGHINTL JAP PA SUB B MPF W1 CPO 6T MOF W1 ARR 1

OSC CEX -- READINESS AND EMERGENCY MGT

POS	P	S	MNT	OSC	LDR	RIC	GRD	AFSC	AFSC TITLE	A	P	SEI	OCC	PEC	S	P	M	A	R	M	R	M	R	M	R	M	R	M	R	M	R	M	R	M	Start	End
60701780M	0	XXXXX	CEX	N	0163	GS-09	3E97L		EMERGENCY MANAGEMENT CRAFTSMAN				0381	5939R	7	J																			09/30/1998	12/31/4712
007057500M	0	XXXXX	CEX	N	0160	CIV	3D051		KNOWLEDGE OPERATIONS MANAGEMENT JOURNEYMAN				0318	55979R	7	J																			11/01/2009	12/31/4712

Position Summary for PAS FTES OSC CEX -- READINESS AND EMERGENCY MGT

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	2	2	2	2	2	2	2	2	2
CIV	ACT	0160	CIVILIANS USDH	1	1	1	1	1	1	1	1	1
CIV	ART	0163	AFR TECHS (MEMO)	1	1	1	1	1	1	1	1	1
Total				2	2	2	2	2	2	2	2	2

MPES Unclassified

Unit Manpower Document

GCID: 1L CID: 0M 911 SECURITY FORCES SQUADRON OL: 0000 (FWRQ) PITTSBURGH INTL JAP PA SUB: B MPF: WJ CPO: 6T MOF: WJ ARR: 1

Unit Summary - FWRQ

CAT	RICK	RIC	TITLE	Today	2012	2013	2014	2015	2016	2017	2018	2019
CIV			Civilians	16	16	16	16	16	16	16	16	16
CIV	ACT	0160	CIVILIANS USDH	15	15	15	15	15	15	15	15	15
CIV	ART	0163	AFR TECHS (MEMO)	1	1	1	1	1	1	1	1	1
Total				16	16	16	16	16	16	16	16	16

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## PUTTING HEALTH CARE SPENDING ON A SUSTAINABLE PATH

WEDNESDAY, FEBRUARY 29, 2012

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

The committee met, pursuant to notice, at 10:01 a.m., in Room 608, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Wyden, Nelson, Whitehouse, Merkley, Sessions, Thune, Johnson, and Ayotte.

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.

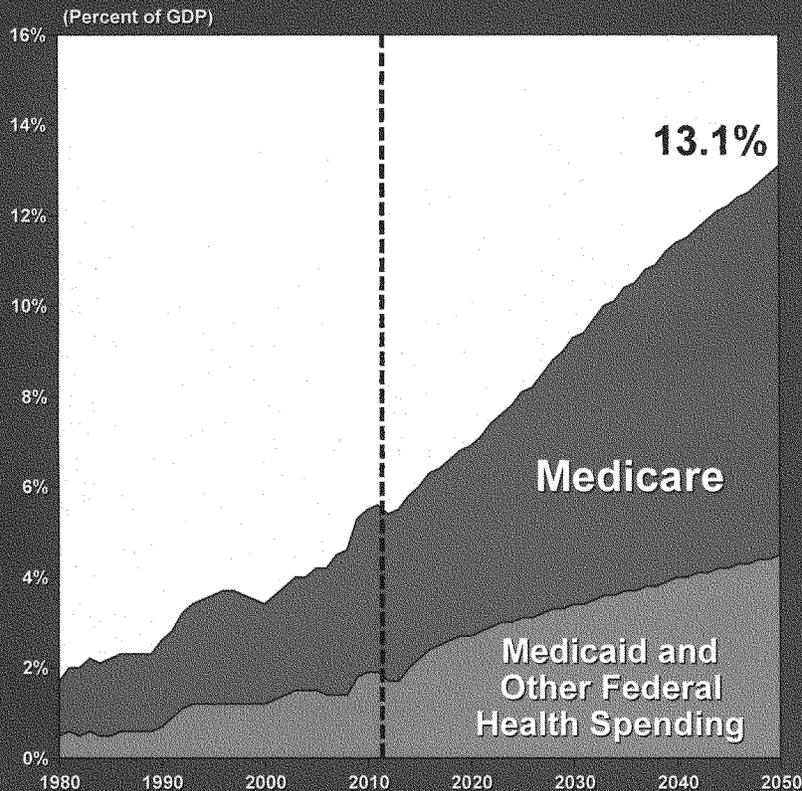
I want to welcome everyone to the Senate Budget Committee today. Our hearing is titled, "Putting Health Care Spending on a Sustainable Path." We will focusing on possible further reforms to the nation's health care system.

We are delighted to have three outstanding witnesses here today. They are Dr. David Cutler, Professor of Economics at Harvard University; Dr. Len Nichols, Professor of Health Policy and Director of the Center for Health Policy Research and Ethics at George Mason University; and James Capretta, Fellow at the Ethics and Public Policy Center. I note that Mr. Capretta worked as a staff member on the Budget Committee with Senator Domenici, and Senator Domenici is somebody that I am still in frequent contact with, so it is especially good to have you here, Mr. Capretta.

Although the health care reform law adopted in 2010, I believe, made progress in changing health care incentives and bending the cost curve on health care, rising health costs remain the single largest factor contributing to the nation's long-term fiscal imbalance. So it is the 800-pound gorilla. We believe we need to build on reforms already in place and find further savings in health care. As we build a budget for the next ten years, it is essential that we find additional savings in every part of the budget. I even had the Secretary of Defense here yesterday and the Chairman of the Joint Chiefs and talked to them about the same requirements. Every part of the budget has to be scrubbed when you are borrowing 40 cents of every dollar that you spend.

According to the Congressional Budget Office, Medicare, Medicaid, and other Federal health care spending could grow to more than 13 percent of GDP by 2050. It is important to remember that rising health care costs are a problem in the private sector, as well. Let us keep that chart up, if we can, for a minute, because I really want to focus our attention. In 1980, these elements of the budget were less than two percent of GDP. In 2010, tripled, up to six percent, and it is going to double again by 2050 on the current trend line.

## Medicare, Medicaid, and Other Federal Health Spending as % of GDP 1980-2050



Source: CBO Long-Term Budget Outlook, June 2011.

Note: CBO alternative fiscal scenario; reflects gross spending on Medicare, Medicaid, CHIP, and outlays for health insurance subsidies through exchanges.

Now, what is absolutely imperative for all of us, for the private sector, for the Federal Government, for State government, for local government, for our families, is that we do not let this trend line develop or continue. It has already developed.

I know some of my Republican colleagues have called for repealing the health care reform enacted in 2010. I believe that would be a mistake. It would take us, I believe, in the wrong direction. Reversing health care reform would be costly. Here is what the Congressional Budget Office concluded when it examined a Republican proposal last year to repeal health care reform. CBO estimates, and I am quoting from them, the Congressional Budget Office—it is

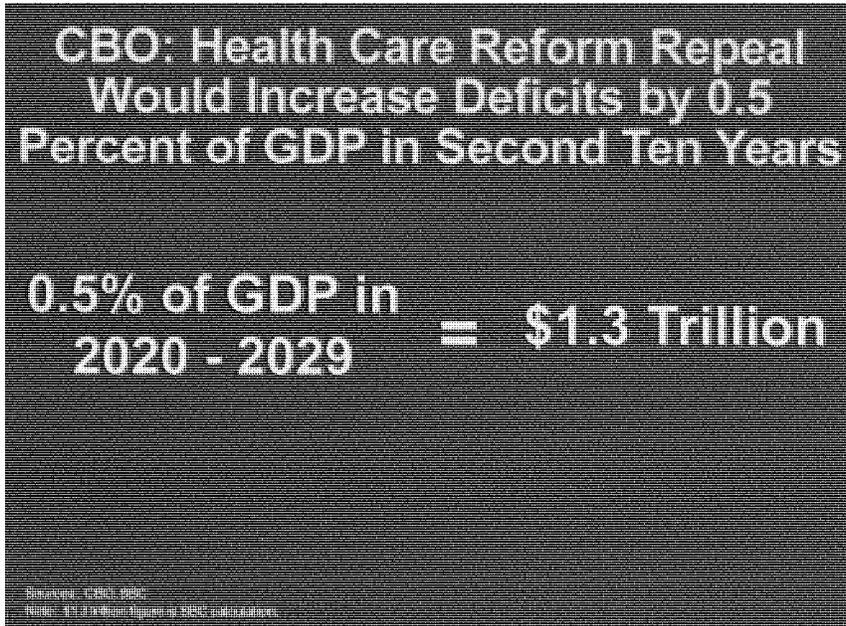
nonpartisan—estimates that enacting health care repeal would increase Federal deficits in the decade after 2019 by an amount that is equal in the broad range around one-half of one percent of Gross Domestic Product. For the decade beginning after 2021, the effect of health care repeal on Federal deficits as a share of the economy would probably be somewhat larger, they say, and would probably continue to increase budget deficits relative to those under current law in subsequent decades. Just to clarify, one-half percent of GDP in the second decade equals roughly \$1.3 trillion. So anybody that is talking about repealing health care reform is talking about adding, according to the Congressional Budget Office, about \$1.3 trillion to the debt.

### **CBO Confirms that Health Reform Law Repeal Will Increase Deficit Over Long-Term**

“... CBO estimates that enacting [Health Care Law Repeal] would increase federal deficits in the decade after 2019 by an amount that is in a broad range around one-half percent of GDP....

“For the decade beginning after 2021, the effect of [Health Care Law Repeal] on federal deficits as a share of the economy would probably be somewhat larger... [and] would probably continue to increase budget deficits relative to those under current law in subsequent decades.”

— CBO Letter to Speaker Boehner on H.R. 2  
January 6, 2011



One of the most important aspects of the 2010 health care reform is that it laid the foundation for even more long-term health care savings by including critical delivery system reforms. These are reforms designed to reward quality instead of the quantity of care. They included Accountable Care Organizations, primary care payment bonuses, readmissions, hospital value-based purchasing, comparative effectiveness research, a CMS Innovation Center, an Independent Payment Advisory Board, and payment bundling.

## Delivery System Reforms in Health Care Reform

- Accountable Care Organizations
- Primary Care Payment Bonus
- Readmissions
- Hospital Value-Based Purchasing
- Comparative Effectiveness Research
- CMS Innovation Center
- Independent Payment Advisory Board (IPAB)
- Bundling

By the way, I was in all the hearings in the Finance Committee, all the hearings in this committee. Virtually every idea brought to those bodies by analysts from whatever political persuasion were put into health care reform.

Senator Gregg, the Ranking Republican on this committee, and I wrote a letter to the Congressional Budget Office and asked them, what are the things that could be done that would give us the biggest bang for the buck in controlling health care costs. The response that we received from the Congressional Budget Office went into significant detail with respect to things that could help hold down exploding health care costs. We put virtually every one of those ideas into health care reform legislation.

Despite these positive aspects of health care reform, many of my Republican colleagues remain determined to dismantle that legislation and, I believe, undo progress that is being made. Let us remember the key elements of last year's House Republican plan for health care. They would fundamentally end Medicare as we know it, replacing the program with a voucher system and reopening the prescription drug doughnut hole. That means seniors would pay more for their prescription drugs. They would block grant Medicaid, which would shift costs onto seniors, children, the disabled, and States. This would also end the countercyclical nature of the program which protects individuals and the economy when we face an economic downturn. They would also defund health care reform, eliminating the new exchanges, the affordability tax credits, and the expanded coverage. This would increase the number of uninsured by at least 34 million people.

## House Republican Health Care Plan

- **End Medicare as we know it**
  - replace with voucher system
  - reopen prescription drug “donut” hole
- **Block grant Medicaid**
  - shift costs onto seniors, children, disabled, states
  - end counter-cyclical nature of program
- **Defund health reform**
  - eliminate exchanges, affordability credits, expanded coverage
  - increase number of uninsured by at least 34 million

There may be some evidence health care reform is having an impact on slowing Medicare spending already, although most of health care reform has not yet been implemented. Here is what former Office of Management and Budget Director Peter Orszag wrote last summer in a Bloomberg column. “And now for some good news,” he wrote. “Medicare spending growth has been slowing noticeably. So far this fiscal year, expenditures have actually declined slightly, according to the Congressional Budget Office. We don’t yet have enough data to tell for sure what is causing the recent deceleration in Medicare spending or whether it will last, but some evidence suggests that maybe a shift toward value in the health care sector. Various hospital executives have told me they have already begun to prepare for less generous reimbursements from Medicare as the new Federal health care reform law takes effect and there is a greater focus on value. They are, therefore, trying to become more efficient now.”

## Former OMB Director Orszag on Slowing Medicare Spending

"And now for some good news: Medicare spending growth has been slowing noticeably. So far this fiscal year, expenditures have actually declined slightly, according to the Congressional Budget Office...."

"We don't yet have enough data to tell for sure what's causing the recent deceleration in Medicare spending -- or whether it will last. But some evidence suggests it may be a shift toward value in the health-care sector. Various hospital executives have told me they have already begun to prepare for less generous reimbursement from Medicare as the new federal health-care reform law takes effect and there is a greater focus on value. They are therefore trying to become more efficient now."

— Former OMB Director Peter Orszag  
Bloomberg Column, "Medicare Spending Slows as Hospitals Improve Care"  
August 23, 2011

If Dr. Orszag is right, that would be a positive sign for the budget and health care outlook. However, it is still clear we are going to need to find additional health care savings.

Look, I have been here 25 years, and over and over, I have heard, hopeful sounds about health care. And over and over, we have been disappointed. So I just say, count me as a skeptic with respect to us having turned the corner.

I do believe—I am not a skeptic about things that were put in the health care reform legislation to attempt to slow down rising health care costs. There are a whole series of experiments in that legislation, again, ideas that were brought to us from every point on the political spectrum, from the most conservative to the most progressive.

By the way, the number one thing that Senator Gregg and I were told from the Congressional Budget Office in our request for what would get us the biggest bang for the buck in slowing down health care cost explosion, number one recommendation—and by the way, the number one recommendation of analysts from the most conservative to the most progressive—was change the tax treatment of health care. It was the number one recommendation of CBO. It was the number one recommendation of analysts, again, from every political perspective. You have to change the tax treatment of health care because you are encouraging over-utilization.

The second thing they told us, you have to change the way you pay for health care because you are paying for procedures, and when you do that, obviously, you incentivize procedures, whether they are helping people become healthier or not.

So I think all of us know how difficult this is. This is now one-sixth of the economy of the United States—actually, more than a

sixth—more than a sixth of the economy of the United States and far more than any other country.

Here are some possible options for further reforming health care to control costs. I want to be clear, this is not an exhaustive list. We could further transform payment policies in Federal health programs. This might include accelerating adoption of bundled payments to providers so that we are not just paying for procedures, expanding Accountable Care Organizations, because all of the evidence before the committees of jurisdiction was the one place that is really working in our system in terms of controlling costs are Accountable Care Organizations, or reforming cost sharing so that purchasers, consumers, have skin in the game.

**Options for Further Reforming Health Care**

- Transform payment policies in federal health programs
  - Accelerate adoption of bundled payments to providers
  - Expand accountable care organizations
  - Reform cost-sharing
- Reform health-related tax expenditures
  - Modify health tax exclusion
  - Modify deduction for HSA/FSA contributions
- Reduce administrative inefficiencies
- Further improve Health IT utilization

And I know that is controversial, but I personally believe in cost sharing. I had a doctor come to me who had practiced in India, practiced in England, practiced in North Dakota. He said, “Senator, the one thing I have learned, consumers have to have skin in the game.”

We could further reform health-related tax expenditures. This is what I mentioned earlier. For example, we could modify the tax exclusion for health care or modify the deduction for Health Savings Account and Flexible Spending Account contributions. This is something that the Simpson-Bowles Commission adopted as a centerpiece of their health care reform.

We could take further steps to reduce administrative inefficiencies because we know there is way too much money spent in administration. My own brother is a doctor—brother-in-law, a doctor, sole practitioner in Richmond, Virginia, 10,000 patients on his rolls, so pretty amazing for a sole practitioner. He had ten other

employees, five of them doing nothing but chasing insurance companies.

I will share one story with my colleague. My brother-in-law one day called me out of just sheer frustration. He said, "Ken, I have just got to share with you an experience I just had. I had a patient that needs urgent surgery. I am not a surgeon. I am not going to do it. I am not going to benefit from the surgery being done. My patient is going to benefit. The insurance company refused to pay. I personally called up the insurance company. I was put on hold for 45 minutes. At the end of the 45 minutes, a person came on and said, 'Doctor, you should not have called this number. You should have called this other phone number.'" They gave him the number, and at that point, my brother-in-law, who is Italian, very expressive, got fairly agitated because he told them, "That is the number I just called. That is how I got you." And again, they denied the procedure. He had a patient that was in pain. He said there was absolutely no question in a medical sense of the need for this to be done. So there are a lot of frustrations out there in the medical community.

And we could further improve health information technology utilization. I note the first two bullets on this chart, reforming payment policies and health-related tax expenditures, were described by CBO in a letter to me and former Ranking Member Gregg as the two most effective measures that could be adopted to bend the cost curve on health care.

I look forward to hearing more from our witnesses.

I turn to Senator Sessions for his opening commentary and then we will go to the witnesses for their testimony, and because we have fewer members here today, that means we are going to be able to have more time for each member to have exchanges with the witnesses.

Senator SESSIONS.

#### **OPENING STATEMENT OF SENATOR SESSIONS**

Senator SESSIONS. Thank you, Chairman Conrad, and thank you for this hearing. I think the title, "Putting Health Care Spending on a Sustainable Path," is a valuable topic for us. It really is, and we have to be serious about it.

I would note that it is critically important that we have honest talk about honest numbers, about real projections and what is going to be happening in the future and what is happening today.

In 2009, in his inaugural budget, President Obama promised to reduce health care costs for both families and the Federal Government. Yet after the President's health care law was enacted, Christmas Eve, a few days before Scott Brown would take office, who would have killed it had he been allowed to take office first, that health care law, according to the Congressional Budget Office Director Douglas Elmendorf, he concluded this. Rising health care costs will put pressure on the Federal budget during the next few decades and beyond. We all agree with that. And he goes on to say, quote, "In CBO's judgment, the health legislation does not substantially diminish that pressure."

In 2007, the President made a campaign pledge to cut the cost of a typical family's premium by \$2,500 a year. That is \$200 a

month. But by the end of the President's first term, health insurance premiums for a typical family with coverage through the workplace will have increased by more than \$2,400.

Before a Joint Session of Congress in September of 2009, the President stated, "I will not sign a health care plan that adds one dime to our deficits either now or at any time in the future, period." However, the legislation that became law included numerous budget gimmicks to hide its true cost. These included double-counted Medicare savings—double-counted Medicare savings—premiums from now defunct class act program scored as a surplus, and hiding the cost of the doc fix. In fact, when the gimmicks are added up, the President's health care costs added \$700 billion to the deficit. This chart indicates that. The claim was that it would save money and reduce the deficit, but when properly accounted, it increased the deficit. This is one of the largest, most dramatic misrepresentations of financial conditions in America I suppose has ever been made.

Former CBO Director Douglas Holtz-Eakin estimated that in the following decade, the second decade, the health care law will likely increase the deficit by nearly \$1.5 trillion while the President contends it was going to save over a trillion dollars during that period.

The President's health care law delays most of the spending until 2014, but begins tax increases and spending reductions earlier, relying on ten years of offsets to pay for six years of spending. The true cost of the new health entitlement over a full ten-year period is \$2.6 trillion. That is how much will be spent. Our income did not increase to pay for that. It adds to the deficit. It does not add to the surplus. It does not reduce the deficit.

Over the next 75 years, the President's health care law substantially increases our unfunded obligations for health care programs. In other words, health care reform was not entitlement reform.

Look at this chart. This is a dramatic thing because we were told if we would adopt this health care plan, we were going to change our debt trajectory. We were going to get off the unsustainable path we are on. And I would say, the facts are quite clear. It makes it worse, does not make it better. It did not change the cost curve, as we were promised, except to make the cost curve worse.

Our national debt per person today is nearly \$45,000 per person, man, woman, and child, more than Greece. The President's budget plan sent to Congress would grow our total debt by another \$11 trillion over the next ten years. By the end of ten years, interest payments will be \$850 billion annually—interest payments. That means that we will spend \$200 billion more on interest than we will be spending on defense.

Similarly, the President's health care policies, rather than tackle the long-term drivers of debt like Medicare, simply raided that program to pay for the new entitlement spending and puts the entire budget on an even more dangerously unsustainable path. In fact, today marks the fourth consecutive year the President has defied the legal requirement in the United States Code to submit a Medicare—as a result of the Medicare trigger—to submit a legislative proposal to Congress that addresses Medicare's coming insolvency. This is not only a requirement of law, it is a requirement of a leader. When your Medicare program is going out of control, we passed

legislation that when that happens, the President should submit a plan to help fix it. He ignores that for four consecutive years.

The President admitted in the introduction of his budget that health care is the major driver of our future deficit growth. But where is his plan to avert the disaster? His budget shows no leadership in addressing the cost of health care entitlements now or in the future. His budget increases health spending over the next ten years and does nothing to alter the unsustainable Federal health care spending over the long term.

By 2030, just eight years past our budget window, nearly 100 percent of Federal revenue will be consumed by entitlement obligations and debt interest payments. Under the President's budget plan, our debt remains permanently above 100 percent of GDP.

Meanwhile, in the midst of the crisis, our Senate Democratic colleagues refuse to even do a budget for the third consecutive year. President Obama and Senate leaders say that they want to help the middle class, but their health care law has dealt a hammer blow to working Americans. Their premiums have gone up. And their refusal to control our surging debt threatens the American people with economic disaster.

As a GAO report yesterday proves, our government is filled with waste, but we just keep on spending. The President's budget even hikes taxes almost \$2 trillion to pay for a new \$1.6 trillion spending increase. All the while, he says his budget cuts spending when it increased spending by \$1.6 trillion.

This is the kind of thing that is causing the American people to be angry with Congress. We say we are putting this country on a sound path. The President repeats it time and time again and it is not so. President Obama's budget would bleed this nation dry, keeping us on an unsustainable course, taking from the private sector to fund the public sector until both have been led to financial ruin.

I choose a more optimistic future. We can do better, a future where we empower the private sector so that millions of Americans can get back to work and that we can leave our children with a brighter future, not one clouded by a mountain of debt.

Mr. Chairman, thank you for the hearing. I know this is a contentious subject. We have some disagreements, obviously, but thank you for allowing me to share these thoughts.

Chairman CONRAD. Well, I think it is important. Look, there are places where we agree. Certainly, on our long-term debt situation, I think you and I are largely in agreement how serious a threat that is to the country. I think you and I are in agreement that we absolutely need a long-term plan, one that does reform entitlements, one, speaking for me, I believe we need to reform the tax system. We have a tax system—I think you probably share this view—that is just totally out of date. We also have to further address discretionary spending, have to have more savings there. So those are areas in agreement.

We obviously have disagreement. We have disagreement on the effect of the Affordable Care Act. We have a fundamental disagreement on whether we have a budget or not. You know, I believe very clearly, the Budget Control Act that passed last year both Houses of Congress, signed into law by the President, provided a budget

for this year and next. It also provided ten years of spending caps, something we rarely do in a budget resolution, and it is the law. It is not just a budget resolution. As we all know, a budget resolution never goes to the President for signature. The Budget Control Act not only passed both Houses of Congress, it was signed into law by the President, and it sets the budget for this year and next and sets ten years of spending caps. It also provided the enforcement mechanisms for this year and next. And it also provided what was, in effect, a reconciliation process to deal with entitlements and revenue.

Unfortunately, the Special Committee could not come to an agreement, and it was one of the—honestly, I have to tell you, maybe the greatest disappointment of my entire 25 years here, that the Special Committee that was given extraordinary power to come up with a plan to reform entitlements and reform revenue. They could have brought legislation to the floor of the Senate and the House that could not be filibustered and that could have taken on these things that absolutely have to be done. They could not reach agreement. I think that was one of the great lost opportunities that I have seen.

I served on the Simpson-Bowles Commission. At least 11 of the 18 of us there did reach agreement, five Democrats, five Republicans, and one Independent, and boy, it was hard, because I did not like it. As I told my colleagues, the only thing worse than voting for it would be voting against it because at least it made progress. It did not do as much as I wanted to do. It did \$4 trillion of deficit and debt reduction. I tried to persuade the Commission to do \$6 trillion, and why did I pick that number? Because with that amount of deficit reduction, we could have balanced the budget in ten years. And that is what I truly believe should be our goal.

Well, we appreciate the witnesses being here. Dr. Cutler, thank you so much for being here. Please proceed with your testimony, and then we will hear from the other witnesses and then we are going to have—we can do seven-minute rounds today. We can have additional time with the number of members that are here. Dr. Cutler.

**STATEMENT OF DAVID M. CUTLER, PH.D., OTTO ECKSTEIN  
PROFESSOR OF APPLIED ECONOMICS, HARVARD UNIVERSITY**

Mr. CUTLER. Thank you, Chairman Conrad, Ranking Member Sessions, and members of the Committee. Thank you for inviting me here. My name is David Cutler. I am a professor of economics at Harvard University, and for about 20-some-odd years, I have worked mostly in the areas of health economics.

The issue of health care sustainability which you are discussing today is a central to our economy and our Federal budget, both given our national needs and the opportunities that are available to us. Most experts believe that at least one-third of medical spending is not associated with improved health, implying waste of about \$750 billion annually and Medicare excessive spending of over \$100 billion annually.

Just to put this in perspective, the \$750 billion is roughly the cost of the TARP legislation and near the cost of the stimulus bill

that was passed in 2009, making the total amount of excessive spending roughly on the order of those commitments.

The question that faces all of us is, therefore, Where can money be saved while simultaneously improving the quality of medical care? And, fortunately, the health policy literature suggests several ways for achieving these cost savings.

The biggest one is poor care delivery; that is, the provision of unnecessary services, inefficient provision of necessary services, and inadequate prevention opportunities, missed opportunities. It is estimated that the costs of poor care delivery are about \$400 billion annually in the health care system.

Second in importance would be administrative costs. The estimate, as the Chairman said, are about \$200 billion annually in administrative costs that are not contributing to an improved health care system. Beyond that are prices that are too high and some amount of fraud and abuse, which together add up to about a third of medical spending. So the question then is: How can we address these areas?

We know several things about this excessive spending. First, it is not a result of a few bad apples; that is, it is not that there are a few physicians or hospitals or other care providers who are poor and if we just got rid of those we would solve the problem. Rather, it is a structural problem built into the medical care system, and so it is going to require a structural solution. And, second, these problems cannot be solved without coordination, and that coordination has to come from the biggest actor in the system, which is the Federal Government through the Medicare and Medicaid programs. So let me offer you some specifics on what I believe can be done.

To address the costs of inefficient care delivery, what we need to do is follow what the best provider organizations do. As the Chairman mentioned in his introduction, there are organizations which are efficient, they are lower cost, they are higher quality, and they do several things well. First, they use information technology very aggressively. That is a hallmark of all businesses in any industries that are doing well.

Congress started on this path with the HITECH Act, and it should be complimented for both that act and the way that it has been followed through. But we need to go the next step. Every health care organization that is successful has in essence removed itself from the fee-for-service payment system and has said, "We will not pay our providers on the basis of what they do but instead how well they do it." This Congress has an opportunity to follow that by committing to a path of replacing fee-for-service payment in Medicare, replacing it entirely or very substantially entirely within a period of time, say 5 to 7 years.

Such a policy would start by expanding on the demonstration programs that have been shown in the CBO evaluation to be successful in the recent Accountable Care Organization Program and extend those methodologies to all conditions and providers within a set period of time. This would provide the backbone and the impetus for the market commitment that is needed to make this change.

In addition, Congress could do quite a good deal on administrative costs. Administrative costs, as I mentioned, are about \$200 bil-

lion a year. The difficult thing or the frustrating thing about administrative costs is that it is not even associated with additional care provision. What it is really buying is frustration.

For the typical doctor in the United States, office-based physician, there are 2.2 administrative workers. By the way, that is twice the number of most other countries. Congress can do several things to address these administrative costs. The recommendations that I have come in two forms. First, it should require specific actions that are generally widely agreed to in the provider and payer community but are not done because of difficulties coordinating them. These include integrating clinical and administrative systems, electronic interchange of information, and centralized credentialing systems. Just on the last point, every doctor has to get credentialed by every insurance company in every setting in which they work annually, and it requires an enormous amount of effort just to keep up with all the different credentialing forms that doctors have to go through. There is absolutely no reason why it has not been standardized except—there is no technological reason. It has been lack of will power and lack of authority to do so.

On the issue of authority, I propose that this Congress establish an administrative simplification agency within the Department of Health and Human Services that would have at its sole mission realizing administrative cost savings. I recommend a specific target of one-third or more in the next 5 years. That amount would be about \$60 billion annually.

The precedent for this is the Office of the National Coordinator of Health Information Technology, which was given the mandate to make health information technology ubiquitous in the health system. This Congress set it up with that mandate, and it oversees the fulfillment of that mandate, and it is working very well. There is no reason why this could not be applied to an equally technically challenging but important issue like administrative simplification.

Together, policies that would reduce the extent of poor care delivery and harmonize administrative rules and reduce administrative costs would significantly slow the growth of medical spending, eliminate about a third of costs over the next few years, and provide significant relief to the Federal budget.

Mr. Chairman, thank you for inviting me, and I would be pleased to answer any questions that you have.

[The prepared statement of Mr. Cutler follows:]



**HARVARD UNIVERSITY, FACULTY OF ARTS AND SCIENCES**  
DEPARTMENT OF ECONOMICS

**DAVID M. CUTLER**  
OTTO ECKSTEIN PROFESSOR OF APPLIED ECONOMICS

**TESTIMONY OF DAVID M. CUTLER**  
**Otto Eckstein Professor of Applied Economics**  
**Harvard University**

**Before the**  
**Committee on the Budget**  
**United States Senate**

**Summary**

The United States spends far more than is needed on medical care. At least one-third of medical spending is not associated with improved health, implying waste of about \$750 billion annually. Thus, cost containment is a central economic issue.

There are two important rules that need to guide any discussion of cost containment. First, we need to eliminate wasteful spending, not valuable spending. Second, we need to reduce the overall level of spending, not simply shift costs from one payer to another.

The question that faces policy analysts, therefore, is finding areas where money can be saved while simultaneously improving care quality. The health policy literature suggests six avenues for cost savings: reducing unnecessary services; efficiently providing necessary services; improving prevention; reducing administrative costs; lowering prices that are too high; and reducing fraud. The Affordable Care Act has a number of provisions addressing these areas of cost savings, but more can be done.

To address the costs of inefficient care delivery, Congress should commit to a path of replacing fee-for-service payment in Medicare with bundled payment systems. Such a policy would start by expanding on the Acute Care Episode demonstration program and the recent Accountable Care Organization program, and extend those payment methodologies to all conditions and providers within a few years.

To reduce administrative costs, Congress should require specific actions including integration of clinical and administrative systems, electronic interchange of information, and centralized credentialing systems. In addition, Congress should establish an administrative simplification agency within the Department of Health and Human Services that would be tasked with realizing administrative cost savings of one-third or more in the next five years.

Together, these policies would significantly slow the growth of medical spending and provide significant relief to the federal budget.



**HARVARD UNIVERSITY, FACULTY OF ARTS AND SCIENCES**  
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February 29, 2012

**TESTIMONY OF DAVID M. CUTLER**  
**Otto Eckstein Professor of Applied Economics**  
**Harvard University**

**Before the**  
**Committee on the Budget**  
**United States Senate**

Chairman Conrad, Ranking Member Sessions, and members of the Committee, thank you for giving me the opportunity to appear before you today to discuss the topic of “Putting Health Care Spending on a Sustainable Path.” My name is David Cutler, and I am the Otto Eckstein Professor of Applied Economics at Harvard University. I have appointments in the Department of Economics, the Kennedy School of Government and the School of Public Health at Harvard. I am a research associate at the National Bureau of Economic Research, and a member of the Institute of Medicine. I have studied the health care industry for over 20 years and have written extensively about the economic and fiscal consequences of health care reform.

The high level and rapid growth of medical spending in the United States is an enormous policy challenge. High medical costs have an immediate effect on family budgets, by reducing the amount that families can spend on housing, clothing, education, and other important goods and

services. In addition, high costs for businesses lead to a variety of labor market impediments,<sup>1</sup> including people feeling locked into their current job, reduced business startups, and reduced employment, especially of lower wage workers. Further, high medical spending poses a strain on budgets at all levels of government. As this committee knows, the long-run budget situation of the federal government is very significantly determined by the growth of medical spending. Thus, policy must focus on reducing that spending growth.

That said, not all policies to lower medical spending are the same. There are two important rules that need to guide any discussion of cost containment:

o *We need to eliminate wasteful spending, not valuable spending.* Cutting spending without consideration to what is cut is not a good policy unless measures are put in place to ensure that the provision of valuable care is enhanced and that the most vulnerable members of our society are protected from the adverse effects that could result from indiscriminate cost reductions.

o *We need to reduce the overall level of spending, not simply shift costs from one payer to another.* It would be easy for governments to reduce their spending on medical care; they could simply pay less for medical care and make beneficiaries pay more. While this would lower government spending, it would raise spending by families. It is, in short, a shift of costs, when we need to reduce the overall level of spending.

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<sup>1</sup> Jonathan Gruber, "Health Insurance and the Labor Market," in Anthony J. Culyer and Joseph P. Newhouse, eds., *Handbook of Health Economics*, Volume 1A, Amsterdam: North-Holland, 2000; Janet Currie and Brigitte Madrian, "Health, Health Insurance and the Labor Market," in Orley Ashenfelter and David Card, eds., *Handbook of Labor Economics*, 1(3), Amsterdam: North-Holland, 1999, 3309-3416.

**OPPORTUNITIES TO REDUCE MEDICAL SPENDING**

The question that faces policy analysts and this Congress, therefore, is finding areas where money can be saved while simultaneously improving care quality. The health policy literature shows that this is possible and suggests six areas where money can be saved and quality simultaneously improved. These areas are shown in Table 1, along with estimates from the Institute of Medicine (IOM) of the *lower bound* of excessive spending associated with each area.

**Table 1: Excessive Medicare Care Spending  
(Lower Bound Estimates)**

<b>Area</b>	<b>Dollars* (billion)</b>	<b>Percent of medical spending</b>
<b>Poor care delivery</b>		
Unnecessary services	\$210	8%
Inefficiently delivered services	\$130	5%
Missed prevention opportunities	\$55	2%
<b>Excessive administrative costs</b>	\$190	8%
<b>Prices that are too high</b>	\$105	4%
<b>Fraud</b>	\$75	3%
<b>TOTAL</b>	\$765	31%

\* Estimates are for 2009. Data are from the Institute of Medicine.<sup>2</sup>

Several categories of spending are associated with *poor care delivery*. This includes unnecessary service use (care beyond clinical guidelines, defensive medicine, and unnecessary choice of high cost services when lower cost services are available), inefficient delivery of services (mistakes, errors, and operational inefficiencies), and missed prevention opportunities. The IOM estimates that these categories together account for 13 percent of medical spending, or nearly \$400 billion annually.

<sup>2</sup> Institute of Medicine, *The Healthcare Imperative: Lowering Costs and Improving Outcomes: Workshop Series Summary*, Washington, D.C.: Institute of Medicine, 2010, Box 21-1.

*Excessive administrative costs* includes costs that insurers incur for billing and claims processing, as well as the costs of billing and bill collection in physicians' offices, clinics, and hospitals. The total cost of excessive administration is nearly \$200 billion annually, or 8 percent of total health spending.

*Excessively high prices* is use of products and services that are more expensive than need be. The recent move by Medicare to implement competitive bidding for durable medical equipment shows the extent to which prices can be lowered without reductions in quality. The IOM estimated that 4 percent of medical spending could be eliminated by lowering prices to competitive levels.

*Fraud* is the final category of excess costs, and accounts for an estimated 3 percent of medical spending.

All told, the IOM estimates that at least \$750 billion in medical spending is wasted annually, amounting to over 30 percent of the total national health bill. To put this in perspective, this is near the entire spending of the American Recovery and Reinvestment Act of 2009. Thus, the United States wastes approximately a stimulus bill every year on medical spending that is not associated with improved health. The IOM further estimates that implementation of known effective strategies to reduce waste could save nearly three-quarters of this amount, reducing medical spending by \$550 billion annually. It is therefore worth considering what changes are necessary to realize these savings. I focus particularly on the costs of poor care delivery and administrative expenses.

**POOR CARE DELIVERY**

The costs of poor care delivery are manifest in several ways. Overtreatment is relatively common and reflects use of expensive care when less expensive care is just as effective. The well-known studies from the Dartmouth Atlas highlight the degree of overused care.<sup>3</sup> Mistakes and clinical errors are a particularly malicious form of poor care delivery, since they simultaneously increase medical spending and harm health. About \$30 billion dollars is spent annually treating hospital-acquired infections.<sup>4</sup> Similarly, missed prevention opportunities drives up acute care costs while worsening population health.

A good deal of research has examined the causes of poor care delivery. There is not a single cause of this inefficiency. It would be nice if we could attribute the excessive spending to a handful of doctors who are not up to date or to a malpractice system run amok. But that is not the case. Rather, the problem is interwoven throughout the health care system.

The characteristics of poor care can be seen with reference to high quality care providers. There are a number of health systems that deliver care that is superior and cheaper to that in general practice. The journal *Health Affairs* recently profiled 15 such organizations.<sup>5</sup> The Institute of Medicine has reported on several more.<sup>6</sup> Organizations such as the Cleveland Clinic, Geisinger Health System, Group Health Cooperative, Intermountain Health Care, Kaiser Permanente, the

<sup>3</sup> Elliott S. Fisher, David E. Wennberg, Thérèse A. Stukel, Daniel J. Gottlieb, F. L. Lucas, and Étoile L. Pinder, "The Implications of Regional Variations in Medicare Spending. Part 1: The Content, Quality, and Accessibility of Care," *Annals of Internal Medicine*, 2003; 138: 273-287; Elliott S. Fisher, David E. Wennberg, Thérèse A. Stukel, Daniel J. Gottlieb, F. L. Lucas, and Étoile L. Pinder, The Implications of Regional Variations in Medicare Spending. Part 2: Health Outcomes and Satisfaction with Care, *Annals of Internal Medicine*, 2003; 138: 288-298.

<sup>4</sup> R. Douglas Scott II, *The Direct Medical Costs of Healthcare-Associated Infections in US Hospitals and the Benefits of Prevention*, Washington, D.C.: Centers for Disease Control and Prevention, 2009.

<sup>5</sup> Profiles of Innovation in Health Care Delivery, *Health Affairs*, March 2011.

<sup>6</sup> Institute of Medicine, *The Healthcare Imperative: Lowering Costs and Improving Outcomes: Workshop Summary*. Washington, DC: The National Academies Press, 2010.

Mayo Clinic, and the Virginia Mason Medical Center all have achieved high quality, lower cost outcomes. Consider just a few examples. The University of Pittsburgh Medical Center reduced its hospital-acquired infections (HAI) rate by 85%; Geisinger cut its readmission rate down to 3.8%; Parkland, a public hospital in Dallas, reduced readmissions for Medicare heart failure patients by about 40 percent in 2010-11; and Denver Health, a safety-net institution, has cut its rate of fatal and expensive cardiac arrest rates more than in half.<sup>7,8</sup>

These organizations are not concentrated geographically, nor do they share particular demographic characteristics of enrollees. Rather, they have three other features in common: (1) they use information technology to learn what works and what does not; (2) they have removed themselves from the fee-for-service payment grid and instead use volume-neutral or value-based compensation systems; and (3) they have freed up employees to do the right job, by training leaders who facilitate quality improvement and empowering employees to make the right care the heart of their mission.

These examples can be replicated nationally. There is no reason why every doctor, hospital, and health system could not implement care processes equal to the best in the country. But policy is needed to make it happen. Two policy components are particularly important. One part is the so-far successful push to disseminate information technology throughout the medical system. The HITECH Act passed as part of the American Recovery and Reinvestment Act of 2009 is

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<sup>7</sup> Paul Barr, "Cutting readmissions: Index allows hospital to track high-risk patients," *Modern Healthcare*, 2011; July 25:10.

<sup>8</sup> Patricia A. Gabow and Philip S. Mehler, "A Broad And Structured Approach To Improving Patient Safety And Quality: Lessons From Denver Health," *Health Affairs*, 2011, 30(4), 612-618.

succeeding in its goal to facilitate the adoption of universal health IT. Congress should rightly celebrate this accomplishment and keep pushing for organizations to do more.

The next step is to create incentives to use those systems appropriately and change the delivery model for health care services. The Affordable Care Act took some steps in this direction with a series of changes to the Medicare program. These include: *direct payment innovations*, including higher reimbursement for preventive care services and patient-centered primary care, bundled payment for acute and post-acute medical services, shared savings or capitation payments for accountable provider groups that assume responsibility for the continuum of a patient's care, and pay-for-performance incentives for Medicare providers; *increased funding for comparative effectiveness research*, to enhance our knowledge of what medical care is helpful, and what is not; *distinguishing medical care providers on the basis of cost and quality*, making that data available to providers, consumers, and insurance plans, and providing financial incentives for relatively low-quality, high-cost providers to improve their care; an *Innovation Center* at CMS to sponsor and encourage innovative care delivery models; and *increased emphasis on wellness and prevention*, through lower cost sharing for preventive care, mandatory nutrition labeling at chain restaurants, employee wellness discounts, and dedicated funding for prevention and public health.

But the Affordable Care Act did not go far enough. To achieve meaningful savings, we need to commit to more systematic payment reform, and in particular a move from fee-for-service reimbursement to bundled payments. A variety of payment methodologies fall into the bundled care heading. Some bundled payments will be at the episode level. For example, primary care

physicians might receive a bundled payment for services delivered in the primary care setting, with bonuses for reducing emergency department and inpatient costs. Similarly, specialists may receive a bundled payment for the services related to the problems they treat – a hip replacement bundle for patients that have a broken hip, for example. In the Congressional Budget Office’s recent review of programs that reform the payment and delivery system, the single reform that demonstrated reduced spending was bundling services, which CBO estimated saved 10 percent.<sup>9</sup>

Other payments will be at bundled at the patient level for an entire year. The Accountable Care Organization (ACO) model that Medicare is pioneering is an example of such a payment system. Evidence from a similar program in Massachusetts shows that a global payment model saved 2 percent in just the first year.<sup>10</sup>

**Recommendation 1: Congress should facilitate cost savings by undertaking three payment reforms in the Medicare program:**

- 1. Adopt nationally the 37 bundles in the Acute Care Episode (ACE) demonstration for cardiac and orthopedic procedures combined with rehabilitation services.**
- 2. Introduce and disseminate bundles for chronic conditions, such as treatment for cancer, coronary artery disease, and diabetes.**
- 3. Establish a date certain, perhaps 5 to 7 years from now, when the vast bulk of payments by Medicare and Medicaid – 80 percent or more – would be bundled episode payment or global patient-based payment.**

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<sup>9</sup> Lyle Nelson, *Lessons from Medicare’s Demonstration Projects on Value-Based Payment*, Washington, D.C.: Congressional Budget Office, 2012.

<sup>10</sup> Zirui Song, Dana Gelb Safran, Bruce E. Landon, Yulei He, Randall P. Ellis, Robert E. Mechanic, Matthew P. Day, and Michael E. Chernew, “Health Care Spending and Quality in Year 1 of the Alternative Quality Contract,” *New England Journal of Medicine*, 2011; 365:909-918.

Ideally, CMS would work with private insurers on the design of each of these steps. Many private insurers are moving in this direction already but are waiting for CMS to take the lead. Together, these policies would send a clear market signal that fee-for-service payment is ending and would incentivize investment in the infrastructure and technology that is necessary for more widespread implementation of bundled payments.

#### **REDUCING ADMINISTRATIVE COSTS**

Spending on administration is much higher in the United States than in other countries, and is much greater than any analyst suggests is needed. For every office based physician in the United States, there are 2.2 administrative workers; in Canada, there are half as many. U.S. hospitals have 1.5 administrative workers per bed; that is 40 percent more than in Canada.<sup>11</sup>

The overall cost of this administrative expense is staggering. The Institute of Medicine estimated that providers and payers in the United States spend \$361 billion on billing and insurance-related administrative costs, of which about half are not associated with improved system operation.<sup>12</sup> The McKinsey Global Institute, the Medical Group Management Association, the American Medical Association, and the association of America's Health Insurance Plans also suggest that administrative costs are excessive.<sup>13</sup> Some of these costs are

<sup>11</sup> David Cutler, and Dan Ly, "The (Paper)Work of Medicine: Understanding International Medical Costs," *Journal of Economic Perspectives*, 2011, 25(2), 3-25.

<sup>12</sup> Institute of Medicine, *The Healthcare Imperative: Lowering Costs and Improving Outcomes: Workshop Summary*. Washington, DC: The National Academies Press, 2010; James G. Kahn, et al., "The cost of health insurance administration in California: estimates for insurers, physicians, and hospitals," *Health Affairs*, 2005; 24(6), 1629-39.

<sup>13</sup> McKinsey Global Institute, *Accounting for the Cost of US Health Care: A New Look at Why Americans Spend More*, Washington, D.C.: McKinsey Global Institute, 2008; Medical Group Management Association, "Administrative Simplification for Medical Group Practices," MGMA Position Paper, June 2005; Stephen J. Ubl and others, Letter to President Obama, May 11, 2009, available at [http://www.whitehouse.gov/assets/documents/05-11-09\\_Health\\_Costs\\_Letter](http://www.whitehouse.gov/assets/documents/05-11-09_Health_Costs_Letter)

paid by insurance companies in their billing and claims processing departments, but this is not the bulk of the costs. Rather, a larger share is paid by providers, in the form of excess personnel and time investment. The typical U.S. hospital spends 10 cents out of every dollar raised just collecting that dollar.<sup>14</sup>

Table 2 provides examples of these costs, including credentialing processes that differ for each insurer and care organization; claims submission and payment processes that are not standardized; and eligibility verification that is needlessly complex.

**Table 2. Administrative Complexity Through the Provider Revenue Cycle**

<b>Stages</b>	<b>Examples of Administrative Costs</b>
Providers Negotiate with Insurers Contracting and Credentialing	Time spent negotiating various contracts and filling out redundant credentialing forms; Lost clinical time due to long approval process for credentialing applications.
Patient Schedules Appointment Eligibility Verification	Patient effort to contact appropriate office personnel and negotiate insurance approval; Providers, insurers, and patients contend with retroactive additions and terminations of employee coverage that complicate eligibility verification process; plan customization and carve-outs add confusion to determinations of covered services.
Patient Visit/Treatment	Prior authorization requirements for treatments and services are often ambiguous and arduous to complete; process for referrals is time-consuming and often does not add value.
Billing and Claims Submission	Variation in claims requirements, lack of standardized codes, lack of uniform operating rules, insurance company companion guide changes, and complexity in identifying the primary insurance company responsible for payment due to lack of standardized identifiers.
Claims Status Inquiries Collections, Remittance, Payment Posting	No verification process in place to determine whether claim was successfully received from provider in the format desired by insurance companies and other payers.
Denials	Variation in use of denial codes across payers creates

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<sup>14</sup> Bonnie B. Blanchfield, James L. Heffernan, Bradford Osgood, Rosemary R. Sheehan, and Gregg S. Meyer, "Saving Billions Of Dollars--And Physicians' Time--By Streamlining Billing Practices," *Health Affairs*, 2010, 29(6):1-7.

Reconciling Over-and Under-Payments	challenges for provider offices; Insurance company systems are outdated and often lack capabilities to identify important data in provider claims; Uneven adoption of electronic capabilities creates room for human error.
Appeals Reporting	Processes vary across insurers and many conducted manually, which is costly and time consuming. Inconsistent requirements across insurers, agencies, hospitals, and other programs.

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Note: This analysis is drawn primarily from research conducted for the Employers Action Coalition on Health Care.<sup>15</sup>

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There is no doubt that these costs can be reduced. Credentialing has been partially streamlined in some areas, and could be streamlined further. There are proposals for standardizing claims submission, payment notification, and eligibility verification, and statewide examples in Massachusetts and Utah that could be expanded. The major impediment to reducing administrative waste is not lack of knowledge, but instead lack of authority and willpower.

The Affordable Care Act took some steps to streamline these costs. In particular, Sections 1104 and 10909 of the ACA establish uniform operating rules for claims submission, adjudication, and other communications between providers and insurers. This complements operating rule requirements enacted as part of the Health Insurance Portability and Accountability Act of 1996. But there is more to be done in this area. In particular, Congress can take two vital steps to further administrative savings.

**Recommendation 2: Congress should mandate several steps to reduce administrative costs to occur within the next three years, including:**

- 1. Requiring EMR vendors to integrate electronic clinical records with claims and bill processing functions;**

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<sup>15</sup> Employers Action Coalition on Healthcare Steering Committee. *Analysis of Administrative Simplification*. 2003; Mark Merlis, *Simplifying Administration of Health Insurance*. Washington, D.C.: 2009.

2. **Requiring providers and payers to implement the electronic exchange of eligibility, claims, and other administrative information; and**
3. **Requiring all payers, hospitals, and physicians to use a single, centralized physician credentialing system.**

The first of these requirements would simplify the transfer of information from clinical systems to billing systems. Since a good share of administrative costs come from the need for clinical documentation in the billing transaction, this would save significant amounts of time and money. The second requirement ensures that payers have mutually compatible billing systems and that providers respond by adopting similarly compatible electronic submission systems. The third requirement specifies that credentialing would be standardized into a single system.

The most efficient way to implement these changes would be to have HHS, in consultation with payers and providers, set national standards. Because the government is such a large share of the medical system, there is no way to achieve administrative simplification without public sector involvement. Private collaboratives are a second alternative, but they lack integration with the public sector and might vary needlessly from locality to locality.

Administrative simplification is very technical, and public sector expertise in these areas is often lacking. As a result, HHS has been slow to use authority given to it to reduce administrative costs. For example, the HIPAA measures on administrative simplification were not fully implemented until well over a decade after the legislation was passed. To address this, Congress should elevate the importance of administrative savings within the health care agencies:

**Recommendation 3: Administrative simplification measures should be allocated to a new office or agency within the Department of Health and Human Services tasked with the specific goal of reducing administrative costs by one-third over the next five years.**

The new agency would promote consensus where such consensus exists, and have the authority to mandate some actions if consensus cannot be reached. Given the level of scrutiny now being placed on administrative costs and the need for savings in this area, I am confident that most such savings will be realized through a consensus process.

#### **SUMMARY**

In sum, the need for cost savings in health care is critical. Fortunately, we have the ability to address the problem. Both poor care delivery and administrative cost simplification are feasible within the next few years. Also fortunately, many of the needed changes are not partisan in nature; efforts to improve care delivery and reduce administrative costs have crossed party lines. Thus, the issue for this Congress is how to start with bipartisan support for delivery system reform and administrative simplification and use that to achieve real cost savings. By working together with the industry participants, experts, and the administration, this Congress can help set the path for an era of health reform that is valuable for our economic health as well as our personal health.

Thank you again for the opportunity to meet with you. I would be happy to answer any questions that you might have.

Chairman CONRAD. Thank you. Thank you for your excellent testimony.

Dr. Nichols, welcome. Please proceed.

**STATEMENT OF LEN M. NICHOLS, PH.D., PROFESSOR OF HEALTH POLICY, AND DIRECTOR, CENTER FOR HEALTH POLICY RESEARCH AND ETHICS, COLLEGE OF HEALTH AND HUMAN SERVICES, GEORGE MASON UNIVERSITY**

Mr. NICHOLS. Thank you, Chairman Conrad, Ranking Member Sessions, Senator Wyden.

Thank you, Senator Conrad—it is a real pleasure to be here again—Ranking Member Sessions, Senator Johnson, and Senator Wyden. It is an honor to offer my thoughts on sustainable health spending before you today. My name is Len Nichols. I am a health economist, professor of health policy, and director of the Center for Health Policy Research and Ethics at George Mason University. My other relevant affiliations are in my written testimony, but I do want to make crystal clear at the outset that my testimony and spoken views are mine and mine alone. I do not speak for any organization, public or private, nor for any other person, living or dead.

[Laughter.]

Mr. NICHOLS. To state the punch line at the beginning, we cannot afford the health system we have, and it is that system that casts doubt on our most sacred Medicare and Medicaid promises. Therefore, any sustainable Medicare solution must be centered around on systemwide reform, and that is why the Affordable Care Act is such an essential step in moving us toward a sustainability health system.

The phrase “structural reform,” of Medicare in particular, has become a rallying cry and litmus test of those who judge all things by the metric of deficit reduction. We are all in favor of deficit reduction, but the problem with this phrase is that it too often means limiting public spending by shifting all financial risk to beneficiaries, providers, private plans, and employers.

To some prominent commentators today, if you are not for fixed growth rates for Medicare spending, guaranteed no matter what else happens, then you are just not serious about health reform, about Medicare reform.

Nothing could be further from the truth. The what I call “spread sheet health economics proposals” of some structural reform zealots would essentially hire health plans to fix our health care woes by containing the financial risk to the Government. This approach acts as if our only serious health care problem is the financial risk of keeping our promises to the elderly and the poorest among us. This approach does nothing to change the fundamental structure of the delivery system and its currently counterproductive incentives. Therefore, it cannot and will not work since providers with market power, which exist quite widely, will simply shift the cost of the uninsured and the public program underpayment to private insurers and self-insured employers, thus worsening, not improving, our international competitiveness.

Structural reform should mean addressing the fundamental problem with our health care system, and that is, of course, our underlying incentive structures are all wrong. Today health plans make

bigger profit margins segmenting the healthy from the sick than from finding and coordinating high-quality care options for all enrollees. At the same time, fee-for-service payment arrangements and byzantine layers of opaqueness when it comes to device and drug costs have long encouraged volume growth and penalized the very coordinating care we now know can improve care and health while lowering the cost of care.

So structural reform ought to mean changing the underlying incentives of insurers, physicians, hospitals, and patients to align their self-interests with our common interest in reducing cost growth per capita while expanding access to high-quality care.

The good news is structural reform of and incentive realignment within our health care system is actually what the ACA is all about.

Imagine a health care system in which insurers make more money helping to coordinate care than in discriminating against the unhealthy.

Imagine a health system in which every clinician patient encounter has to support its joint decisionmaking complete information on the patient along with current best practice information about options for that kind of patient with those symptoms and family history.

Imagine a health system in which primary care physicians make more money seeing fewer patients per day than they do today as teams become co-managers with the patient of specific pathways to health restoration.

Imagine a health system in which specialists and hospitals actually cooperate with primary care teams and patients to reduce unnecessary utilization while improving quality.

This would be a health system that had been structurally reformed, and this would be a health system in which we can afford to strengthen Medicare and Medicaid going forward while extending access to health insurance for all Americans.

This is the health care system that the Affordable Care Act, with help from the information technology David talked about, and meaningful use investments pursuant to the ARRA is trying to give us the tools to create.

These tools include new market rules that will convert private insurers from risk selectors into value seekers. In anticipation of this happening in 2014, the really good news is the private sector is already doing the same sorts of thing. Karen Ignani reported in October an amazing set of survey results of private sector innovation using the exact same payment models that we have in the Affordable Care Act: accountable care organizations, medical home, bundling, all that stuff. And together they signal that that is indeed the way all payers are moving.

So the structural reforms that matter most for families and governments alike are smarter incentives for providers within the delivery system as a whole, and here the ACA takes a multipronged approach we have already talked about. The overarching goal now in sight is a three-part aim: better health, better care, and lower cost.

At the end of the day, there are only four ways to reduce health spending: we can reduce utilization, lower prices, have better qual-

ity, or better underlying health of the population. We need to pursue all of them. They all are pursued in the ACA. There are no silver bullets, contrary to wishful thinking.

But we are not going to get any of them without realigning incentives. The hard job of policy and really what you are called upon to do is to help develop incentives that will link provider and patient self-interest to our social interest in each of these targets, and that is, in my view, exactly what the ACA does with the payment reform pilots we talked about.

To me the most exciting is the innovation challenge grants which have turned up an amazing amount of interest in basically telling CMS this is the proposal we think will work for us where we live and work. And we do not have final counts yet because they will not release them, but I know when you apply they tell you where you are in the queue. And I know folks that did apply. Over 7,000 letters of intent were filed, over 2,000 applications to become innovation challenges around the country, which says something about the scope of folks who are thinking in these similar ways.

But the ACA is far from perfect. It needs at least three additional features to smooth our transition to a better system. The first two I put together, and I will not belabor the point, but I think you know exactly where I am coming from: malpractice and SGR reform. It may seem like an odd pairing, but the truth is nothing could do more than get more physicians convinced that the Federal Government actually wants to be a partner. Nothing could do more than get physicians engaged in the reform enterprise than taking care of those problems. I know they are not easy, but I am telling you, it will be well worth the cost.

But the final tool I want to mention today is to direct the CMMI, the Medicare and Medicaid Innovation Center, to create a new initiative or grantmaking window of opportunity on community-wide payment and delivery reform. You could call it an accountable care community program. A precondition would be what Rochester, New York, and Grand Junction, Colorado, have demonstrated: the ability to assemble all relevant stakeholders, including consumers, at the planning table. You have all payers, all hospitals, all physician groups basically agreeing on how to do multipayer payment reform, the best hope by far in transforming our system. What these communities and others like them want and need is for Medicare to be a partner with them and to basically join the party.

So what I am trying to convey in this testimony is basically this final point. If we want to reform the system, we have to get the incentives right. It is far better to get the health care system growth rate you are willing to incentivize by empowering clinicians and patients and by inducing plans to help them rather than to try to hit an arbitrary growth rate you could try to force with rigid budget caps on payments to health plans alone. The latter will not work, and the former is the only sustainable path.

Thank you very much.

[The prepared statement of Mr. Nichols follows:]

**Putting Health Care Spending On a Sustainable Path**

**Statement of**

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**For the Committee on the Budget**

**United States Senate**

**February 29, 2012**

**Washington, DC**

## Putting Health Care Spending On a Sustainable Path

Len M. Nichols, Ph.D.

February 29, 2012

Chairman Conrad, ranking Member Sessions, other distinguished members of this Committee, it is an honor and a privilege to offer my thoughts on sustainable health spending. My name is Len M. Nichols. I am a health economist, Professor of Health Policy, and Director of the Center for Health Policy Research and Ethics in the College of Health and Human Services at George Mason University in Fairfax, Virginia. My other affiliations relevant to the subject of today's hearing include: Editor-in-Chief of the online Payment Innovation Community, a project jointly sponsored by the American College of Cardiology and the American Journal of Managed Care<sup>1</sup>; Board member of the National Committee on Quality Assurance,<sup>2</sup> Academy Health,<sup>3</sup> and the Arkansas Center for Health Improvement,<sup>4</sup> member of the National Committee on Vital Health Statistics,<sup>5</sup> and recently I was selected, along with 72 other health professionals from around the country (out of 920 applicants), to be an Innovation Advisor to the Center for Medicare and Medicaid Innovation.<sup>6</sup> I do want to make crystal clear at the outset, however, my written testimony and spoken views are mine and mine alone and that I do not speak for any organization, public or private, nor any other person, living or dead.

I am certain you know the CBO projections on health spending and deficits as shares of GDP at least as well as I do, so I will not belabor the obvious first point in any hearing with this title: we cannot afford the health care system we have, and therefore we cannot afford projected health care cost growth for our major public programs along with the anticipated tax expenditure for employer-sponsored health insurance.

But the fundamental point is that we cannot afford our current health care system, for it is that system that casts our most sacred Medicare promises into doubt at the moment. Therefore any

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<sup>1</sup><http://paymentinnovations.cardiosource.org>

<sup>2</sup><http://www.ncqa.org>

<sup>3</sup><http://www.academyhealth.org>

<sup>4</sup><http://www.achi.net/index.asp>

<sup>5</sup><http://www.ncvhs.hhs.gov>

<sup>6</sup><http://innovations.cms.gov/innovation-advisors-program>

humane and sustainable Medicare solution must center on system-wide reform. As a consequence, I am continually surprised when I see that the loudest proponents of “structural reform” of Medicare are even more vigorously opposed to the Patient Protection and Affordable Care Act (hereafter, the ACA), because it is the most promising and closest thing to comprehensive health system reform our country has ever tried. But I learned a long time ago not to waste time trying to understand why some people prefer partisan posturing over logical consistency and factual analysis.

“Structural reform” of Medicare has become a rallying cry and litmus test of those who judge others (and all things, really) by the metric of commitment to deficit reduction. Unfortunately, the term is often misused, or at least oddly misplaced. The problem with the mindless use of the term “structural reform,” from my perspective, is that it is too-often used to actually mean guaranteed public spending limits, with all remaining financial risk shifted to beneficiaries, providers, private plans and employers. To some prominent commentators today, if your preferred solution does not include “spreadsheet economics” assertions that Medicare cost growth will somehow be forced to be no higher than X per cent per capita and therefore Y trillions will be saved over the next Z years, then you are deemed just not serious about Medicare reform.

Nothing could be further from the truth. My criticism of spreadsheet health economics is fair when applied to the Ryan budget and Roadmap,<sup>7</sup> but also to the various so-called bi-partisan commissions that have weighed in in very broad terms about health costs recently.<sup>8</sup> In general, most, but not all, proposals of premium support suffer from the fatal flaw of essentially just telling all beneficiaries they must join private health plans and then telling health plans that we

<sup>7</sup> [http://cbo.gov/ftpdocs/121xx/doc12128/04-05-Ryan\\_Letter.pdf](http://cbo.gov/ftpdocs/121xx/doc12128/04-05-Ryan_Letter.pdf)

<sup>8</sup> I say “so-called” because most had far more conservative than liberal members, and their solutions overemphasized spending cuts rather than a balanced consideration of modest tax increases, i.e., they by and large accepted the partisan and dubious premise that we are as a nation grossly overtaxed. It is hard for me to square that premise with the facts that: (a) our taxes take 10 percentage points less from our GDP than the OECD average, 15 or more percentage points less than 11 countries, including the Netherlands, Norway, Austria, and France, countries often governed by conservative parties; (b) we have a military budget and worldwide obligations that exceed all other nations’ combined; and therefore (c) we do far less income redistribution than any other advanced nation on the planet. So to propose deficit reduction that is 2:1 spending cuts to revenue increases, or worse, is to effectively reduce an already thin social safety net in the richest nation on earth. This is not my idea of biblical justice, which requires balance and sustainability, among other things. Senators and other readers might find the following short books helpful for perspective on setting social priorities: C. Marshall, *Little Book of Biblical Justice*, Good Books, 2005; W. Brueggemann, *The Prophetic Imagination*, Fortress Press, 2001; M.D. Meeks, *God the Economist*, Fortress Press, 1989.

(the government) will pay this much and no more for health insurance and we expect you (the plans) to figure out how to make this work for beneficiaries and providers. This common version of premium support is essentially a system of hiring plans to fix our health care woes while containing the financial risk to the government. Indeed, for some advocates, our only serious health care woe IS the financial risk for our government in keeping current promises to the elderly and the poorest among us. The only thing “structural” about the kind of Medicare (and Medicaid) reform they propose is that it would re-structure aggregate government payments to grow at an arbitrary and fixed rate. It does nothing to change the fundamental structure of the delivery system and its currently counterproductive incentive structures.

Therefore, it cannot and will not work. Not because plans wouldn’t try (and some have more potential than others, to be sure) but because they do not have sufficient market power. If they could do this alone, don’t you think they would have already? Knowledge about the importance of local provider market power is not as widespread as it should be, but scholarship is starting to make clear that this problem is real and growing and will make the shrinking premium support voucher (in real terms) worth less and less over time in many areas of our country.<sup>9</sup> So the net effect of a “plans only” voucher approach to “structural reform” will be to significantly curtail access to needed and effective care for all but the highest income beneficiaries. This may or may not be the goal; I try hard not to attribute motives. But in any event this approach is manifestly not sustainable, since providers with market power will simply shift public program underpayment for real costs to private insurers and self-insured employers, thus worsening, not improving, our international competitiveness for high value added jobs, the ones we had better develop strategies to keep if we are going to remain a mostly middle class society.

I want to offer a different vision of structural and sustainable Medicare reform for your consideration today.

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<sup>9</sup>Nichols, Len M. “Making Health Markets Work Better With Targeted Doses of Competition, Regulation, and Collaboration,” *St. Louis University Journal of Health Law and Policy* 5(7):7-26; Paul B. Ginsburg, <http://hschange.org/CONTENT/1162/1162.pdf>; Nichols et al, “Are Market Forces Strong Enough to Deliver Efficient Health Care Systems? Confidence is Waning,” *Health Affairs* March/April 2004. *Competition in the Healthcare Marketplace: Hearing Before the Subcomm. on Consumer Prot., Product Safety, and Ins. Of the Comm. On Commerce, Science, and Transp.*, 111th Cong. 85-99 (2009) (statement by Len M. Nichols).

*True Structural Reform*

“Structural reform” should mean addressing the fundamental problem with our health care system, and that is this: our underlying incentive structures are all wrong. Today, health plans make bigger profit margins segmenting the healthy from the sick than from finding and coordinating high quality care options for all enrollees. At the same time, fee-for-service payment arrangements – plus over 8000 CPT codes and byzantine layers of opaqueness when it comes to device and drug costs to patients – have long encouraged volume growth and penalized the highly coordinated care we now know can improve care and health while lowering the total cost of care in many instances.

So, “structural reform” ought to mean changing the underlying incentives of insurers, physicians, hospitals, and patients to align their self-interest with our common interest in reducing cost growth per capita while expanding access to high quality care, so that all Americans can reach their productive potential and propel our economy to sustainable economic growth. The good news is, structural reform of -- and incentive realignment within -- our health care system is actually what the ACA is all about.

Imagine a health system in which insurers made more money helping to coordinate care toward more efficient health production and maintenance – with consumer engagement -- than in discriminating against the unhealthy. Imagine a health system in which every clinician-patient encounter had, to support its joint decision making process, complete information on the patient along with current best practice information about diagnostic and therapeutic options for that kind of patient with these symptoms and with that particular history and family risk factors. Imagine a health system in which primary care physicians were able to be better compensated while seeing fewer patients per day than they do today because primary care teams become co-managers with the patient of the patient’s specific pathway to health restoration or maximization, given their possibly multiple chronic conditions. Imagine a health system in which many specialists and hospitals cooperate with primary care teams and post-acute facilities and *patients and their families* to reduce unnecessary utilization while improving quality, and health outcomes because all could share in the savings off our currently unsustainable baseline to incentivize them to help us make it so. THIS would be a health system that had been structurally reformed, and this would be a health system in which we can afford to strengthen Medicare and

Medicaid going forward, while extending access to health insurance and high quality care for all Americans. This is the health system that the ACA – with help from the health information technology and meaningful use investments pursuant to the ARRA – is trying to give us the tools to create.

The single biggest change that will take place if the ACA remains the law of the land in 2014 is this: for the first time ever in these United States it will be less profitable for insurers to segment risks than to discover and coordinate high quality care for all enrollees, especially for the sickest among us. Thus, the necessary but targeted use of federal power to change the rules of insurance markets will fundamentally alter the business model of every health insurer, and that in turn will unleash health plans on a vigorous search for value in our health care delivery system, exactly what patients (and taxpayers) need. In anticipation of this happy day, the search has already begun, with promising early results.<sup>10</sup>

The Medicare Advantage analogue to this insurance market incentive realignment is the ACA's required shift from formulaic overpayment of private health plans to a payment system that will increasingly be based on competitive bidding while rewarding quality performance and patient satisfaction. Early results on this score are promising as well.<sup>11</sup>

But the structural reform that matters most for the long run affordability of our health care system, for families and governments alike, in the ACA and in the real delivery system where millions of health professionals improve patients' lives every day, is the structural reform of incentives for providers within the delivery system as a whole. Here the ACA takes a multi-pronged approach that is worthy of attention and praise, which I will follow with specific suggestions to improve on it in the spirit of what has already begun.

The first key thing the ACA did for delivery system incentive realignment is to signal, through the market basket update reduction,<sup>12</sup> that "business as usual" is over, because we cannot afford it. That provision, already in effect, lowers the growth factor of Medicare hospital payments by

<sup>10</sup> Higgins, Aparna et al, "Early Lessons from Accountable Care Models in the Private Sector: Partnerships Between Health Plans and Providers," *Health Affairs* 30, No. 9 (2011):1718-27; and "Transforming Care Delivery," *AHIP Issue Brief* January 2012; Zirui Song, Dana Gelb Safran, Bruce E. Landon, Yulei He, Randall P. Ellis, Robert E. Mechanic, Matthew P. Day, and Michael E. Chernew, "Health Care Spending and Quality in Year 1 of the Alternative Quality Contract," *New England Journal of Medicine*, 2011; 365:909-918.

<sup>11</sup> <http://www.hhs.gov/news/press/2011pres/09/20110915a.html>.

<sup>12</sup> Section 3401.

a percentage equal to economy-wide productivity. Thus, our collective signal to hospitals, and to all providers really, is that we are no longer going to pay more each year automatically without demanding that hospitals become at least as much more efficient as the economy as a whole. I think this is one of the main reasons Medicare spending growth was so low last year,<sup>13</sup> and why the search for efficiency in hospital operations is at least as intense as the health plan search for ways to engender more value for their enrollees.<sup>14</sup> Reductions in the overpayment to Medicare Advantage health plans, while enabling some to do better through superior quality performance, sent a parallel signal, as did corrections to mispriced physician procedures, also called for in the ACA. One good thing the Ryan Budget did, since it retained all the ACA Medicare savings proposals, was to buttress this signal in an important way: it apparently does not matter who wins the upcoming elections, the federal government is going to become a much more demanding buyer of health care for Medicare enrollees, either through health plans alone as hired proxy for the government -- the Ryan Budget / spreadsheet economics way -- or through creating tools for providers and patients and private plans together to implement and act upon improved incentives, the ACA way.

The ACA vision for becoming a more demanding buyer points to the heart of structural delivery system reform. The overarching goal is the three part aim: better health, better care (including wider access to high quality care), and lower cost, but the focus of today's hearing (and most discussion in budget contexts) is about lower spending. At the end of the day, there are only four basic sources of lower health spending: (1) reduced utilization; (2) lower prices; (3) higher quality which can help lower use and/or prices but may also increase cost in some areas over current baseline; and (4) better underlying health in the patient population. We need to pursue all of them, since there are no silver bullets, contrary to a lot of wishful thinking.

#### ***Sources of Spending Reduction***

Use could be reduced from higher quality, e.g., better coordination of care in transitions between hospitals and other settings, including home, or through better ongoing co-management -- including patient engagement -- of patients with complex and multiple chronic conditions. These

<sup>13</sup> Martin, Anne B., et al. "Growth in US Health Spending Remained Low in 2010; Health Share of Gross Domestic Product Was Unchanged from 2009," *Health Affairs* 31 No. 1 (2012):208-219.

<sup>14</sup> <http://www.optuminsight.com/resources/browse/articles/innovations-from-optuminsight-flexibility-critical-in-building-acos/>.

quality improvements, as well as reductions in inappropriate use -- tests and procedures that the existing evidence base does not support for some of the patients who are getting them -- are incentivized in the ACA through the care transitions benefit, the penalty for hospitals with unreasonable re-admission rates, and the myriad pilots that finance infrastructure and/or reward the achievement of utilization reductions through better care.<sup>15</sup>

Prices could come down as a result of government fiat, but note also that government price cuts could lead to necessary price increases quoted to private payers, so this is not as simple a lever as some might think (especially in Medicaid, which already often underpays for services). Prices could also come down as a result of process improvements, if transaction prices are determined in competitive environments. Both process redesign (e.g. “Lean” production techniques, as Virginia Mason Medical Center uses in Seattle, Washington and Denver Health uses in Denver, Colorado) and administrative simplification (in particular, standardizing claims adjudication algorithms) can lead to this kind of price reduction.

The largest potential source of price reductions is probably input price reductions, specifically, labor costs, device costs, and drug costs. Physicians and nurses do earn more here in relative terms than in most countries, and more optimal scope of practice and care delivery arrangements could achieve net input price reductions as well. A little used but possibly major source of price reductions would be physician and hospital collaboration to drive device and drug prices and spending to their minimum efficient levels, if traditional incentive arrangements between manufacturers and some physicians can be superseded by service payment contracts. The final source of price reduction is countervailing market power against those hospitals and physician groups – or integrated systems – that charge private payers considerably higher than their patients’ costs today. These circumstances are more common than is widely known. In the limit, countervailing buying power in these markets might be applied through community-wide negotiation with local and specific anti-trust immunities, or all payer rate-setting as a last resort. Only Medicare, or all payers acting in concert, has enough countervailing market power to be effective in some markets today.

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<sup>15</sup> These include: the three ACO models (shared savings, Pioneer, and Advanced Payment); the four bundled payment models; medical home projects (Multi-payer Advanced Primary Care Practice demo, the Comprehensive Primary Care Initiative, the FQHC Advanced Primary Care Practice demo, and the Independence at Home program).

Quality could be improved through better patient engagement, better adherence to evidence based best practices, and better care coordination. Care coordination might raise costs relative to baseline in many cases. So “savings” to be shared must be net of these quality-enhancing cost increases.

Finally, health itself could be improved from behavioral changes (diet, exercise, smoking cessation, etc), in the short, intermediate and long runs. Behavior can be channeled by wellness programs sponsored by employers or community entities like schools or churches, by value based insurance design and decision support to optimize health maintenance and the balance between self-care and health service use, and by community public health resources like nutrition education plus exercise- and fresh food-friendly environments. All of these health enhancing strategies are encouraged and incentivized in the ACA as well.

#### *ACA and Private Sector Reform Specifics*

All of the new payment model initiatives in the ACA that were mentioned above are designed to start and then accelerate physician and hospital collaboration and our collective transition away from FFS/pay for volume health care at the point of service. The really good news is that the private sector is organizing similar types of incentive realignment pilots as well. This is essential because every clinician and clinician manager I have ever met, and I am old enough and have given enough hospital association and medical society keynote addresses to have met quite a few over the years, every single one always expressed a strong preference for one set of incentives from payers, one set of quality metrics, one set of patient acuity adjusters and feedback loops, etc., rather than the byzantine plethora they labor under today. Indeed, without new incentives in place for a majority of patients in a given practice or hospital, it is highly unlikely that care delivery will change from the current focus on volume and uncoordinated care.

And while the ACA may be responsible for the type and scope of interest in payment and delivery reform models being tried now in the 49 states which AHIP recently reported on,<sup>16</sup> similarly the spread of these initiatives within the private sector is surely also driving more plans and provider groups to consider the public-private partnerships that CMMI is trying to create

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<sup>16</sup>Martin et al, op cit, footnote 13.

around the Comprehensive Primary Care Initiative,<sup>17</sup> the Multi-Payer Advanced Primary Care Practice Demonstration,<sup>18</sup> and through both Pioneer and Advanced Payment ACOs.<sup>19</sup> When providers see the federal government, state government programs, and private payers all focused like a laser beam on reducing costs while better measuring and improving care quality, patient experiences and outcomes, structural reform is not only possible, it becomes likely.

It is fair to say that many were disappointed with the initial shared savings ACO proposed rule,<sup>20</sup> but since then interest in CMMI pilots has been increasing, from 32 full speed Pioneer ACOs to 8 states coordinating large multi-payer collaborations to transform physician practices into patient centered medical homes, 5-7 sets of private plans providing incentives to transform primary care with 75 physician practices each within defined local markets and the as yet unreported but expected (and rumored throughout delivery system circles) very high interest in both the 4 bundled payment models about to be tested and the open ended innovation challenge grants which were submitted near the end of January.<sup>21</sup> Based on what I'm hearing from applicants to that grant opportunity from around the country, interest is very high in this unique opportunity to tell CMMI/CMS what new payment and care delivery arrangements make sense to particular set of providers, plans, and employers who are indeed willing to pursue the three part aim (better health, better care, lower cost) on the ground in the real world. This is not your father's "one size fits all" Medicare demo from decades past.

***Suggestions for Improving the Chances for Real Structural Reform***

So what tools and approaches could be added to the ACA/CMMI array that could solidify and even turbo-charge our transition to a sustainable – and structurally reformed – health care system and by extension, Medicare program? There are many, but I will emphasize two in the remainder of my testimony.

First, malpractice and SGR reform: This may seem an odd pairing into one suggestion, especially since malpractice is currently a state prerogative, like clinician licensure. But as twin devices to

<sup>17</sup> <http://innovation.cms.gov/initiatives/cpci>

<sup>18</sup> <https://www.cms.gov/DemoProjectsEvalRpts/MD/ItemDetail.asp?ItemID=CMS1230016>

<sup>19</sup> <http://innovations.cms.gov/initiatives/aco/pioneer>; and <http://innovations.cms.gov/initiatives/aco/advance-payment/>

<sup>20</sup> <http://www.commonwealthfund.org/Newsletters/Washington-Health-Policy-in-Review/2011/May/May-9-2011/Model-ACO-Health-Centers-Skeptical.aspx>

<sup>21</sup> [http://www.innovation.cms.gov/documents/pdf/CMMIreport\\_508.pdf](http://www.innovation.cms.gov/documents/pdf/CMMIreport_508.pdf)

re-earn physician trust and engagement in the reform enterprise, they are similar and complementary nonpareils indeed.

Malpractice reform should have been part of the ACA. I believe and perhaps some of you know that it could have been if all Republicans had not decided to unanimously oppose the ACA, despite the fact that it is analytically similar to the Chafee-Dole proposal of 1993, which also had 17 other Republican Senator co-sponsors who wanted to provide a constructive Republican alternative to solve the uninsured and affordability problems addressed by President Clinton's Health Security Act and now by the ACA.<sup>22</sup> Alas, here we are. I am no malpractice expert, and I know some states' clinicians are satisfied with their current systems and so they should not be changed without giving them a chance to preserve what works from clinician perspectives. But I also know that most physicians are not happy with their local malpractice system and so providing concrete reform options and incentives for the system to work better both from their and from their patients' perspectives would go a long way toward proving to physicians that the federal government wants to be a better partner in delivery system restructuring than it has been in the past. I am certain that it will be much easier to engender physician buy-in to the payment and delivery reforms we need if we can reduce their fear of being sued for not doing unnecessary tests and procedures. The amount of money actually saved from malpractice reform is not nearly as important as is the fear of being sued in holding back practice pattern transformation and the fruition of incentive realignments that we need.

But even malpractice pales in comparison to our ongoing SGR saga as "proof" that the Congress and the Medicare program cannot be trusted to be good partners with physicians. Imagine if there was some kind of national internet referendum on congressional salaries and that in the absence of a majority vote to the contrary -- to be held on some pre-determined website on some random day between Christmas and New Year's each December -- your salaries for one year would be cut by 20% or more. Then imagine the people could also vote to preserve your salary levels one

<sup>22</sup> That proposal had an individual mandate, re-organized individual and small group markets, subsidies for the low income population, and was paid for with Medicare savings and reductions in the open-ended tax preference for employer sponsored health insurance. See <http://www.kaiserhealthnews.org/Stories/2010/February/23/GOP-1993-health-reform-bill.aspx>; <http://www.kaiserhealthnews.org/Graphics/2010/022310-Bill-comparison.aspx>. The Republican co-sponsors included current senators Grassley (IA), Hatch (UT), Bond (MO), and Lugar (IN), and former senators Bennett (UT), Cohen (ME), Danforth (MO), Dominici (AZ), Durenberger (MN), Faircloth (NC), Gorton (WA), Hatfield (OR), Kassebaum (KN), Simpson (WY), Specter (PA), Stevens (AL), and John Warner (VA).

month at a time, instead of for 12 months. This is how the SGR debate looks to many physicians. One month reprieve? Two months? Twelve months? Forever? Never? I know it costs real money to fix the SGR problem. And I agree it is a contrived problem, bequeathed to us by former Ways and Means Chairman Bill Thomas, who put the SGR provision in the Balanced Budget Act of 1997 in expectation that the specter of draconian physician payment cuts would force our nation to have a structural Medicare reform conversation. For what it's worth I'm pretty sure Chairman Thomas never intended that we would postpone that conversation this long. But the good news is, we're having a structural Medicare reform conversation now, so the crying need for the annual or monthly SGR kabuki dance has passed. Just fix it, MEDPAC has recently given you at least a starting point to move forward,<sup>23</sup> winding down the wars in Iraq and Afghanistan might lessen the budget pain as well, so just do it and clear away another obstacle to adult conversations on structural delivery system reform along the way.

But by far the most important enhancement which Congress could now give Medicare, the CMS and the CMMI in particular, to turbo-charge genuine structural reform in our health care system, would be to encourage or require openness to accepting, supporting, and joining community wide, multi-payer and multi-stakeholder delivery and payment reform proposals that are developed on the ground in the real world, not in Washington or Baltimore. I have had the privilege to watch and even participate a bit as Rochester, New York and Grand Junction, Colorado have developed true community-wide visions of how to achieve the three part aim for *all* patients, not just public or private sector or currently insured patients. Their local consultative processes include all relevant hospitals, physician groups, health plans including Medicaid, consumer advocates, social service providers (in Rochester's case) and even behavioral health providers (in Colorado's case). Each of these communities, in their own way, promises to achieve structural transformation of their health system if their proposals are implemented. Basically, they just need Medicare to say yes, share relevant data in real time and join the party (and help finance the 3 year transition to a sustainable system). They have each applied for Innovation Challenge grants, and are awaiting formal word on that opportunity, so we shall keep our fingers crossed on their behalf, and on behalf of what our nation could learn from them.

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<sup>23</sup>[http://www.medpac.gov/documents/10142011\\_MedPAC\\_SGR\\_letter.pdf](http://www.medpac.gov/documents/10142011_MedPAC_SGR_letter.pdf).

I would strongly recommend that you consider directing CMMI to create a specific major initiative or grant-making window on community-wide payment and delivery reform. You could call it, an “Accountable Community” program. A pre-condition would be what Rochester and Grand Junction have demonstrated: the ability to assemble all relevant stakeholders, including consumers, at the planning table, so that true multi-payer payment reform could make providers’ transitions smoother and thereby better health, quality, and cost outcomes occur must faster. Of course community proposals have to be rigorously reviewed and judged to credibly reduce public sector cost growth, in addition to their local goals.

But what I am trying to emphasize in this entire testimony is that Medicare is more likely to perform well and achieve “structural reform” type results in the long run if the underlying health system – in the real communities where all people live and all providers work and all patients actually seek care – is transformed to be more efficient, more patient-centered, and more focused on quality measurement and less on volume and financial protection of the status quo. That is, the federal government needs to recognize that many communities’ local goals are goals we all share. In my opinion and experience, we are far more likely to succeed if the entire health community in a given area has similar incentives, commitment, and feedback loops, than if Medicare or Blue Cross or The Local Grand Hospital Where All Our Children Were Born and All Our Grandfathers’ Died tries to do this on their own.

One final point on structural reform: Spreadsheet economics does have one seductive feature which attracts support, particularly among those who don’t study the health system for a living; it “guarantees” a particular cost growth path for Medicare or Medicaid, or at least purports to, whereas my approach to structural reform has no such guarantee. I will argue that guarantees of this sort are not good things, and here’s why.

Hard target growth rates carved in stone are by definition inflexible. They do not allow program managers to ask or care why targets cannot be met, whether because more people enrolled than anticipated or because costs could not be lowered as fast as desired for any reason. They simply enforce (or at least would try to enforce) cuts or growth limits in voucher or overall spending amounts to meet the spending target. I grant you this may be the only way to guarantee that federal taxes never collect more than the 18% of GDP that they do today, and if you really think

that's the most important priority for our nation, you can stop reading now, if you haven't already.

Whereas, targets growth rates like those embedded in the ACA, which also empowers a group of experts, appointed by the President and confirmed by the Senate to the Independent Payment Advisory Board to recommend specific and credible alternative policies if the current law provisions do not work as planned, are a much wiser alternative to inflexible targets. First of all, with proper delivery system reform incentives, actual savings may exceed growth rate reduction targets. Indeed, the CBO really only scored the payment cuts in the ACA: the market basket update reduction, the MA payment cuts, and the revisions of mispriced procedures account for the great bulk of anticipated savings over the first 10 years of the ACA. If *any* of the payment reform initiatives like Pioneer ACOs, comprehensive primary care, bundled payments, or even more creative ideas emerging from Innovation Challenge grants work and then spread, savings from the ACA could be much greater than the targets already set to more than offset anticipated subsidy costs. Second, if the anticipated savings do not materialize, or if subsidy costs or private health care spending exceeds expectations, then the IPAB would be empowered to think broadly and creatively about how best to achieve the overall health spending growth targets set in the law. But here's the key difference in an IPAB-like situation and a hard target from spreadsheet economics: *Congress would have the ultimate authority about what to do in the IPAB-like case.*

If the Congress, in its collective wisdom, did not like what the IPAB proposes, it could enact alternative policies to hit the targets, or it could decide to change the targets and raise taxes if indeed costs exceed the targets for reasons the Congress judges to be worth asking the American people to pay for. By contrast, the hard target approach attempts to take accumulated political judgment and a balanced approach to our fiscal options out of the decision, and would therefore remove authority from Congressional hands and thereby lock us into a health spending pathway that can never be altered. I must infer some proponents of this approach simply do not trust Congress to exhibit fiscal discipline. A better way to fix that problem is to hold regular elections, not constrain health policy once and for all time to live out the wishful thinking of a spreadsheet exercise completed in the absence of ongoing input from real communities where health providers and patients actually work and live.

In summary, it is far better to get the health spending growth rate you are willing to incentivize by empowering clinicians and patients and by inducing plans to help them achieve it, rather than to hit the growth rate you could (try to ) force with hard budget caps on payments to health plans alone.

Thank you again for the opportunity offer thoughts today. I would be glad to answer any questions my testimony may provoke, today or in the future.

Chairman CONRAD. Thank you.  
Mr. Capretta, welcome back to the Budget Committee.

**STATEMENT OF JAMES C. CAPRETTA, FELLOW, ETHICS AND  
PUBLIC POLICY CENTER**

Mr. CAPRETTA. Thank you, Mr. Chairman. It is a real pleasure to be here. I appreciate you saying that.

Chairman CONRAD. Please proceed with your testimony, Mr. Capretta.

Mr. CAPRETTA. Thank you. Mr. Chairman, Ranking Member Sessions, and members of the Committee, thank you for the opportunity to participate in this very important hearing. My name is Jim Capretta, a fellow at the Ethics and Public Policy Center. As the Chairman noted, I was very privileged to work for Senator Domenici on this Committee for a decade. I also served as an associate director for health programs at OMB from 2001 to 2004. I want to make three points today.

The first is: Why do we have budget problems today, not just in the future but actually today? It is sometimes argued that we have budget problems because of discrete tax or spending decisions made over the last decade or so. This line of argument relies entirely on what might be called the fallacy of the uncontrolled baseline. As I indicate in my testimony, a longer-term perspective clearly indicates that entitlements are the problem, and most especially the health care entitlements. Over the past 40 years, Federal tax collection has averaged about 18 percent of GDP annually. Meanwhile, back in 1972, the Federal Government spent 4.4 percent of GDP on the big three entitlement programs—Social Security, Medicare, and Medicaid. So there was plenty of revenue left over for other priorities.

Today we spend 10.2 percent of GDP on those programs, according to CBO. That is an additional 6 percentage points of GDP on just three programs, more than the entire size of the Defense Department. Over the next 25 years, CBO expects spending on these programs to go up another 6 percentage points to 16 percent of GDP.

My second point is that the health care law made the budget outlook worse, not better.

Chairman CONRAD. Jim, could I just stop you on that? Because people who are listening may hear your 16 percent and they saw my chart that had 13 percent. We actually have the exact same numbers, I think. The only difference is you have included something more than was on our chart.

Mr. CAPRETTA. It is the difference between time periods. I went out 25 years. Your chart goes to 2050. I also have added in Social Security.

Chairman CONRAD. Yes.

Mr. CAPRETTA. So mine is Social Security, Medicare, Medicaid, plus the health care law entitlements out to 2035. Yours is out to 2050 just for the health care entitlements.

Chairman CONRAD. Yes. So I think that is very important for people to understand. We do not have a disagreement here. In fact, we have an agreement. His numbers include Social Security, mine do not, and we have a different time frame. So I just wanted to

make sure that people do not think, gee, right away these guys are disagreeing on the extent of the problem, or not.

Mr. CAPRETTA. Thank you. Thank you for the clarification.

During the debate over the health care law, it was often argued that the added Federal cost of the coverage provisions would be more than offset by other tax hikes and spending cuts. But this perspective rests entirely on how one accounts for the Medicare taxes and cuts that were enacted in the law. There are other issues, as Ranking Member Sessions, Senator Sessions, indicated, but I want to focus on the Medicare HI trust fund.

The Medicare HI trust fund, like Social Security, has generally been funded with dedicated taxes. When it is projected to run short of funds, the only remedy is to increase revenue or cut back spending from the trust fund.

Prior to enactment of the health care law, the HI trust fund was in exactly this situation and needed to be shored up. Thus, some changes were needed.

If those changes had been enacted entirely on their own, it is unquestioned that the budget outlook would have been improved very substantially by the fiscal consolidation of bringing the trust fund into balance.

But that is actually not what happened because, unlike Social Security, changes to Medicare HI not only shore up the trust fund, they also count under what is called "PAYGO" for budget scorekeeping purposes. Thus, the large spending cuts and tax increases associated with Medicare were spent twice under the bill. They were spent to pay future Medicare obligations, and they were spent to stand up a new entitlement.

Some argue that while this may be true, it is the longstanding practice of Congress. That is true, also, but of course, the magnitude here is much, much bigger. In a forthcoming paper from the Mercatus Center, Charles Blahous, the public trustee for the Medicare program, estimates that the deficit impact of this and other provisions of the health care law is about \$340 billion and perhaps more over the period 2012 to 2021.

Over the long run, the difference between the unfunded liability before and after enactment of the law is about \$10 trillion over a 75-year period on a present-value basis. That \$10 trillion that has now supposedly shored up the trust fund is actually also being spent on the new health care entitlement. So our fiscal position is really not better off; it is actually worse off because that \$10 trillion was going to have to be saved and dedicated entirely to Medicare if we had not put it toward the health care law.

My third point is that in terms of putting health spending on a sustainable path, we need to focus very much on Medicare. Medicare is a big part of the problem, and the solution is not actually more Government micromanagement, but actually a functioning marketplace.

The key question health reformers must answer is this: What process is most likely to succeed in bringing about continual and rapid improvement in the productivity and quality of patient care? Because the only way to slow the pace of rising costs without compromising quality is to actually make the sector more productive; more health bang for the buck.

Now, Medicare's role in this problem is very much sometimes overlooked. It is often said that American health care is characterized by extreme fragmentation and lack of coordination, much duplication and waste, an overemphasis on procedure-based medicine, and a lack of accountability for the all-too-frequent cases of low-quality care. That is all true. But why is it this way? The main reason—not the only reason but the main reason—is that Medicare is run today as a traditional fee-for-service program.

Medicare is the largest purchaser of health services in most markets. Four out of five enrollees are in the traditional program. Medicare pays a pre-set rate to any licensed provider for any service rendered on behalf of a program enrollee, with essentially no questions asked. Nearly all Medicare beneficiaries also have supplemental insurance, from their former employers or the Medigap market. Thus, they pay no more at the point of service. This kind of first-dollar coverage provides a powerful incentive for additional use of services. Whole segments of the U.S. medical industry have been built up around the incentives embedded in these arrangements. Moreover, all of the various providers of services have their own Medicare fee schedule and can bill the program separately from all the others when they render services.

Congress and Medicare's administrators have tried for many years to change this dynamic through payment rate reductions, all to no avail. The health care law relies on much more Government engineering, what I would call engineering, of the delivery system to try to change this basic dynamic. I do not think they will work. A recent CBO study has already indicated that many, many years of demonstration efforts in this area have essentially failed. This has been going on now for 20, 25 years. It is not a new effort to try to change the basic dynamic of how Medicare fee-for-service operates.

The alternative to centralized cost control is a functioning marketplace. In 2003, Congress built such a marketplace for the Medicare drug benefit. It was predicted at the time that it would not work, that costs would go up, that no one would participate in the program, that premiums would rise very rapidly. All have proved to be wrong.

Yesterday, at a hearing before the House Budget Committee, the Chief Actuary for Medicare, Richard Foster, testified that in every year of the drug benefit's operation, seniors have migrated from high-cost, low-efficiency plans to low-cost, high-efficiency plans in each and every year.

The result has been an incredible record of success. In 2012, the average beneficiary premium is just \$30 for seniors. When the program started in 2006, it was \$26. That is a \$4 increase in 6 years.

Finally, just one last note. I know I am over my time.

Chairman CONRAD. I interrupted you, so you are fine.

Mr. CAPRETTA. Thank you, Mr. Chairman. I am finishing up.

At yesterday's hearing, Mr. Foster was also asked very directly by Chairman Paul Ryan if competitive bidding as part of premium support could help alleviate cost pressures in the rest of Medicare, like it has in the drug benefit. His very direct answer was, yes, it could, and he based this response on the evidence he sees in the

drug benefit, other parts of Medicare, and modeling work his office has done over many years.

Thank you very much

[The prepared statement of Mr. Capretta follows:]

Testimony Presented to the Senate Budget Committee:

**“Putting Health Care Spending on a Sustainable Path”**

James C. Capretta  
Fellow, Ethics and Public Policy Center

February 29, 2012

Mr. Chairman, Ranking Member Sessions, and members of the committee, thank you for the opportunity to participate in this very important hearing on “Putting Health Care Spending on a Sustainable Path.”

It is a particular pleasure for me to appear before you today as a witness because I worked for this committee for a decade as one of the staff members when Senator Domenici served as Chairman and Ranking Member.

I will make three basic points in my testimony today:

1. Rapidly rising entitlement spending is the cause of our nation’s fiscal problems, and escalating health costs is the primary reason for the entitlement spending surge.
2. The health care law that passed in 2010 has made the fiscal problem much worse because it used Medicare cuts and taxes to increase non-Medicare entitlement spending *and* pay future Medicare benefits. Further, the Medicare

cuts are very unlikely to be sustained over the long term anyway.

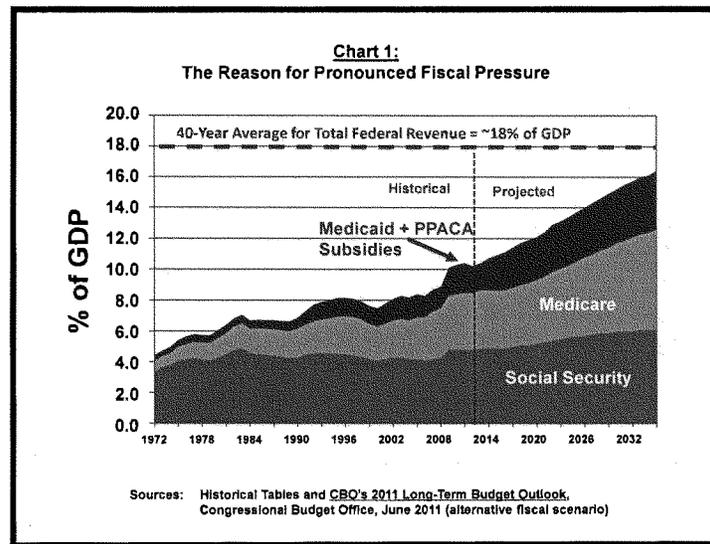
3. Putting health spending on a sustainable path requires significant Medicare reform, but the federal government can't "engineer" this reform through regulations, demonstrations, and micromanagement. The answer is a functioning and dynamic marketplace.

### **The Reason for Pronounced Fiscal Pressure**

It is sometimes argued that the reason we have budget problems today is because of discrete tax or spending decisions made over the last decade or so. But this line of argument relies on what might be called the fallacy of the uncontrolled baseline. It gives a pass to the massive run-up in spending due to the growth in entitlements, and especially health care entitlements, and tries to assign all of the blame for our fiscal woes to tax policies that have held tax collection at about the historical post-war norm for the United States.

But, as shown in Chart 1, a longer-term perspective clearly indicates that entitlements are the problem, and most especially the health care entitlements. Over the past forty years, federal tax collection has averaged about 18 percent of GDP annually. Meanwhile, back in 1972, the federal government spent 4.4 percent of GDP on the big three entitlement programs, Social Security, Medicare, and Medicaid. So there was plenty of revenue left over after covering the costs of these entitlements for other governmental

priorities.



Today, spending on just those three programs is expected to reach 10.2 percent of GDP, according to the Congressional Budget Office (CBO). So, in other words, today the government is spending an additional 6 percentage points of GDP on just these three programs compared to 1972. To put that in perspective, spending on defense and other security-related functions of the government totals only 5.6 percent of GDP in 2012.

This trend toward devoting more and more resources to entitlements is only going to accelerate as the baby boom retires. Over the next twenty-five years, CBO expects spending on these programs, plus the new entitlements created in the health care law, to push total spending on these programs over 16 percent of GDP, with reasonable

assumptions about the growth in provider payments and other factors. If that were to occur, there would be virtually no room left in the budget for anything else, assuming the historical level of tax collection.

### **The Health Law Makes the Budget Outlook Much Worse, Not Better**

During the debate over the health care law, it was often argued that the added federal cost of the coverage provisions would be more than offset by other tax hikes and spending cuts. Indeed, it was suggested that the new law would actually reduce the long-term budget deficit.

But this perspective rests critically on how one accounts for the Medicare taxes and cuts that were enacted in the law, and specifically the taxes and cuts that were assigned to the Medicare Hospital Insurance (HI) trust fund.

The Medicare HI trust fund, like Social Security, has generally been funded with dedicated taxes. Consequently, when the trust fund is projected to run short of funds, the only remedy is to increase revenue with tax hikes or slow spending from the trust fund with cuts.

Prior to enactment of the health care law, the HI trust fund was in exactly this situation (and continues to be to this day). Thus, some changes were needed to ensure the trust fund could continue paying full benefits beyond the moment when the trust fund

was projected to be depleted of reserves.

If those changes — new taxes dedicated to Medicare HI and Medicare HI spending cuts — had been enacted as standalone provisions, there’s no question that the long-term budget outlook would have improved by the exact amount of the combined Medicare tax hike and spending cut.

But that’s not what happened. Because, unlike Social Security, changes to Medicare HI not only shore up the trust fund, they also count under what is called the “paygo” scorecard for budget scorekeeping purposes. Consequently, in 2010, when the health law cut Medicare spending by about \$450 billion, and raised substantial new revenue for the program too, *those funds were spent twice*: once to pay for Medicare benefits that were in jeopardy due to the depleted trust fund, and again to pay for the large entitlement spending increase contained in the health care law. As CBO Director Douglas Elmendorf put it, “The key point is that the savings to the HI trust fund under the PPACA would be received by the government only once, so they cannot be set aside to pay for future Medicare spending and, at the same time, pay for current spending on other parts of the legislation or on other programs.”<sup>1</sup>

Some argue that while this may be true, it has been the longstanding practice of Congress to count Medicare HI changes in this manner. That is of course correct. But no previous legislation has come close to the 2010 health law in terms of the fiscal

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<sup>1</sup> “Effects of the Patient Protection And Affordable Care Act On the Federal Budget And The Balance In The Hospital Insurance Trust Fund,” Director’s Blog, Congressional Budget Office, December 23, 2009 (<http://www.cbo.gov/publication/25017>).

consequences of this double-count. In a forthcoming paper from the Mercatus Center, the public trustee for the Medicare program, Charles Blahous, estimates that due in large part to this double-count, the health care law will add at least \$340 billion cumulatively to federal deficits over the period 2012 to 2021.<sup>2</sup>

Over the long run, the added cost to the federal budget is even more staggering. In the 2009 Medicare Trustees' Report, the Medicare Trustees estimated the Medicare HI trust fund had an unfunded liability of \$13.4 trillion over the seventy-five year projection period (in net present-value terms).<sup>3</sup> In the 2011 report, that unfunded liability was estimated at \$3.0 trillion.<sup>4</sup> Thus, the double-counting of Medicare HI spending cuts and taxes has paid for both about \$10 trillion in Medicare benefits over the next seventy-five years, *and* an equivalent amount of other entitlement spending in the health law.

Of course, this analysis of the double-count assumes that the Medicare cuts will be sustained at all over the coming years, which is very much in doubt because the cuts in the Medicare program contained in the health law are mainly blunt, across-the-board payment rate reductions that hit every provider of service the same regardless of the quality of care. According to the Office of the Actuary at the Centers for Medicare and Medicaid Services, the deepest of these cuts — the annual “productivity factor” adjustment — will push the total revenue for about 15 percent of all institutions,

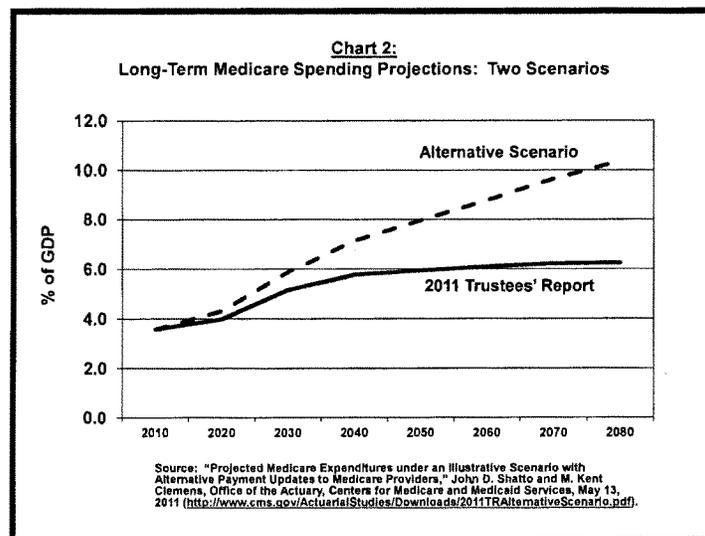
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<sup>2</sup> “The Fiscal Consequences of the Affordable Care Act,” Charles Blahous, Mercatus Center (forthcoming).

<sup>3</sup> “2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds,” May 2009, p. 69.

<sup>4</sup> “2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds,” May 2011, p. 87.

including hospitals, that are providing services to Medicare patients below their total costs by the end of the decade, and thus force many them out of the Medicare program. By 2030, the percentage of “underwater” providers would reach 25 percent.<sup>5</sup> The actuaries have made it very clear that having such a large number of facilities with negative total margins would seriously jeopardize access to care for seniors, which is why they do not believe these Medicare cuts are viable over the long run.



For the past two years, the actuaries have issued an alternative analysis of Medicare's future spending path to give the public a more realistic assessment of the

<sup>5</sup> "Projected Medicare Expenditures under an Illustrative Scenario with Alternative Payment Updates to Medicare Providers," John D. Shatto and M. Kent Clemens, Office of the Actuary, Centers for Medicare and Medicaid Services, May 13, 2011, p. 8 (<http://www.cms.gov/ActuarialStudies/Downloads/2011TRAlternativeScenario.pdf>).

program's future. As indicated in Chart 2, this alternative scenario shows Medicare spending rising from 4 to 10 percent of GDP over the coming decades instead of leveling off at about 6 percent of GDP in the official Trustees' projections. It's clear from this alternative scenario that the health law has not solved our health cost or entitlement problem.

### **Putting Health Spending on a Sustainable Path**

The key question health reformers must answer is this: what *process* is most likely to succeed in bringing about continual and rapid improvement in the productivity and quality of patient care? Because the only way to slow the pace of rising costs without compromising the quality of American medicine is by making the health sector ever more productive. More health bang for the buck, if you will.

Providing an answer to this question requires properly diagnosing the problem. Why are health care costs rising so rapidly, including for the federal government? The prevailing view has been that the federal government's health programs experience rapidly rising costs because they are victims of the runaway cost train that is pulling the entire system down the tracks at too fast a rate. According to this way of thinking, the only way to slow the government's costs is to slow the whole train.

But this thinking misses a crucial point. Yes, one aspect of cost escalation is an exogenous factor. Rising wealth and medical discovery are fueling the demand for more

and better treatments. That should not be resisted in any event. But there is widespread agreement that costs are also high and rising because of waste and inefficiency—and here the problem is not some force outside of government's control but *existing* governmental policy.

At present, the vast majority of Americans get their health insurance through one of three sources: *Medicare*, for the elderly and disabled; *Medicaid*, for low-income households; and *employers* for the working-age population and their families. In each of these instances, the federal Treasury is underwriting rapid cost escalation because, as premiums rise, so does the federal subsidy.

Medicare's role is especially important in this regard. It is often said that American health care is characterized by extreme fragmentation and lack of coordination, much duplication and waste, an overemphasis on procedure-based medicine, and a lack of accountability for the all-too-frequent cases of low-quality care. That's all true. But why is it this way? The main reason is how Medicare is run today, and most especially the traditional fee-for-service (FFS) program.

Medicare is the largest purchaser of health services in most markets today. Four out of five enrollees are in the traditional FFS. With FFS, Medicare pays a pre-set rate to any licensed provider for any service rendered on behalf of a program enrollee, with essentially no questions asked. Nearly all Medicare beneficiaries also have supplemental insurance, from their former employers or purchased in the Medigap market. With this

additional coverage, they generally pay no charges at the point of service because the combined insurance pays 100 percent of the cost. This kind of first-dollar coverage provides a powerful incentive for additional use of services. Whole segments of the U.S. medical industry have been built around the incentives embedded in these arrangements. Moreover, all of the various providers of services have their own Medicare fee schedule, and can bill the program separately from all the others when they render services to Medicare patients.

Congress and the program's administrators have, without interruption, tried to hold down Medicare's costs by paying less for each service provided, and that's true also of the Medicare cuts in the health law. Those providing services to Medicare patients have responded by providing more services, and more intensive treatment, over time for the same conditions that patients present to them.

Some believe these problems can be fixed through federal efforts to "engineer" more cost-effective health care delivery. That's the theory behind Accountable Care Organizations, other Medicare pilot projects, the comparative effectiveness research funding, and the new \$10 billion Center for Medicare and Medicaid Innovation.

But Medicare's administrators have been trying for many years to change the dynamic in the traditional fee-for-service program and have failed. Recently, CBO issued

a detailed report documenting the failure of scores of demonstration efforts to deliver better care at lower cost.<sup>6</sup>

The basic problem is that the only way to build a high-quality, low-cost network of care is to exclude those from the network who are low-value and high-cost. And that's something Medicare has never been able to do because that involves picking winners and losers. It's far easier, and more tempting, to simply impose across-the-board payment reductions for all providers of services, without picking among physicians and hospitals. And so such arbitrary cost-cutting has become the default mechanism for hitting budget targets of various kinds over the years.

#### **Premium Support and Defined Contribution Health Care**

The alternative to centralized cost-control efforts is a functioning marketplace with cost-conscious consumers. In 2003, Congress built such a marketplace, for the new prescription-drug benefit in Medicare. Two features of the program's design were important to its success. First, there was no incumbent government-run option to distort the marketplace with price controls and cost shifting. All private plans were on a level playing field. They competed with each other based on their ability to get discounts from manufacturers for an array of prescription offerings that are in demand among beneficiaries and their physicians.

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<sup>6</sup> "Lessons from Medicare's Demonstration Programs on Disease Management, Care Coordination, and Value-Based Payment," Congressional Budget Office, Issue Brief, January 2012.

Second, the government's contribution to the cost of drug coverage is fixed and is the same regardless of the specific plan a beneficiary selects. The contribution is calculated based on the enrollment-weighted average of bids by participating plans in a market area. Beneficiaries selecting more expensive plans than the average bid must pay the additional premium out of their own pockets. Those selecting less expensive plans pay a lower premium. With the incentives aligned properly, participating plans know in advance that the only way to win market share is by offering an attractive product at a competitive price because it is the beneficiaries to whom they must ultimately appeal.

This competitive structure, with a defined contribution fixed independently of the plan chosen by the beneficiary, has worked to keep cost growth much below other parts of Medicare and below expectations. At the time of enactment, there were many pronouncements that using competition, private plans, and a defined government contribution would never work because insurers would not participate, beneficiaries would be incapable of making choices, and private insurers would not be able to negotiate deeper discounts than the government could impose by fiat. All of those assumptions were proven wrong.

What actually happened is that robust competition took place, scores of insurers entered the program with aggressive cost cutting and low premiums, and costs were driven down. Yesterday, at a hearing before the House Budget Committee, the chief actuary for Medicare, Richard Foster, testified that in every year of the drug benefit's

operation, seniors have migrated from high-cost, low-efficiency plans to low-cost, high-efficiency plans.

The result has been a strong record of success. In 2012, the average beneficiary premium is just \$30 per month for seniors — up just \$4 per month since 2006.<sup>7</sup> Overall, federal spending has come in roughly 40 percent below expectations.

Similar changes — what might be called a defined contribution approach to reform — must be implemented in the non-drug portion of Medicare, as well as in Medicaid (excluding the disabled and elderly) and employer-provided health care.

In Medicare, that would mean using a competitive bidding system — including bids from the traditional FFS program — to determine the government’s contribution in a region. Beneficiaries could choose to enroll in any qualified plan, including FFS. In some regions, FFS might be less expensive than the competing private plans. But in some places, it almost certainly would not be, and beneficiary premiums would reflect the cost difference. This kind of reform could be implemented on a prospective basis so that those already on the program or nearly so would remain in the program as currently structured.

Moving toward a defined-contribution approach to reform would allow for much greater federal budgetary control, which is of course a primary objective and tremendously important for the nation’s economy and long-term prosperity. But this isn’t

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<sup>7</sup> “Medicare Prescription Drug Premiums Will Not Increase, More Seniors Receiving Free Preventive Care, Discounts in the Donut Hole,” Department of Health and Human Services, Press Release, August 4, 2011 (<http://www.hhs.gov/news/press/2011pres/08/20110804a.html>).

just a fiscal reform. It's a crucial step toward better health care too because it would put consumers and patients in the driver's seat, not the government. With consumers making choices about the kind of coverage they receive as well as the type of "delivery system" through which they get care, the health system would orient itself to delivering the kind of care patients want and expect.

Critics might claim that this improved fiscal outlook from defined contribution health care would come at the expense of the beneficiaries, who would bear the entire risk of costs continuing to rise faster than the government's newly fixed contribution. But that would only be the case if building a functioning marketplace had no discernible impact on the productivity of the health sector. It is far more likely that converting millions of passive insurance enrollees into cost-conscious consumers will have a transformative effect on health care delivery, and for the better. There would be tremendous competitive pressure on those delivering services to do more with less, and find better ways of giving patients what they truly need. Any health sector player that did not step up and improve its productivity would risk losing substantial market share.

At yesterday's House Budget Committee hearing, Mr. Foster was asked very directly by Chairman Paul Ryan if competitive bidding as part of a premium support model could help alleviate cost pressures in the rest of Medicare. His very direct answer was, yes, it could, and he based this response on the evidence he sees in the drug benefit, the other parts of Medicare, and modeling work his office has done over many years.

This committee should be commended for concerning itself with how to put health spending on a sustainable path. That is a crucial issue for the country. I believe the answer lies in moving away from a failed model of micromanaged payment systems and toward a decentralized system in which consumers themselves make the resource allocation decisions. That approach has the potential to keep costs under control even as it makes the system more responsive to patients' needs.

Chairman CONRAD. Thank you. Thank you for your very good testimony, Mr. Capretta. We appreciate it.

In terms of the questioning, we are going to allow 7 minutes because of the number of colleagues who are here. I think we can do that and still get done by noon. I am going to start on our side with Senator Wyden, and I do this because nobody on our side has spent more time more focused on health care reform and actually coming up with substantive, serious proposals for that purpose. Senator Wyden?

Senator WYDEN. Well, thank you, Mr. Chairman. And I think you know how much we are going to miss you next year. I would almost like to anchor you to that chair, because if we are going to deal with these issues, your voice and your influence is key, and I thank you for all your courtesies over these many years.

Gentlemen, I am going to start with Medicare because the rights of senior citizens have been my overriding passion in terms of public service, and we better be darn passionate about this subject, because protecting the Medicare guarantee, especially right now when the trustees have said that Medicare is not going to be able to pay the bills in 2024, means that we are going to have to have some bipartisan action here on Capitol Hill, and soon.

And it seems to me that getting that bipartisan action is going to require accepting some key facts about how the program actually works today.

For example, when you hear Medicare discussed in the media—TV and elsewhere—Medicare is often described as solely a Government program. Now, the facts show otherwise. In my home State, for example, almost 60 percent of the senior citizens secure their Medicare guarantee through the private sector. This is Medicare Advantage and private Medigap plans.

So the first challenge is to get an agreement on some of these key facts, and then the question is really how should we go about securing the future of the program. And I would like to start with you, Dr. Nichols—you have done good work on this in the past—and ask your thoughts about what I think are the three key principles for strengthening Medicare for the future.

The first is keeping traditional Medicare for all time as a robust option so that then you would have the Government's purchasing power and private sector innovation making each other better. That is principle number one.

Principle number two is guaranteed affordability and choice for everyone on Medicare by requiring that the Government's contribution for their Medicare provides the same benefit that they get today. I am not interested in providing any senior citizen in this country with a coupon, and I have always rejected it. So with principle two, we can make sure that does not happen.

Principle three is ironclad consumer protections that stop cold anybody who tries to fleece a senior or tries to game the system. And that also means you kick somebody out when they are trying to cut corners and are not complying with the rules.

So the question for you, Dr. Nichols, is: Regardless of what you call this—and you have correctly said there are a lot of ways you can name this. Regardless of what you call this, are those the kind of core principles of a Medicare future in your view that can actu-

ally work, be bipartisan, protect the Medicare guarantee, and get us on top of this challenge?

Mr. NICHOLS. Well, Senator Wyden, I think we might have talked about this in the past, and I have said this in public. Both God and the devil are in the details here, so it really does depend.

I know you are in favor of this. If you add risk adjustment to those principles to make sure that the competition is on a level playing field—and I know you are for that—then it would indeed be, in my view a linchpin of how—what you might even call “pro-beneficiary competition,” to throw a new word out there because we haven’t so confused about the other ones, because it would indeed, in my view, as you put it in the first principle, enable the private sector’s innovation and creativity to be buttressed by the public sector’s guarantees and, indeed, its own innovation.

You know, my colleague Jim here talked about how Medicare is the biggest buyer. That is actually in some ways an advantage because Medicare can drive, therefore, an incentive realignment. Yes, Medicare’s payment schedule is what is out there, but private plans adopted it because it was more efficient for them to have the fee-for-service schedule come from Medicare than to develop their own.

So, in fact, when Medicare does innovation on paying hospitals or now paying physicians differently, we get progress that way. The private sector can benefit from that, and that is exactly the kind of dovetailing I think you are talking about.

But the principle of pro-beneficiary competition where you maintain those provisions, to me that is about as good as we are going to get.

Senator WYDEN. Well, thank you very much, and I am very pleased that you also mentioned the risk adjustment factor. That is absolutely key in any approach that, in effect, tries to play side by side Government’s purchasing power and the innovations that come from the private sector because if people are going to, in effect, be empowered to have that choice, you are going to have to have vigorous risk adjustment. And I really appreciate your pointing that out as well. And you are right, you can call this a variety of different things, and we hear all these names essentially slung around almost indiscriminately, and that is why I appreciate your saying that those core principles—and I think those are the kinds of things Democrats and Republicans can talk about together—are what is needed for ensuring the Medicare guarantee for the future.

One question for you, Dr. Cutler, and I have long admired your work, as you know: Senator Grassley and I have introduced a bipartisan proposal to open up the Medicare database. This, of course, is the database that ensures that the procedures for which providers and doctors are reimbursed, that that database would be available to the public so that the American people, in effect, could go online in a fashion that would protect the privacy rights of each senior citizen, but that information would be made available to the public. Would you be in support of the kind of effort Senator Grassley and I are making there?

Mr. CUTLER. Thank you for the kind words, and the very short is, yes, absolutely. It is fundamental that we be able to understand

what is happening. Or to put it another way, no business ever got better without knowing what it was doing.

Senator WYDEN. You are being logical.

Mr. Chairman, thank you for the time and, again, for all your courtesies on this issue and so many others.

Chairman CONRAD. Thank you for your extremely hard work. I appreciate it very much.

Senator SESSIONS?

Senator SESSIONS. Thank you, Mr. Chairman. I would just echo that. Senator Wyden is one of a handful of the most knowledgeable people in this Senate. He is spending a tremendous amount of time. He works across the aisle. He works to achieve a better health care system, and I appreciate that.

Mr. Chairman, I would yield to Senator Johnson. He just a year or so ago was in private business dealing with health care for his employees, and he came here to make a difference.

Chairman CONRAD. I will recognize Senator Johnson for 7 minutes.

Senator JOHNSON. Thank you, Mr. Chairman and Senator Sessions. And that is right. I have been a business person. I actually have faith in the free market, and I think that is really the fundamental disagreement we have here over the health care law. The only reason I ran for

the United States Senate, by the way, is because they passed the health care law. And I really think it is the greatest single assault on our freedom in my lifetime. I think it is going to bust a hole in a horribly broken budget.

Certainly what I found out about the free market system operating in it for 31 years, it guarantees the best possible price, the lowest possible cost. As economists, I think you would probably—I hope you agree with that. I hope they are still teaching free market economics at Harvard.

It also guarantees the highest possible quality and the highest possible level of customer service. Isn't that what we want, really, with any good, but isn't that what we want with health care? I have no idea why anybody has faith that a command economy, that Government can actually do a better job than what the free market can do in terms of health care?

Dr. Nichols, you talked about information. I have been here a year. All I hear is the information technology debacles in the Government. Where has Government ever controlled administrative costs? Where has Government provided the highest-quality service, the highest possible level of customer service? I just do not see it. And so I do not share that same faith.

One of the things, as I have been listening to these hearings, for example, Mr. Capretta, you talked about the fact that we are not addressing the main drivers of our deficit—Social Security, Medicare. We had Secretary Geithner here. He fully admitted there is no plan—after 4 years, there is no plan by this administration to save Social Security and Medicare.

Yesterday we had Senator Panetta, who I truly admire, I really respect, but he basically said it is the same old game. We are playing games here in Washington rather than fixing our problems, and I think a classic example of this is Obamacare. I think the

American people were sold a bill of goods. There were three guarantees I remember in the private sector made about Obamacare.

First of all, it would reduce premiums on an annual basis by \$2,500 per family. In fact, the Kaiser Family Foundation says, no, premiums have increased by \$2,300.

If you like your health care, you can keep it. Yet we have granted 1,200 to 1,700 waivers for 4 million Americans.

They also said not one dime would be added to the deficit, and that is what I really want to zero in on. I have had discussions with Director Elmendorf about CBO's estimate that only 1 million people would lose their health care coverage, their private insurance, and get dumped on the exchanges at highly subsidized rates. Now, I bought health care for 31 years. The decision is going to be very linear. It is going to be—and, again, as economists, I want you to confirm this because I think this is true. Somebody in a business is going to look at it and say, listen, I could pay \$15,000 for a family plan, or I can pay the \$2,000 penalty. And I am not throwing my employees to the wolves. I am not exposing them to financial risk. I am going to make them eligible for huge subsidies in the exchanges, \$10,000 if you have a \$64,000 household income.

Now, the McKinsey Group has already conducted a study; 30 to 50 percent of employers are already indicating they are going to drop coverage. The CBO estimated only 1 million individuals out of the 180 million that get health coverage from their employees are going to drop coverage.

Now, I just want to ask that question. First of all, Dr. Cutler, let me ask you, I believe it was your 2008 memo that claimed or formed the basis for President Obama's assertion that we would be saving \$2,500. How could you possibly write anything that would assume that we would be saving \$2,500 4 years after the passage of Obamacare?

Mr. CUTLER. Let me answer your question directly. What I was talking about then was the implications for the typical family and all of their medical spending over some period of time after the act was implemented. So it is very difficult to take something that was enacted in 2010 and ask about savings very early in—

Senator JOHNSON. So did President Obama just misrepresent what you had written for him?

Mr. CUTLER. No, actually—no. I believe he stated accurately what he—I will not attribute any motives to him. What I heard him say accurately reflects my view.

And I just want to come back to one thing that the Chairman said in the introduction to the hearing, which is that already medical cost increases are coming in well below expectations, not all of which is the recession, part of which is very low growth in Medicare due to direct provisions of the Affordable Care Act, those having to do with the payments to Medicare Advantage plans, the hospital—

Senator JOHNSON. Okay. As economists, Dr. Nichols, do you believe that 1-million-person estimate of people being dropped out of employer coverage, do you think that is even close to accurate?

Mr. NICHOLS. Well, Senator Johnson, it is a very interesting question, and I would take you to an economics discussion and look at what happened in Massachusetts. But the logic, before we get

to the specifics, is today there is no penalty for not offering, and we see a lot of firms offering. Tomorrow there is a penalty for not offering. Why do we think they would all drop? And it does come down to—and I think you are right. It comes down to—

Senator JOHNSON. There will be an incentive to drop because it is a \$2,000 penalty, but you are making your employees eligible for \$10,000 in subsidies.

Mr. NICHOLS. Well, it depends on—

Senator JOHNSON. And, by the way, it is not a penalty because you are still paying insurance at the rate of \$12,000 to \$15,000 a year, only paying \$2,000 for a penalty. So we have created the incentive—

Mr. NICHOLS. But today there is on penalty—

Senator JOHNSON. A huge incentive.

Mr. NICHOLS. With respect, sir, today there is no penalty for not offering. But what I am trying to get to here is—

Senator JOHNSON. But there is an incentive to have market rates for your employees. That is why people provide it now. They do not want to expose their employees to financial harm. That goes away with the health care law.

Mr. NICHOLS. I believe they provide it to compete for labor in a competitive labor market. We agree with that, right? And, fundamentally, as you know quite well since you were a businessman, it is part of the total compensation package. So if it were to be the case that firms would indeed do the calculus as you are suggesting and they would drop, they could not just send the worker over there. They would have to give the worker higher wages. Fundamentally, the compensation packages would adjust.

Senator JOHNSON. No, they would not.

Mr. NICHOLS. Well, my—

Senator JOHNSON. They just do not have to do that.

Mr. NICHOLS. That would be—

Senator JOHNSON. Again, we—

Mr. NICHOLS. Then what you are saying is today's compensation levels are silly because, in fact, today's compensation levels are the function of incredibly competitive markets, and why would they give them this insurance today if they do not have? They have to, to compete for those workers.

Senator JOHNSON. Mr. Capretta, I would like to hear your thoughts on that, the 1-million-person estimate versus the 180 million people that will be exposed to that possibility.

Mr. CAPRETTA. An analysis done by the Urban Institute, economists at the Urban Institute, indicates that the—the point I think you are trying to make is that the benefit moving to the exchanges, if an employer drops and someone goes into the exchange, they will get a new Federal subsidy in the exchange. If that Federal subsidy exceeds the subsidy they would have in an implicit subsidy through an employer-paid premium that they get through their former employer, they unquestionably would be better off in the exchange rather than the old employer plan. In other words, the Federal Government is going to be giving them more money to go into the exchange than they would have if they had stayed in the employer plan.

There are a large number of Americans basically below about 250 or 300 percent of the poverty line who are in that category and are currently getting job-based coverage today. I believe that the drop rate will be well above what CBO indicated in their estimates, but I do agree with Len that we have to understand that labor markets are competitive and so the total compensation package is likely to be the same for a worker when they are working with an employer. The employer, if they do not want to give them tax-free health benefits, they will give them cash. But the question is: Will they be better off in the exchange rather than the employer-based plan? And I think there are a lot more workers, many more than 1 million, who will be better off in the exchange than in the employer-based system, and one way or another, we know the iron law of entitlements is that people find their way to the money. And so when the Federal Government is putting a large subsidy structure out there that says, here, if you come into the exchange, we are going to subsidize you at six, seven, eight, nine, ten thousand dollars in your premiums, and if you stayed in the employer plan your subsidy was going to be \$4,000, yes, there is going to be migration into the exchanges. It may not happen in year one, but it will happen over time, and people will sort themselves out. High-wage workers will stay in the employer-based system because they will be better off there, and low-wage workers will all eventually find their way into the exchanges.

Senator JOHNSON. Well, my final comment is I do not think very many people can be turning down thousands of dollars worth of subsidies, but thank you, Mr. Chairman.

Chairman CONRAD. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair.

Just to follow up on this, Dr. Nichols, the best information we have is from the Romneycare pilot project, if you will. What can we glean from this about this core issue of migration in and out of exchanges?

Mr. NICHOLS. You know, it is a great question, and it is a nice national experiment for us. We love that in economics. And the truth is in Massachusetts employer coverage actually went up, firms offering actually went up, so they did not follow the kinds of rules we are talking about.

I think it is extremely important to remember the way the mandate is structured, both in Massachusetts and in the Federal law, and that is, if you have access to an employer-sponsored plan and the out-of-pocket premium does not exceed a certain threshold, then the mandate requires you to take the employer-sponsored plan. It turns out a lot of folks who were not taking coverage had it offered to them, and they had been basically free-riding on the rest of us, and when they got sick, they went to the hospital, and we basically all paid for that. And now they are going to have to pay their fair share. A lot of what the mandate is about is about making people pay their fair share, and so, in fact, in Massachusetts what we found was firms did not drop, they indeed expanded employer coverage. So that is the one national experiment observation we have.

Senator MERKLEY. It is kind of fascinating because when the issue first came up, I think there was very much the argument

that we have been discussing as to why employers would migrate. And I think if I had been asked, I would have said, yes, it sounds like they would. And trying to really understand why they are not is a valuable insight here, so thank you for that.

I wanted to switch to some other things. One of the really big issues in health care, as far as I can see, is that our doctors and nurses and physician's assistants are retiring as part of the baby-boom generation, and we have all of us as baby boomers who need a lot more health care. An entire title of the Affordable Care Act was dedicated to trying to expand the supply of health care practitioners, but I think it only really moved the needle a little bit. I do not think any of you in your testimony commented on this fundamental supply-demand problem. Any quick insights as to what Congress should be thinking about or doing?

Mr. NICHOLS. Well, I would jump in; I am sure my colleagues have thoughts as well. But it seems to me I would suggest you consider both a short-and a long-run strategy. In a short-run strategy, I think we need to figure out how to leverage the resources we have now, and that would mean everything you can do—and you can do a lot—to encourage scope-of-practice revision so that we indeed use so-called mid-levels—those are below physician degrees—use them far more efficiently. There are a lot of ways you can change Medicare and Medicaid payment policy to make that indeed the reality.

Second, in the longer run, I think you are going to have to acknowledge that we need to change the incentives for going into primary care. It is kind of interesting. A lot of folks have decided primary care is the solution, but there are nowhere near enough primary care docs today. So we need, I would say, very targeted loan forgiveness programs and other kinds of things that might indeed induce the—

Senator MERKLEY. So we have some of those in the Affordable Care Act. Is it too soon to evaluate them?

Mr. NICHOLS. Sir, we do not have any for physicians. We took them out in the name of, I would say, penny-wise, pound-foolish. And so we have to think hard about putting that kind of investment back in.

Senator MERKLEY. Okay. Thanks.

Mr. CUTLER. If I just can add one thing, I agree with Len's comments entirely. There is an enormous amount of the clinical personnel that is actually wasted doing administrative transactions now. So when people follow nurses around the hospital with a stopwatch recording what they do all day, the most common thing that a nurse does is document things, typically taking electronic output and writing it on paper so that it can then be re-entered in a different computer.

And so when we were talking about the administrative simplification earlier, amongst other things, in addition to saving the money, it would free up the resources that could be used to have people provide more direct primary care.

Senator MERKLEY. Thank you. My wife is a nurse, and I can say this is an enormous frustration, if you will, and a source of inefficiency.

One of the issues that was voted on by the House but not by the Senate was getting rid of the antitrust exemption in the medical world. Any thoughts on whether that actually would have a positive impact? And, by the way, I think over 400 Members of the House voted in favor of that bill, huge bipartisan support to get rid of that antitrust exemption.

Mr. CUTLER. The antitrust issues are extremely important here because one of the things we want to do—everyone on the panel agreed with that—is to allow greater integration of care, greater coordination of care, and that will often have to involve areas where antitrust has traditionally been very difficult.

I think at minimum we ought to think about for integrated organizations, even if they are not physically the same organization, relaxing many of the constraints on antitrust and kickback rules because the organization will be accepting a total amount of money and will not be in a position to be charging higher prices, for example.

So I think it is one of the issues that we are going to need to look at, particularly as we push those kinds of organizations.

Senator MERKLEY. So from your answer it almost sounds like the assumption you are operating from is that antitrust policies are in place and a problem for coordinated care. But my understanding is actually that insurance companies are exempted from antitrust. The House bill was about getting rid of that exemption. So any clarification on that?

Mr. CUTLER. I was thinking about the provider side where we have similar issues. On the insurance side—

Senator MERKLEY. I see.

Mr. CUTLER. Yes, in fact, there has actually been a very big and worrisome consolidation in the insurance industry, which is actually problematic, because as the insurance industry consolidates the prices go up.

Senator MERKLEY. So for coordinated care on the provider side, you might need to relax some of the antitrust provisions.

Mr. CUTLER. That is right.

Senator MERKLEY. But in terms of insurance competition, it might make sense to get rid of the exemption. Is that—

Mr. CUTLER. That is correct.

Senator MERKLEY. That is helpful.

How about in terms of we are talking about the costs of Medicare, and one of the issues that has come up over time is that we do not have the same power in Medicare to negotiate the price of drugs we have, say, in the Veterans Administration. I believe that the estimate for the dual eligibles was something like \$60 billion over 10 years, the savings. I am not sure how much the savings would be if you expand beyond the dual eligibles. But is this an issue that should be revisited?

Mr. NICHOLS. Well, I would go back to Jim's report, which I think we all agree with, of how well the drug competition has worked in the program. I do not remember quite the dire predictions you do, but I am happy to see that it is working, and I think a lot of us did think it would.

So I would say you should probably keep it in your quiver. It would be a smart thing to have on the table. There is no question

countervailing power is going to be necessary in a market context. But it seems to me your drug project in Medicare is working pretty well, and you might want to just not mess that up.

Mr. CAPRETTA. Just to follow on that, I would say that the Medicare program has the ability to regulate prices in the rest of the program today, and it has been—I think my own judgment is that it has been basically not an effective way of controlling costs.

Just back to your question about physician supply, Congress enacted a way of paying physicians in 1989 that was intended to encourage primary care. This is going to get to your drug benefit question. But 23 years later, it is the primary cause—not the only cause, but it is the primary cause for our overemphasis on procedures and procedure-based specialist care and discouraging primary care.

So there are lots of unintended consequences when the Federal Government regulates prices, and I think in the drug benefit, what is working does not need to be—you should not be fixing that.

Senator MERKLEY. Thank you. Thanks.

Chairman CONRAD. Senator Sessions.

Senator SESSIONS. I will recognize Senator Thune for my time.

Chairman CONRAD. I will recognize Senator Thune for 7 minutes.

Senator THUNE. Thank you, Mr. Chairman, and thanks, Senator Sessions, for yielding, and thank you for calling this hearing. I want to thank the panel for being willing to be here and to testify as well.

Entitlement spending, as we all know, is the biggest driver of our national debt. Spending on health care entitlements is projected to increase significantly in the coming years, and I think it is imperative that this issue be addressed.

I was asked yesterday by some constituents about why it is that Congress seems unable to deal with the budgetary problems the country faces and to do it in a bipartisan manner. And I have to say that if you look at it historically, there are lots of examples of where divided Government led to solutions where we were able to do big things and take on big challenges. And you can go back to 1983 with Social Security reform when you had a Republican President and a Democratic Congress, or 1986 with tax reform when you had a Republican President and a Democrat House; or 1996 when President Clinton and a Republican Congress did welfare reform and the following year the first balanced budget in a generation.

So there are lots of examples of where, you can do big things in divided Government, but you have to have Presidential leadership. You have to have a President who is leaning into problems and trying to solve them. And the President with his budget that he gave us a couple of weeks ago is leaning away from these issues. There is not, in my view, anything materially in a serious way that addresses the serious fiscal problems that we face or takes on these entitlement programs in a way that allows us to make sure that they are there for future generations.

But I wanted to ask a couple of questions, if might, and I will direct this one to whoever wants to respond to it. But one of the key pieces of the President's health care law is an unelected, unaccountable board of 15 people know as the Independent Payment Advisory Board, or IPAB. IPAB's members can serve for up to two

6-year terms. They are charged with recommending changes to the Medicare program in order to bring spending in line with some predetermined targets. But what strikes me about it is that rather than making tough choices to improve the long-term sustainability of Medicare, the President has apparently decided that it is politically expedient to sit on the sidelines of this debate and pass the buck to this board of unelected, unaccountable bureaucrats to make these across-the-board cuts in payments to doctors and other providers that can only reduce seniors' access to quality health care.

I guess my question is, and I come back to the issue of leadership: Is this a responsible form of leadership? Should we not have a better model of taking on these challenges than to have this IPAB, again, which is now answerable to anybody in the position of making big decisions like this?

Mr. CAPRETTA. Well, I agree with the premise of your question. I think the Independent Payment Advisory Board was a poorly structured concept that was stuck into the health care law. If you read the statute, the IPAB really only can do one thing to keep costs under control.

First of all, it is going to have a very short term focus. Every year it has got to report to try to hit a budget target the following year, basically, and the only things it can do essentially are all the things that have already been done many times over the years, which is cut provider payment rates. It can go in and say to—for a while not hospitals, but other parts of Medicare, we are going to pay you 3 percent less next year than we were otherwise planning to, and that is how we are going to hit our budget target. And, again, as you indicated, it is an unaccountable—there is no ability for the electorate to sort of weigh in through their representatives in Congress anymore.

So, yes, I think we are moving it in that way. I think it was a bad idea, and also its mandate is a bad idea. And I think a lot of people do not realize that the health care law essentially put a global cap on Medicare spending that the IPAB is now enforcing through these administrative actions. And potentially, over time, the truth is that Medicare payment rates are already well below, in most areas of the program, what private insurance is paying to access care for seniors. The solution is not further depression of prices in Medicare. Medicare is already paying well, well below what everybody else is paying. The problem is that Medicare, because of its fee-for-service structure, is very inefficient, and this IPAB will not solve that problem.

Mr. NICHOLS. You might imagine, sir, I beg to differ just a little, and I would offer two observations quickly, if I could.

One, what the IPAB is designed to do is to actually come up with plans that would hit a specific target, but that is not arbitrarily imposed. It actually goes to Congress and you have six months to react, or 60 days to react to that, and if you do not like it, you can do something else. But their charge is to stay focused like a laser beam on exactly how the various incentives in the private and the public sector are playing out. With some amendments at the end, they actually have to focus on total health spending in the country. They have to think about the levers they can move, which are in the Medicare program.

But I would differ a bit with Jim in there is purview in they can change the way we pay, and that is far more important than the level. I agree, the level is not the deal. The deal is the incentive structure that induces the kind of behavior we want. I would submit to you, compared to a formula that fixes the growth rate in arbitrary levels and has no recourse, IPAB is set up to give you expert opinion and then you decide, and that is a much better, in my degree, of—

Senator THUNE. Mr. Cutler, if I could ask—I have a question for you, too, in the interest of time—your testimony advocates for the Accountable Care Organization model for Medicare included in the President’s health care law and in support of that argument you cite the CBO’s recent review of value-based payment delivery demonstration projects saying, and I quote, “The single reform that demonstrated reduced spending was bundling services,” unquote.

Mr. CUTLER. Mm-hmm.

Senator THUNE. However, when CBO looked at four Medicare value-based payment demonstrations, it found that three of those programs showed little or no savings from Medicare. CBO also looked at 30 care coordination programs conducted by CMS over the last decade and found that, on average, Medicare spending was either unchanged or increased relative to the spending that would have occurred in the absence of the program. Why should we think that payment delivery changes in the President’s health care law are going to be any different?

Mr. CUTLER. Thank you for the question. What the CBO found very clearly is that when you take payments not for the person as a whole but for a particular episode of illness, so, for example, a very common episode is an elderly woman falls down and breaks her hip and then there is care provided in the hospital and out of the hospital and so on, when you bundle all of those payments together, you achieve significant savings, about ten percent savings there, because the doctors are able to handle that.

What is a little bit harder at the moment is getting organizations to deal not just with the broken hip or the cardiovascular problem but with the patient as a whole. There, the demonstrations have not been so successful. But out in the world, the real world practice, there are a number of organizations that have been extremely successful at it and where the demonstrations are just sort of getting going.

So it is most people’s belief that we know how to do it for particular conditions and we are learning how to do it for the broader patient aggregate.

Senator THUNE. Well, obviously, CBO was not getting the—must not have seen some of the anecdotal examples that you are referring to of where they achieved those. I mean, the conclusions that they drew are different than yours.

Mr. CUTLER. They saw them. What they tend to do is they see ten studies and they say, well, three of them were successful, seven of them were not, therefore, we are going to conclude that this program on the whole was not successful, rather than seeing the three studies and saying, aha, someone has figured out how to do this. Therefore, the market, as Senator Johnson was saying, therefore, the market is really going to move in that direction, particularly

if you say that that is the way you are going to survive in this market, is by being better and higher quality. And I think that the way that they have chosen to think of it is fundamentally not based on the right economic model there. They are sort of assuming that the folks who have not been able to do it will never figure it out the way that other folks have.

Senator THUNE. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator NELSON.

Senator NELSON. Well, speaking of that, Dr. Cutler, that is part of the reason for instituting Accountable Care Organizations. Would you give us your cut on that?

Mr. CUTLER. Yes. Thank you. The best organizations we know of across the country are organizations that, in essence, are acting like Accountable Care Organizations—the Mayo Clinic, the Cleveland Clinic, Intermountain Healthcare in Utah, Kaiser in California. What all of those organizations do is they bring together all of the providers and they say, our goal is the best care for this patient. And when they do that, what they find is that they eliminate things that they are doing that are wasteful and very expensive.

So, for example, at Intermountain Healthcare in Utah, they figured out how to cut their caesarian section rate by a third and have better health outcomes by reinforcing what the doctors told them, which is that early induced labor in women before 39 weeks was associated with higher C-section rates and poorer outcomes. Just by doing that, by standardizing that, you manage to save enormous amounts of money and improve care quality.

That is what these kinds of organizations—that is what the successful ones do. That is, to come back to Senator Thune's comment, the unsuccessful ones have not figured out how to do that, but they will.

Senator NELSON. Now, as they start to implement the ACOs under the bill, you are seeing different models. You are seeing those like Kaiser that you talked about. You see those that are organized around a hospital. And you see those that are organized by physician practices. I would like any of your commentary about whether or not a hospital buying up doctors' practices, which is happening in Florida, if that is not contrary to what we are trying to get at with ACOs.

Mr. NICHOLS. Well, Senator, I will say it again. I think you might not have been here yet. Both God and the devil are in the details here. I think we really do believe that coordinated care among physicians, hospitals, plans, is going to work out better for everybody. If we get the incentives right, they will all be aligned to do that.

But you are absolutely right, and trust me, it is not just Florida. There is a lot of purchasing of physician practices. There are a couple of reasons, and I think they speak to your question. One is a lot of physicians are, frankly, just tired of the treadmill of trying to make a living in a small practice, seeing 30 or 35 patients a day if you are primary care. It is exhausting, and what they can see is they can have a salary, more guaranteed income, and that is very attractive to a lot of people, particularly, apparently, among the younger generation.

Second, there was a Medicare payment snafu, one of Jim's, I am sure, favorite examples, where we basically lowered the payment to cardiologists in the outpatient setting but not if they were hospital employees. Well, guess what. Three-fourths of them became hospital employees in about 12 months. So is that good for America? Well, probably not. It does create the potential for the incentive realignment to occur once they become on salary, but not if to guarantee to make that salary work they have to generate the same amount or even more work that they were before. So it all depends on the incentive structure after you get it done.

Senator NELSON. Was that snafu corrected?

Mr. NICHOLS. Not yet.

Senator NELSON. Well, ideally, would it be of ACOs, ideally, that you would have a physician-based ACO that would coordinate with the hospital and all the other health care providers to get the best bang for the buck.

Mr. CUTLER. My guess—

Senator NELSON. Is that the ideal?

Mr. CUTLER. My guess is that is the way the market will go, and the reason for that is because once you are inside an ACO, inside any coordinated organization, the hospital is no longer a profit center. It is a loss. It is a cost center. That is, keeping people out of the institution is much better than putting them in the institution. And so, in fact, many of the most successful organizations, what they do is they really, quote, "starve" the hospital. That is, they just keep people away from it. And it is very hard to see a hospital running something that says, oh, by the way, I want to keep my beds empty.

Senator NELSON. I want to go back to Medicare Advantage. The thought occurred to me as you all were talking about that council or whatever it is called, IPAB, that looks at the overall spending, that at least in Florida, I can say that one of the great success stories of the new health care law is Medicare Advantage. Enrollment is up about 20 percent and premiums are down for seniors 26 percent. As a result, Florida, having had already a third of its seniors on Medicare Advantage, is moving somewhere around 40 percent of seniors, and I would not be surprised if it does not get up to 50 percent of seniors on Medicare Advantage. Now, does that not lessen, then, the concerns that you have over here with IPAB. Would you comment on that, any of you. Dr. Cutler?

Mr. CAPRETTA. I have a comment on that, if I will. I do not mean to jump ahead of the other two. But I think if you look at what has happened in Medicare Advantage over the last year, the administration announced and pushed forward a demonstration project for Medicare Advantage where they essentially created a quality bonus system, and then they pay basically every Medicare Advantage plan a bonus. So they were all basically high quality. So that mitigated—and that was an administration action that was not required in law, and that mitigated, and the cost, I think—do not quote me on this—about \$6 billion. That mitigated, to some extent, the cuts that were enacted in the health care law.

It is important to note, however, that both CBO and the actuary's office who look at the Medicare program expect enrollment in

Medicare Advantage to drop precipitously when the big cuts in Medicare Advantage take effect in 2013 and beyond.

Senator NELSON. Unless the bonus system works as it was intended, which is to get them into higher quality plans.

Dr. Cutler, you were shaking your head in agreement with what I was saying. Tell me what you are thinking.

Mr. CUTLER. I think you are correct that people had feared the program would disappear. In fact, enrollment is way up, even as the costs are down in the program, and that has contributed to the lowest growth of Medicare spending since just after the Balanced Budget Act in 1997. And amongst other things, it means coming back to the IPAB issue that the implications for out-year Medicare spending really need to be thought about very hard. Forecasting is a very difficult issue, but if I had to guess, I would guess that our current forecasts are too high on what that spending is going to be, given the data that are coming in.

Senator NELSON. And, Mr. Capretta, I do not mean to in any way diminish your comments. I think that when we get on down to 2013, 2014, we have to be concerned. But what we are seeing is insurance companies having an incentive to have higher quality ratings. That, to me, seems to be a good thing because it is a win for the patients. It is a win for the taxpayer. And it is a win for the insurance company. We call that a triple win.

[Laughter.]

Chairman CONRAD. That is good. Let me thank the Senator.

I am going to take my questioning time now and then we will go to Senator Sessions.

I would like to direct the attention of the panel to a proposal Senator Wyden has been working on, a bipartisan proposal. I would be interested, Dr. Cutler, are you familiar with what Senator Wyden has been working on?

Mr. CUTLER. Yes, I am, sir.

Chairman CONRAD. Dr. Nichols, are you familiar?

Mr. NICHOLS. Yes, sir.

Chairman CONRAD. Mr. Capretta?

Mr. CAPRETTA. Yes, sir.

Chairman CONRAD. If I could ask each of you, in turn, your opinions of what Senator Wyden has been working on, pros, cons, what could be done to tweak it to make it better. I will start with you, Dr. Cutler.

Mr. CUTLER. So, first, let me say that I think Senator Wyden has shown an enormous amount of leadership on this, and as someone who studies this for quite a lengthy period of time, I am really extremely encouraged to see that.

I think where Senator Wyden started in his question is exactly right, which is that what we need to think about is how to structure the guarantee for senior citizens that is something that they can rely upon and that is also something that is going to be associated with cost savings for us. And I guess there are two components to that.

One is setting up a functioning market for individuals to choose. As we know, as this committee knows, the Medicare Advantage program has been a mess over time, and so some of what Senator Wyden is doing is trying to replace the mess with something that

actually works for people and for the taxpayers, and that is enormously important.

I would then couple that with a management of the traditional fee-for-service program that turns that from a mess into something that works, and it comes back to the thought I was having as Senator Thune was asking his question, is we need a way to manage that program that does not make every single change be an impossibly high hurdle, because as we need to adjust rapidly as the private sector does, we need to be able to adjust rapidly in the Medicare program, as well.

And so where I go with Senator Wyden's proposal is to say, absolutely, make the competitive part work, do the risk adjustment and the other sorts of things, and then couple that with a very aggressive look at the traditional program to make that work, and then really play it out so one does not have to choose either an entirely traditional program or an entire program without any traditional program.

Chairman CONRAD. Thank you.

Dr. NICHOLS.

Mr. NICHOLS. Well, the first thing I have to say in relation to Senator Wyden's proposal is I applaud the very instinct of bipartisanship. You know, Senator Conrad, and Senator Wyden, too, how much time I personally spent in trying to make our last conversation more bipartisan as a nation. So I just think the more you all do that, the better, and we will all applaud.

Second, what I like about the principles the Senator laid out in his comments this morning and what is there, you define a benefit package, none of this voucher coupon stuff. You make sure you are really going to make the government contribution to the fair competition between fee-for-service and the Medicare Advantage type plans. That competition—the payment is based upon the competitive bidding of the process, and I think we all would agree, competitive bidding is way better than any kind of administrative fiat. It is going to work, and it has the virtue of reflecting the cost and the efficiencies achievable in different parts of our country. I know I do not have to tell you all, it is a big country. It is very diverse. You are going to have very different levels of what is actually achievable.

And third, I like the way that the risk adjustment and the consumer protections are emphasized when the Senator talks about it, and I think that is absolutely essential to going forward.

How I would tweak it is a little bit along the lines David just said. I would really encourage you all to think hard about reflecting the regional variation that is out there and think about, what if you could grant discretion to a piece of Oregon, or maybe the whole State. I know the Governor there is actually pretty creative about these matters, as well. Or corners of Colorado, corners of New York where there are people ready to do essentially what I would call real competitive action, but they need Medicare to be free of the rules that have been encumbered upon them.

And so one of the steps is to have data available, but another step is to let Medicare actually structure something that might be different in one part of the world as long as they are hitting the goals you set for the program. I think that is the hallmark, Sen-

ator. We want to move to a world in which you all set the targets, you let the real world determine how to reach the targets, and you keep the beneficiaries protected. That is what you do.

Chairman CONRAD. Mr. Capretta.

Mr. CAPRETTA. Thank you, Mr. Chairman. I hope what I am about to say does not hurt Senator Wyden in his efforts, but I very much applaud what you are doing. I think it is exactly the right direction to go—

Chairman CONRAD. Okay. You are killing him now.

Mr. CAPRETTA. Yes, exactly—

[Laughter.]

Mr. CAPRETTA. Dead on arrival from here on out. The key in Medicare—the thing to understand is remember there was a famous study about McAllen, Texas, that Atul Gawande put out in the New Yorker, and the President read it and it was passed around and it was a very interesting article, very insightful, and it was all about the over-built system in McAllen, Texas, basically, procedure-based, heavy over-built system. And the question the article did not address is why in McAllen, Texas, was it so over-built. And a subsequent analysis later on, basically pinpointed it on Medicare fee-for-service, that Medicare fee-for-service financed and underwrote the over-built system in McAllen, Texas.

If you have a competitive system where someone can offer the Medicare package of benefits on a competitive basis, you will not have that happen anymore because people will have to pay a much higher premium to stay in an over-built fee-for-service-driven system like that. Competitive bidding will have the ability to weed that out of the system.

And I think—so based on many versions of this—this goes all the back to Breaux-Thomas in the late 1990s and various versions since—on a bipartisan basis, I think there is general agreement that the best place to start in Medicare is a bid system with fee-for-service participating because that is the only way we will ever really figure out what the right price is.

Chairman CONRAD. Yes.

Mr. CAPRETTA. If we try to figure it out on our own, we are going to either underpay or overpay or probably both.

Chairman CONRAD. Well, I think there is enormous wisdom in your last observation. I have been here 25 years and I am personally convinced of what you just described.

Final question for me, tax treatment of health care. Dr. Cutler, keep it the same way, needs to be changed, reasons why.

Mr. CUTLER. We need to change it. It is a mistake both from health policy to encourage people to spend more and for fiscal policy, for the government's budget. The one thing I would say, though, is if for some reason the ACA were repealed or the coverage expansions went away, it would be a huge mistake to do that because what you would have, you would have a lot of employers dropping their coverage of health insurance and you would have an enormous increase in uninsured people. So what I worried about was major changes in that without building some alternative place where people can go. Now that you have a place and an ability to do that, now we really ought to address that.

Chairman CONRAD. Dr. Nichols.

Mr. NICHOLS. I would concur, especially with the latter point that as long as we keep the commitment to making sure all Americans have access to decent health insurance in some way, then you are certainly free, and I would encourage you to improve the tax treatment issue.

The high-cost plan tax that is in the Affordable Care Act is basically a back-door kind of twist or game way of accomplishing something approximating what we would do if we were in power, and, of course, we are not and there is a reason we are not. We could not get elected saying this very much. But there is no question we should cap it and let Katy bar the door. I do believe it will be easier to do a couple years after the Affordable Care Act is actually implemented in 2014 and beyond because there is going to be much more science and transparency devoted to the issue of what is the actuarial value of a given plan. That has always been the bugaboo in how we implement it. And what ought to happen, of course, is you set the cap at an actuarial value that you think is the minimum thing we should be subsidizing and let people have more if they want it. It is America. But they get to pay for it with their own dollars.

Chairman CONRAD. Mr. Capretta.

Mr. CAPRETTA. I very much concur. I stated in my testimony that I think we need to move toward a defined contribution health care system, and that includes the employer-based system. So the tax treatment needs to move away from an open-ended system to something that is more fixed and defined.

By the way, if you move it toward individual control, a lot of the portability, preexisting condition problems we see in today's system would go away when people actually owned their own insurance with the government providing oversight.

Chairman CONRAD. Okay. Those were very good answers. I appreciate it very much.

Senator SESSIONS.

Senator SESSIONS. Thank you very much. These are very valuable discussions and I appreciate it.

There are a number of us on our side that feel that the House-passed reform plan for Medicare was unfairly characterized and dismissed, leading even the President to criticize Congressman Ryan right when he was sitting right before him. I salute Senator Wyden for saying, well, maybe there is some common ground yet to be found here and pick up the discussion and has carried it further. Maybe that will lead us into a better place. But I just want to say, there is hard feeling on this side because it seems when it comes to entitlement reform, the President has made a decision not to go forward, and anybody who suggests realistic reforms gets criticized. So that is a problem.

But we do not know where things will come out. I remember, Mr. Capretta, being, I think, the last vote for the prescription drug bill, Part D. And I was arguing with Don Nichols and Jon Kyl, our two superb negotiators, on whether to vote for it or not. And I said, I do not trust these numbers. I want a firm cap. If it goes above \$40 or \$60 billion a year, I want the program to cut the expenditures. They said competition can work, and we cannot get that. We can get only one of two things. If we get the cap, we will not get the

competition, and we believe competition is better. I remember being in the hall, both of them arguing to me this. A lot of people think our members of Congress are all totally stupid, but this was a real serious discussion. So I finally agreed that I would vote for it, and I do not know what the margin was, but it passed with a pretty good margin. Would you say that Senator Kyl and Nichols were correct, Mr. Capretta?

Mr. CAPRETTA. Yes, they were. One anecdote there is that in the Ways and Means Committee when the bill was being considered, an amendment was offered because of concern of the prices going up. They were worried about the beneficiary premium going up too fast. This was an amendment offered from the Democratic side, and they offered an amendment saying the premium for the beneficiary could be no more than, in this year, \$35 per senior. Of course, now, because of the competitive bidding process, it has come in at \$30. If we had accepted that premium, they would be paying even more today than they actually turned out to pay.

Senator SESSIONS. The numbers I have are that even this year, in real terms, premiums went down.

Mr. CAPRETTA. Yes.

Senator SESSIONS. And the cost of Part D is coming in about 45 percent below CBO's initial estimate.

Mr. CAPRETTA. That is correct.

Senator SESSIONS. Would each of you agree that that is because competition has worked better than we expected, or many expected at the time?

Mr. CUTLER. Can I just add—

Senator SESSIONS. Yes.

Mr. CUTLER. —two factors to that. One is that people were mistaken in their estimates of whether the elderly would be willing to shift to generic medications over branded medications, where people thought they were less willing to do that, and it turns out the elderly were more willing to do that.

And the second one—

Senator SESSIONS. Of course, the companies push that—

Mr. CUTLER. Yes.

Senator SESSIONS. and advertise it—

Mr. CUTLER. That is right.

Senator SESSIONS. —because it helped them—

Mr. CUTLER. That is right, but even in the sort of—if you look at what the estimates were at the time, they were off.

But second is something that is a little bit bigger than just the Medicare drug benefit, which is that pharmaceutical cost increases have fallen across the board, and part of the reason for that is that many drugs have gone off-patent. Think about a variety of the cholesterol-lowering medications. And new drugs have not come on in the amount that we thought they would. So, actually, nationally, pharmaceutical growth is extremely low, even beyond the Medicare drug benefit.

Senator SESSIONS. Dr. Nichols, do you think competition played a role in that?

Mr. NICHOLS. I have no doubt that competition worked and that a lot of us were for it, and we all thought CBO was pessimistic. If I remember correctly, the actuary had a lower estimate and for

some reason that was not in the public domain at the time, but anyway, I think it finally made it.

Senator SESSIONS. Yesterday, the President missed the deadline for responding to the funding warning issued last May by the Medicare Trustees. The warning is required under Section 1105 of Title 31, U.S. Code, and it arises when general revenues will account for more than 45 percent of Medicare's outlays for the current fiscal year or any of the next six fiscal years. And the point of this is that most people think Medicare is an actuarially sound program, but now, almost half of the funding is coming from the General Treasury, and this is a troubling thing. So I think Senator Gregg offered this when he was Ranking or Chairman of the Budget Committee and I think it provides an opportunity for us to examine the program.

Would you advise—I will ask each of you—would you advise the President to take this opportunity to confront the unsoundness of Medicare funding and submit a proposal for reform? Mr. Capretta?

Mr. CAPRETTA. Very much so. The reason why the trigger was put in place, and I think Senator Conrad and others worked on it, as well, and at the time, was—you have to understand that Medicare has a couple parts to it. Part A, the Medicare HI Trust Fund, is a real trust fund, and so when that goes broke, it really is a trigger and people have to pay attention.

But there is a huge part of Medicare, Part B, that is paid for out of a trust fund notionally but has an open-ended tap on the Treasury. That is why this general revenue trigger was put in place, to say, hey, wait a second. We cannot just have this thing run on without some view of how much is being taken out of the Treasury every year to pay for it. And if you do not have something like this, the Part B program looks like it is permanently solvent even when costs go up ten, 12, 15 percent a year.

So you needed something that said, hey, we need to take a look at this to make sure this does not go out of control, and they came up with the trigger and I think it should be followed.

Senator SESSIONS. Dr. Nichols and Dr. Cutler, if you would comment on that.

Mr. NICHOLS. Well, Senator, I definitely agree that it is time—past time—to get as many serious proposals about Medicare reform in the public domain as we can come up with. I cannot speak to the wisdom of the President doing it tomorrow or next week or, Lord knows, I would defer to you on the law. I will observe that the key to all of this, as I think, as well or better than most, is bipartisan agreement, ultimately, and that means what we need to have, I think, is a tripartite discussion between Republicans, Democrats, and in Congress and the Senate and the President. But I concur, it is well past time for us to come as a nation to this.

Mr. CUTLER. I agree with that. In many ways, what you are doing here is trying to lay the foundation for some of that, and that is something to be quite applauded, that people will try and figure out the right answer.

Senator SESSIONS. Well, I thank you and thank Senator Conrad. Senator Conrad supported that, and he and Senator Gregg proposed it together, I guess. So I think that it does provide an opportunity for us to confront things. And with regard to the question

of whether Republicans voted to end Medicare, those who voted for the Ryan budget, it was voted the “Lie of the Year” in 2011 by PolitiFact. It did not end Medicare. It did reform it, and we can disagree about how to do that.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you,  
Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman. Let me first thank you for holding this hearing. I think this is one of the most important issues that we have to address, and it is a particularly challenging one because of the nature of this problem, and I would like to ask the witnesses to comment on this aspect of it.

I think that, first and foremost, across our health care system we have a system cost problem. You look at Medicare, you look at Medicaid, you look at the Defense TRICARE program, which Secretary Gates said was eating his budget alive. You look at VA costs, you look at Kaiser, United, Blue Cross. Wherever you go, you see the same problem, which is rapid cost growth way above other costs in the system. And that leads me to believe that there is a system problem in our health care system and that if we just go at it by cutting Medicare benefits for seniors or lowering their access to care, we are making a terrible mistake. And I am not alone in feeling that way. George Halvorson, who is the CEO of Kaiser, says going that way is so bad a decision that it is, to quote him, “almost criminal” and an “inept way of thinking about health care.” We have to address this as a system problem.

And it has a number of components: better electronic information technology. The Economist Magazine wrote several years ago that the health care system had the worst information technology support of any industry in America except the mining industry.

Quality improvements, you are not getting those hospital-acquired infections when you go in there. Avoidable. They cost tens of billions of dollars and tens of thousands of lives.

Emphasis on primary care and prevention so you are catching disease early rather than waiting until it is really acute and then treating it like crazy. Reducing the preposterous administrative costs that bedevil this system. And then payment reform so that all the participants in the system are motivated to keep you well rather than motivated to do as much to you as they can.

I think that there is a pretty clear consensus on this. There are health care organizations that are out there across the country that have committed—their CEOs have committed their corporations to following this path. It is everywhere from Kaiser in California to Palmetto in the South to Intermountain in the West to Gunderson and Geisinger in Wisconsin and Pennsylvania. I mean, there is a lot going on, and really responsible actors—I can think of four reports off the top of my head—say that the annual savings from following this method are between \$750 billion and \$1 trillion a year, which means in our budget-speak, where we usually multiply by 10, a bigger number.

So here is my concern: If that is the nature of the reform that would be in our best interest to pursue—and I see a lot of heads nodding—the problem is that the scoring of it does not work because it is a different kind of process. Atul Gawande said it is a

process of experimentation and learning. I analogize it to the early days of the aircraft industry where we have to get the quality right in the same way that we had to move from wooden aircraft with canvas frames to precision 747s coming down a tube of decision support into a runway with 500 people onboard and nobody worried about a thing. And you do not get there by Government direction. You do not get there by taking away benefits from people. You get there by creating the conditions for innovation.

The problem is when that is your mechanism for solving the problem, it is hard to score. And my great frustration is that we had Bowles and Simpson here in those seats, we had Rivlin and Domenici here in this seats. I made this point. They said, "Yes, you are right. This is the biggest thing. This is what we have to get done. This is the most important part of it." But we did not put it in because we cannot figure out how to score it.

So what are the steps that we could take in Congress or that the executive branch could take to either, if you cannot score it, perhaps you can simply set goals so that there is some more reality to it. This business of bending the curve of health care cost to me is a meaningless metric. And what can we do to put some teeth, some benchmarks, some actual accountable measurement into getting this done rather than being led, I think, on the inept course by a bunch of economic folks who are driven to it by the fact that they can score it?

Mr. NICHOLS. Well, Senator, first of all, that was a very nice statement. I hope you wrote that down. I would like to use it in the future because it pretty much sums it up very, very well. I could not agree more that if we do not get the incentives right, everything else is commentary.

What I would suggest you consider is, first of all, there have been some successes lately. One of them is the Affordable Care Act, because it has done, among other things—in fact, I would offer the most important thing it has done is it has sent a signal to the entire stakeholder universe in our Nation. Business as usual is over, and business as usual is over because we cannot afford it.

Senator WHITEHOUSE. And, by the way, for all the rows that we have had over the Affordable Care Act, so-called Obamacare, there has not been quarreling about those provisions. They went through really without dissent. There has never been any problem with them. And folks out there who are in the business, who are running corporations, who are CEOs, know that they need to do this stuff.

Mr. NICHOLS. And I believe Congressman Ryan adopted them in his budget on the House side. So I think you are right. And the good news is the providers who are leaders out there, as you just named a number, get it and they are trying as hard as they can to figure this out.

I think you can do two things. You can send even more clear signals about the pace at which Medicare as a buyer will move into this, I will just say, value-based purchasing mode, make it clear, date certain, by so-and-so you will have—and that I think is really, frankly, all you need if you also make Medicare a partner. We talked about some of that earlier. I would be glad to lay it out for

you, but fundamentally making Medicare a partner in the provision of more efficiency.

The private sector is already doing similar things. You want to help marry those two in communities that are ready. I know Rhode Island has gone a long way in that regard, also.

Senator WHITEHOUSE. Thank you.

Mr. CUTLER. I agree entirely. One of the things that will help is to go even farther, that is, move—everywhere it says demonstration or pilot or whatever, say, no, within X period of time, 5 to 7 years, we will move that way.

I think the other thing that will be important, since everybody's attention has been captured, to think particularly at a regional level about working with that, so, for example, in Massachusetts where health costs are an enormously big issue like they are everywhere else, people are sitting around discussing what do we believe the growth of medical spending ought to be and what can the State government and the private insurers and the Federal Government help us to do to achieve that. The number that we come up with in our State is that we believe medical spending ought not to grow any more rapidly than the economy for some period of time while we reduce our share of the \$750 to \$1 trillion equivalent, and more or less everybody agrees that that is feasible and that that is something we have to do for the State. And now the question is: How do we go about making it happen?

So some of it might be taking particularly rancorous discussions out of a national framework, moving that into a more actionable local framework with the backstop that, by the way, the Federal Government is going to change the way that it does business.

Senator WHITEHOUSE. Do you mind, Mr. Chairman, if I get a third answer?

Chairman CONRAD. No.

Senator WHITEHOUSE. I am over my time. I do not know if others are waiting.

Chairman CONRAD. Certainly we should give the other witness an opportunity.

Mr. CAPRETTA. Thank you. Just a couple words about this.

First of all, I very much agree with the way you framed the issue, which is, how do we get a process in place that allows for management and integration of care in a sensible way that takes costs out of the system, someone is overseeing that, does it on a continuous basis. But I would note a couple things.

Intermountain Healthcare already essentially does this. They have rigorous protocols. You know, a patient comes in; it is not a guess what they are going to do with them. If they come in with these sort of symptoms and this sort of diagnosis, they channel them a certain way based on longstanding protocols that they developed and refined over decades. They did this despite the Government, not because of the Government. They did it against all odds, really, because the Government incentives push them in exactly the other direction.

Senator WHITEHOUSE. The opposite way.

Mr. CAPRETTA. So the question is: What can we do to bring this about in other places in a more rigorous, ongoing way?

Just to segue a little bit back to the drug benefit question, how did we get seniors to move out of branded drugs to generics? It is because they offered low-premium plans that said if you take generics, which made all the sense in the world, you are going to pay a lower premium, and you are going to get it extremely in better care. Okay?

So I think we need to think hard about consumer engagement in this. What can we do to incent people to want to enroll in Inter-mountain Healthcare or their similar equivalents around the country and not just assume the Government can engineer it? Because Government trying to engineer it and force it through, there are a lot of obstacles to having the Government do it itself.

Chairman CONRAD. I want to thank all of the members who participated. I have to say, this is the most encouraging hearing on health care I have been part of in probably 5 years. I really think we are on the brink of finding a way forward, and I am extremely encouraged by it.

I want to thank each of the witnesses. I think you were all outstanding in your own way. Dr. Cutler, Dr. Nichols, Mr. Capretta, thank you very much for your participation, and thanks to the members who participated today as well.

[Whereupon, at 12:04 p.m., the Committee was adjourned.]

HARVARD UNIVERSITY  
DEPARTMENT OF ECONOMICS

DAVID M. CUTLER  
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March 5, 2012

Senator Jeff Sessions  
United States Senate

Re: Question for the Record, "Putting Health Care Spending on a Sustainable path"

Dear Senator Sessions:

Thank you for the very important question about the Medicare plan recently proposed by Senator Wyden and Congressman Ryan. I am pleased to elaborate on my answer in the hearing. I conceptualize the Medicare program in three parts: the traditional Medicare system (Parts A and B), the Medicare Advantage system (Part C), and the drug benefit (Part D). Senator Wyden pointed out that the Medicare Advantage system performs poorly: government costs are higher than need be, and quality is haphazard. I agree with this, as did the other witnesses.

Thus, the first step is to reform the Medicare Advantage program to make it work better. I believe that a competitive bidding system is preferred to the current administered pricing regime. It is very difficult for the government to determine the right prices to pay plans, while plans do know their costs. Indeed, we have the example of Part D to show us the benefits of competitive bidding. Part D is not perfect, but it works reasonably well.

By advocating a bidding system, however, I do not mean a traditional voucher system. Rather, I would have a more structured market that works better for consumers. This includes:

- o Significant consumer protection guarantees;
- o Risk adjustment;
- o A guarantee that beneficiary costs for the traditional program never go above their current levels;
- o Extensive monitoring of quality metrics of Medicare Advantage plans, including denial of renewal to plans with very poor records; and
- o Payments to plans that are based on performance, not just costs, building on the initial steps with the star system.

Letter to Senator Sessions  
March 5, 2012  
Page 2

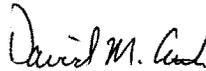
Since only one-quarter of Medicare beneficiaries are in the Medicare Advantage program, reform of the traditional Medicare program is urgently needed as well. Indeed, by numbers it is more important than the Medicare Advantage program. Thus, the second step is to reform the traditional Medicare program so that it becomes higher quality and lower cost. We discussed many of the issues here during the hearing. To highlight a couple of salient topics, I think payment reform to replace fee-for-service reimbursement with bundled payments, and better monitoring and dissemination of quality are both essential.

You raise the issue of whether the same entity that operates the traditional Medicare program should also run the Medicare Advantage program. This is a very important question on which I do not have a firm view. On the one hand, running an insurance exchange and operating a health plan are two different activities. On the other hand, one does not want to proliferate agencies, each with its own administrative structure and costs. I would welcome more discussion of this issue.

Regardless of the division of these responsibilities, I think it is essential that Congress delegate more responsibility for running the traditional Medicare program to technical experts, and use legislation as sparingly as possible. Congress should set system goals – the general split between government and individual payments, the types of services that must be provided or should not be offered, etc. – and then leave the operation to others. The current strategy is the equivalent of having Congress vote on every detail of a new fighter jet. Such a system would not work, in much the same way that the current Medicare program does not work.

Thank you for your interest. I would be pleased to discuss these matters further.

Sincerely,

A handwritten signature in cursive script that reads "David M. Cutler".

David Cutler



# **TAX REFORM TO ENCOURAGE GROWTH, REDUCE THE DEFICIT, AND PROMOTE FAIRNESS**

**THURSDAY, MARCH 1, 2012**

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

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, Whitehouse, Sessions, Grassley, Thune, Toomey, Johnson, and Ayotte.

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. I very much appreciate the participation of these witnesses.

Today's hearing will focus on tax reform. Our hearing is titled, "Tax Reform to Encourage Growth, Reduce the Deficit, and Promote Fairness." We have, I think, three really outstanding witnesses this morning.

Dr. Len Burman is the Daniel Patrick Moynihan Professor of Public Affairs at the Maxwell School at Syracuse University. Dr. Burman is a former director of the Tax Policy Center at the Urban Institute, the Brookings Institution, and a former Deputy Assistant Secretary for Tax Analysis at the Treasury Department during the Clinton administration.

Dr. Diane Lim Rogers is the chief economist at the Concord Coalition. Dr. Rogers previously served as the chief economist on the House Budget Committee and the House Ways and Means Committee and has a distinguished background as well.

Dr. Daniel Mitchell is a senior fellow at the Cato Institute. Dr. Mitchell was an economist for Senator Packwood and the Senate Finance Committee. I can tell you Senator Packwood is somebody that I worked with very, very closely. For many years we co-chaired a deficit reduction caucus here in the Senate. We met very faithfully for many years and I think played a constructive role in the deficit reduction plans that actually produced a balanced budget, and there was no more faithful participant than Senator Packwood. I have never forgotten that. So, Daniel, I do not know if you staffed him in some of those efforts, but I am forever grateful.

Welcome to all of you. We look forward to your testimony. I believe tax reform has to be part of the solution to the Nation's long-term budget crisis. We need a comprehensive deficit reduction plan. We need to address discretionary spending. We need to reform our entitlement programs. We need fundamental tax reform that makes the Tax Code simpler and more fair, improves U.S. competitiveness, lowers rates, and, I believe, raises additional revenue for deficit reduction.

The state of the Tax Code is simply indefensible. This current Code was originally designed in the 1920s when we faced a very different global environment. It is completely out of date. It is inefficient; it is hurting our ability to compete on a global basis.

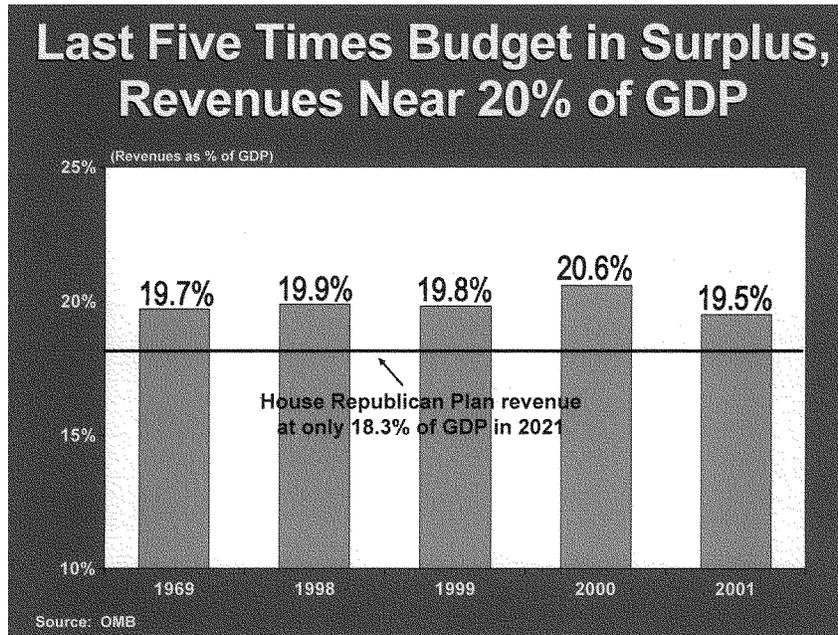
**The Need for Tax Reform**

- 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

In addition, it is, I believe, hemorrhaging revenue from the tax gap, tax havens, and abusive shelters. It is riddled with expiring provisions which create enormous uncertainty for citizens and businesses and makes it more difficult for all of us to plan. And by simplifying and reforming the Tax Code, we could actually reduce tax rates, as Simpson-Bowles recommended, while still raising additional revenue to address our long-term fiscal imbalances.

I believe it is clear we need more revenue. Revenue in 2011 was about 15 percent of GDP, near the lowest level in 60 years as a share of our national income. Some of my Republican colleagues have argued that revenues should not exceed 18 percent of GDP because that is the historic average. But I would remind them, on the five occasions when the budget has been in surplus since 1969, revenues have not been 18 percent. Revenues have ranged between 19.5 percent of GDP and 20.6 percent. We will likely need even higher revenue levels in the future because the country now faces

an unprecedented demographic situation with the retirement of the baby-boom generation.



Adopting fundamental tax reform would also help spur economic growth and create jobs. Here is how CBO Director Doug Elmendorf described the economic benefit of tax reform in his testimony before the Senate Budget Committee last month, and I quote: “I think analysts would widely agree that reform of the Tax Code that broadened the base and brought down rates would be a positive force for economic growth, both in the short term and over a longer period. Scaling back tax expenditures should be at the heart of any tax reform we consider. Tax expenditures are the countless preferences, loopholes, credits, deductions, and exclusions that have riddled the Tax Code for years, both for individuals and corporations. Tax expenditures are really just spending by another name.”

## CBO Director Elmendorf on Economic Benefit of Tax Reform

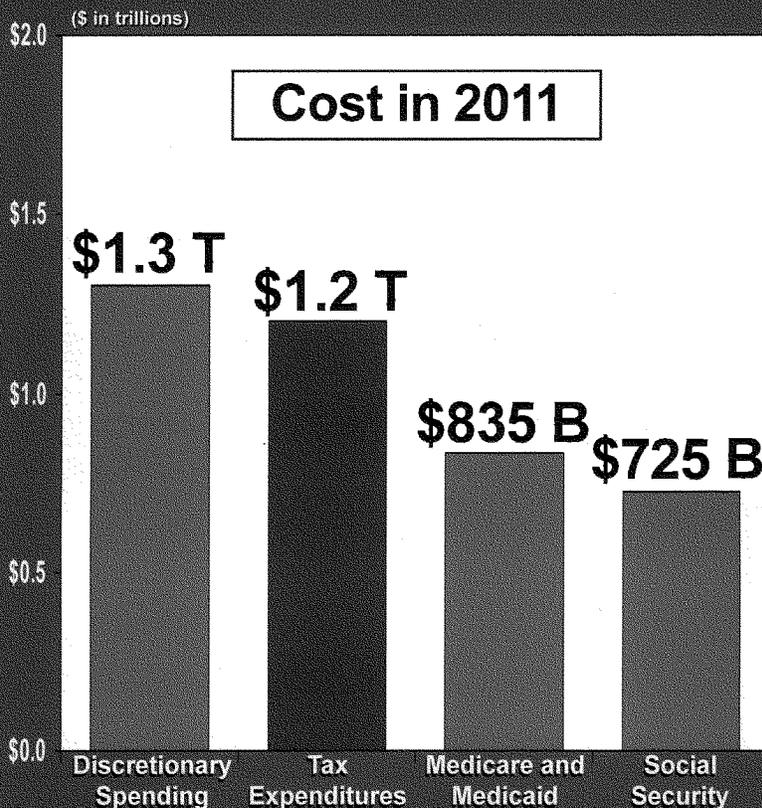
**“I think analysts would widely agree that reform of the tax code that broadened the base and brought down rates would be a positive force for economic growth, both in the short term and over a longer period.”**

— Congressional Budget Office Director Doug Elmendorf  
Testimony before Senate Budget Committee  
February 2, 2012

Much of the complexity of the current Code can be traced to the proliferation of these provisions, and I can say to you—I am on the Finance Committee as well—they get very little review. They get much less review than the appropriated accounts. By scaling them back, we could simplify the Code, reduce rates, and vastly improve the economy’s efficiency and, I believe, our competitive position.

The cost of tax expenditures is simply staggering. In 2011, we spent \$1,200,000,000 on tax expenditures. That is almost as much as we spent on all of discretionary spending and more than we spent on Medicaid, on Medicare, and Social Security.

## Comparing Cost of Tax Expenditures and Other Federal Spending



Source: JCT, CBO, SBC

Here is how conservative economist Martin Feldstein described tax expenditures in an opinion piece in the Wall Street Journal, and I quote: "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-based subsidies would also greatly simplify tax filing."

I am just in the midst of working on my own tax return. Anything that would simplify that, hallelujah.

## Economist Feldstein on Need to Reduce Tax Expenditures

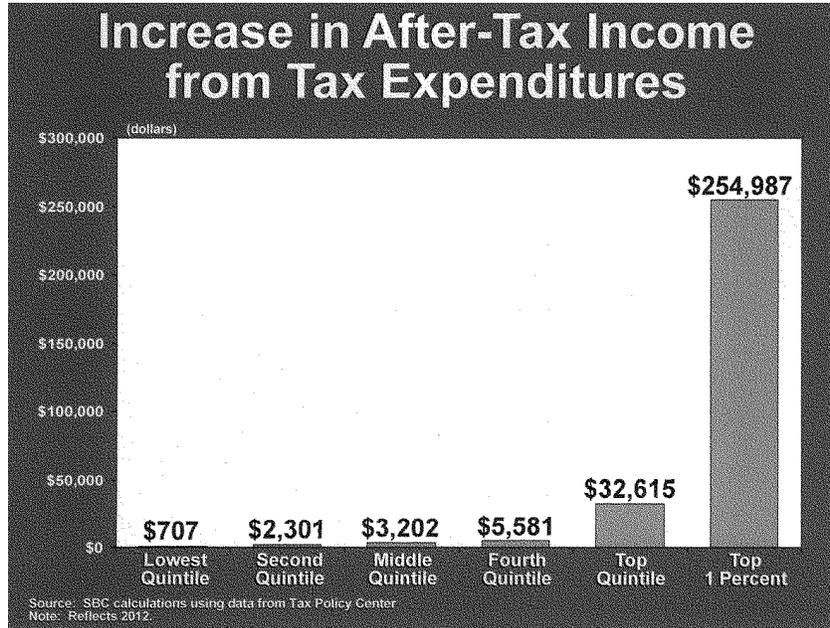
"Cutting tax expenditures is really the best way to reduce government spending.... [E]liminating tax expenditures does not increase marginal tax rates or reduce the reward for saving, investment or risk-taking. It would also increase overall economic efficiency by removing incentives that distort private 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 Advisors under President Reagan  
 "The 'Tax Expenditure' Solution for Our National Debt,"  
*Wall Street Journal*  
 July 20, 2010

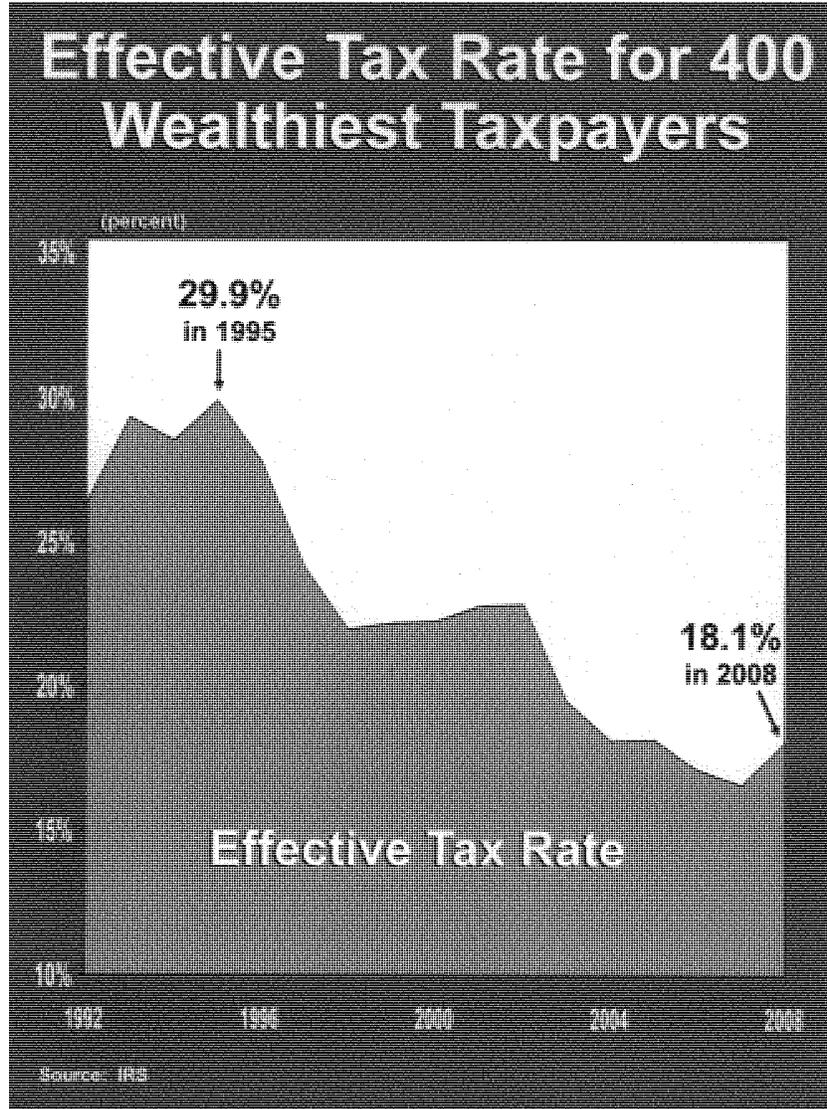
"In short"—this is going back to Mr. Feldstein—"cutting tax expenditures is not at all like other ways of raising revenue."

I think Dr. Feldstein has it about right. Scaling back tax expenditures also has the benefit of improving the fairness and potentially the progressivity of the Tax Code. Tax expenditures are clearly worsening the disparity between how those who are the best-off among us are taxed compared to everyone else.

If we look at the increases in after-tax income from tax expenditures, we can see that the top 1 percent will receive about \$255,000 from tax expenditures in 2012. In comparison, the middle quintile, the 20 percent that are in the middle of the income distribution, will receive about \$3,200 from tax expenditures.



One of the results is that the effective tax rate for the wealthiest in the country, the rate actually paid after factoring in exclusions, deductions, credits, other preferences, has fallen dramatically. The effective tax rate for the 400 wealthiest taxpayers fell from almost 30 percent in 1995 to 18.1 percent in 2008. I believe the Fiscal Commission provided a useful framework for the kind of fundamental tax reform that we need to consider.



Here are the key elements of the tax reform included in the Bowles-Simpson plan:

## 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

One, the plan eliminates or scales back tax expenditures and lowers tax rates.

Two, it promotes economic growth and improves America's global competitiveness.

Three, it makes the Tax Code more progressive.

Four, the Commission's report included an illustrative tax reform plan that demonstrates how eliminating or scaling back tax expenditures can actually lower rates. Instead of six tax brackets for individuals, the plan includes just three: 12 percent, 22 percent, and 28 percent. The corporate rate would also be reduced from 35 to 28 percent. Capital gains and dividends would be taxed as ordinary income. The mortgage interest and charitable deductions would be reformed, better targeting these tax benefits. The child tax credit law and the earned income tax credit would be preserved to help working families. And the alternative minimum tax would be repealed. Hallelujah again. The Commission's plan also increased revenues to 21 percent of GDP by 2022.

That is the kind of tax reform framework that I believe we need to consider. 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 more revenue. And, again, I want to go back to the fundamental question of economic growth. Economic growth. We need to focus like a laser on what will help grow our economy, what will help us be more competitive as a Nation.

With that, I will turn to Senator Toomey, who is filling in for Senator Sessions this morning. We will go to Senator Toomey for his opening remarks, and I want to welcome him to the Ranking Member's chair.

**OPENING STATEMENT OF SENATOR TOOMEY**

Senator TOOMEY. Thank you very much, Mr. Chairman, and I, too, would like to thank the witnesses for joining us today. I appreciate the fact that you have decided to convene this hearing. I think this is a very important topic, and I could not agree more that fundamental tax reform is critical to maximizing economic growth and solving our really very, very challenging budget deficit problems. So I am looking forward to this discussion.

I also want to reiterate my appreciation for your interest in pursuing a budget. I very strongly believe that is a fundamental responsibility of not only this Committee but the full Senate, and I certainly hope we will pursue that.

There are three items, really, that I would hope we can explore this morning in particular with respect to the Tax Code. One is efficacy, especially from the point of view of maximizing economic growth, achieving a healthy economy. A second is fairness, which is something that the testimony from the various witnesses touches on fairly extensively. And then, finally, some specific reform ideas. Let me just briefly touch on each of these, if I could.

In terms of a Tax Code that maximize economic growth, we do have some differences of opinion, and some of them are fairly fundamental. In Dr. Rogers' testimony, there is a segment where she suggests that—and I am just going to quote briefly, and I know you will have a chance to elaborate and comment on this. But you say that, “we shouldn't worry much about higher taxes having large dampening effects on demand if those tax increases are mostly on higher-income households with low marginal propensities to consume.”

I really wonder if that is not the wrong way to look at the challenge that we face, and I say that for several reasons. Number one, my concern is this fails to acknowledge that a lower propensity to consume also occurs with folks who have a higher propensity to invest, and I think that it is investment more than anything else that drives economic growth.

Secondly, I think here sometimes in Washington we obsess about encouraging demand, which is encouraging consumption. In fact, prosperity is not equivalent to consumption. If you ask me, prosperity corresponds more to production. And so just as a family or a business that is having hard times, I think we would seldom suggest the thing to do is go out and borrow a lot of money and spend it because if you do, you will have more things. But are they more prosperous? Is that a family or business that is economically in better shape?

No, exactly the opposite. A family or business would be in better shape if they became more productive, and then they have the ability to consume.

So I think consumption follows production, not the other way around, and I hope that we will address how we can find ways to use the Tax Code to create the greater incentives for more productivity, focus more on the supply side than on the demand side.

On the fairness, I think we have some definitional differences. I rather like Dr. Mitchell's definition that he offered regarding a fair tax system as one that treats everyone equally. I think a lot of Americans would probably find that intuitively reasonable.

I would suggest another way to look at it, which is not inconsistent, would be that fairness involves earning one's reward through honest effort. That is a reasonable way to look at fairness.

We are going to inevitably talk about progressivity, and one of the things that I hear frequently is that we need a more progressive Tax Code. But I think we should observe that by the most meaningful measures, the Tax Code has never been more progressive than it is today; and our Tax Code is more progressive than virtually everyone else in the world. And the most meaningful measure, I think—and I would like to hear the witnesses' view on this—is the ratio of income taxes paid to income earned as a percentage of total income taxes paid and total income earned. I think that is the most meaningful metric. And by that metric, certainly the top 10 percent, I think virtually any subset at the high end, is at an all-time high, or very nearly so, and the trend is unambiguously upward.

At the same time, we have the greatest percentage of Americans ever, or at least in recent decades, who pay no income taxes whatsoever. And so that combination being the case, it strikes me as odd that people's notion of fairness is that we need further concentration, a greater percentage of Americans who pay nothing at all, and a greater percentage of the total burden concentrated on the people who are paying the most already. That strikes me and many people, I think, as a little counterintuitive.

One last point on the fairness is something that I think is really important, and that is, the income inequality. There is no question that is real. It has grown. It is big. I think we ought to ask ourselves what is the cause, and it seems to me the biggest contributing factors are a substantial number of Americans who, through a lack of adequate education and skills and in some cases habits, simply are not able to fully participate in the economy and are not able to enjoy the many opportunities that are out there. And we ought to be asking ourselves what can we be doing to help these folks fully engage, fully participate, and fully benefit. But it is not at all clear to me that confiscating more income from productive Americans does anything to help those folks who are not fully able to participate.

Lastly, on the specific reforms, I agree with several of the points that the Chairman made. Certainly maximizing growth with a system that is consistent with most Americans' idea of fairness, I think that is probably the most important objective.

I think it is also important for the Government not to be picking winners and losers, for politicians not to be deciding what activities should be subsidized and which ones should be favored and which ones should not.

I absolutely agree that to achieve those things we should be broadening the base and lowering rates, and in my service on the super committee, I proposed an approach that was consistent with what the bipartisan commission looked at and one that would, in fact, have broadened the base, would, in fact, have lowered marginal rates. And, in fact, I have been a big fan of a mechanism to reduce the value of deductions to generate offsetting revenue that was developed by Marty Feldstein and Maya MacGuineas, which I

think is one of many possibilities but a particularly constructive way to do it.

So these are some of the things I hope we will be able to develop, Mr. Chairman. I appreciate the witnesses and I appreciate your having the hearing today.

Chairman CONRAD. Well, I appreciate your statement. I think it was thoughtful and serious, and that is what we need more of around here. It would be a good thing for the entire institution to have these discussions at this level of seriousness.

With that, we will go to Dr. Burman. Welcome. Good to have you here. Please proceed with your testimony.

**STATEMENT OF LEONARD E. BURMAN, PH.D., DANIEL PATRICK MOYNIHAN PROFESSOR OF PUBLIC AFFAIRS, MAXWELL SCHOOL, SYRACUSE UNIVERSITY**

Mr. BURMAN. Thank you, Chairman Conrad and Senator Toomey. I love talking about tax reform. Actually, listening to the two of you in your opening statements, it sounds like the divisions are really not that great. If we could just set up the rules so that you could just pass something today, we would be in much better shape as a country.

Senator Conrad, Senator Toomey, Senator Wyden—who is not here, but who serves on the Committee—you have all had real leadership on the issue of tax reform and taming the budget, and I really appreciate your bringing this issue to where it needs to be on the national agenda.

It is certainly true that the Tax Code desperately needs reform. That is one thing I think everybody agrees about. It is unfair, it is inefficient, it is mind-bogglingly complex, and it does not come close to raising enough revenue to pay for the Government.

The objectives you set out for this hearing are exactly the right ones. We need to encourage growth, we need to reduce the deficit, we need to promote fairness. And I would add one more, which is we need to simplify it so that we do not go crazy at tax time and we actually can understand how the tax system affects us.

Economists often talk about a trade-off between economic growth and fairness, and tax reform actually gives you an opportunity to—in tax reform there is not necessarily a trade-off, and I think Chairman Conrad made this point: that if we can broaden the base and lower rates, we could raise revenue, which would reduce the deficit, which is a huge threat to prosperity, and we would improve economic individuals by not picking winners and losers, as Senator Toomey said.

The other thing is that we do have to be aware of issues of fairness and inequality, and I think extreme inequality, which the United States has verged towards in recent years, is itself anathema to economic growth. There is a lot of evidence that unequal economies grow more slowly than ones where there is more equality.

The pro-growth tax reform, eliminate loopholes and preferences, curtail tax expenditures, lower rates, raise enough revenue to pay for the Government. The last point is really important, as you are well aware. The ballooning public debt could do tremendous harm to the economy. The fact that tiny Greece's debt crisis roiled the

world economy is really disconcerting. If the U.S. were foolish enough to follow in Greece's path, our collapse would be cataclysmic. We are the richest country in history, and we would bring down the entire world economy. And you could imagine the depression that would last for a generation.

Talk about things to boost economic growth, and one thing that the deficit threatens to do in the future—not while the economy is as weak as it is now but over time—is it will push up interest rates, and higher interest rates could do more to hurt investment and economic growth than anything you would do in the tax system, even if you raised marginal tax rates.

Economists like the idea of lower tax rates, but they are not a panacea, and they can be downright counterproductive if they produce budget deficits if you cannot do the base broadening to offset the effect of the lower rates.

Studies by the nonpartisan staffs of the JCT, CBO, and Treasury—all who were under Republican appointees at the time—concluded that deficit-financed tax cuts ultimately sap the economy if they lead to higher tax rates in the future.

There really seems like there should be a bipartisan basis for tax reform that is associated with deficit reduction for a couple of reasons. One is that “starve the beast”—this theory that if you just constrain Federal revenues, Government would be smaller—clearly is not working. In the Bush administration, this was the operating principle, and what seemed to happen was that deficit financing was contagious. It was not just deficit financing for tax cuts, but it was deficit financing for wars, a new drug benefit, the Bridge to Nowhere. Basically the idea was that you do not have to pay for Government because we are not going to raise taxes. I think if you actually said that taxes would go up when Government got bigger, that would be much more of a constraint to the size of Government than saying, well, we will never raise taxes under any circumstances.

The other issue is tax expenditures, which you both touched on. Tax expenditures are spending, and so far they have had a really privileged status in the budget process. If you propose a new spending program run through the Tax Code, that is a tax cut, and that is something you can get bipartisan agreement for. If you propose a comparable new spending program, which might be much more efficient, that is Big Government and that is bad.

I actually made this point at a hearing with Martin Feldstein 10 years ago, and he looked at me and he said, “So we have really been complicit in messing up the Tax Code and the growth of Government.” And I said, “Yeah.”

You know, among economists—not all of them. I suspect Dr. Mitchell might disagree with me on this. But among economists there is a lot of agreement that reining in tax expenditures is a good idea. I have a paper where I try to model the effect of treating tax expenditures as tax cuts rather than more spending. And what you end up with is that people perceive tax expenditures as basically Government spending at a discount. And people like things that they can get for free or that they do not have to pay for, so you end up with much more in the way of tax expenditures because people do not actually perceive the full size of Government. You

might even get more in the way of direct spending, too, because they do not see that they are actually paying for these things. So you have bigger Government. It is more inefficient because you have a lot of things run through the Tax Code that actually ought to be run through direct spending programs. And this is something that conservatives ought to care about, and liberals ought to care about it as well because if tax expenditures have privileged status, then when you talk about cutting the budget, you are focusing on things that help lower-and middle-income people a lot more, and you are leaving out these programs that are more like the mortgage interest deduction, which mostly benefits high-income people and actually might well be counterproductive.

There is some evidence on taxpayers' perceptions about these things. There is a survey by Pew of taxpayers' views about tax reform. There is some good news. One is that 59 percent of respondents favored a major overhaul of the tax system. They did not ask what kind. That is, of course, where you run into problems. Fifty-seven percent said that they thought that the wealthy were not paying their fair share and that that is the top problem.

Senator Toomey talked about progressivity. I guess I do take a different view of the data. It is certainly true that higher-income people are paying a larger share of taxes than they have in the past. But that is because they have earned so much more of the income than the rest of the population. Their incomes have soared. A big problem, even if you do not care about equity, just from the perspective of democracy, is that if 80 percent of people see themselves as not benefitting from economic growth, they see almost all the gains going to people at the top, ultimately that is unsustainable, and they will support things that will really sap economic growth: trade barriers, more regulations, and things like that.

The income tax is not the whole solution. I completely agree that we need to deal with underlying causes, fundamentals, education, other things that are barriers to opportunity. But the Tax Code can help, and in particular, the Tax Code serves an important role in helping lower-income people.

There is a chart in my testimony showing poverty reductions from different programs, and the biggest poverty reduction, especially for children, 4 percentage points, is from the earned income tax credit. And when you take on tax reform, that needs to be a major priority.

Actually, I could go on for hours, but my time has expired. I would be happy to answer your questions, and thank you again for inviting me.

[The prepared statement of Mr. Burman follows:]

Embargoed Until 10am  
March 1, 2012

Statement of

Leonard E. Burman  
Daniel Patrick Moynihan Professor of Public Affairs  
Maxwell School  
Syracuse University

Before the  
Senate Budget Committee

Tax Reform to Encourage Growth, Reduce the Deficit, and Promote Fairness

March 1, 2012

Chairman Conrad, Ranking Member Sessions, Members of the Committee: Thank you for inviting me to share my views on tax reform.

The tax code desperately needs reform. It is unfair, inefficient, mind-bogglingly complex, and doesn't come close to raising enough revenue to pay for the government. I'm tempted to say that it couldn't be worse, but sadly that is not true. Some proposals masquerading as reform would increase the deficit, thereby undermining our economy, and are also deeply unfair. Thus, it is not only imperative that we reform the tax system, but that any reform meet the objectives you set out in the hearing title: encourage growth, reduce the deficit, and promote fairness. I'd add one more goal—simplify the tax system so that ordinary Americans can understand it.

Economists often talk about a trade-off between fairness and economic growth, but you have an opportunity to simultaneously advance both objectives with tax reform. For example, the standard prescription of broad base and lower rates can be a win-win for fairness *and* growth. Moreover, extreme inequality is itself anathema to economic growth. The tax system mitigates inequality and tax reform would be a failure if it undermined that important role.

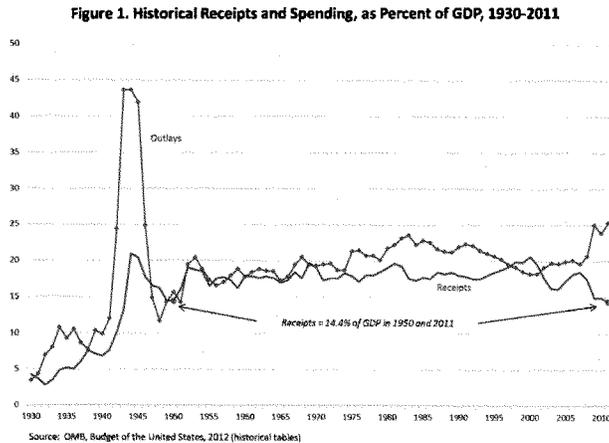
In my testimony today, I will talk about the relationship between tax reform and economic growth, tax revenues, and fairness. Then I will discuss some models for tax reform and how capital gains should be taxed in a reformed system. I will conclude by looking at policy options if the kind of massive base broadening in the Bowles-Simpson plan proves to be infeasible.

### Tax Reform and Economic Growth

A better tax system would be good for the economy. Loopholes, complexity, continuing deficits, and high marginal tax rates all entail an economic cost. Loopholes and preferences sap the economy because individuals and businesses are spurred to make bad economic decisions solely because of the tax rewards they bring. Thus businesses are less productive than they could be. Moreover, the geniuses who invent schemes to exploit loopholes might be doing socially productive work—like figuring out how to produce products that people around the world would like to buy—if they weren't devoted to engineering tax shelters.

The cost of compliance with the individual and corporate income taxes will be roughly \$200 billion in FY 2012. Not all of that reduces GDP—more than half of that estimate represents the time individuals spend keeping records, learning about the law, and completing returns—but it all represents an economic cost. If the law were simpler, Americans would have more time to pursue other activities, and companies could invest less in their tax departments and more in innovation.

Perhaps the biggest failure of the tax system is that it hasn't come close to paying for the costs of government for the past dozen years. To be sure, I'm not advocating that the budget be balanced every year. It makes sense to run deficits during recessions to help spur the economy, but the budget should be close to balance over the business cycle. Currently, revenues are at their lowest level since the Truman Administration. (See figure 1.) OMB and CBO project a slight improvement as the economy recovers, but then the red ink comes back with a vengeance.



As the members of this committee know well, ballooning public debt could do tremendous harm to the economy. The fact that tiny Greece's debt crisis roiled the world economy is especially disconcerting. If the US were foolish enough to follow in Greece's path, our collapse would be

cataclysmic. We are the richest country in history—and intricately connected with all the other major nations. If we failed, we would bring down the rest of the world economy with us. I never want to find out how that plays out.

Finally there is the issue of marginal tax rates. One of the singular accomplishments of the Tax Reform Act of 1986 was the dramatic reduction in marginal tax rates. The tax rate on the wealthiest individuals fell from 50 percent to 28 percent and the corporate tax rate was cut from 46 percent to 34 percent. This was done without sacrificing revenues or progressivity because a host of tax breaks and loopholes were eliminated. As you know, that was also the approach taken by the president's fiscal commission, on which Chairman Conrad and Senator Crapo served, and the Bipartisan Policy Center's Debt Reduction Task Force, on which I served.

Lower tax rates are not the economic panacea that supply siders make them out to be—and can be downright counterproductive if they produce budget deficits—but in a fiscally responsible setting, they produce tangible economic benefits. The tax rate is a good barometer of the incentive to avoid taxes. At a 50 percent tax rate, every dollar of income hidden from the tax authorities saves 50 cents in tax. At a 25 percent tax rate, tax avoidance is half as profitable. Thus tax shelter schemes become more and more profitable as tax rates rise and diminish in value as rates fall. We will never have a perfect tax system, but the cost of our tax system's imperfections diminishes at lower rates.

However, if low tax rates are accompanied by larger deficits, any short-term economic gains may prove illusory. Even if lower tax rates boost the economy in the short run, the much higher tax rates required to pay back the resulting debt with interest in the future will entail a far bigger economic cost than setting rates at the level required to tame deficits and keeping them there. Studies by the nonpartisan staffs of the JCT, CBO, and Treasury (all under Republican appointees) concluded that deficit-financed tax cuts ultimately sap the economy if they lead to higher tax rates in the future.

Policymakers must figure out what government needs to do and, after the economy has recovered from the recession, pay for it. That will probably require higher tax rates or significant tax reform.

### **Tax Reform and Revenues**

As you well know, the question of whether tax reform should raise revenues is highly contentious. Some point to the precedent of the Tax Reform Act of 1986, which was designed to be revenue-neutral, as a rationale for holding the line on tax revenues now. I believe that revenue-neutral tax reform now would have no chance of passage. In 1986, although the whole package did not increase revenues, a large corporate tax increase financed large cuts in individual taxes. This was feasible because the corporate tax code was riddled with costly tax preferences and investment subsidies. Corporate CEOs and shareholders were more than happy to trade corporate tax increases for substantial cuts in their own tax rates. But I think a substantial corporate tax increase would be infeasible and undesirable at a time when our corporate tax rates are the highest in the world.

And revenue-neutral reform of the individual income tax would necessarily mean that some, and probably many, individuals would pay higher taxes. The losers would strongly oppose the reform, probably dooming it to failure.

Moreover, as the Chairman has articulated well, we need more revenues. The retirement of the baby boomers and soaring healthcare costs mean that there will be enormous pressures on spending. Unless you are prepared to renege on the promises we have made to seniors, eviscerate the social safety net, and weaken our national defense, we will need more revenues (as well as spending cuts, especially in entitlements). House Budget Committee Chairman Ryan has done a great service to the nation by putting forward a plan that would eventually balance the budget with spending cuts alone. The plan shows just how draconian those cuts would have to be, and the public response to that plan suggests that a spending-only solution is utterly infeasible.

Some argue that limiting federal revenues is the only way to restrain government spending. That was certainly the operating principle of the previous Administration.

Although this argument—sometimes called “starve the beast”—appears plausible, it is hard to imagine that spending could have been higher as the Bush tax cuts slashed revenues. Government grew much faster from 2001-2009 than during the Clinton Administration. While some of that was war-related, nondefense discretionary spending also sped up and the largest expansion in Medicare since its inception was enacted.

It appears that instead of constraining spending, deficit financing was contagious. If deficits don't matter when considering tax cuts, why should they be considered when evaluating a new drug benefit or a “bridge to nowhere?”

The late William Niskanen posited a public choice critique of “starve the beast” when he was president of the libertarian Cato Institute. If deficits finance 20 percent of government spending, then citizens perceive government services as being available at a discount. Services that are popular at 20 percent off the listed price would garner less support at full price.

Niskanen found strong statistical support for the hypothesis that higher revenues constrain spending in a time series regression of revenues against the change in spending between 1981 and 2005. Another Cato researcher, Michael New, tested Niskanen's model in different time periods and using a more restrictive definition of spending (non-defense discretionary spending) and found the earlier results to be robust.

Niskanen and New might actually have understated the effect of deficits on spending. The message during the last decade seems to have been not that spending and tax cuts were available at a discount, but that they were free. Spending for wars, Medicare expansion, and “no child left behind” happened at the same time that taxes were falling. Citizens could be forgiven for forgetting that there is any connection between spending and taxes.

My guess is that if President Bush had announced a new war surtax to pay for Iraq or an increase in the Medicare payroll tax rate to pay for the prescription drug benefit, both initiatives would have been less popular. Given that the prescription drug benefit only passed Congress by one

vote after an extraordinary amount of arm-twisting, it seems unlikely that it would have passed at all if accompanied by a tax increase.

Starve the beast doesn't work. Disillusioned conservative Bruce Bartlett called it "the most pernicious fiscal doctrine in history."

I also think that revenue-increasing tax reform would be more popular than a revenue-neutral package because Americans have embraced the notion of shared sacrifice when they supported the underlying objective. For example, in the past, we have supported tax increases to finance wars. As Joint Chiefs of Staff Chairman Admiral Michael Mullen has said, "The most significant threat to our national security is our debt." A tax reform that raised revenues, reduced the debt, and simplified the tax system in a fair way could be sold to the American public, especially if it had bipartisan support among policymakers. The Bowles-Simpson and Bipartisan Policy Center plans are both good examples of such plans.

### **Tax Reform and Fairness**

Fairness is an essential element of a good tax system. There are two elements of fairness—one is to treat people in similar positions the same way. Broadening the base and eliminating unwarranted subsidies (and penalties) helps to advance that goal.

The other is to require a larger proportional contribution from those who are better off than those with more modest means. This objective, sometimes called progressivity, is more subjective. However, surveys suggest that the public supports more progressivity—at least at the top of the income scale. Pew commissioned a survey in December 2011 (table 1) that found that 57 percent of respondents felt that the wealthy do not pay their fair share of taxes. By comparison, 28 percent thought complexity was the most vexing defect of the federal tax system and only 11 percent ranked their own tax burden as the top concern. This suggests that the public would favor a more progressive tax system—and would be unhappy if tax reform undermined progressivity.

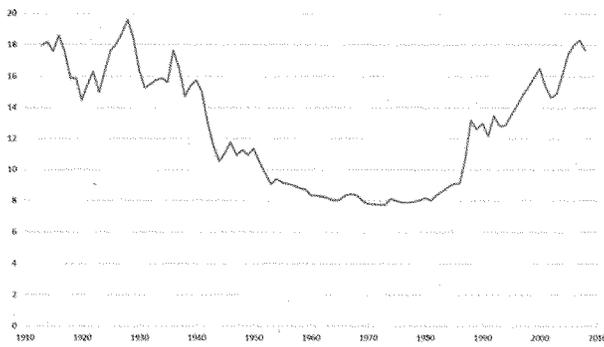
**Table 1. Pew Survey of Views about Federal Taxes**  
Shares in Percent

	<b>Mar 2003</b>	<b>Dec 2011</b>
<i>Federal tax system is ...</i>		
Very/Moderately fair	51	43
Not too/at all fair	48	55
<i>What bothers you most ...</i>		
Amount you pay	14	11
Complexity of system	32	28
Feel wealthy people don't pay fair share	51	57
<i>Tax system ...</i>		
So much is wrong, Congress should completely change	52	59
Works pretty well, Congress should make minor changes	44	34

Source: Pew Research Center, "Tax System Seen as Unfair, in Need of Overhaul," December 20, 2011.

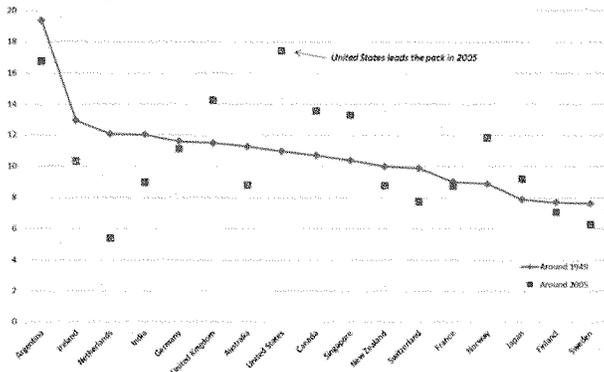
The increasing concern about the tax burdens of the wealthy may be connected to a striking rise in economic inequality. In 2007, before the Great Recession, both income and wealth inequality had reached the highest levels in almost 80 years. For example, data collected by economists Thomas Picketty and Emmanuel Saez (see figure 2) show that, in 2007, the top 1 percent of households earned over 18 percent of all income (excluding volatile capital gains) for the first time since 1929. The income share of the top earners plummeted during the great depression falling below 10 percent from the 1950s through the 1970s before rising steadily starting in the 1980s. Income inequality in the United States is now among the highest in the developed world. (See figure 3.)

**Figure 2. Income Share of Top 1 Percent, Excluding Capital Gains, in Percent, 1913-2008**



Source: Thomas Picketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," *Quarterly Journal of Economics*, 118(1), 2003, 1-39. Updated data at <http://elsa.berkeley.edu/~saez/TabFig2008.xls>.

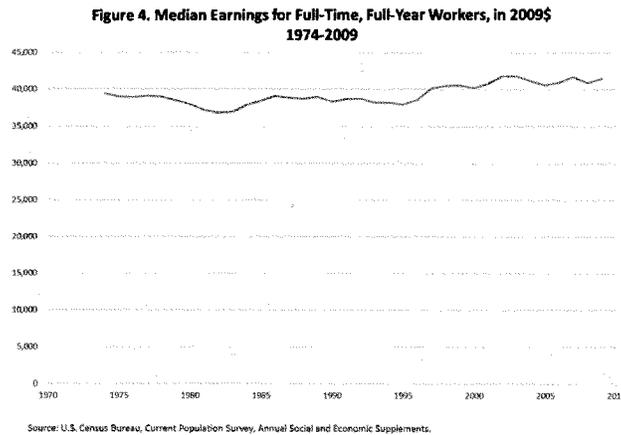
**Figure 3. Top Income Shares in Selected Countries, 1949 vs. 2005**



Tony Atkinson, Thomas Picketty, and Emmanuel Saez, "Top Incomes in the Long Run of History", *Journal of Economic Literature*, 49(1), 2011, 5-73.

Rising inequality might not be a pressing concern if families at all income levels were gaining ground, but that is patently not the case. The middle class in the United States has experienced almost no income growth for the past 30 years. Incomes by a variety of measures have grown barely faster than inflation. For example, figure 4 shows that median earnings for full-time, full-year workers grew by only 0.15% per year from 1974 to 2009 after adjusting for inflation. Some point out that total compensation has grown faster because most workers still get health insurance at work and the cost of health insurance has far outstripped inflation. But I doubt that workers perceive more economic gain when it's explained that almost all of their pay increases have gone to pay for increasingly expensive health insurance.

If economic mobility in the U.S. were high, inequality would be less troubling since everyone would have a similar chance at success, but that is also inconsistent with the evidence. Children of rich parents are much more likely to grow up rich than children of lower-income people. Upper-income children have access to better schools, live in safer communities, and when they grow up, have better connections to help them succeed.



While I view rising economic inequality as undesirable in its own right, I'd argue that even those who do not care about inequality *per se* should be concerned about this trend. If the bottom 80 percent of the population feels like they're not getting their fair share, that could lead to a populist revolt. Voters might be tempted to support calls for trade restrictions, more regulation, or throwback policies like a return to the gold standard. Any of those responses could be extremely detrimental to economic growth. For that reason, those who benefit most from the current system have an incentive—completely beyond any notion of altruism—to try to mitigate extreme inequality in ways that entail less economic cost.

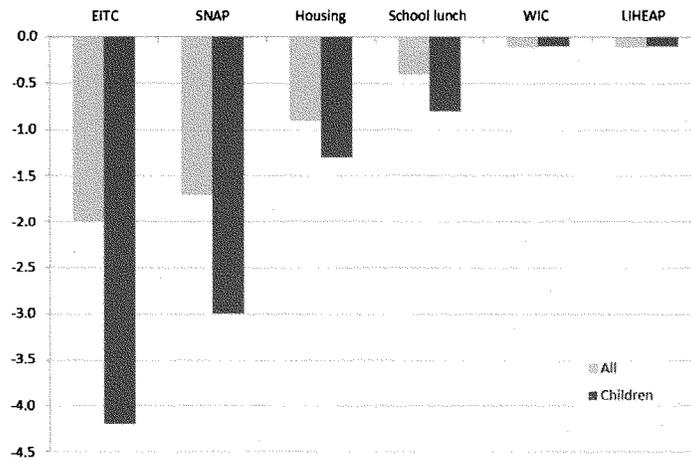
What's more, development economists have long observed that very unequal economies grow slower than economies with less skewed income distributions. There has been debate about whether economic inequality causes slower growth. It is possible that the causality goes in the

opposite direction because richer countries can afford better public education and other services that boost economic opportunity for those with low incomes. But a study by economist William Easterly concludes that inequality causes slower growth because poor families cannot afford to invest in their own or their children's human capital, which makes for a less productive workforce.

To be sure, the best approach is to provide more economic opportunities, especially better and more affordable education, but not everyone can or should go to college. The income tax plays an important auxiliary role. It's not the perfect solution because it adjusts outcomes rather than opportunities, but equalizing opportunity is simply impossible. Some people are born smart, rich, good-looking, or with the ability to jump very high or throw a baseball very fast.

There is one more aspect of fairness: the income tax is now a critical component of the safety net. The Census Bureau recently developed a new alternative measure of poverty that accounts for the effect of tax and transfer programs on poverty levels. (Astoundingly, under the standard measure of poverty, anti-poverty programs can't reduce poverty because they are not counted in families' incomes.) The single most effective program at reducing poverty in 2010 was the Earned Income Tax Credit (EITC). It reduced overall poverty rates by 2 percentage point and the child poverty rate by 4.2 percentage points. (See Figure 5.) Overall, this single program cut child poverty by more than 20 percent. It encourages work and helps a significant fraction of working families and children escape poverty.

**Figure 5. Effect of Selected Government Programs on Poverty Rates in 2010**



Source: Kathleen Short, "The Research Supplemental Poverty Measure: 2010," US Census, Current Population Reports, P60-241, November 2011.

While the EITC and other tax provisions helping low-income working families such as the child tax credit could certainly be simplified, a fair reform would preserve the tax-based safety net that so many low-income families and children rely upon.

### **Models for Tax Reform**

I will not go into detail in this testimony about how to reform the tax system. There are many good models. The Wyden-Coats Bipartisan Tax Fairness and Simplification Act of 2011 would significantly simplify the tax code by eliminating the unfair and pointlessly complex alternative minimum tax, eliminating a number of loopholes and preferences, and consolidating and simplifying some of the remaining tax subsidies. Senator Wyden has been a steadfast advocate of tax reform and I applaud his efforts with Senator Coats to move tax reform onto the agenda.

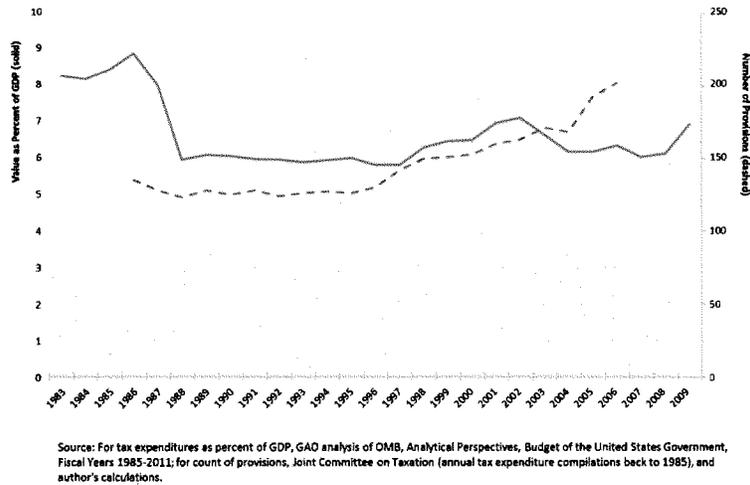
For reasons I outlined above, I think that tax reform should contribute to deficit reduction. The proposals of the Bowles-Simpson commission and the Bipartisan Policy Center (BPC) task force both would have closed a portion of the deficit through higher revenues. The two plans had a number of features in common. They both would massively broaden the tax base while slashing individual and corporate income tax rates, and both were designed to be at least as progressive as current law. As in the Tax Reform Act of 1986, both plans would eliminate the differential in tax rates between capital gains and ordinary income. Since capital gains are disproportionately held by those with very high incomes, the increase in tax rate on capital gains offsets the effect of reducing ordinary income tax rates for the wealthy. Like Wyden-Coats, both plans would eliminate the alternative minimum tax.

The BPC plan would simplify the tax system so much that about half of households would no longer need to file a tax return. By turning the popular deductions for charitable contributions and mortgage interest into flat credits, the IRS could pay the tax credit directly to the charity or financial institution at the time a payment is made, eliminating the obligation to claim the credit on a tax return. Withholding by employers and financial institutions would exactly match tax liability for many households.

BPC's plan, unlike Bowles-Simpson, would rely on a new 6.5 percent value-added tax (VAT) as a supplemental source of revenue. Bowles-Simpson gains all of its revenue from base broadening, which is more extensive than in the BPC plan.

The other common feature of the two bipartisan plans is that, arguably, their "tax increases" are accomplished entirely via spending cuts. As you know, a large and growing number of spending programs are run through the tax code in the form of tax expenditures. Somewhere between \$800 billion and \$1.2 trillion of spending (depending on whether you take a broad or narrow view of what qualifies as a tax expenditure) is accomplished via deductions, exclusions, credits, or other tax preferences. The number of tax expenditures increased by 60 percent between 1996 and 2006 (from 126 to 202). (See Figure 6.) Eliminating or scaling back inefficient tax expenditures is a way to reduce the size and scope of government, just as cutting direct spending would do. Both plans would eliminate almost all of these stealth spending programs.

Figure 6. Number and Value of Tax Expenditures, 1983-2009



### Taxing Capital Gains and Dividends as Ordinary Income

A lynchpin of the Tax Reform Act of 1986 and the two recent bipartisan tax reform proposals is that they cut ordinary income tax rates and tax capital gains and dividends the same as other income. This is a very controversial proposal as some view a preferential capital gains tax rate as an essential element of a pro-growth tax plan. My research suggests that this argument is wrong. Lower capital gains tax rates provide enormous opportunities for inefficient tax avoidance and are as likely to harm the economy as help it. What's more, taxing capital gains in full allows for substantial cuts in ordinary income tax rates while maintaining progressivity.

Long-term capital gains (those on assets held at least one year) and qualifying dividends are taxed at a top rate of 15 percent. By comparison, the top tax rate on other income is 35 percent. If Congress does nothing, the rates on gains will increase to 20 percent in 2013 and the top rate on dividends will return to 39.6 percent. The Affordable Care Act included a surcharge on investment income of 3.8 percent, which would raise the effective rates to 24 and 44 percent.

While long-term capital gains have been taxed at lower rates than other income for most of the history of the income tax, dividends have only been taxed at a lower rate since 2003. The argument for a lower dividend tax rate is that corporation income is already taxed at the company level. Taxing the dividends again corresponds to double taxation. A similar argument is often made to justify lower capital gains tax rates. However, the lower rate is a very imperfect offset. While some corporations pay a lot of tax, some are able to use tax breaks to significantly reduce their effective corporate tax rate.

The ideal adjustment for corporate double taxation — at least from the economist's perspective — would be to "integrate" the individual and corporate taxes. In other words, corporate income would be allocated to shareholders and taxed at individual rates. For technical reasons, however, this is much easier said than done.

While double taxation is a plausible rationale for tax breaks on corporate capital gains and dividends, the lower tax rate also applies to non-corporate capital gains. This is harder to justify. Proponents support capital gains tax breaks for several reasons: (1) a significant portion of capital gains simply represents inflation and we shouldn't tax that; (2) a lower tax rate on capital gains encourages risk-taking and entrepreneurship; and (3) high capital gains tax rates create an inefficient "lock-in effect."

None of these arguments is compelling. Although a significant fraction of capital gains represents inflation, that is also true of other forms of capital income and expense. For example, at a 3 percent inflation rate, the first \$3 of interest on a \$100 savings account simply offsets inflation, but it is taxable nonetheless. Interest expense is also understated when there is inflation for the same reason. If capital gains are taxed at lower rates, then interest expense should also be deductible at lower rates. Otherwise, there are large incentives for tax sheltering. (See box.)

Capital gains taxes have mixed effects on risk-taking. To the extent that losses are ultimately deductible (and my research with Alan Auerbach and Jonathan Siegel found that they almost always were), the capital gains tax includes a kind of insurance. Investors have to share gains with the government, but losses are also shared. Moreover, economist James Poterba has found that much of the capital that finances new investment comes from foreigners and pension funds and is thus not subject capital gains taxes and unaffected by capital gains tax breaks.

One other area of concern is the effect of the tax on entrepreneurial activity. In fact, the income tax treats investments of "sweat equity" very favorably. Entrepreneurs do not have to pay tax on the value of their labor until it produces income. Effectively, investments in one's own business are expensed in the sense that tax is avoided altogether on the value of the uncompensated labor invested. Like an IRA or 401(k), this makes entrepreneurial capital tax free. To the extent that entrepreneurial capital ultimately produces returns in the form of capital gains, entrepreneurs effectively pay a negative tax rate on their own labor input

#### The Simplest Tax Shelter

- Borrow \$10 million at 5% interest
- Invest \$10 million that will pay \$10,500,000 in a year
- Borrowing generates \$500,000 interest deduction. At a 35% tax rate, that reduces your federal income tax by \$175,000. (There may also be state tax benefits.)
- The \$500,000 capital gain is taxed at 15%. That adds \$75,000 to your tax bill.
- On net, you save \$100,000.
- Because of the tax savings, this deal would be worthwhile even if the investment paid less than \$500,000 (even though, absent taxes, it would make no sense)

Note: this scheme is so obvious that it is not permitted. However, a whole industry is devoted to finding economically equivalent tax shelters.

*"A tax shelter is a deal done by very smart people that, absent tax considerations, would be very stupid."* -- Michael Graetz, Columbia University Law Professor

because the contributed labor is expensed while the ultimate return is only partially taxed. And capital gains that are considered “small business” might even be taxed at a zero rate.

There is one special case where this extremely favorable tax treatment seems especially problematic: hedge fund managers and private equity investors who have a “carried interest” in a business deal. These transactions have gotten a lot of attention because the people who engage are ultimately taxed at low capital gains tax rates, often on enormous incomes. They argue, with some justification, that their tax treatment is the same as other entrepreneurs (although they should be taxable on the value of the “carried interest” when it is granted them at the outset of the deal). But it offends taxpayers’ sense of fairness that multi-millionaires can often earn giant incomes and pay the same tax rates as lower-income working people.

Treating carried interest like other wage and salary income is one approach to diminishing this inequity. The “Buffett Rule,” which stipulates that millionaires pay an average tax rate of at least 30 percent, is another, but that amounts to creating a new AMT—albeit a better targeted one than the existing provision. A better and more consistent approach would be to tax all capital gains the same as other income.

Another argument made in favor of lower capital gains tax rates is that taxing capital gains produces a “lock-in effect.” It is certainly true that a capital gains tax discourages asset selling. Investors can postpone the tax indefinitely simply by holding. However, my research with William Randolph and the research of other scholars has found that the “lock-in effect” is surprisingly small. This may seem surprising, but one admittedly casual bit of evidence in favor of a small effect may be found on the pages of any financial publication. Not the editorial page, which might rail endlessly against the incentives created by capital gains taxation, but the finance and investing section, which often reports financial strategies that involve much buying and selling with little if any discussion of the tax consequences.

The argument against providing capital gains tax breaks is that removing them could improve both efficiency and equity. Lower capital gains tax rates fuels inefficient tax shelters that entail a significant economic cost. Second, it is unfair and inefficient to favor people like hedge fund managers and investors who earn a substantial portion of their income from capital gains rather than other more highly taxed forms of income. Third, the vast majority of capital gains are realized by people with very high incomes. Thus, tax breaks on capital gains undermine the progressivity of the tax system. (See Table 2.)

Equating the tax rate on capital gains with the tax rate on other income would allow a high degree of progressivity with lower top income tax rates. Indeed, that was what made the 28 percent tax rate on top income possible in the Tax Reform Act of 1986. The Bowles-Simpson and Bipartisan Policy Center’s deficit reduction plans both paired full taxation of capital gains with a substantial cut in top income tax rates, while maintaining progressivity.

Taxing gains and dividends as ordinary income would also significantly simplify the tax code. The alternate rate schedule for capital gains and dividends is needlessly complex. And tax lawyers say that half of the tax code is devoted to defining and monitoring the boundary between tax-favored capital gains and other fully taxed forms of income.

Table 2. Distribution of Net Long-Term Capital Gains and Qualified Dividends, 2010

Cash Income Group	% with Gains	% of Gains	Average (\$)	% with Dividends	% of Dividends	Average (\$)
Lowest Quintile	1.0	0.3	4,008	5.2	1.2	1,013
Second Quintile	1.9	0.5	4,178	8.5	2.9	1,525
Middle Quintile	3.9	1.3	5,493	13.3	4.9	1,843
Fourth Quintile	7.6	3.0	7,792	23.2	8.8	2,283
Top Quintile	21.3	94.1	100,623	48.7	81.6	11,511
All	5.9	100.0	56,690	17.1	100.0	5,923
<b>Addendum</b>						
80-90	14.5	5.1	15,896	38.1	9.9	3,513
90-95	21.0	3.9	17,392	47.8	7.0	4,165
95-99	32.0	15.6	55,460	67.9	18.8	9,460
Top 1 Percent	47.6	69.5	646,110	82.8	46.0	74,281
Top 0.1 Percent	63.9	46.6	3,225,323	90.0	26.8	397,067

Source: Tax Policy Center, <http://www.taxpolicycenter.org/T09-0490>

Additional issues surround the taxation of dividends. The economists' ideal solution to the problem of double taxation is the same as for capital gains: imputation of the corporate tax to individuals. That, however, does not appear to be helpful advice for policymakers in the real world.

Economists Raj Chetty and Emmanuel Saez suggested cutting the dividend tax rate in exchange for raising taxes on corporations. The logic was that this would enhance economic efficiency because it would reduce or eliminate the incentive corporate managers currently have to invest retained earnings in unproductive pet projects rather than pay dividends.

Of course, just as under the individual income tax, raising corporate tax rates amplifies the incentive to engage in tax sheltering. This can be especially damaging to our economy when corporations operate in an international environment. For that reason, Rosanne Altshuler, Benjamin Harris, and Eric Toder of the Tax Policy Center suggested almost exactly the opposite approach: Tax gains in full (up to 28%) and dividends as ordinary income and use the revenue gained to lower corporate rates. This would allow for a substantial cut in corporate tax rates and, they argue, would be a progressive change, especially if much of the corporate tax is ultimately borne by workers in the form of lower wages. That strategy could be especially effective if paired with a significant corporate tax reform aimed at closing loopholes and further rate reduction.

#### What if Major Revenue from Base-Broadening Proves Infeasible?

As discussed above, the major bipartisan tax reform plans call for wholesale elimination of tax expenditures to finance major rate reduction. This would clearly be highly desirable, but it may not be feasible. The biggest tax expenditures include very popular items such as tax-free health insurance, 401(k) plans and pensions; the mortgage interest deduction; the deduction for charitable contributions; and the deduction for state and local taxes. If scaling them back proves elu-

sive, it may be difficult or impossible to raise revenue without either raising income tax rates or adopting a new revenue source as a supplement to the income tax.

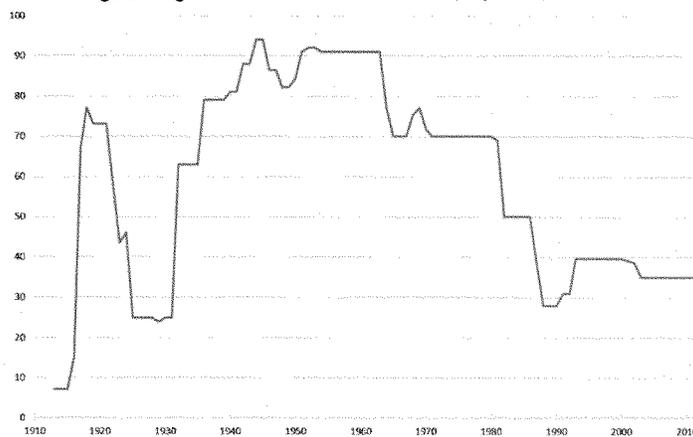
As noted, the BPC proposed to introduce a small VAT in the U.S. The advantage of a VAT is that it does not tax saving and is thus thought to be more conducive to economic growth than the income tax. The tax has never gained traction in the U.S. because conservatives are concerned that it would fuel more growth in government and liberals worry that it is regressive. To address the first concern, I have suggested that a VAT be earmarked to pay for government's health care costs. I believe this would actually help to constrain spending since, for the first time, consumers would see a connection between their health benefits and their tax bill. If health care costs continue to grow faster than the economy, the VAT rate will rise, which taxpayers would dislike. This could build support for sensible measures to constrain government health care spending.

The regressivity of a VAT may be offset by refundable tax credits designed to match the typical VAT levied on a family at the poverty line. This is similar to, although much smaller than, the "prebate" proposed as part of the national retail sales tax (or "FairTax").

Most economists' favorite new revenue source would be a carbon tax. By putting a price on carbon emissions, the tax would provide consumers and businesses an incentive to economize on the burning of fossil fuels and boost carbon saving innovations. This is a far better approach than providing subsidies to particular technologies. The government isn't smart enough to know which technologies should be subsidized. The advantage of the carbon tax is that private profit-maximizing enterprises could decide for themselves which technologies can best replace fossil fuels. The disadvantage of a carbon tax is that it seems even less politically viable than a VAT.

If substantial base broadening and new revenue sources are ruled out, the only remaining option to raise revenues is to raise marginal tax rates. This would not be my first choice, but it would certainly be better than allowing the debt to continue to grow unchecked. Top tax rates are very low by historical standards. Although higher than they were in the immediate aftermath of the Tax Reform Act of 1986, top tax rates are now (and were during the Clinton Administration) lower than at any time between 1932 and 1986. (See Figure 7.) While it is possible that the economic costs of taxation have grown over time—for example, because the technology of tax avoidance has improved—it is unlikely that returning tax rates to their levels in 2000 would be very harmful. Despite predictions that the economy would collapse in 1993 when tax rates increased, economic growth was quite robust until 2000. And notwithstanding forecasts that the Bush tax cuts would turbocharge the economy, growth was anemic throughout the last decade (even before the Great Recession). This certainly does not prove that economic growth is independent of tax rates, but it does suggest that, at least at current tax levels, other factors are more important.

**Figure 7. Highest Individual Income Tax Bracket, in percent, 1913-2012**



Source: Tax Policy Center, <http://taxpolicycenter.org/taxfacts/displayfact.cfm?Docid=543>

This concludes my testimony. I would be happy to answer any questions.

Chairman CONRAD. Thank you.  
Dr. Rogers, welcome. Please proceed with your testimony.

**STATEMENT OF DIANE LIM ROGERS, PH.D., CHIEF  
ECONOMIST, THE CONCORD COALITION**

Ms. ROGERS. Thank you very much. Chairman Conrad, Senator Toomey, and members of the Committee, thank you for giving me this opportunity to testify before you today on the topic of tax reform in the context of our larger fiscal and economic challenges. I am the chief economist at the Concord Coalition, but the views expressed here are my own.

I have recently heard the three tax reform goals in the title of this hearing—encouraging growth, reducing the deficit, and promoting fairness—referred to as a “fiscal trilemma,” suggesting it might not be possible to achieve all three.

The good news is that it really is possible to find tax policy changes that would do well for all three goals. The bad news is that actually following through on those changes will not be without hard choices.

I wish I could tell you that the idea that we just need to cut tax rates, to grow the economy, to reduce the deficit, and to lift all boats is realistic. But, unfortunately, in the real world, we face real budget constraints and a real scarcity of resources where real economists know that optimizing means not just maximizing benefits, all the things that make us happy, but weighing benefits against costs so the benefits net of costs are maximized.

In the context of the real world and our real experiences with tax policy, this suggestion that we just need to cut tax rates, which grows the economy, which reduces the deficit, and which lifts all boats, is, sorry to say, pure fantasy.

I make three main points in my testimony regarding the three goals of encouraging growth, reducing the deficit, and promoting fairness, which I can boil down to three impossibility theorems.

Number one, it is impossible to grow the supply side of the economy through continued, seemingly easy deficit-financed tax cuts.

Number two, it is impossible to reduce the deficit without allowing, and even seeking, higher revenues as a share of our economy.

And, number three, it is impossible to promote fairness in the tax system without being willing to raise tax burdens on the rich.

On the first point, the problem with deficit-financed tax cuts is that higher deficits immediately and certainly reduce national saving, which is the sum of public plus private saving, dollar for dollar. Deficit-financed tax cuts are not a free lunch. For the deficit-financed tax cut to turn out to be something good for national saving, we have to hope that the private sector will respond to the tax cut by increasing their own saving by even more than the cost of the tax cut, which is the increase in the deficit and the decrease in public saving, in order for national saving on net, the sum of public plus private, to rise.

Over the past couple decades, we have learned that national saving tends to move with public saving. When deficits fell in the late 1990s, national saving rose. When deficits rose again during the Bush administration, national saving fell and even went negative. Our economy cannot grow over time if we are not saving.

On the second point about deficit reduction, CBO projections show economically unsustainable deficits under a business-as-usual baseline where tax cuts are repeatedly extended and deficit-financed. These deficits do not shrink after the economy has fully recovered because our deficits are largely structural not just cyclical, and this means we cannot just grow our way out of our deficits.

Tax cut lovers point to the fact that even with extended tax cuts, revenues as a share of GDP remain around their 40-year historical average as if where we have been in the past is any guide to where we need to be in the future. The fascination with the magic 18-percent-of-GDP threshold has always struck me as odd, particularly when those who want to keep living in the past regarding the level of revenues might not be willing to cut entitlement spending enough to match it—an understandable view given the demographic and health cost trends that are driving the growth in spending, and at the same time are largely impossible to reverse. Sticking to the historical average level of revenues thus would ensure ever escalating deficits.

On the third point about fairness, the increase in income inequality at the top of the income distribution has clearly been exacerbated by the 2001 and 2003 tax cuts. There seems near universal agreement within Congress and the administration that the bulk of these tax cuts should be extended, however, and deficit-financed; that if we were to allow any of these tax cuts to expire, it should only be the upper brackets. But given that the rich benefit more than anyone else from all of the tax cuts, even the lower-bracket ones, and given that now we are working so hard to find ways to reduce the deficit, I wonder why policymakers have not asked themselves more often: Are these tax cuts really worth their cost?

Another way to reduce the worsening of income inequality caused by the tax system would be to broaden the tax base by reducing these so-called tax expenditures we have been talking about. That would be filling in the holes and the dips in the tax base so that different forms of income are treated more evenly and equitably. This is a horizontal equity issue, treating those with equal incomes equally, that turns out to actually have a vertical equity implication as well, because given our progressive rate structure, the rich in the higher tax brackets benefit the most from the exemptions, deductions, and preferential rates that are now in the system.

These tax expenditures are clearly upside down subsidies that ought to be reduced or eliminated if we care about reducing income inequality and the deficit—and the size of Government, incidentally—at the same time.

In my prepared testimony, I elaborate on why a base-broadening, revenue-raising, tax-expenditure-reducing tax reform is a first best way to achieve all three goals: encouraging economic growth, reducing the deficit, and promoting fairness. My ideas for second best ways usually involve letting the Bush tax cuts expire as scheduled or at least offsetting the cost of the portions you wish to keep.

I would be happy to take your questions.

[The prepared statement of Ms. Rogers follows:]

**“Tax Reform to Encourage Growth, Reduce the Deficit, and Promote Fairness”****Testimony of Diane Lim Rogers, Chief Economist, The Concord Coalition****Before the Senate Budget Committee**

March 1, 2012

Chairman Conrad, Senator Sessions, and Members of the Committee, thank you for giving me this opportunity to testify before you today on the topic of tax reform and the many good things tax reform could accomplish. Your title to this hearing provided a great way to organize my thoughts and my remarks to you today, as we are all contemplating changes to tax policy that will help our economic circumstances in three major ways: (1) to support and expand our economy, (2) to reduce the budget deficit, and (3) to respond to trends in income inequality.

**i. Tax Reform to Encourage Growth**

Growing the economy through tax policy isn't as simple as "cutting taxes" to reduce overall tax burdens. Tax cuts all have benefits, but the first thing one learns in an economics class is in a world of scarce resources, we maximize well being by weighing costs against benefits, and at the margin starting from where we are right now. Tax cuts that might benefit particular households and businesses don't necessarily pass society's cost-benefit test, even based on a narrower and naïve goal of maximizing GDP.

Our experience with the Bush tax cuts has demonstrated the problem with the simplistic "cut taxes, grow the economy" view. Their major contribution to record-high deficits clearly reduced national saving and economic growth, they were not very effective at growing the supply side of the economy (even according to the Bush Administration's own Treasury Department), and they are not the kind of tax cuts that provide high "bang per buck" in a recessionary economy. Some of us were questioning the economic wisdom of the Bush tax cuts back in 2001 when our budget projections showed \$5.6 trillion in surpluses over ten years (FY 2002-11), worrying that the surpluses should have rather been saved in preparation for the impending retirement of the baby boomers and the associated pressures on the federal budget,

as well as for emergencies like wars and natural disasters.<sup>1</sup> Now that we face a forecast of economically unsustainable deficits over the next ten years under a “business as usual” (policy extended) baseline, it’s hard to believe we’ve continued to extend and deficit finance these same costly tax cuts, despite their less than stellar performance.

We now can no longer afford to run suboptimal tax policy that fails to weigh costs against benefits. Constructing smart tax policy within the broader context of fiscal responsibility requires recognizing the connections and tradeoffs between tax rates, tax bases, revenues, public and private saving, and economic growth. The theory behind supply-side tax policy suggests that reducing tax rates encourages taxpayers to work and save and thus is good for the size of the tax base and for revenues. But in practice, tax cuts rarely pay for themselves, as the more extreme Laffer curve version of supply-side economics would suggest. We experienced higher revenues and budget surpluses following the tax rate increases enacted under the Clinton Administration and lower revenues and high deficits following the tax cuts under the George W. Bush Administration. In looking for economically efficient ways to raise revenue, there’s room to improve the existing income tax base before we play around with the rate structure or add new tax bases. A tax cut needs to do more than provide just some marginal benefit; there must be enough benefit to make the cut worth its cost, relative to competing demands. If reducing tax rates encourages economic activity but doesn’t pay for itself (such as with a rate cut that increases the deficit more than it encourages private saving), it’s not necessarily good for the economy.

There is no policy area where conservatives and liberals are further apart than tax policy. Conservatives argue that tax cuts that raise returns to saving and investment, or increase the rewards for work, are always good for the economy, in good times and in bad. Liberals argue that tax cuts primarily raise the incomes of the rich and squeeze out benefits for the poor, and are the least effective type of stimulus when the economy is in a recession. Both sides tend to neglect the adverse long-term economic effects of any type of tax cut that is deficit financed.

The debate is confusing because not all tax cuts are created equal, and the economic effects of those tax cuts differ across three dimensions: (1) the condition of the economy; (2) how the policy affects relative prices (substitution or incentive effects) versus real incomes (income or distributional effects); and (3) how the cost of the policy is paid for. When evaluating the effects of any particular tax cut on the economy, one should ask the following questions.

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<sup>1</sup> See chapter 2 (pp. 79-92) in the *Economic Report of the President*, January 2001 ([http://www.gpoaccess.gov/usbudget/fy02/pdf/2001\\_erp.pdf](http://www.gpoaccess.gov/usbudget/fy02/pdf/2001_erp.pdf)).

***Where's the Binding Constraint?***

In a cyclical downturn, increasing aggregate supply (the productive capacity of our economy) won't do any good, because the problem isn't too little capacity, but too much idle capacity. To increase the level of economic activity, or GDP, we need to increase demand for goods and services so that more of current supply is used. Think of the uses or demand side of the GDP equation —  $C + I + G + (X - M)$  — and contemplate what the government's fiscal policy can do to increase consumption (C), investment (I), or net exports (X-M) indirectly via tax cuts and other subsidies, versus increasing direct government purchases of goods and services (G). In terms of the boost to GDP, tax cuts and subsidies are automatically handicapped relative to direct spending, and unless they produce multipliers of greater than 1, they will fall short of the success of dollar-for-dollar direct government purchases.

But in a full-employment economy, fiscal policy is ineffective in increasing demand-side GDP because supply is the limiting factor. GDP can be increased only by encouraging growth in the stock of those productive resources — the supply side of the economy. In this case, we need to ask how we can use fiscal policy to increase incentives to work or to save. How can fiscal policy be reformed to reduce any of the preexisting disincentives and distortions to economic decisions created by current policy?

***What Kind of Tax Cut Is It?***

Tax cuts typically generate two types of effects on the microeconomic decisions of households and businesses: a substitution effect whereby relative prices are changed to encourage substitution into more lightly taxed activities and away from highly taxed ones, and an income effect whereby the higher cash flow to those receiving the benefits of the tax cut generates a change in their economic activity.

**1. Substitution effects and supply-side tax policy.** In a full-employment economy, tax policy's effect on relative prices is more important than it is in a recessionary economy. Marginal tax rates are what affect choices concerning the sources and uses of income. Tax cuts that reduce the marginal tax rates on labor or capital income will encourage substitution into greater labor supply or saving, boosting incomes and GDP. Tax cuts without any effect on marginal tax rates, in contrast, do not improve incentives at the margin. An example of a tax cut that reduces average tax rates and boosts average after-tax returns without reducing the marginal tax rate is that of raising the contribution or income limits on tax-preferred savings accounts. Because many higher-income taxpayers are already maxed out on the tax-preferred options, and might continue to be even after the higher limits, increasing the availability of the tax subsidy for

those households can cause shifting of existing savings (moving money out of taxable accounts into tax-free ones) without necessarily creating any new savings. The policy would generate positive income effects for these taxpayers even without any substitution effects.

Empirical research on the significance of substitution effects shows that higher-income households are more responsive to changes in marginal tax rates than lower-income households, probably because they can fine-tune their work hours more easily, and because the relative price change itself is usually larger at higher income levels given the progressive, graduated rate structure of the federal income tax. In fact, many lower-income households are entirely exempt from the federal income tax and so are completely unaffected by changes in marginal income tax rates. This has encouraged economists to suggest that flat rate tax systems (with a single marginal tax rate above some exemption level of income) would generate positive and sizable supply-side effects on labor supply and saving. But hold that thought, because how much the tax cut would cost in terms of lost revenue and the deficit would affect the supply side of the economy as well.

Increased supply-side incentives can also be achieved by reducing differences across marginal tax rates on different sources and uses of income. Broadening the income tax base by reducing tax expenditures would raise the overall average tax rate but would do so by raising marginal tax rates only on those sources and uses of income that are currently undertaxed in the definition of taxable income. By reducing the tax advantage to those currently undertaxed forms of income, the substitution effects away from higher-taxed income would actually be reduced and that type of income would be encouraged, even as the economy-wide average tax rate rises.

Must one be a supply-side economist to believe in the existence of these supply-side types of responses? No. Economists of all stripes broadly agree in the theory that households and businesses respond to relative price changes when those agents are given the opportunity and have the capacity to do so. Economists also agree that marginal tax rates matter in terms of their incentive effects. The debate over how valuable to the economy supply-side tax policy can be is largely over how large those substitution/incentive effects are in the real world, relative to the other economic effects of tax policy.

**2. Income effects and demand-side tax policy.** In a recessionary economy, the income effects of tax policy matter more. The distribution of the dollar benefits of a tax cut will affect how much the demand for goods and services is stimulated. Tax cuts focused on the top marginal tax rates don't deliver anymore dollars to lower-income households who have the highest propensities to consume. The effect on relative prices matters less than the effect on the levels

and distribution of after-tax income. In fact, an economy-wide tax cut isn't a prerequisite of a successful demand-side tax cut. Consider a purely hypothetical and purely redistributive (income-effects-only) Robin Hood policy that increases taxes on the rich and gives the proceeds to the poor. This would increase aggregate demand in the economy by simply shifting income away from savers toward non-savers. Note that this is quite contrary to the optimal strategy in a supply-side tax cut designed to increase labor supply and saving.

Perhaps even more curious, fiscal policies that might seem ineffective or unjustified in terms of incentive effects (such as Social Security cost of living adjustment makeups for seniors, tax breaks for new homeowners, and the "Cash for Clunkers" program) might nonetheless have a high bang per buck in terms of stimulating aggregate demand in a recessionary economy. Even if those policies actually do nothing to encourage the economic activity they're ostensibly designed to, as long as they steer dollars to households with high marginal propensities to consume, they can nevertheless turn out to be pretty effective in stimulating demand.

On the flip side, we shouldn't worry much about higher taxes having large dampening effects on demand if those tax increases are mostly on higher-income households with low marginal propensities to consume. We also shouldn't be too concerned about the potential recessionary effects from tax increases that would take effect only after the economy is back to full employment.

The timing of tax cuts matters. At either the business level or household level, temporary tax cuts are likely to have a greater stimulative effect on the demand for goods and services than permanent tax cuts, because the timing of transactions is relatively easy to change — according to University of Michigan economist Joel Slemrod's hierarchy of responses.<sup>2</sup> A temporary tax cut will generate a large effect as the qualified activity is shifted forward whenever a tax cut has a deadline, even if the same tax cut, because it is only temporary, has a much smaller or negligible long-term effect on the components of aggregate supply.

#### ***How Is the Tax Cut Being Financed?***

**1. Deficit financing sometimes helps and sometimes hurts.** In a recessionary economy, deficit financing will increase the countercyclical stimulative effect of any particular tax cut on

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<sup>2</sup> Joel Slemrod, "Tax Systems" in NBER Reporter, Summer 2002. (<http://www.nber.org/reporter/summer02/slemrod.html>) and "Income Creation or Income Shifting? Behavioral Responses to the Tax Reform Act of 1986," American Economic Review, 85(2), May 1995 (<http://www.jstor.org/pss/2117914>).

aggregate demand by promoting consumption of goods and services in excess of personal incomes. But that doesn't mean any deficit-financed tax cut (or spending) makes for the best stimulus, because there are longer-term economic costs still associated with the deficit — the debt has to eventually be repaid in higher taxes or reduced spending in the future. That puts limits on the amount of deficit-financed stimulus that's economically justified. We want to maximize the economic bang for the buck in deficit-financed stimulus, so fiscal responsibility requires that we determine a level of deficit spending we deem worth it, put high bang-per-buck spending or tax cuts at the front of the line (ranking fiscal policies from most effective to least), and draw the line at the credit limit we've implicitly established.

In a full-employment economy, however, deficit financing represents a dollar-for-dollar decrease in public saving, making it harder for the tax cut to increase national saving unless private saving is encouraged by more than the cost of the tax cut. This is not quite as high a standard as the tax cut paying for itself (as proposed by the Laffer curve) — which is  $1/t$  times as hard ( $t$  being marginal tax rate on private returns to saving). This is why the Bush tax cuts have been evaluated as a net negative for economic growth by William Gale and Peter Orszag within the first few years of the Bush tax cuts, and by Gale more recently.<sup>3</sup> It also explains why increased tax rates during the Clinton Administration coincided with higher, not lower, economic growth.

The choice to deficit finance now does not permanently avoid a tougher choice. Deficit-financed tax cuts do not pay for themselves, and they imply inevitably higher taxes or lower spending in the future. This intergenerational redistribution is another economic effect of the tax cut.

**2. On the other hand, paying for the tax cut sometimes hurts and sometimes helps.** In a recessionary economy when the goal is increasing current consumption, offsetting the cost of the tax cut with spending cuts or tax increases will reduce the net stimulative effect on aggregate demand for goods and services. The more the offset affects lower-income households (those most constrained), the larger the negative effect. Paying for a tax cut going to primarily high-income households with a cut in spending that benefits primarily low-income households would likely be contractionary, not stimulative.

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<sup>3</sup> William G. Gale and Peter R. Orszag, "Bush Administration Tax Policy: Effects on Long-Term Growth," Tax Notes, October 18, 2004 ([http://www.taxpolicycenter.org/UploadedPDF/1000698\\_Tax\\_Break\\_10-18-04.pdf](http://www.taxpolicycenter.org/UploadedPDF/1000698_Tax_Break_10-18-04.pdf)) and William G. Gale, "Five Myths about the Bush Tax Cuts," Washington Post, August 1, 2010 (<http://www.washingtonpost.com/wp-dyn/content/article/2010/07/30/AR2010073002671.html>).

In a full-employment economy, however, finding budgetary offsets to the cost of a tax rate reduction is likely to be better for encouraging aggregate supply and boosting GDP than deficit financing. That's because the deficit reduces public saving dollar for dollar, while empirical evidence has shown that the adverse effect of the offsetting policy on private saving is likely to be something less than dollar for dollar.

***Tax Cuts Matter, but Aren't One Size Fits All***

So are tax cuts good for the economy? It depends. As countercyclical policy during a recession, deficit-financed tax cuts can help stimulate demand, but deficit-financed spending is likely to be even more effective if it is deliberately targeted toward lower-income households. As supply-side policy during periods of full employment, tax cuts are most effective if they increase incentives at the margin to work and save — that is, by reducing marginal tax rates or leveling rates across different forms of income — but any deficit financing is likely to produce a net negative effect on national saving.

That's why a revenue-raising (relative to current policy, or revenue-neutral relative to current law) tax reform that reduces or levels out effective marginal tax rates and broadens the tax base at the same time is such a win-win-win formula:

- **Win #1: It attends to the economy's needs.** In a full-employment setting, revenue-raising tax reform encourages supply-side private-sector economic activity without generating offsetting reductions in public saving. In a recessionary economy, raising revenue primarily from higher-income households minimizes any dampening effect on short-term demand for goods and services, while supporting greater levels of high bang-per-buck fiscal stimulus.
- **Win #2: It creates the right price incentives and distribution of income.** By focusing on lower marginal tax rates and a broader, more neutral tax base achieved through reducing tax expenditures, it reduces the distortionary effects of tax policy on economic decisions, creating the right kind of substitution/relative price effects to maximize its economic effectiveness, while also generating income effects that can be helpful as countercyclical policy.
- **Win #3: It doesn't increase the deficit.** As a deficit-neutral tax cut (relative to current law as well as current policy), it avoids the direct decrease in public saving that is harmful in a full-employment economy, without requiring alternative budgetary offsets that would force cuts in more stimulative forms of (direct) spending when the economy is still recovering from a recession.

Tax cuts are always an attractive option in the political world where budget constraints are often ignored. But in the real world and in real time — where budget constraints bind and opportunity costs matter — policymakers must be mindful of the fact that the effectiveness of any particular tax cut depends on our economic circumstances and goals and how those mesh with the structure of the tax policy.

## II. Tax Reform to Reduce the Deficit

When it comes to tax policy, the economy, and the deficit, it is common to hear this simple line of reasoning: “cut taxes, to grow the economy, to reduce the deficit.” In the previous section I explained why the first causal relationship doesn’t usually hold true. And for this section, the bad news is that the second causal relationship doesn’t hold either. We can’t just “grow our way out” of budget deficits; we’ll actually have to make structural changes to our spending and revenue programs.

CBO has shown that our current (still) record-high deficits are largely structural, not just cyclical. The projections show that even as the economy continues to recover, deficits will come down only modestly before they rise again dramatically. The current business cycle has done nothing to change the longer-term path of the federal budget, other than to temporarily create another short-term demand for federal dollars.

Economists agree that the federal budget is on an unsustainable path and that for the continued health of the economy, deficits must eventually come down to levels lower than the growth rate of the economy (allowing the debt/GDP ratio to be stabilized). Even though a sizeable level of deficit spending over the next one or two years can be justified to support the economic recovery, a commitment to bring down deficits to lower, more sustainable levels over the next decade is essential not just for longer-term economic growth but for shorter-term economic stability (via the confidence of global investors in the U.S. economy).

Tax policy has to be part of the solution. It is true that the greatest pressures on the federal budget in the decades to come are in the entitlement programs because of the aging of the population coupled with rising per-capita health costs. But it is hard to see how our society would choose cuts in real, per-capita benefits of the magnitude necessary to both achieve sustainable deficits and keep revenues at the historical average. And even if we would choose to do so, we would never do it very soon; entitlement reforms would have to be phased in much more slowly than tax reforms could take effect.

The historical average level of revenues/GDP has very little bearing on what the right level of revenues is going forward. The right level of revenues is that which is adequate to pay for the government we desire. (And the right size of government is that which we are willing to pay for.) Given the dramatic changes in the structure of our population and the continued growth and evolution of our economy, it is difficult to see how what was right over the past 40 years—and it wasn't even quite adequate then—could be right over the next 40 years.

***The Current-Law Baseline: Why It Matters and Why Budget Rules Should Respect It***

Adjusting the CBO current-law baseline to construct the Concord Coalition's "plausible baseline" (a "business as usual" projection) nearly quadruples the ten-year deficit from \$3.1 trillion to \$11.8 trillion—with \$6.5 trillion of the \$8.7 trillion difference due to tax policy and the plethora of expiring, deficit-financed tax cuts in current law.<sup>4</sup> If current tax cuts were extended and deficit financed (as usual), federal revenues would never rise above 17.5 percent of GDP over the ten-year budget window. In contrast, under current law where expiring tax cuts expire as scheduled, revenues rise to 21 percent of GDP by the end of the ten-year window, which is consistent with an economically-sustainable level of deficits over the next 10-20 years according to CBO. So whatever we do on the tax policy front, we should commit to achieving current-law revenue levels.

There are many tax policies that would be consistent with the current-law baseline level of revenues. I have characterized the three main approaches as: "do nothing" (let the Bush tax cuts expire as scheduled at the end of 2012), "do it big" (broaden the tax base by reducing tax expenditures, paying for lower tax rates), and "do it to the rich" (such as via a surtax on millionaires and/or large corporations). Each approach has different relative advantages regarding their economic effects and political attractiveness. The best economic effects would come from increases in revenue accomplished through progressive base broadening/reduced tax expenditures. We could do any combination of the approaches, and, most significantly for this Budget Committee: *all would be encouraged in practice with a commitment to strict, no-exceptions, pay-as-you-go rules—on new or extended tax cuts and not just spending increases.* Such a commitment would immediately get us back on the path to sustainable deficits.

<sup>4</sup> See "The Concord Coalition Plausible Baseline," The Concord Coalition, updated January 2012: <http://www.concordcoalition.org/concord-coalition-plausible-baseline>.

In addition, to encourage a base-broadening approach to tax reform, the Budget Committee could make further use of their reconciliation instructions to the committees of jurisdiction. On the expiring tax cuts, for example, the budget committees could require the tax-writing committees to come up with a level of revenues at or at least closer to the current-law baseline, effectively requiring that a certain portion of the cost of extending expiring tax cuts be offset with other revenue increases. And in their policy statements or other report language accompanying the budget resolution, the budget committees could recommend that at least x% of those offsets (up to 100%) be comprised of reductions in tax expenditures as listed and scored by the Joint Committee on Taxation.

***Is Deficit Reduction Contrary to Economic Growth?***

But what about the economy? Can we really pursue deficit-reducing revenue increases without jeopardizing economic growth—goal #1?

For both the short-term and longer-term economic goals, reducing the deficit is not necessarily contrary. The design and the timing of the policies are crucial though. For the short term, specific and credible policy commitments to deficit reduction—even if the policies take effect later—would immediately help to keep U.S. credit-worthiness high and interest rates low. For the longer term, deficit reduction is essential to increase national saving and hence economic growth.

Even if continued deficit spending, in general, is justified in our still-recovering economy, it doesn't imply that all deficit-financed spending is worth its cost. We should look for opportunities to decrease spending on the least-effective (perhaps even counter-productive) and least-responsive activities, in order to either free up resources for more effective uses or for deficit reduction, considering both short- and longer-term goals. We should be maximizing "bang per buck"—broadly defined—to extend both to the relationship between deficits and national saving, and to longer-term tax policy.

By far the largest and most reliable connection between tax policy and economic growth over the past several decades has been through the beneficial effects of surpluses and the adverse effects of deficits on national saving. The budgetary effects of tax policies have mattered far more than the microeconomic responses to the policies, because the former have been huge and certain, while the latter have been small and uncertain.

### ***The Bush/Obama Tax Cuts***

This seems a good place to remind the Committee that the *Bush* tax cuts continue to be the single most costly policy proposal in President *Obama's* budget. This is a choice policymakers have to make and legislate: whether to extend some or all of them, and if and how they will be paid for.

When the CBO completes their analysis of the President's budget, they will show the effects of the proposals relative to current law. That presentation will make clear that the single most costly proposal in the President's budget is still the deficit-financed extension of all but the high-end Bush tax cuts, which by the Administration's own numbers costs \$1.3 trillion (\$2,173 billion to extend all the tax cuts minus \$849 billion in high-end ones that would be allowed to expire)—without counting the cost of associated continued AMT relief (another \$1.9 trillion), or associated interest costs, which the OMB tables do not break down but CBO says would be about \$790 billion for the full complement of extended tax cuts. Given that only \$849 billion out of \$4.5 trillion in tax cuts, or less than 19 percent, would be allowed to expire, the associated interest costs from the extension of the remaining cuts are likely to be over \$600 billion over ten years. (This is consistent with the OMB showing in Table S-8 that the debt service costs associated with all their adjustments to get from the current-law baseline to their "adjusted baseline" are \$640 billion.)

Gathering these numbers from all the different places in the Obama budget tables they appear and adding them up, we find that leaving aside any new tax policies for the moment, the Obama Administration is proposing to extend *expiring* tax cuts at a total cost (including associated interest costs) of almost \$4 trillion over the next ten years alone. In other words, the President is proposing \$4 trillion worth of (just) *old* "Bush" tax cuts in his budget. That figure does not include the costs (or revenue gains) of any new tax policies the President proposes, which speak more in terms of what they target than in how much money they lose or save.

Back in 2001 when we faced \$5.6 trillion in surpluses (FY2002-11) there were still at least some of us saying a big tax cut was not a good idea, given the impending retirement of the baby boomers and associated effects on the fiscal outlook. (I was writing the chapter on the fiscal outlook in President Clinton's final economic report at the time.<sup>5</sup>) If *not* paying for the tax cuts was *not* a good idea back then, why would it be a good idea now?

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<sup>5</sup> See *Economic Report of the President*, January 2001, op. cit.

***Reducing Tax Expenditures Is Reducing the Size and Scope of Government***

Those who oppose deficit reduction on the revenue side of the budget usually assume higher revenues will lead to larger government. But the holes in our income tax base—the special exemptions, deductions, credits, and preferential rates—amount to over \$1 trillion/year (about 90 percent of this in the individual income tax and 10 percent in the corporate), nearly as much as all of discretionary spending combined<sup>6</sup>. While not all tax expenditures can be unambiguously labeled “spending in disguise,” most of them can. The Tax Policy Center’s Donald Marron and Eric Toder have estimated that about 65 percent (\$600 billion in 2007) of tax expenditures are “replacable by a spending program.”<sup>7</sup> Thus, “filling out” the tax base by reducing these tax expenditures would level out and support lower marginal tax rates (reducing the economic distortions caused by taxes), and reduce both the deficit and the effective size of government.

**III. Tax Reform to Promote Fairness**

Reducing the deficit by broadening the tax base is also appealing if one is concerned about the inequality in the distribution of income and the “vertical equity” of the tax system. Tax expenditures are very different from other types of (direct) government spending, because they’re spending (“poking holes”) through the progressive income tax system, which affects high-income households far more than others. This makes tax expenditures some of the most regressive government subsidies around, and cutting them one of the most progressive ways we could reduce the size of government and the deficit at the same time.

Income inequality has been increasing, particularly at the very top, and so it seems our desire to ameliorate these changes by trimming any government spending that goes to the rich. But there’s not much on the spending side of the budget that directly benefits higher-income households, and even we were willing to cut Social Security and Medicare benefits on the rich,

<sup>6</sup> Donald B. Marron, “How Large Are Tax Expenditures?”, Tax Notes, March 28, 2011 (<http://www.urban.org/uploadedpdf/1001526-Expenditure-Estimates.pdf>).

<sup>7</sup> Donald Marron and Eric Toder, “Measuring Leviathan: How Big Is the Federal Government?”, presentation at Loyola Law School, January 14, 2011 (<http://events.ils.edu/taxpolicy/documents/PANEL2MarronToderSizeofGovernment-presentationFinal01-06-11.pdf>).

these would be small changes relative to their incomes. The only place in the federal budget where benefits go disproportionately to the rich (relative to their incomes) is via the tax system. Thus, the only route to substantially reduce income inequality at the top of the distribution is to raise tax burdens and reduce tax subsidies there.

*Raising* taxes on the rich means the policy should be revenue gaining, helping both of the previous goals: deficit reduction, and hence economic growth (via effects of lower deficits on national saving). The fairness goal doesn't support revenue-neutral tax reform, unless revenue gained from the rich is used to pay for tax cuts to middle-income households.

For a long time, President Obama has defined "the rich" as those households with annual incomes over \$250,000. Limiting tax burden increases to households with over \$250,000 in income, however, can be terribly constraining in terms of the dual goals of raising large amounts of revenue in economically efficient ways, especially if changes are limited to statutory tax rate increases. A Tax Policy Center analysis has illustrated the challenge in keeping the current, full-of-holes definition of the tax base, limiting burden increases to these upper-income households, and raising enough revenue to get to economically-sustainable deficit levels.<sup>8</sup> Marginal tax rates on the rich are then forced to climb to levels that would indeed be around the peak of the Laffer curve.

Still, there seems to be a lot of public sentiment to intentionally "target" tax increases on the rich. Warren Buffett's low effective tax rate (especially relative to that of his secretary) has inspired a near consensus that "the rich" do not pay their fair share of taxes and that any future tax reforms, whatever the levels of revenues produced, should steer more of the tax burden onto those lucky few. For some, the definition of "the rich" has moved into the "millionaires and billionaires" category now. (And that naturally means that more of us will be supportive of the idea of raising taxes on (just) "the rich.") The Administration's interpretation of the Buffett rule, as described in their budget (pg. 39) is that "no household making over \$1 million annually should pay a smaller share of its income in taxes than middle-class families pay"—even though their specific tax proposals largely honor their long-held \$250,000 threshold.

As I wrote in Tax Notes (in a column I titled "Who Wants to Tax a Millionaire"<sup>9</sup>), there are lots of ways to raise tax burdens on millionaires, some economically smarter than others. While a

<sup>8</sup> Rosanne Altshuler, Katherine Lim, and Robertson Williams, "Desperately Seeking Revenue," Tax Policy Center, January 2010 (<http://www.taxpolicycenter.org/publications/url.cfm?ID=412018>).

<sup>9</sup> Diane Lim Rogers, "Who Wants to Tax a Millionaire?," Tax Notes, February 6, 2012, pp. 725-7.

specific surtax on incomes over \$1 million seems like the simplest and starkest way to do it, such a policy would raise the distortionary effects of the tax system by raising effective marginal tax rates on income already counted as taxable. Economists would prefer to raise millionaires' taxes by including more of their total income in what counts as (fully) "taxable income," or by reducing the size of some of the subsidies given to them through various tax expenditures.

Talk of millionaire tax increases naturally brings proposals for some form of "millionaire surtax" first to mind, but there are many other ways we could increase the taxes that millionaires pay. We could let overall income tax rates increase by, for example, letting the Bush tax cuts expire—either all of them, or just the upper-income provisions. We could tax capital gains and dividend income, and other types of currently tax-preferred income, at the same rate as "ordinary" (labor) income. Finally, we could broaden the tax base to reduce tax expenditures that largely benefit higher-income households, such as limiting itemized deductions to a tax-rate ceiling—a policy the Obama Administration has repeatedly proposed in their budgets.

All these options would raise tax burdens on millionaires—both in absolute and relative terms—but would produce different economic effects in terms of the concentration of the millionaires' higher tax burden, the level of potential revenue raised, and the incentives to work or save.

The more targeted the tax burden to millionaires, the more limited the total revenue potential, and the more we have to worry about adverse effects on incentives via higher marginal tax rates. The more a proposal's tax base is limited to currently-taxable income above a million dollars, the higher the effective marginal tax rate will be at those millionaire income levels, for a given level of revenue. The exception to the targeting versus incentives tradeoff is where we can find ways to broaden the tax base that concentrate higher burdens on millionaires by limiting the benefits of tax expenditures (such as the percentage applied to itemized deductions) or by phasing out benefits completely at higher income levels.

Proposals to let all of the Bush tax cuts expire may seem contradictory to the "Buffett rule" of raising the tax burden on (only) millionaires, and yet it would raise the most revenue from millionaires—and not just a lot more revenue overall. It's a reminder that even millionaires benefit from lower-income tax cuts, too; in fact, households who are fully above the lower brackets benefit more in dollar terms from reduced lower-bracket rates than do households who fall in the middle of them.

***Tailoring Base-Broadening Tax Reform for the Buffett Rule***

Although most proposals to reduce tax expenditures in “across the board” ways will naturally burden higher-income households the most, there are ways to explicitly limit the higher burdens to households above a certain tax bracket or income level, to make any base-broadening proposal as progressive as one wants to.

One example of a base-broadening revenue proposal that limits higher burdens to higher-income households is the limit of itemized deductions to 28 percent, which President Obama has now proposed in all four of his budgets. But the President went further in this year’s budget to propose reducing a wider array of tax expenditures to higher-income (still above \$250,000 income) households, including the exclusion of employer-provided health benefits. The proposal sticks to the idea of making sure upper-bracket taxpayers benefit no more from these tax expenditures than they would if they were only in the 28 percent bracket. Administratively, limiting exclusions isn’t as easy as limiting deductions, however, because we would need additional information reported on individual tax returns—the addition to taxable income of the previously excluded type of income. But the expanded proposal does improve the bottom line significantly; compared with the limit on itemized deductions only, this version raises about double the amount of revenue, \$584 billion over 10 years according to the Administration.

New as well this year in the President’s budget is the proposal to not just let the tax rate on dividends go up to a less-preferred rate but to eliminate the preference entirely for high-income households, treating dividends as ordinary income for them. So even with the Administration’s consistent push to let the upper-end Bush tax cuts expire, they are expanding the impact of the expiration this year, likely encouraged by their new emphasis on the Buffett Rule.

***(Even) Broader Tax Increases Still a Preferable Way to Raise Taxes on “the Rich”***

Raising taxes on the rich by reducing (just) their tax expenditures is economically preferable to raising taxes on them by raising their rates, but raising taxes on the rich by raising taxes more generally—without discriminating by income level or type of person or business—is better still. Economists would prefer to avoid the awkwardness, complications, and inefficiencies that result from targeting tax increases (or tax cuts, for that matter) to a very specific category of taxpayers. Raising taxes overall, by either letting (even all of) the lower Bush tax rates expire or reducing tax expenditures, would naturally burden higher-income households disproportionately and hence enhance the progressivity of the income tax system, simply

because the rich benefit the most from current tax rate cuts (even lower-bracket ones) and tax subsidies.

“Broader” tax reform strategies—which would apply a broader and more uniform definition of the tax base to a broader (larger) number of people and businesses—would allow tax rates to stay low while the deficit is reduced more significantly. And because such deficit reduction would be achieved by efficiency-enhancing yet progressive tax policy changes, the dual goals of adequately supporting demand in a still-recovering economy and encouraging the supply of productive resources over the longer term would be achieved.

**Conclusion: A “Trilemma” for Tax Reform?**

I have recently heard the three tax reform goals the Committee outlined for this hearing—economic growth, deficit reduction, and fairness—referred to as a “fiscal trilemma,” with the implication that achieving all three goals simultaneously might be difficult.<sup>10</sup> But as I’ve described today, I believe that base-broadening, revenue-raising, tax-expenditure-reducing tax reform can easily be consistent with all three goals.

The Budget Committee could play a very critical role in achieving fiscally-responsible tax reform by enforcing current-law baseline revenue levels through effective budget rules and instructions to the tax-writing committees.

Politically arbitrary labels such as the choice of budget baselines matter a lot, because politicians need these simple metrics to demonstrate their success as policymakers. Republicans will always want to be known as the tax cutters, while Democrats will always push for more progressive taxation. Setting a goal of sticking to the current-law revenue baseline, which is achieved by base broadening rather than higher rates, is a way of honoring the seemingly inconsistent tax policy goals of both parties. It seems reasonable that policymakers should start from a current-law standard, because making changes relative to current *law* is their legislative responsibility, after all, even if the policy-extended baseline is a more accurate reflection of “business as usual.”

Economically, however, it doesn't matter if we view such tax policy as raising revenue relative to a current-policy baseline or as keeping revenue constant relative to a current-law baseline.

<sup>10</sup> Stolen from the title of an upcoming tax reform conference at Tulane University (<http://www.ssrn.com/update/ern/ernann/ann12048.html>).

All that matters is that the policy raises enough revenue to keep deficits at an economically sustainable level — where the economy's growth has a chance to keep up with the growth of the debt — while minimizing the distortionary effects of taxation.

No matter how one might choose to interpret it — as a policy change consistent with Republican goals of reducing tax rates and government's interference with market decisions (the subsidies given out through the tax code), or as one consistent with Democratic goals of reducing the deficit by progressively raising revenue as a share of our economy — this type of bipartisan tax reform will be crucial to achieving fiscal sustainability. For now this seems the most promising area for significant progress on deficit reduction to happen relatively quickly, while we continue to work on economically smart ways to control spending in the rest of the federal budget.

Chairman CONRAD. Thank you very much.  
Dr. Mitchell, welcome. Good to have you here.

**STATEMENT OF DANIEL MITCHELL, PH.D., SENIOR FELLOW,  
CATO INSTITUTE**

Mr. MITCHELL. Thank you, Chairman Conrad and members of the Committee, for the opportunity to testify. My views expressed here are my own.

Let me just touch on some of the highlights of my testimony. We have a lot of problems in our Tax Code: high tax rates, biased treatment of income that is saved and invested, distorting loopholes, worldwide application, corruption, and complexity. And tax reform does have the potential to reduce or perhaps even eliminate a lot of these problems, but it could also make them worse depending on what set of principles and guidelines you use when looking at tax reform. And I would like to suggest a few of them.

Tax rates should be as low as possible for the simple reason that taxes are a price. It is the price of whatever is being taxed, and we do not want a high price being imposed on work and entrepreneurship.

We also want to make sure that the tax system does not discriminate against capital formation. As far as I understand, every single economic theory, even Marxism and socialism, they all agree that saving and investing are keys to long-run growth and higher living standards. And so it does not make sense to impose multiple layers of tax on income that is saved and invested compared to income that is consumed.

Another principle—and Len will be very happy to hear this—is that we should get rid of all the preferences and penalties in the Tax Code. We do not want people making economically inefficient choices solely because the Tax Code is luring them in that direction. That makes the economy less productive.

And then we want territorial taxation. This is what I call the “good fences make good neighbors” approach to taxation. Most other countries around the world, especially for things like corporate taxation and labor income, practice territorial taxation, and I just think it creates a much simpler and fairer tax system.

If you look at all those principles and you follow them to their logical conclusion, the ideal system is some sort of low-rate, consumption-based, loophole-free tax system. The best-known of those systems is the flat tax developed by Professors Hall and Rabushka at Stanford University’s Hoover Institution. But the value-added tax, assuming it is a replacement tax not an add-on tax, also is a single-rate, consumption-based, loophole-free tax system. And even in theory, a national sales tax could fulfill the same goals.

All of these tax regimes may have different collection points, but they all share the low rate, the consumption base, and at least in theory could be free of loopholes.

Now, of course, any discussion of tax reform, as we have already seen on this panel, gets into the issue of the deficit. But I think that is actually a proxy. What we are really talking about is what you can do on taxes depends a lot on what you do on the spending side. And I guess my simple analysis is that it is very difficult to

have a good tax system if you have a very large government, and I use Sweden as an example in my testimony.

On a per-krona-raised basis, Sweden probably has one of the best tax systems in the world. But because that tax system is expected to collect 50 percent-plus of GDP, the overall system becomes rather punitive, and I think it helps to explain why Sweden, which back around 1970 was one of the five richest countries in the world, has since fallen a bit and suffered several decades of rather mediocre growth.

On the other hand, in places like Hong Kong and Singapore, it is almost impossible to have a bad tax system because the overall burden of government is only about 20 percent of economic output. That is why Hong Kong has a flat tax. Singapore has a progressive system, but the top rate is only 20 percent. And neither jurisdiction has the pervasive double taxation of capital that we see—no capital gains or dividends double taxation, and neither has a death tax or a wealth tax.

Now, of course, our challenge—and as Budget Committee folks, you all know this more than anybody—is that we already have seen a big expansion of the size of Government during the Bush-Obama years. When Bill Clinton left office, we were spending 18.2 percent of GDP. Now we are up to 24 percent, but, heck, a couple of decades down the road, we are going to be looking back upon 24 percent of GDP as some sort of wonderful time because we are expected, based on the CBO long-run forecast—and there is an alternative forecast and a baseline forecast—we could be up over 50 percent of GDP. And that is just the Federal Government alone, not counting 12, 13, 14, 15 percent of GDP for State and local government spending.

And that is really the challenge of tax reform. If you are going to have growing Government, it is very, very difficult, even if you are like Sweden, and even if you put in place a system designed to minimize the damage per dollar collects to have a good tax code. If Government is expanding, tax reform is almost certainly a very challenging exercise.

I have in my testimony two charts looking at the rising burden of Government spending based on an average of the baseline and alternative scenario from the CBO long-run forecast. But then, interestingly, I also take an average of the alternate and baseline scenario for tax revenue, and it turns out that even if all the tax cuts are extended from 2001 and 2003, because of what is called “real bracket creep,” Federal revenues are going to grow, obviously over several decades, above that 18-percent average, above the 20 percent that, Mr. Chairman, you were citing in those charts about when we had a balanced budget. As a matter fact, it will get up to 25 percent of GDP by the time you get to the end of the 75-year forecast. And, again, that is an average of the baseline and the alternative scenario.

One other point that I think is very important to mention is that economic growth does matter, and taxes do affect economic growth. Now, yes, a lot of people exaggerate. Talk to someone about their favorite tax cut. You solve all the world’s problems if you do it. And, yes, there is a lot of exaggeration. But I also put in my testi-

mony a CBO sensitivity table showing how even very, very small differences in economic growth can have an impact.

And so I would urge a lot of caution about higher marginal tax rates. If you are going to raise revenue, which I do not like, I would agree with everyone else on the panel, it would be better to go after loopholes.

And then one last thing, since my time is running out, that I think underscores this issue. My final table in the presentation looks at what happened to tax revenues from the rich between 1980 and 1988. In 1980, when we had a 70-percent tax rate, people making over \$200,000 a year paid \$19 billion to the IRS. By 1988, when the top tax rate had come all the way down to 28 percent, those rich people were paying \$99.7 billion to the IRS, which is sort of a Laffer curve on steroids, although obviously there were lots of other factors going on, including 40 percent inflation, 7 to 8 percent population growth, other pro-growth reforms, that would have caused more rich people and more taxable income to appear. But certainly I think that one bit of evidence from the 1980s is proof—not to mention the new evidence we just saw from the United Kingdom where they are collecting less revenue at the new 50-percent tax rate than they collected at the old 40-percent tax rate.

But with that, I see my time is running out. I will be very happy to answer questions. Thank you.

[The prepared statement of Mr. Mitchell follows:]

**Statement of**

**Daniel Mitchell,  
Senior Fellow,  
Cato Institute**

**before the Committee on the Budget, United States Senate, March 1, 2012**

**Tax Reform to Encourage Growth,  
Reduce the Deficit, and Promote Fairness**

Mr. Chairman, Members of the Committee, thank you for the opportunity to testify. My name is Dan Mitchell. I am a Senior Fellow at the Cato Institute. The views I'll be expressing today are my own.

The internal revenue code is needlessly punitive and complex. Some of its major flaws are:

1. High tax rates – Marginal tax rates on additional increments of productive activity are too high, discouraging people from productive behavior.
2. Biased treatment of income that is saved and invested – Because of the capital gains tax, the corporate income tax, the double tax on dividends, and the death tax, there is pervasive double taxation on capital, causing very high effective marginal tax rates.
3. Distorting loopholes – Many provisions of the internal revenue code are explicitly designed to encourage economically irrational choices.
4. Worldwide application – The United States have the world's most onerous tax system for international activity.
5. Corruption – While in most cases technically legal, the common practice of swapping favorable tax policies for political support is corrosive.
6. Complexity – Nearly 100 years of tax changes have produced 72,000 pages of law and accompanying regulation.

Tax reform has the potential to reduce, or perhaps even eliminate, these problems. But it also could make them worse. To ensure the best possible outcome, lawmakers should be guided by these principles.

- A. Tax rates should be as low as possible – Taxes are a price, and it doesn't make sense to impose a high price of work and entrepreneurship.

- B. The tax system should not discriminate against capital formation – Since every economic theory, even Marxism and socialism, holds that saving and investment is a key to long-run growth and higher living standards, it doesn't make sense to impose extra-high tax rates on capital.
- C. Government should not tilt the playing field with preferences or penalties – Luring people into making economically inefficient choices makes the economy less productive.
- D. Territorial taxation – This is the good-fences-makes-good-neighbors approach to tax policy. Disputes with other nations become trivial if each nation is in charge of taxing economic activity inside its borders.

The ideal system, based on the above principles, is a low-rate, consumption-base, loophole-free tax.

The best-known tax meeting these criteria is the flat tax, as developed by Professors Hall and Rabushka at Stanford University's Hoover Institution.

But the value-added tax also satisfies these principles – assuming it is replacement rather than add-on tax. And a national sales tax also shares these theoretical qualities.

All of these tax regimes have different collection points, but the tax base is identical. All economic activity is taxed, but only one time and at a low rate.

If lawmakers want to improve growth, particularly in a competitive global economy, where labor and capital can cross borders in search of pro-growth fiscal policy, they should seek to reform the tax system so it fulfills these principles.

Economists will not agree on how much additional growth such a system will generate, but they generally will agree that a low-rate, consumption-base, loophole-free tax is the way to minimize the damage caused by taxation.

#### **Tax reform and the deficit**

No discussion of taxation is complete without also looking at the spending side of the fiscal ledger.

Simply stated, it is very difficult to maintain a tax system that is conducive to growth if the burden of government spending is on an upward trajectory.

Sweden is a good example. On a per-Krona-raised basis, Sweden has a very good tax system. But since that tax system is designed to collect about 50 percent of the economy's output every year, the overall impact of the tax system is punitive and helps to explain why Sweden, which used to be one of the five richest nations in the world back when the welfare state first began, has suffered several decades of mediocre growth.

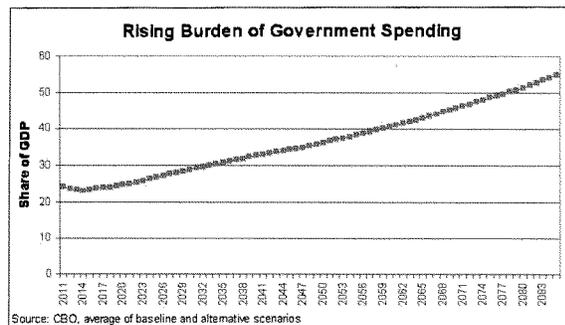
In places such as Hong Kong and Singapore, by contrast, it is difficult to have a bad system because the burden of government is much smaller – about 20 percent of economic output. This is one of the reasons why Hong Kong has a flat tax and Singapore’s so-called progressive system has a top tax rate of just 20 percent. And neither jurisdiction imposes double taxation on capital gains or dividends, and neither has a death tax or wealth tax.

Unfortunately, the burden of government spending jumped significantly in the United States during the Bush-Obama years, and the long-run projections – to be blunt – indicate that the United States will become another Greece.

But the important thing to understand is that more than 100 percent of the problem is on the spending side of the fiscal ledger.

How can something be more than 100 percent of the problem? It’s in the numbers.

The burden of spending is supposed to climb dramatically because of a combination of entitlement programs and demographics. This chart shows CBO’s long-run estimate of federal spending as a share of GDP, based on taking an average of the baseline and alternative fiscal scenarios.



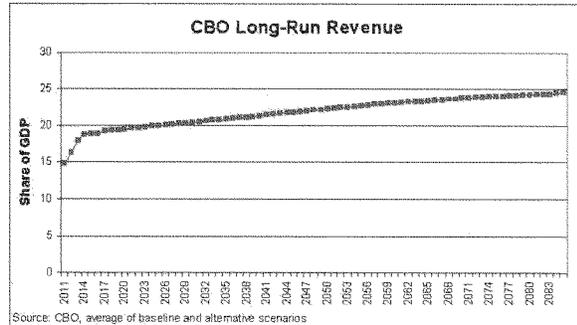
For the post-WWII era, federal spending averaged about 20 percent of GDP. And when Bill Clinton left office, the burden of spending was down to 18.2 percent of economic output.

Rapid spending increases during the Bush-Obama years have dramatically expanded the size of the federal government, up to about 24 percent of GDP. And the federal budget will consume more than 50 percent in the future if policy is left on autopilot.

Now let’s look at the same numbers, but for revenue. During the post-WWII era, federal revenues averaged about 18 percent of GDP. They are temporarily below that amount

because of the very tepid and weak economic expansion. But even with that weak recovery, revenues are supposed to be above average by the end of the decade.

What’s most remarkable, however, is that CBO projects that federal revenues will climb significantly in coming decades, largely because of real bracket creep.



And since revenues are climbing well above the long-run average, it is quite fair to say that more than 100 percent of the long-run fiscal problem is that spending is climbing even faster.

This is why tax reform should not be a revenue-raising exercise – especially since economic growth is very important for sound fiscal policy. These numbers, taken from the CBO sensitivity tables, show how even tiny changes in economic growth can have a substantial impact on revenue.

**How Selected Economic Changes Might Affect CBO’s Baseline Budget Projections**

(Billions of dollars)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total	
												2013-2017	2013-2022
Growth Rate of Real GDP Is 0.1 Percentage Point Lower per Year													
Change in Revenues	-1	-4	-8	-13	-18	-23	-29	-35	-42	-49	-57	-66	-278
Change in Outlays													
Mandatory spending	*	*	*	*	*	*	*	*	*	-1	-1	*	-2
Debt service	*	*	*	*	1	2	3	5	7	9	12	3	39
Total	*	*	*	*	1	2	3	4	6	9	11	3	36
Change in the Deficit*	-1	-4	-8	-13	-19	-25	-32	-39	-48	-58	-68	-69	-314

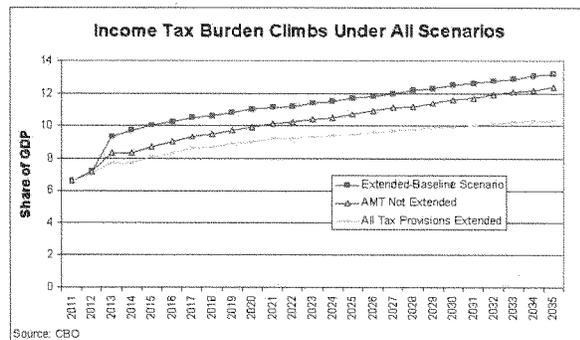
**Tax reform and fairness**

Like beauty, fairness is in the eye of the beholder.

Proponents of tax reform generally define fairness as a system that treats everyone equally, which is why the flat tax is appealing.

But there are others who want the tax code to impose harsher burdens on those who produce more output.

I'll make two points. First, the income tax burden is expected to rise in coming decades, even if the 2001/2003 tax cuts are made permanent. These numbers from the CBO long-run outlook show that income tax receipts will rise to record levels.



Second, there is a big difference between tax rates and tax collections. Here's some data from the IRS's annual Statistics of Income Bulletins.

These numbers show taxpayers, taxable income, and tax rates in 1980, when the top rate was 70 percent, and the same data for 1988, when the top rate was 28 percent.

<b>1980 Taxes Paid on Income Over \$200 Thousand</b>			
	<b>1980 Returns</b>	<b>1980 Taxable Income</b>	<b>1980 Income Tax Paid</b>
<b>\$200k - \$500k</b>	<b>99,971</b>	<b>\$22,696,007</b>	<b>\$11,089,114</b>
<b>\$500k - \$1 Mill</b>	<b>12,297</b>	<b>\$6,512,424</b>	<b>\$3,613,165</b>
<b>\$1 Mill-plus</b>	<b>4,399</b>	<b>\$7,913,225</b>	<b>\$4,301,111</b>
<b>Total</b>	<b>116,757</b>	<b>\$36,221,656</b>	<b>\$19,003,420</b>

<b>1985 Taxes Paid on Income Over \$200 Thousand</b>			
	<b>1985 Returns</b>	<b>1985 Taxable Income</b>	<b>1985 Income Tax Paid</b>
<b>\$200k - \$500k</b>	<b>547,239</b>	<b>\$134,555,949</b>	<b>\$36,446,620</b>
<b>\$500k - \$1 Mill</b>	<b>114,562</b>	<b>\$67,552,225</b>	<b>\$19,040,802</b>
<b>\$1 Mill-plus</b>	<b>61,896</b>	<b>\$150,744,777</b>	<b>\$42,254,821</b>
<b>Total</b>	<b>723,697</b>	<b>\$352,852,951</b>	<b>\$97,742,243</b>

This is remarkable evidence for the so-called Laffer Curve. The IRS got five times as much money at a 28 percent rate as it did at the 70 percent rate.

Obviously, there were many other factors besides lower tax rates that contributed to this huge surge in taxable income and tax revenues, but it certainly appears that reasonable tax rates are more effective at generate revenue than confiscatory tax rates.

Thank you very much. I will be happy to answer questions.

Chairman CONRAD. Thank you. Thank you. I appreciate that.

Let us go right to the questions, and I think we will have to wait and see what our time per round is. I have just been advised there is going to be a vote at 11:30, so I think we will probably go to shorter rounds than I had earlier thought because we would like to—depending on how members show up, we might be able to get done by 11:30. If not, we will come back.

Let us go right to the question.

Simpson-Bowles had the top rate at 28 percent, but it also had dividends and capital gains at ordinary rates in the underlying numbers.

So how say you, witnesses, on the question of cap gains and dividends at ordinary rates if rates were at 28 percent? Do you think that is a good idea? A bad idea? Why or why not? Dr. Burman, we will start with you, and we will go right through the panel.

Mr. BURMAN. Well, I actually wrote a book about capital gains, and one of the things that struck me in my research is that people think of low capital gains tax rates as this big boost to growth, and there are some reasons to think that. It encourages certain kinds of investments. But the lower capital gains tax rate is a huge bonanza for tax shelter activities, basically designed to make wages look like capital gains. You have all these people in hedge fund and private equity businesses who are earning their income taxed at a 15-percent rate rather than at a 35-percent rate, and there are probably too many people in that line of work just because they are following that tax subsidy. And a lot of the tax shelters that are designed to take advantage of the lower capital gains tax rate are really, really inefficient. The company is doing things for—or individuals are doing things for tax purposes that would make no sense absent the subsidy.

What is more, a lot of the people who are in the business of inventing these tax shelters could actually be doing socially productive work under other circumstances, like maybe trying to invent products, American products that people would want to buy around the world.

Simpson-Bowles, the Bowles-Simpson proposal I think is exactly the right way to go, and this is what Ronald Reagan did in 1986: get individual income tax rates low enough that you can tax capital gains the same as other income, eliminate that huge source of distortion. Tax lawyers say that half of the Tax Code is devoted to policing the boundary between capital gains and ordinary income, and it is essentially not all that good at it.

You know, obviously, there are issues of double taxation, but the income tax is a balancing act. There is no right way to tax capital gains under an income tax. Maybe this is why Dr. Mitchell would say we should just go to a consumption tax. But if we have an income tax, we should tax capital gains the same as other kinds of income.

Chairman CONRAD. Dr. Rogers?

Ms. ROGERS. I suspect that—I mean, I largely agree with what Len said, and that is because I come from a bias of thinking that the right basis of taxation is income. So, when you talk to Dr. Mitchell, he is coming at it from the perspective that consumption is the right basis of taxation, and this is where the disagreement

is in terms of the incentive effects of taxing capital gains and dividends like labor income or preferentially.

So those who favor a consumption base are going to say that that is not an even treatment because under a consumption base you should have a lower rate of taxation on capital income.

I think it is a trade-off, and I think that if you believe in an income tax base as the measure of ability to pay the standard for taxation, then it makes no sense to tax capital income at a preferential rate to labor income.

Distributionally, you get a good result from that. You could think of under an income tax base capital gains and dividends preferential rates are a tax expenditure, and reducing that tax expenditure by treating all forms of income the same would raise burdens much more on higher-income households than lower-income households simply because higher-income households get a large fraction of their income from these forms.

The question then becomes an empirical one. If you worry about the incentive effects of raising tax rates on capital, you have to weigh that incentive effect and possibly some decrease in private capital formation against the cost of not doing so, which is higher deficits. You know, the benefit you get from raising the tax rate on capital income is that you get more revenue and you reduce the deficit and you raise national saving that way.

So that in my opinion is a surer way to raise national saving than to keep tax rates on private capital low to hope for more private sector capital formation.

Chairman CONRAD. Dr. Mitchell.

Mr. MITCHELL. In tax reform the rate is actually the simple part. As you are seeing from our discussion here, it is the definition of income. Do you want sort of the Haig-Simons comprehensive income base, or do you want the Fisher-Ture consumption base? Although I think those terms are misleading because the comprehensive income tax is really a tax on income plus net worth, changes in net worth, and a consumption base is just a tax on income, but with income only being taxed one time, whether you are taxing it once when earned or once when spent with something like a value-added tax.

I guess one thing I would add to the discussion—because obviously in terms of just the description, I agree with my colleagues on what these trade-offs are. The one thing I would add is that because of globalization, because the world economy is much more competitive, and because capital is especially mobile across national borders, I think that really underscores how it is very important to keep tax rates low.

Now, obviously, if we figured out how to have tax rates at 10 percent, then whether you had double taxation would not matter because the overall effective rate, even when you add all the double taxes, would not be that much. So, yes, if you can keep tax rates low, double taxation does not matter much. If you keep tax rates low, loopholes do not matter that much.

Chairman CONRAD. Let me ask the panel this question, and I have only got about 2 minutes left, so if you could give succinct answers, I would appreciate it.

In the Commission, we had a series of analysts come in, and it was interesting how uniform their recommendations were. They, from whatever philosophical perspective, recommended that we go to a hybrid system, that we have part a tax on income, part a tax on consumption. Their argument was that you would improve the incentives for savings, for investment, and ultimately for economic growth if you did.

Obviously, the concern is if you have a hybrid system that you raise more revenue than you otherwise would, but just going to that fundamental question, I would be interested in the responses of the panel. Dr. Burman?

Mr. BURMAN. So that is actually basically the Nordic system that Dr. Mitchell was talking about. There are definitely advantages in terms of economic growth, and it is a more coherent way to provide a lower tax rate on capital.

I also have another proposal, which is a value-added tax that is actually dedicated to paying for health care, and use that as a way to cut individual income tax rates dramatically. I realize that is a bigger reach, but it is actually simpler. We know how to—value-added taxes are used everywhere else in the world, and that would effectively lower the tax rate on capital relative to labor.

Chairman CONRAD. Dr. Rogers?

Ms. ROGERS. Well, the big reason to go for a hybrid system is because if you went all the way to a consumption base, it becomes much more difficult to retain the progressivity in the system. So I think that is the idea that you move toward a consumption base in one part of the system in order to improve incentives to save and invest, but you keep some kind of income tax so that you can add progressivity to the system through the income tax.

Chairman CONRAD. Dr. Mitchell?

Mr. MITCHELL. Well, we already in effect have a hybrid system today because, with IRAs and 401(k)s we are protecting savings from double taxation. We have the lower rates for dividends and capital gains which do the same thing. Obviously, I think anything that moves us toward this consumption base will be better for growth.

Chairman CONRAD. You know, it is so interesting. It is really striking how many people, if you just take the politics out, suggest that structure.

Senator Toomey?

Senator TOOMEY. Thanks, Mr. Chairman. Let me just follow up a little bit on this, and then I would like to move to a couple of other areas.

If you look at the President's proposal on tax policy, the effect, in particular on dividend treatment, is really stunning. What the President is proposing in combination, to treat dividend income as ordinary income and given what he is proposing to do to ordinary income rates at the top, it is a tripling of the tax that we currently have on dividend income from a current 15 to about 45 percent. And, Dr. Rogers, I think in a comment you made, you made a passing reference to a trade-off that acknowledges if you raise taxes enough on investment income, it does have an impact on capital formation.

If we triple the return on investment on an aspect of dividend income, an aspect that has already been taxed because a corporation is only dividending after-tax income, and we about double the tax on capital gains, are you not worried that that could have a really significant detrimental effect on capital formation which is critical to economic growth? And maybe each of you could briefly address that.

Mr. BURMAN. At current tax rates, I think there is something of a concern, but actually the empirical evidence on the effect of cutting dividend tax rates was that it did not have a very large effect on corporate payouts, except in companies that were solely owned.

You know, the issue of double taxes is a complicated one because there are a lot of companies that do not pay any tax at all, and there are some companies that are taxed at the full rate. The Bush administration actually had a proposal to target dividend relief to the actual double taxation. If companies were paying tax—Walmart pays a 35-percent rate; G.E. pays a rate close to zero. Walmart could pass on to their shareholders a real break against dividends, and G.E., the tax would be levied at the shareholder level. And I think that is actually a better approach.

Ms. ROGERS. The President's tax proposals suffer from a problem of trying to narrow the group of people that he is willing to raise tax burdens on, and the Tax Policy Center actually did an analysis over a year ago that I cite in my testimony that illustrates the problem with limiting tax burden increases to a very small segment of the population. Obviously, the narrower the set of the population that you are willing to raise burdens on, the more you have to raise burdens on those people.

So my complaint about the Obama tax proposals is that there is a lot of targeting to the \$250,000 and up category of households, and as a result, you are going to get higher increases in marginal tax rates on those households.

Senator TOOMEY. Dr. Mitchell?

Mr. MITCHELL. Tripling the double tax on dividends is a misguided idea, but I would like to augment that concern with something else. By pushing dividend rates up to close to 45 percent, when you also factor in what is happening because of the health care law to the taxation of capital income, and then you compare that to what is happening with capital gains, which also would go up under the President's budget, but they would be split apart with one rate much higher than the other, and that then causes distortions in terms of retained earnings versus distributed earnings.

So if you are going to have double taxation, at least have double taxation where you are treating it equally so you are not adding not only a distortion between income that is saved versus income that is consumed; you then do not want to have an additional distortion between how the different forms of double taxation are applied.

Senator TOOMEY. Thank you. My second question—and Dr. Rogers in a way anticipated this question, but, everybody so far has discussed the virtue of broadening the base and lowering rates as the dynamic, a fundamental dynamic of tax reform. The President in his corporate tax reform proposal seems to be moving in that direction. But isn't it true that he is going in the exact opposite direc-

tion on individual tax policy where he is calling for a narrowing of the base on which taxes would apply and an increase in marginal rates? Isn't this the exact opposite of what we have all discussed as the more constructive direction for tax reform?

Mr. BURMAN. I actually share the same concern. Dr. Rogers pointed out that we are just focusing on a small portion of the population because of a campaign promise. That is why I actually think your focus on tax reform is really key. We should be looking at just—instead of just piling onto this clearly broken system, we should be looking at completely overhauling it and removing as many distortions as we can and then raising enough revenue to pay for the Government in a way that is fair and conducive to growth.

Ms. ROGERS. The President is actually proposing to broaden the definition of the individual income tax base, but only for households over \$250,000. So if you look at his proposal to limit itemized deductions to the 28-percent bracket, he has expanded that in this budget to include other tax expenditures like—including the exclusion of employer-provided health benefits. But all of these reductions in tax expenditures would be limited to the households in the \$250,000 and up category.

So in a way, he is broadening the base, but he is only broadening the base for that narrow group of households.

Mr. MITCHELL. Boy, I hate all this agreement we are having. It is taking away all the fun.

[Laughter.]

Senator TOOMEY. I have one more question.

Mr. MITCHELL. If you are going to raise revenue—which I do not think is the problem, but the Simpson-Bowles approach is a constructive way of doing it because in effect you are saying I will give you \$1 of lower tax rates, you give me \$2 back of your preferences. But tax rates at least get lowered.

The President's plan is really the outlier in terms of the public policy analysis on this issue, and I assume it is just based on a perceived political benefit of playing the class warfare card.

Senator TOOMEY. Thank you. And my last question. We have touched on the issue of progressivity several times in several ways. It is helpful if there is some consensus about what the best metrics are. So I will suggest that the most meaningful metric, I think from an objective point of view, is to look at the ratio of total income taxes paid as a percentage of total income earned.

Could each of you suggest whether you think there is a better metric, a more meaningful metric for measuring the concentration of the tax burden?

Mr. BURMAN. I think that is right. The right metric is the effective tax rate and how that varies by income level, and by that metric, the tax system has been becoming less progressive over time.

Senator TOOMEY. Not by the metric I just defined. If you—

Mr. BURMAN. Taxes as a share of income?

Senator TOOMEY. No. The metric that I am talking about is the total taxes paid for a given subset of the population, the percentage of the total tax burden divided by the percentage of total income earned. That is a pretty standard metric that is used. We have it on one of our charts here, and it gets to the fact—it goes to the

point—because what you—you made a comment, Dr. Burman, that the reason for the increase in the tax burden in a given upper-income bracket is because of a greater share of income. Well, there is a way to adjust for that, and that is to look at a ratio of the total burden—the total taxes paid divided by the total share of income. And by looking at that ratio, I think that suggests relative shares of the tax burden in a much more meaningful way.

Mr. BURMAN. I think the basic notion of progressivity that—and, obviously, there is a lot of disagreement about this, but in public finance textbooks, the basic notion of progressivity is how does the tax burden affect—that basically higher-income people should pay a larger share of their income than lower-income people do. Our tax system is designed to do that. But by that measure, the proper measure is taxes as a share of income, and by that metric, the tax system has been becoming less progressive over time.

Chairman CONRAD. Thanks.

Senator Whitehouse?

Senator WHITEHOUSE. Thank you, Chairman.

Let me ask the witnesses a little bit more about the complexity of the Tax Code. We have heard, I think fairly frequently, about the effect of health care costs on some of our export industries, that an American car overseas carries an extra \$1,500 or \$2,000 of cost by comparison to its international competitors because of the way we have paid for our health care system.

It strikes me that there is a similar situation with respect to our tax system on trade that countries that basically tax at the point of purchase and export before that point of purchase send out tax-free goods into the international market, whereas we tax at the corporate level, that cost gets built into the product, and it carries that cost out into the international market. I am interested in how much you think there is a trade disadvantage that ensues from that, and I am also interested in quantifying a bit your views on how much of a drag on the economy comes just from the sheer complexity of the Tax Code.

It has been said that Americans spend 6 billion hours a year engaged in compliance with our Tax Code, and presumably there are more productive ways of devoting those 6 billion hours, as Dr. Burman suggested, than chasing our tail around the complexities of the Tax Code.

And the third point I would ask each of you about, again relatedly, is there is both the possibility of favoritism from the complexity and the related possibility that the general public, which is not in a position to take advantage of that complexity, begins to lose confidence in the whole taxing process, that it is a racket, and that if you can get your lobbyists in there, you get the special deals.

So from a point of view of trade, from a point of view of public confidence, and from a point of view of just sheer burden, weight on the economy, could you talk a little bit more about complexity? And to the extent there is data out there that puts any numbers behind this rather than just general observations, I would be interested in those. Dr. Burman first, I guess, from one side to the other.

Mr. BURMAN. So on the issue of trade, it is actually complicated. People think that a value-added tax, which is common everywhere else in the world, is a subsidy to trade because it is rebated on exports, and it is imposed on imports. But that actually just makes it neutral. It means foreign goods are treated the same way as domestic goods.

The big problem we have is that our corporate and individual tax systems have so many ways in which they tax different activities at different rates, and this affects trade but in a way that I think is really hard to measure. It probably hurts us relative to a more neutral tax system, but I do not know of any particular dollar measures of that.

In terms of the costs of complexity, Joel Slemrod, who is an expert on this at the University of Michigan, recently estimated that complying with the tax system cost \$215 billion in 2011. That is an enormous amount of money. Half of that is the cost of time that people spend learning about the tax system, filling out their tax forms, recordkeeping, and all of that. If we can simplify the tax system so we can reduce that, that is a pure gain to the economy.

I think you are exactly right that the complex tax system certainly creates opportunities for people to game the system, and that creates the perception of unfairness. The other thing is people just do not understand how it affects them, and it really undermines the support for it. It used to be that people thought the income tax was the fairest system because it is progressive. Now they think it is much less fair than other taxes, and I think it is mostly because they do not even understand how it affects them, and that is a big problem.

Senator WHITEHOUSE. Dr. Rogers?

Ms. ROGERS. I think on the international trade issue, a lot like other aspects of the economic effects of tax policy, I think all of us tend to overestimate how much taxes matter and that there are many other economic factors that swamp the effect of different tax rates.

On complexity, I do not really have anything to add from what Dr. Burman said.

Senator WHITEHOUSE. Do you agree?

Ms. ROGERS. I would agree, of course. And the cynicism—I wrote down “cynicism.” I was not sure if you said that, but I sort of thought about the complexity of the tax system and seemingly arbitrary nature of who gets what kinds of tax breaks. I think it does make your average American cynical about the tax system, and everyone assumes that it must be that the rich or someone else other than themselves pays a much lower tax burden. And I think that the problem with that is it encourages the tax gap to get bigger, that people are more inclined to cheat on their taxes because they think that they cannot get a lower tax burden an officially legal way, so they are going to try to trim their income or exaggerate their deductions. And they think that they deserve that because they think that everyone else must be getting much—

Senator WHITEHOUSE. When they look at hedge fund billionaires paying lower rates than they do, G.E. paying nothing, and ExxonMobil getting tax subsidies, it is kind of hard—I mean, that is not an unreasonable position to—

Ms. ROGERS. Right. An advantage to lowering, if you can broaden the base, is you create less of that perception, you also create less incentive for people to mischaracterize their income or misstate their income. And it would be good for the tax gap as well as for general tax reform goals.

Senator WHITEHOUSE. Dr. Mitchell?

Mr. MITCHELL. Your discussion in your question, you mentioned the cost of health care built into the price of a car, and it just underscored in my mind how important tax reform could be if we could deal with the health care exclusion and begin to address the third-party payer problem, that would be a wonderful thing that tax reform could generate.

In terms of the VAT and trade, I agree with the other people on the panel. The simple way to think about it is if we impose a VAT, well, American-produced cars will have a VAT imposed on them and so will German-produced cars. Just like in Germany today American-produced cars have a VAT, so do German-produced cars. I do not think there is a trade benefit to a VAT at all.

In terms of complexity, Commerce Clearinghouse, I think it is, estimates 72,000 pages of code and regulation. In Hong Kong it is 157 pages, and that is after six decades of having a flat tax. I was giving a speech in Slovakia at the Economics University of Bratislava. I mentioned the 72,000-page figure. This professor pulls off her shelf a magazine and says, "This is our tax code." I said, "Wow, that is amazing. Your income tax is only that thick?" And she said, "No, this is our entire tax code—VAT, excise taxes." She opens it up and she pulls out like 20 pages: "This is our 19-percent flat tax."

So, yes, we have enormous complexity, and other countries have managed to fix it.

Senator WHITEHOUSE. The real cost to the complexity on the economy.

Mr. MITCHELL. Well, Professor Slemrod, whose son was my intern, has done great work on that, but there are also figures that OMB has generated. The Tax Foundation is very famous on that issue as well.

Chairman CONRAD. Thank you.

Senator Grassley?

Senator GRASSLEY. I only have two questions. The first one I will direct to Dr. Mitchell, and the second one, any or all of you on the panel that want to deal with it.

We have talked a lot about the dividend tax and the capital gains tax. I want to come at it from just a little different angle. Dr. Mitchell, the President in his tax reform framework as well as many others have expressed concern about how the current Tax Code incentivizes debt financing over equity. Of course, I have concerns about the distorting effect that this has on business decisions.

The President seems to give lip service to the issue of his tax reform proposals, but his budget proposes more than doubling the tax rate on dividends and raising the top statutory rate on capital gains.

Wouldn't this proposal make the incentive for debt financing even worse?

Mr. MITCHELL. Our current Tax Code does make debt more favorable than equity, and I do agree that that causes enormous problems in that if you have an economic rough patch and the value of your stock falls, the company does not go out of business. If all of a sudden your debt payments become unworkable, then you have a much, much deeper problem. And, clearly, if you are increasing the tax rate on dividends from 15 percent to close to 45 percent and nothing is really changing, or nearly as significantly anyhow, in terms of the treatment of debt, then I assume that it would be just conventional wisdom that, yes, you would be making that problem worse.

Senator GRASSLEY. Okay. Then, as I said, any or all of you, a big reason that the current Tax Code incentivizes debt financing is because interest is fully tax deductible. In contrast, dividends are not deductible to the corporation and at the same time are subject to a level of taxation at the individual. We tried to correct this bias in the Tax Code by lowering the rate on dividends. What proposals or combination of proposals would you recommend for eliminating the current bias for debt financing?

Mr. BURMAN. Economists' favorite way to deal with the issue of double taxation and debt equity is to somehow integrate the individual and corporate taxes, and I mentioned, at least indirectly, when talking about the Bush administration's proposal to provide a dividend break to the extent that companies that already pay taxes, the ideal thing is to have the corporate tax basically serving as kind of a withholding tax, just like the wage withholding works now, and individuals would get a credit for the taxes paid at the company level. That would be neutral between debt and equity, and it would guarantee that some—I mean, the income is really earned by the shareholders. It is not earned by the company. Indirectly they are passing it through.

Chairman CONRAD. Senator Grassley, can I—

Senator GRASSLEY. Go ahead.

Chairman CONRAD. Not on your time. Can I ask you just to repeat what you said? I want to make sure that I understand what you just said in terms of it would eliminate the bias between debt and equity by the last proposal you made.

Mr. BURMAN. Well, basically you treat corporations the same as S corporations or partnerships. The shareholders would be taxed on the share of earnings the corporation made that was on their behalf, and that is neutral.

Chairman CONRAD. Okay. Let us make sure we restore Senator Grassley's time that I used.

Senator GRASSLEY. Did you finish what you wanted to say? Anybody else?

Ms. ROGERS. I just wanted to point out that in the President's budget, in his framework for business tax reform, he does talk about reducing that bias in favor of debt versus equity. But the way he approaches it is he talks about eliminating or reducing the deductibility of interest. He talks about this in very general terms, though, and the administration is very careful to say that that sort of change, which is a major change, would be necessary in order to broaden the corporate tax base by enough to support a low marginal tax rate like 28 percent.

So it is a good illustration of the trade-off, that in order to keep the marginal rate low, you have to be willing to pare back on some of these preferences that are in the existing income tax.

Mr. MITCHELL. Just to augment on what Len said, if you did something like, say, a flat tax, the way that capital income is treated is a withholding tax at the business level. So individuals do not have to worry about reporting and paying taxes on dividends and interest because that is all done at the institutional level, I guess in sort of the same way that our employers withhold our personal income tax, but in the case of the taxes on capital income, you would not even need to reconcile it in any way. So the nondeductibility is the way that you would have a neutral treatment in something like a flat tax role. But, of course, if you replace the personal income tax with a VAT, I assume the problem just automatically disappears.

Senator GRASSLEY. I yield back my time.

Chairman CONRAD. I thank the Senator.

Senator Wyden.

Senator WYDEN. Thank you very much, Mr. Chairman. I want to thank all the panel. I know you have spent a lot of time in the tax reform precincts. Dr. Burman, many thanks for the kind words that you offered to Senator Coats and Senator Begich and myself on our bipartisan tax reform proposal.

Let me kind of start with what I think is one of the central concerns about where we are now in the tax reform debate.

As the history of this is every bit of tax reform is absolutely totally and completely impossible until 15 minutes before it comes together. And so every group is inclined to say we better just get ours now, we better just address what we are concerned about. Let us say you are concerned about the corporate rate, you are concerned about one proposal or another. And you see what amounts to a kind of juggernaut of support for piecemeal reform. And we are seeing that once again. We had the administration's proposal unveiled in terms of corporate reform, as Chairman Conrad knows. In fact, up here with Senator Thune and Senator Grassley, we are all on the Finance Committee. Secretary Geithner came in. And I tried to lay out my concerns about piecemeal reform. I think you have to do corporate reform and individual reform together. And you have this great history with respect to how 1986 came together.

Is that your sense, that piecemeal approaches to this are not going to get it done and in many respects make this dysfunctional mess of a system, as Senator Whitehouse just pointed out on the complexity issue, even worse if you try to go at it piecemeal?

Mr. BURMAN. I completely agree. If you take on little bits—well, let us say revenue-neutral corporate tax reform. I do not think there is much support for that in the business community, and the problem is that the companies—revenue neutral means some companies are going to pay higher taxes and some are going to pay lower taxes. The ones paying higher taxes are not going to be happy about it. I think it makes much more sense to do it in a systematic—basically deal with the whole Tax Code together.

And actually the one area where I differ a little bit with Senator Wyden—and it is probably because I would never have to run for elective office—is that I think the most effective tax reform would

be one that raised revenue and helped to reduce the deficit, and the reason is any tax reform is going to involve some people paying higher taxes. And I think if you had the sense that there was shared sacrifice, instead of thinking of it as paying higher taxes now, that we are lowering taxes on our children and our grandchildren, something—I mean, I think there is bipartisan support for children and grandchildren—that would be much more effective.

In the past, people have supported tax increases for things they believed in, for wars, for example, and I think people would—if people were convinced that it was being done in a fair way and was making the tax system simpler—and, Senator Wyden, you have been so steadfast in your support for simplifying the tax system, and I think it is really important. Making it simpler and lowering the burden on our children, I think that would be—that is the best strategy.

Senator WYDEN. Let me ask all three of you a question that I think relates to, again, how this can actually get done. My concern is as of right now the lame duck session of the 2012 Congress will look pretty much like the lame duck session of the 2010 Congress, and you will once again see this drumbeat about how you have to re-up the Bush tax cuts because the economy is still by any kind of calculus going to be a challenge, and if you do not, come January 1, we will have these increases on businesses and individuals, and nobody wants to see that happen. And so once again, almost by default, we will just sort of re-up for this broken mess that we have today.

By my calculation, it is 8 months really until the election, and for the life of me, after all of these blue-ribbon committees—and it is really striking. Senator Conrad and I have talked about this. Paul Volcker chaired a reform committee for President Obama, and the Volcker Commission put out a release, and I was not even in town. Senator Gregg, who was my partner in that effort, put out a press release that I did not even know about—it was wonderful and wonderfully helpful—saying, oh, my goodness, Paul Volcker agrees with everything that the two of us have said, and by the way, it was not all that different than the Bush reform commission and a variety of other committees that you have talked about.

So the work has been done. What is wrong with saying, particularly now with Chairman Baucus, our Finance Committee Chairman, and Chairman Camp, the Chairman of the Ways and Means Committee, two good people, we have Republicans who have been listening, what is wrong with the idea of using the next 8 months to buckle down, do the hard work in terms of laying out a tax reform proposal, and trying to find a way to do it either in the lame duck session of the 2012 Congress or early next year so that there actually is a timetable and a focus for making this happen? Because I think absent that, we will just relitigate the Bush tax cuts. You will be able to set your calendar by it. You know, you will do it in the post-2012 election lame duck, and you can do it in 2014 and 2016. You can do it for the rest of your adult life that way. But it is not going to fix this mess of a system.

So why don't we just go down the panel and say what would be wrong—you have good people, Finance, Ways and Means, bipartisan interest. What would be wrong with using the next 8 months

to try to put this together so that sometime shortly after the election this issue could be addressed? Why don't we just go right down the panel. Dr. Burman?

Mr. BURMAN. I completely agree with you, although your optimism is really striking that we could do this in an election year.

Senator WYDEN. Well, remember, I did note that it is always impossible, totally, completely, thoroughly impossible until 15 minutes before it happens.

Mr. BURMAN. One thing that I would really like would be actually President Obama could do what President Reagan did and say, "I am going to ask my Treasury Department to put together a real plan for tax reform that basically we will release after the election, have the Republican opponent agree to a budget that does as much for the deficit as basically the current law." So presumably President Obama would want more in the way of loophole closing and tax increases, and his opponent would want more in the way of spending cuts. Have a comparison of proposals where the numbers really add up, and do not keep on playing kick the can.

Senator WYDEN. I know my time is up, Mr. Chairman. Can the other two just answer?

Chairman CONRAD. Yes.

Ms. ROGERS. I do not think the end of 2012 has to turn out like the end of 2010 did. There are three things that are different now:

The economy is in much better shape right now, so the idea of actually letting some of the Bush tax cuts go might be more palatable.

Second, we have had these fiscal commissions give us recommendations. We have a lot of good tax policy recommendations, including your own, on the table now.

And, third, the Presidential election will be over.

So I think that for all those reasons there is much more hope that we could actually do better the next time around when the Bush tax cuts come back for renewal.

Mr. MITCHELL. It sounds great in theory. I am all in favor of revenue-neutral tax reform, and I think you are right that it seems impossible until something happens. I think back in 1986 there was a story about how tax reform—the logjam was broken because of pitchers of beer, I think at the Dubliner. So perhaps that might be an avenue to pursue.

Senator WYDEN. Thank you, Mr. Chairman.

Chairman CONRAD. Thanks.

Senator JOHNSON.

Senator JOHNSON. Thank you, Mr. Chairman. I would be happy to go that approach, and I would be happy to work with you, Senator Wyden.

We have been talking about tax reform, but this hearing is also on reducing the deficit and promoting fairness, so let me just pop up a couple charts here. Let us first talk about what I view as the primary problem—spending. The last 10 years, we spent about \$28 trillion. According to the President's budget, over the next 10 years we will be spending about \$47 trillion. So we are not talking about cutting spending. We are just trying to limit the rate of growth. That is the first one.

Mr. Chairman, you have talked repeatedly about the 4 years of surplus, which was great. That is where we should be.

No, not yet. You are getting ahead of me.

[Laughter.]

Senator JOHNSON. But you are talking about the one side of the equation when taxes did pop up above 19 and for one year above 20 percent, but I think the real story, the flip side of that is in 1998 spending was 19.1 percent, the following year 18.5 percent, and the next 2 years 18.2 percent. So I would argue the real reason that we had surpluses is because spending came in line with historical revenue, which is about 18.1 percent. And now we are at 24 percent spending, and that is a real problem.

I would also like to dispel the notion—now you can go. During the Budget Committee hearing on defense spending, I tried to dispel the popular belief that the wars are causing our current deficits. This is a similar type of graph showing that the Bush tax cuts are not causing our deficits. The final year there in 2012—no, say 2011 where we actually have figures, our deficit was \$1.3 trillion. But the Bush tax cuts accounted for \$113 billion of that, less than 10 percent. It is spending that is causing our deficit problem, not necessarily the Bush tax cuts. I really do not know too many people that are proposing tax cuts. We are just trying to forestall the possibility of tax increases that we think will harm economic growth.

Let us go to fairness. I guess I would like to ask each of the panel members just a very simple question: What do you think is the maximum percentage that the Federal Government should take out of any worker's paycheck? Out of any American's dollar of income, what is the maximum amount the Federal Government should take out of that dollar of income? Dr. Burman?

Mr. BURMAN. It actually depends on what the Government has to pay for. Our current rates are very low by historical standards. We can certainly raise marginal tax rates. I have not—

Senator JOHNSON. Excuse me. Really, it is a very—really, it is a very simple question, with all due respect. Please, just a percentage. What is the maximum amount that you think the Federal Government should take out of any American's dollar of income? Just the maximum percentage, what do you think? What is fair? Easy, just a percentage, a number. What do you think?

Mr. BURMAN. But it depends on the base, and, the broad base, you could actually lower rates.

Senator JOHNSON. But what is the maximum amount that should be—in terms of fairness, what is the maximum amount? Please, just a percentage.

Mr. BURMAN. Well, Emmanuel Saez and Peter Diamond had an estimate that 44 percent was sustainable and was justifiable.

Senator JOHNSON. So you think that would be fair, that would be the maximum amount, 44 percent.

Mr. BURMAN. If we cannot do anything about the base. That would not be my preference.

Senator JOHNSON. Which would leave those individuals about 56 percent—

Mr. BURMAN. No, that is the marginal rate—

Senator JOHNSON. Dr. Rogers, what do you think is the maximum amount that should be taken out of any American's dollar of income? The maximum amount, a percentage. A simple question.

Ms. ROGERS. As the marginal tax rate or average tax rate?

Senator JOHNSON. Marginal. Out of a dollar of income, what is the maximum amount the Federal Government ought to lay claim to?

Ms. ROGERS. I believe it should be no more than the rate at which the incentive effects would be bad. So we want to stay below Laffer curve rates, which, by the way, is 70- to 80-percent marginal tax rates.

Senator JOHNSON. So you believe that an American making \$1 should pay 80 percent, so it would be 20 percent free on that dollar's worth—

Ms. ROGERS. That is just the last dollar, though. That is the marginal tax rate. An average burden, we can—

Senator JOHNSON. You think that—

Ms. ROGERS. —do a lot better than—

Senator JOHNSON. So you think that would create an awful lot of incentive to earn that last dollar then?

Ms. ROGERS. No, of course not. You asked a very hypothetical question about the maximum—

Senator JOHNSON. Well, it is a very basic question.

Ms. ROGERS. Maximum marginal tax rate on any one American? Like I can pick the richest guy in the country?

Senator JOHNSON. Okay. Dr. Mitchell, what do you think is the maximum amount that the Federal Government ought to lay claim on an American's dollar of income?

Mr. MITCHELL. Well, for much of our Nation's history, it was zero. We did not have an income tax. And at the Cato Institute, we long for the days of a limited central government, and so in my fantasy world, it is zero.

I will point out that just the other day the Hill did a poll asking people what the maximum tax rate on the rich should be, and I think the number was like 30 percent—which, of course, is lower than the current tax rates and certainly far lower than what the President is proposing.

I think the academic evidence is pretty strong that if you had tax rates at 20 percent or below, you would be doing very, very little damage to the economy.

One key thing to understand about the Laffer curve, the revenue-maximizing point is the point where you are doing so much damage to the economy that you are losing this much taxable income and that offsets completely the effect of the higher tax rates. Why would we ever want to get anywhere close to where we would be destroying so much private sector income that the Government does not even collect more revenue? And as I said earlier—I forget whether it was my testimony or a question—we have already seen in the U.K. that they are collecting, according to the latest data, less money at a 50-percent tax rate than a 40-percent tax rate. So I do not think the revenue-maximizing tax rate—not that I want to be there. I do not think it is anywhere near 70 to 80 percent. I think it is much, much lower, especially in the long run.

Senator JOHNSON. And, of course, Maryland, they had their 2007 millionaires' tax which they projected would raise \$330 million worth of income, and it raised \$120 million, 36 percent.

Dr. Mitchell, you earlier were talking about the difference in revenue raised from 1980 to 1991. Let me just kind of give you some historical effective tax rates. In 1980, the effective tax rate on the top 1 percent was 35 percent, and they paid 19 percent of the income tax. In 1991, the effective rate was 24 percent. It had gone down. They were paying 25 percent of the total income tax burden. In 2007, which was the record year, the effective tax rate had been lowered to 22.5 percent. So it went from 35 percent in 1980 to 22.5 percent. The share of the top 1 percent's income went from 19 percent to 40.4 percent, which, by the way, in 2007—that was the high watermark—the top 1 percent paid more of the income tax burden than the entire bottom 95 percent.

I do not know. To me that seems like they are paying their fair share. And my concern about trying to raise taxes on the rich again is the minute we do it, the day afterward, our colleagues on the other side of the aisle will be saying they are not paying their fair share again. At what point have we gone too far?

That is it. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Johnson.

Senator Thune.

Senator THUNE. Mr. Chairman, I would yield to my colleague from New Hampshire, Senator Ayotte, if she wants to ask questions in the interest of time. We are going to have a vote here pretty soon.

Chairman CONRAD. Thank you, Senator.

Senator Ayotte.

Senator AYOTTE. Thank you so much, Senator Thune, and thank you, Mr. Chairman. I appreciate our witnesses being here today.

I wanted to ask a particular question about the President's corporate tax proposal that he has put out recently, and as I understand it, in that proposal he has provided that income earned by subsidiaries of U.S. corporations operating abroad will be subject to a minimum rate of tax, though the specific rate is not yet clear.

As I understand it, this would make our tax treatment of foreign profits unique in the world because most have a territorial system, and that in my view one of the concerns I have about this is this will impose higher tax rates on U.S. multinationals. We have a global economy at a time when obviously our unemployment rate is not what we would like, and we would like to further create jobs. And operating abroad relative to our foreign counterparts, that if we do not have the similar type of territorial system, then we will be less competitive. And I would like your viewpoint on the President's approach, and in my view, it just seems to make common sense that if we develop a different approach than the rest of the world that disadvantages our corporations, then we are going to hurt our employment prospects here in the United States of America.

So can you comment on that?

Mr. MITCHELL. I mentioned in my testimony that territorial taxation is theoretically the right approach. We have a worldwide tax system, but we try to mitigate the effect of the worldwide tax sys-

tem with a policy known as “deferral,” which means we delay the extra layer of tax until you bring the money back. That, of course, creates a perverse incentive for companies to keep money overseas instead of bringing it back. We try to deal with that with repatriation holidays when the right answer is just going territorial.

The President’s plan would be to actually go more in the direction of worldwide taxation and for U.S. companies competing for market share in other countries—well, here is a great example. If an American company is competing against, say, a Dutch or a Canadian company for business in Ireland, the Dutch and Canadian companies only pay the 12.5 percent Irish corporate tax rate. There is no additional layer of tax in their home country.

The U.S. company pays the 12.5 percent to Ireland, but then you have the additional 35 percent U.S. tax rate. You get a credit, but you still would wind up, even if the credit works fully, which usually or oftentimes it does not, you still have a tax burden that is almost 3 times as high as your foreign competitors. And with lots of low-tax jurisdictions around the world, the U.S. really stands out like a sore thumb with our high corporate tax rate. It is becoming an increasing problem for U.S. multinationals.

And, of course, one-fourth of our exports are from U.S. companies to their foreign subsidiaries, so anything we do that reduces the market share overseas of U.S. subsidiaries overseas is going to hurt exports and jobs in America. So I think it is a very unfortunate proposal.

Senator AYOTTE. Any further comment?

Mr. BURMAN. I am not fond of minimum taxes. I have written a lot about the individual alternative minimum tax. I think you should decide what income is and just tax it and not have different rules for different situations.

The problem with the territorial system—and it is true that most of our competitors have it—is that it creates a huge incentive for companies to shelter income from U.S. tax. Basically any income that they can make it look like is earned overseas is completely exempt from U.S. tax. So there is something of that incentive now, but eventually when the income is repatriated, it is taxable.

So it is just very, very complicated, and there is really a possibility that U.S. companies would have even more incentive to move their activities overseas because that is the way they can be completely exempt from U.S. tax. And if they go to a place like Ireland, which has a very low corporate tax, or other tax havens, they can avoid tax entirely.

You also have this transfer pricing problem that basically the deal for multinational companies is to have as much of their income go overseas as possible and have as much of their deductions in the United States. And that is very, very hard to police and monitor, and it will be harder under a territorial system. So that is the main concern.

Senator AYOTTE. Can I just say, just as a follow-up—and I certainly want to hear your comments as well. I appreciate it. But doesn’t that put us in a difficult position when our system is going to be different than the rest of the world? And I understand the policing problem. I would rather resolve the policing problem than make us at a competitive disadvantage that hurts our ability to ex-

pand and create jobs, particularly where our unemployment rate is. So, I am not sure I heard you answer that somehow if we keep a different way of taxing other than the rest of the world that that somehow is going to not harm our competitiveness. I mean, that is really the core of the concern.

So I understand the policing problem. I would rather see us resolve the policing problem. But—

Mr. BURMAN. Well, I think it is very hard to resolve the policing problem, and probably impossible. That is actually where tax reform really becomes a key factor, that if you can find a way to broaden the base and lower the rates, then it becomes much less of a factor in companies' location decisions and where they choose to engage in economic activity.

It is possible for—the U.S. has had a different system than a lot of our competitors for a while, and there are a lot of reasons that companies operate in the United States, primarily because we have a giant market that they want to be close to. So the tax system is one factor. It is not irrelevant, but it is not as important as some of the critics would make it out to be.

Senator AYOTTE. Well, certainly our regulatory climate adds to it as well.

Go ahead. I am sorry.

Mr. MITCHELL. I agree with a lot of what Len says, and I think it underscores the importance of the corporate tax rate. Right now, yes, companies try to declare income in Ireland rather than the U.S. because we have a 35-percent rate, and so they use transfer pricing and other things like that, oftentimes, I am sure, very aggressively. But if our rate came down, if we were the low-tax country instead of having the second-highest corporate tax rate in the world, then companies would be trying to declare income in the U.S. rather than someplace like Germany or France that might be higher than us.

So the rate is—just like with individual tax reform, you get the rates down low enough, and a lot of problems just disappear.

Senator AYOTTE. My time is up, and I know we have a vote. I just want to say one thing. In my view, the President, with the rate that he has proposed, it is not low enough because it is going to essentially, with State and local taxes, only going to put us and move us from seventh to perhaps fifth among the 6.7 countries, and it depends on where Japan does their rate. And so I certainly think that the reform proposal has to be more aggressive, and also I am very concerned about those that are organized like my husband's business, a small business in New Hampshire as an LLC. His proposal is to increase taxes on those businesses, and that makes up a substantial number of small businesses in this country.

I know our time is up and we have a vote.

Chairman CONRAD. Thank you very much, Senator.

Senator Thune.

Senator THUNE. Thank you, Mr. Chairman.

Let me ask a question about the proposal that the Obama administration put forward was a 25-page framework for corporate tax reform, and yet, as you know, if you are going to be serious about corporate tax reform, it seems to me that you also need to have the

individual tax reform integrated into that because of the way that so many of the business tax returns are filed today.

Do you think it makes any sense to do corporate-only tax reform given that most business income is today earned by pass-through businesses? And should Congress consider base broadening that will raise taxes on those who pay taxes at the individual level in order to pay for lowering the corporate tax rate? Which is essentially what you would be doing if you just did the corporate side only.

Mr. BURMAN. My understanding of the proposal is that it is more than corporate, that there actually are changes that occur at the individual level, too. My preference would be to do tax reform on the whole income tax together, probably the estate tax as well, collectively, and fix the entire Code.

There are certainly reasons to want to fix the corporate tax system. Our rates are high relative to the rest of the world, and we do not raise much revenue. But I think revenue-neutral business tax reform would be very difficult to begin with, and if we are going to do tax reform, we should fix the whole thing.

Senator THUNE. Agreed?

Ms. ROGERS. I agree with that.

Senator THUNE. I mean do you agree that it essentially creates a two-tiered system? If you only corporate, you may have small businesses that are going to be paying a higher income tax rate than corporations in this country?

Ms. ROGERS. I think it is better to do tax reform across the board so that there is a sense of shared sacrifice that Len mentioned earlier. I think that it is very difficult to do this base-broadening reform if you just broaden the base in certain parts of the Tax Code, because people are going to resist that if they feel like they are being picked on and no one else is. So I think you need to do the base broadening both in the individual and in the corporate and lower overall—keep overall tax rates low.

Senator THUNE. Agree, Mr. Mitchell?

Mr. MITCHELL. If I have heart disease, diabetes, and cancer, I would want the doctor to cure all three, so I obviously prefer the comprehensive approach. But if the doctor can only cure one, I suppose that is better than nothing. But, yes, I agree with my colleagues on the panel. If we could fix the entire mess, life would be good.

Senator THUNE. Yes, it would leave some pretty sick patients, though, if you only did part of it, I would think.

You know, if you look at some of these proposals in the budget, in particular to tax dividend income as ordinary income, it really would be dramatically increasing the tax on investment income. In fact, it would triple. It would go from 15 percent to 39.6, and then when the 3.8 percent tax on unearned income comes in for high earners because of the health care bill, there would essentially a 44-percent top marginal rate on investment income. And plus you have the whole that income already having been taxed at the corporate level.

There was a recent study by Ernst & Young that found that when you take into account the double taxation, the top tax rate on dividends, you would go from 50.8 percent to 68.6 percent,

which would be significantly higher than the rate of tax on dividends imposed by literally all of the OECD countries, as well as many of the sort of our major economic competitors in emerging countries like Brazil, Russia, India, and China.

So when the President rolls that out, it seems to me at least that it really does have the potential of hurting America's competitiveness with those around the world with whom we compete. So could you comment on how that kind of a drastic increase in the tax rate that would apply to dividend income to a level well above our competitors is likely to affect our economy and economic growth and our competitiveness?

Mr. BURMAN. I have not seen the Ernst & Young study. It sounds like they are assuming that the income is fully taxed at the company level, at the corporate level, and part of the problem is that there is wide disparities in taxation at the corporate level. Only about half of the income is subject to tax. A better approach is to try to broaden the base so that you are taxing all the income the same way and then tax it at a lower rate. But I cannot comment on that particular study because I have not seen it.

Senator THUNE. Yes.

Mr. BURMAN. And I should also point out that what is being proposed for dividend taxation would still have dividends be taxed at a lower rate than they have been for most of the history of the income tax back to World War II.

Ms. ROGERS. Again, there are costs and benefits associated with raising or lowering tax rates, so, obviously the cost to worry about is when you raise marginal tax rates that high, what are you going to do to private incentives? The benefit of raising tax rates is you will raise revenue from that. Even at a high marginal tax rate, it is still not so high that it is going to actually reduce revenue as you raise the rate. So it is a trade-off.

Senator THUNE. Dr. Mitchell?

Mr. MITCHELL. I think the Ernst & Young study, the best way to understand it is that even though, as Len said, effective rates sometimes at the corporate level can be lower, usually if a company is earning profits, any additional profits will be at the marginal rate of 35 percent, and it is the marginal rate that determines incentives for additional expansion, production, job creation, and things like that. So I look at that Ernst & Young study as being very worrisome because, as was already mentioned in our discussion, capital mobility in a modern globalized economy is enormous. And I do worry that we send out a signal that it is better to create jobs, to expand output in countries other than the U.S.

Now, interestingly, the Obama administration, Gene Sperling the other day was saying, well, maybe we could solve this by getting all countries to agree to a minimum corporate tax. That is sort of like, well, if we all agree to do bad policy, then maybe taxpayers have no escape. I think that is a very worrisome mentality in terms of how taxpayers should be treated.

Senator THUNE. Okay. Thank you.

Mr. Chairman, I know we have a vote on, and Senator Sessions I think maybe wants to get a question in here. So thank you.

Chairman CONRAD. Let me just say we have about 3 minutes remaining in the vote, so, Senator SESSIONS, do you want to come back?

Senator SESSIONS. Well, thank you for having the hearing. I will not use my time. I was just looking at a recent article from Bloomberg yesterday about the complexity of the Code. In particular, the President's Budget would introduce four separate definitions of income and three different amounts: \$250,000; \$247,450 and \$267,500. One of the people commented that taxpayers just give their papers to their accountant and say, "Tell me how much to write the check for." And then another one said just plug it in the computer to figure it out.

Would you agree that we have really gone beyond reasonableness of any rational defense in creating a Code that is too complex? Maybe three of you can give an answer to that.

Mr. BURMAN. Yes, it is pointlessly complicated and perceived as unfair, and it is clearly counterproductive. It is not raising enough revenue to pay for the Government.

Ms. ROGERS. While I love the ability to use Turbo Tax to do taxes, I actually think it does a disservice to the American people in that they do not really understand what they are doing in terms of what they are being taxed on and how much they are paying.

Senator SESSIONS. Dr. Mitchell?

Mr. MITCHELL. I would agree. The complexity is a hidden tax, especially when you factor in the misallocation of talent, resources, time, and energy that could be much better used for productive things for our economy.

Senator SESSIONS. Mr. Chairman, I know of one staffer who delayed his marriage for several months, into the next calendar year, because once he calculated his new tax liability he realized he had withheld enough. After getting married they would pay another \$6,000 in taxes.

Chairman CONRAD. That is true love.

[Laughter.]

Senator SESSIONS. It is really—the last thing this Government needs to be doing is taxing and penalizing people who choose to marry, I think.

But at any rate, thank you for the hearing, and I know the time is short. I thank all of you for your—I had three different hearings this morning that were important to me, and I was glad Senator Toomey and Senator Thune could step in.

Chairman CONRAD. It was very good. I appreciate it very much. I appreciate the witnesses. Honestly, Senator Thune and I were just saying, if you were going to design a tax system, it would be hard to design one that would be a whole lot worse than the one we have. So, look, we have to do better. We have to do better.

I thank the witnesses. I thank the members for their participation.

[Whereupon, at 11:47 p.m., the Committee was adjourned.]

Dr. Leonard E. Burman  
Response to Senator Nelson's Question for the Record

You have identified the major goals of tax reform. I do not believe that one is more important than the other and, indeed, sometimes the goals are in conflict. For example, economists believe a lump-sum tax (sometimes called a poll tax) would be most efficient because taxpayers couldn't do anything to avoid it so it would not distort people's economic decisions. In practice, a lump-sum tax is very unfair, and widely perceived as unfair, as former British Prime Minister Margaret Thatcher learned when her government enacted a small poll tax. Some complexity is necessary to properly measure taxpayers' ability to pay tax and deter fraud and abuse.

I agree that tax reform should make a contribution to deficit reduction, but that is because I think it would be infeasible and undesirable to reach fiscal balance purely through spending cuts alone. The underlying objective is not deficit reduction, per se, but enacting a tax system adequate to finance the government when the economy is at full employment. (There are good economic reasons for running deficits during a deep recession.)

Some reforms could advance all of the goals simultaneously. For example, both the Bowles-Simpson commission and Bipartisan Policy Center (BPC) task force (on which I served) proposed to eliminate or curtail most tax expenditures and to lower income tax rates in a way that increased total revenues. If such base-broadening and rate reduction were possible, it could promote growth and fairness and significantly simplify the tax system. The BPC plan would even eliminate the requirement to file a tax return for about half of taxpayers. The politics of eliminating tax expenditures is, as you do, difficult, but if it is feasible the approach would be far more efficient than simply raising tax rates. Most economists would also favor a carbon tax or raising the gasoline excise tax (presumably after gas prices fall to normal levels) because such taxes can make the economy work better.

**Diane Lim Rogers, The Concord Coalition**

**Response to Question for the Record from Senator Bill Nelson**

Hearing on "Tax Reform to Encourage Growth, Reduce the Deficit, and Promote Fairness,"  
March 1, 2012, Senate Budget Committee

Response to Question #1:

Senator Nelson, you list four possible goals of taxation—the three in the hearing’s title, plus simplification—and you ask whether one should be emphasized over the others. Given that the implicit weights different policymakers will assign to the goals are largely subjective, I believe the only way to get bipartisan agreement on a reform is to make sure the proposal does well in terms of all four of those goals.

We discussed in the hearing, and I elaborate in my prepared testimony, why it’s entirely possible to come up with a tax reform plan that would achieve all those goals. The key is to seek base-broadening, tax-expenditure-reducing, revenue-raising (and hence deficit-reducing) policy changes. Then we improve economic efficiency (reducing the distortions of the tax system across different forms of income), we reduce the size of government (by reducing the subsidies that are run through the tax code in terms of deductions or credits, exemptions, and preferential rates), we raise revenue to reduce the deficit but without raising marginal tax rates, and so we raise public and national saving and hence economic growth. Moreover, by reducing the spending that occurs through the tax code, we are able to reduce government spending in an unusually progressive way, because higher-income households benefit disproportionately from the largest tax expenditures in the federal income tax system. All these changes simplify the tax system, too, because they broaden the definition of taxable income and make more uniform the effective tax rates that apply to different sources and uses of income.

Of course, putting such a policy together is easy in theory, but in practice it will still involve hard political choices. The largest tax expenditures in the federal system are those in the individual income tax, very obviously benefitting families (even if especially the rich ones), and they are perceived by the public as more like “entitlements” or deserved benefits, rather than as the “loopholes” that smaller tax expenditures within the corporate income tax are often labeled. It may not be any easier (politically) to reduce these tax expenditures than it is to cut benefits (even to higher-income households and even slowly over time) under the Social Security and Medicare programs.

Dr. Daniel J. Mitchell

To answer Senator Nelson's question:

I would rank the four objectives in the following order, for the following reasons.

1. Promoting economic growth - Even small differences in growth can make a big difference in long-run living standards. In a competitive global economy, it is especially important to have a tax system that does not needlessly discourage productive activity. This is why a low-rate tax system is important, particularly if it is free of distorting loopholes and also avoids punitive double taxation of income that is saved and invested.

2. Simplifying the tax system - All of the complexity in the tax code is the result of bad tax policy. The complicated international tax rules only exist because the U.S. imposes a "worldwide" tax instead of a simple and competitive "territorial" system. The bewildering rules for business taxation largely exist because lawmakers force companies to overstate their income thanks to policies such as depreciation. That problem doesn't exist with expensing. The difficult parts of the personal tax code are partly the result of double taxation, and those problems disappear if all capital income is taxed just one time at the source. The other complexities for individuals are the result of tax preferences, which could be eliminated as part of a shift to lower tax rates.

3. Using tax reform for deficit reduction - Since deficits and debt are the result of a federal government that is too large today and expected to become an even bigger problem in the future, tax reform should not be undermined by an attempt to increase the overall tax burden. That being said, a better tax system will boost economic performance. As shown in the CBO sensitivity tables, this means more taxable income and additional tax receipts.

4. Improving tax fairness - If fairness is defined properly so that it means treating all taxpayers the same and having equal rules for everyone, this would rank at the top of the list. In the current political climate, though, fairness often is misinterpreted to mean redistribution and punitive tax rates imposed on those who generate the most output. This ideology is very counterproductive, oftentimes leading to tax rates that are so high that governments collect very little revenue. And in some cases, tax rates are so punitive that the government loses revenue.

**PERSPECTIVES ON THE PRESIDENT'S FISCAL  
YEAR 2013 BUDGET REQUEST FOR THE U.S.  
DEPARTMENT OF DEFENSE**

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**TUESDAY, MARCH 6, 2012**

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

The Committee met, pursuant to notice, at 10:04 a.m., in Room SD-608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Sessions, Johnson, and Ayotte.

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.

We want to welcome everyone to the Senate Budget Committee today. In today's hearing we will again focus on defense issues. Last week, we heard testimony from the Pentagon, from Defense Secretary Panetta; the Chairman of the Joint Chiefs, General Dempsey; and the Comptroller of the Department of Defense, Mr. Hale. Today we will hear from three outside defense policy experts. Our witnesses include Dr. Michael O'Hanlon, senior fellow at the Brookings Institution; retired Lieutenant General David Barno, senior advisor and senior fellow at the Center for a New American Security; and Dr. James Carafano, Director of the Allison Center for Foreign Policy Studies at the Heritage Foundation.

Dr. Carafano, am I pronouncing your name correctly?

Mr. CARAFANO. Yes, Senator.

Chairman CONRAD. Good. Welcome to all of you. We appreciate your being here and look forward to your testimony.

I want to begin by emphasizing that I am and always have been a very strong supporter of defense spending. I think I have supported every dollar that has been voted here during the wars in Iraq and Afghanistan. Even though I did not think going to Iraq was a wise decision, nonetheless when troops are in the field, I have always felt we ought to fully support them with the finances of the country.

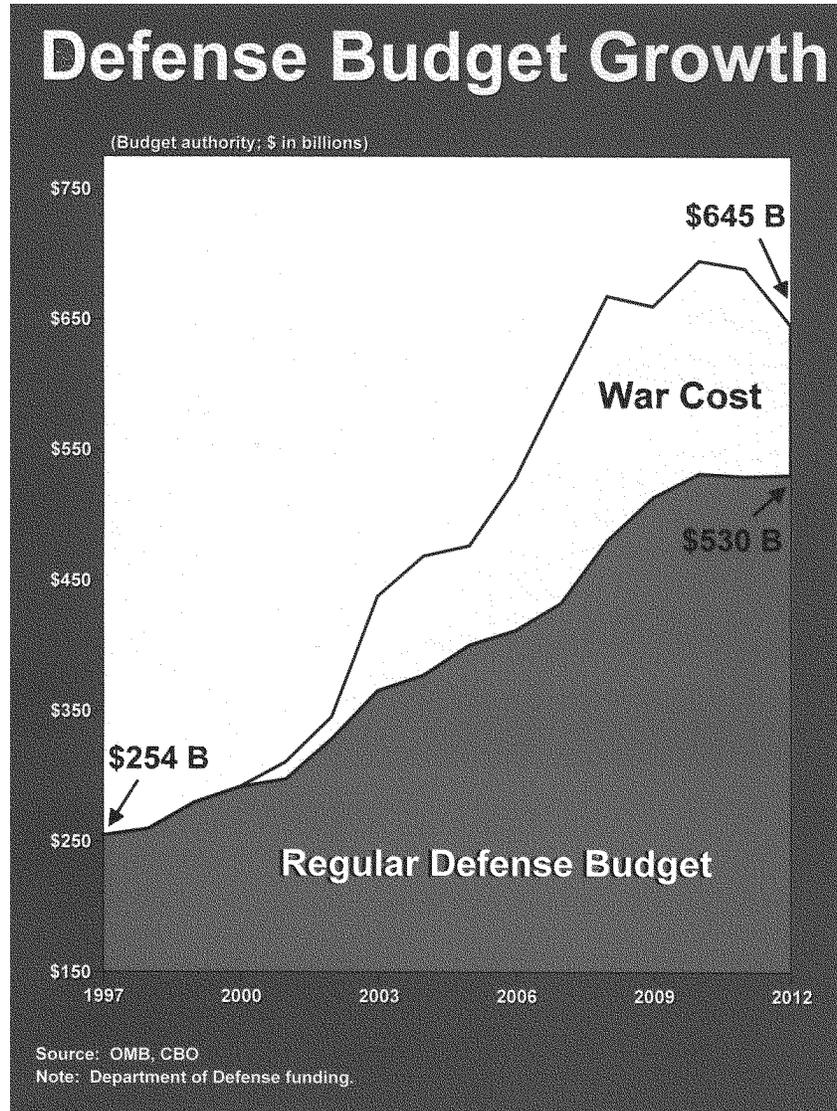
I believe providing for the national defense is the Government's single most important responsibility. And make no mistake: Congress will continue providing our troops with what they need to complete their missions.

We also have to recognize the country still faces serious threats in places all across the globe. Iran I think is something that is now at the forefront of public opinion and discussion here. We have certainly seen that in the last few days. But we have many other pots boiling as well: Syria, now a call by Senator McCain for air strikes against the regime there to protect people that are being slaughtered. We also have Iraq and Afghanistan, Pakistan, and many other points across the globe that are troubling and are hot spots.

But given the long-term fiscal crisis that we confront, every area of the budget has to come under scrutiny. Every area has to come under scrutiny. And I believe we are going to have to find more savings in the core defense budget. We have already agreed in the Budget Control Act to \$487 billion over 10 years. We have a sequester that is in line. It will be pulled, the trigger will be pulled on a sequester at the end of this year that will call for an additional \$535 billion of savings over the next 10 years out of defense. So now we are talking, the two combined, \$1 trillion over 10 years. That is real money. And the sequester I think is very, very poorly designed. I do not believe the sequester should go forward as it is. The cut is much too abrupt at the beginning, and it is done in a way that is, frankly, ham-handed. It is just across-the-board slashing. We are going to have to be smarter than that as we seek to save money.

I also believe we cannot rely solely on declining war costs for savings and defense. I do not know how many of you saw the very interesting Walter Pincus article in the Washington Post this morning, very thoughtful, talking about how at the top the Defense Department has exploded in personnel and costs. All of us know this, and it is something that deserves our review.

The administrative cost at the Department of Defense has mushroomed. The reality is that defense spending, both in the core defense budget and in war costs, has grown dramatically and has been a factor contributing to recent deficits. In 1997, we spent \$254 billion on the Department of Defense. This year, we include war costs; we will spend \$645 billion on the Department.

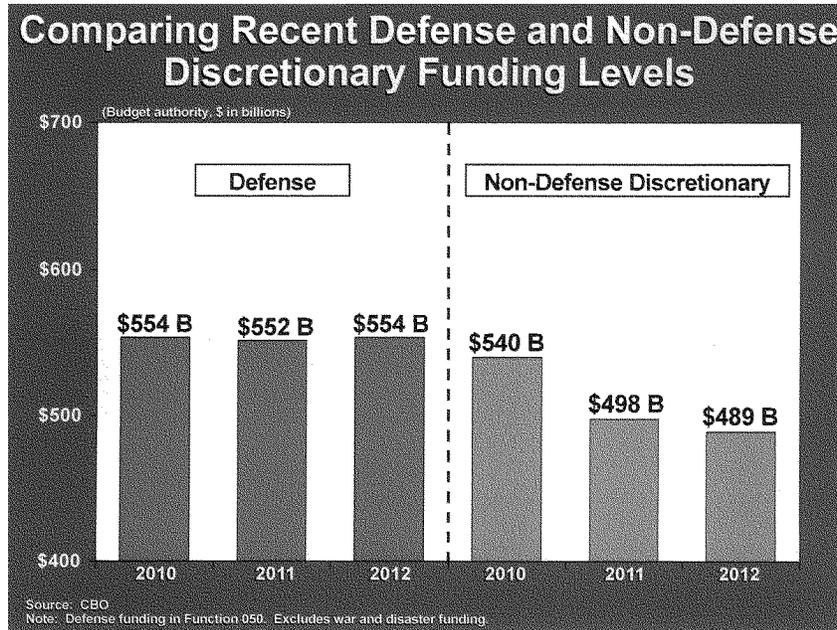


If we compare recent overall defense spending in budget function 050 to recent nondefense discretionary funding, we see that overall defense funding has remained at about \$554 billion since 2010, not including war costs, while nondefense funding has fallen from \$540 billion in 2010 to \$489 billion this year.

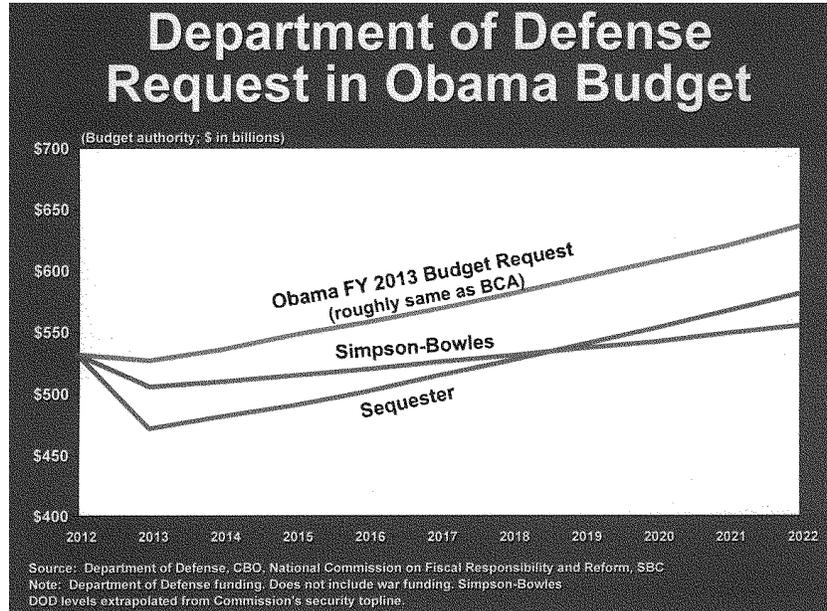
Now, let us be clear. Both of those were from a very high base. Both of those had seen significant runups since 2008. I mean, that is the reality.

Over the next 10 years, the President's Department of Defense request would roughly match the levels set in the Budget Control Act, not including the sequester. As we can see from the blue line

on this chart, the President's request would provide a steady increase in the defense budget from 2013 on. These are in dollar terms, not inflation-adjusted terms. I understand some will make the argument, well, you have to factor in inflation here. That is fair. Nonetheless, in dollar terms we see the budget rising steadily from 2013. And, again, that is a very high base.



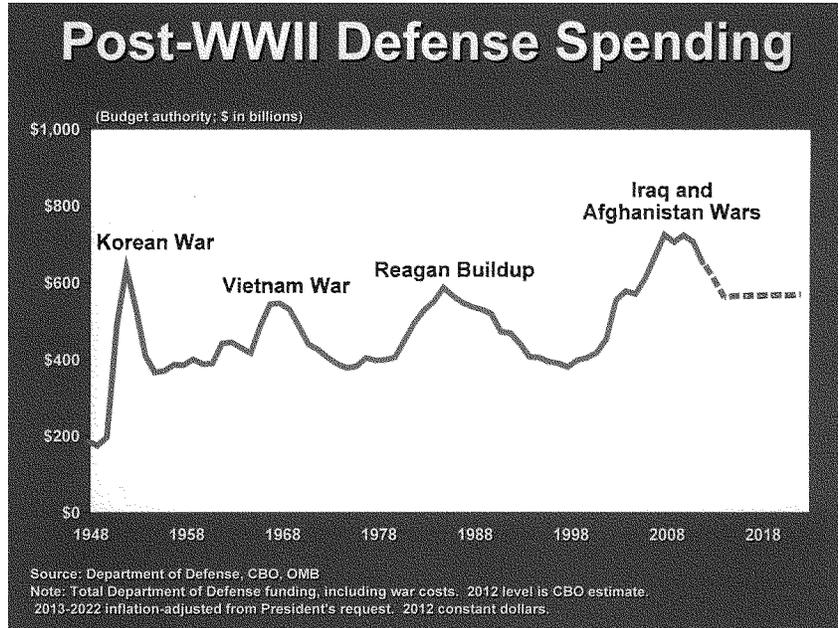
The red line on this chart shows what would happen to Department of Defense funding if the sequester were implemented. Obviously, we would see, as I referenced earlier, a much steeper drop in 2013, but then steady growth after that. I believe the steep drop in 2013 required by the sequester would be a mistake. I referenced that earlier.



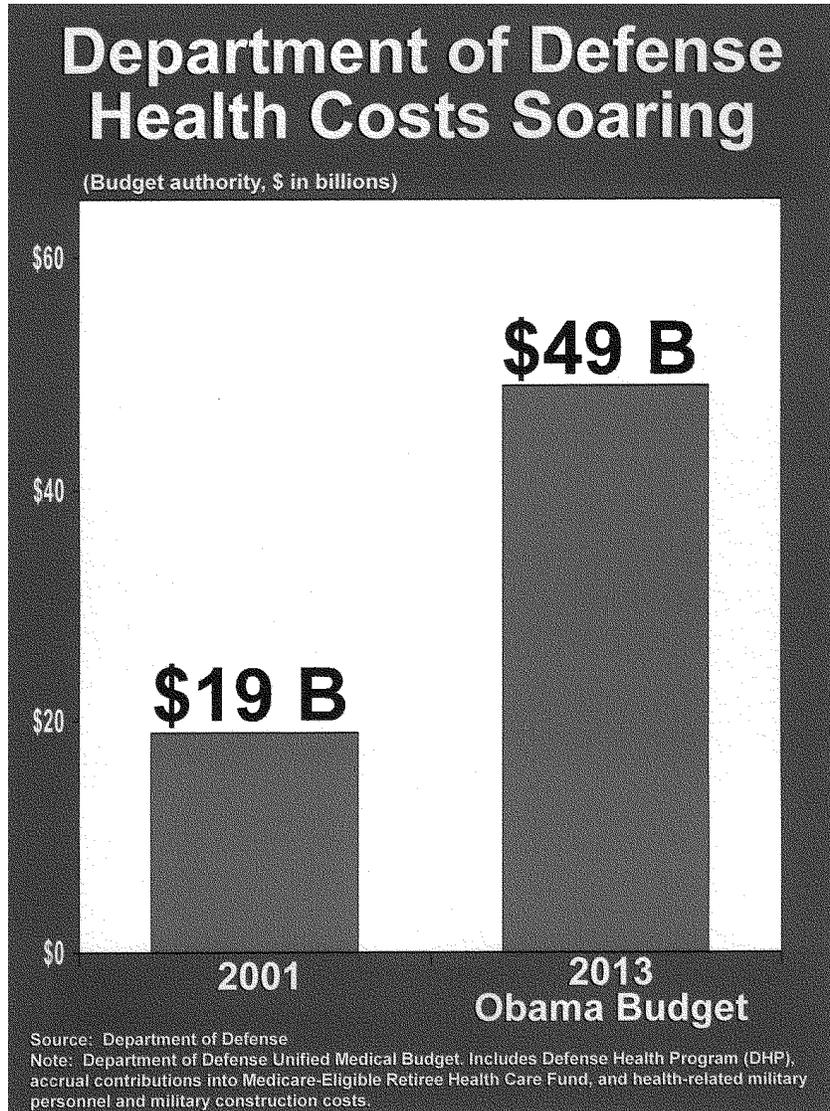
You know, this is a big ship that we are trying to steer here, this ship of state, and it is hard to make quick turns. Over time, if you make a relatively smaller adjustment now, you make a big difference down the road. So my personal belief is that is what we ought to be aiming at here, not these abrupt shifts.

The green line on this chart represents the proposed Department of Defense funding under the Simpson-Bowles plan, which would provide a smaller drop in 2013 than the sequester, but slower growth in funding after that. I voted for Simpson-Bowles, did it with my eyes wide open. A lot of things I did not like about it. A lot of things I did not like about it, but it did have a balanced approach. It did cut discretionary spending, both defense, nondefense. It did reform entitlements, including Social Security and to a lesser extent Medicare. It did have a revenue component not by raising marginal tax rates but by broadening the base. I thought it was a pretty balanced approach, and I was proud to support it.

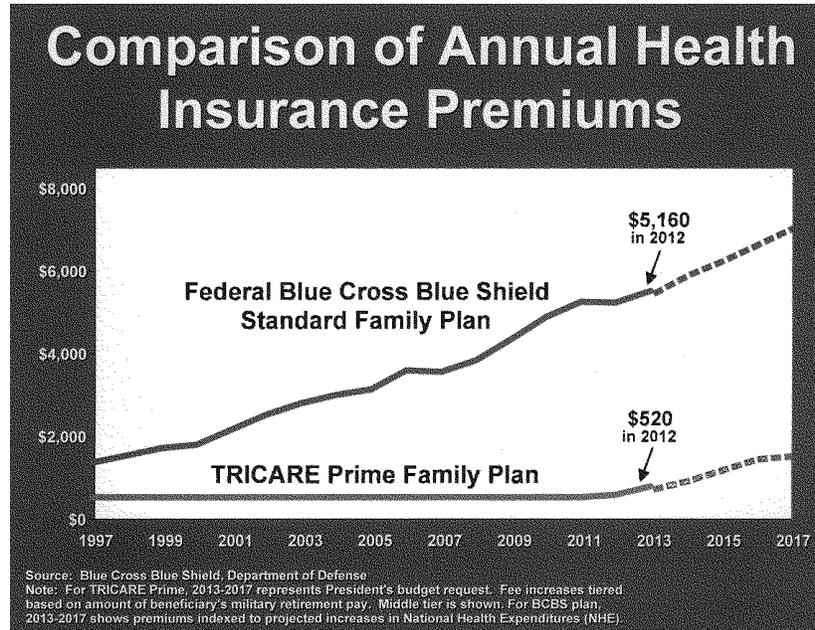
This next chart puts our defense spending in a historical perspective. We can see that even with the drop in war costs included in the President's budget, defense spending would remain very high by historical standards, near the peaks of the Korean War, the Vietnam War, and the Reagan defense buildup during the Cold War. And this is inflation-adjusted. This is in steady 2012 dollars. So this is, I think, telling us we are at a very high level of defense spending in relationship to where we have been with respect to the Korean War period, the Vietnam War period, and the Reagan defense buildup.



One of the biggest drivers of rising spending in the core defense budget is rising health care costs. In 2001, we spent \$19 billion on the Department of Defense unified medical budget, which includes TRICARE and other health-related expenses. In 2013, under the President's budget, we will spend \$49 billion. Look, there is not a defense analyst that we have talked to that has not said TRICARE is a runaway train. We have to find a way to reform it.



The next chart compares the cost of annual health insurance premiums for a typical Federal worker under the Federal Blue Cross Blue Shield Standard Family Plan. That is the plan many of us have. That is the plan I happen to have. I think that is the plan most people who are in Federal service have. Whether they are Senators or Congressmen or Federal workers in any agency of the Government, I think that is the option that is most frequently chosen by people—Blue Cross Blue Shield Standard Option.



So if we look at the comparison, it shows the health insurance premiums for typical Government workers have been rising steadily just like premiums for private sector workers and will reach \$5,160 in 2012. In comparison, military retirees have seen almost no increase in their TRICARE fees since the program was created in the 1990s. Our former servicemembers are now paying one-tenth the amount paid by the typical Federal worker. They are paying \$520. A typical Federal worker is paying \$5,160.

We need to remember that the more the Defense Department spends on health care, the harder it is to find resources to devote to improve our warfighting capability. And I want to emphasize that there is no question in my mind we owe an enormous debt to those who served in uniform. So their jobs are unlike most civilian jobs in that they are putting their life on the line for our country every day. So, clearly, a difference is justified. I do not question that. I am not suggesting here we ought to have the military go from \$520, which is their TRICARE cost, to \$5,160, which is what the typical Federal Government worker is paying for a family policy. But I do think it raises the question of reform of TRICARE just as we move to reform other health care programs.

We also know the Department of Defense continues to have serious financial management problems. Here is how the Government Accountability Office Comptroller General Gene Dodaro described the situation in testimony just last week, and I quote him: "Serious financial management problems at the Department of Defense have prevented DOD's financial statements from being audited."

## Comptroller General Dodaro on Department of Defense Financial Management Problems

“Serious financial management problems at the Department of Defense (DoD) ... have prevented DoD’s financial statements from being audited....

“While we are encouraged by DoD’s recent plans and efforts to fundamentally transform its financial management operations, several DoD business practices, including financial management, remain on GAO’s list of high-risk programs designated as vulnerable to waste, fraud, abuse, and mismanagement or in need of transformation.”

— Government Accountability Office Comptroller General Gens L. Dodaro  
Testimony before House Committee on Oversight and Government Reform  
March 1, 2012

Let me repeat that. “Serious financial management problems at the Department of Defense have prevented DOD’s financial statements from being audited.”

You know, if you have unauditible financial statements, you have a problem. And, unfortunately, there are other places in the Federal Government where we have this same problem. Frankly, that is just unacceptable. We have to have auditible financial statements for every agency of the Federal Government.

The Comptroller General went on to say in his testimony, “While we are encouraged by DOD’s recent plans and efforts to fundamentally transformer its financial management operations, several DOD business practices, including financial management, remain on GAO’s list of high-risk programs designated as vulnerable to waste, fraud, abuse, and mismanagement, or are in need of transformation.”

While it is good to see there is some progress being made in this area, it is unacceptable the Pentagon is still incapable of being audited. It is very difficult to weed out waste, fraud, and abuse if we cannot get an accurate accounting of where defense dollars are going or any other dollars are going.

It is also troubling that the Department of Defense continues to spend billions of dollars every year on programs that are later completely canceled. Here is how an article in the Federal Times described the problem last month, and I quote: “In the budget submitted on February 13th, the Department of Defense proposed canceling or changing production schedules for about 20 major programs.”

## Department of Defense Spends Billions on Programs Later Cancelled

"In the budget submitted February 13, the DoD proposed canceling or changing production schedules for about 20 major programs...."

"Although the costs associated with ending these efforts might not be that large, the amount of money already spent on them is substantial...."

"Over the past 10 years, the Pentagon has spent about \$46 billion, using current dollar estimates, on development programs that were terminated and never entered production, according to a July 2011 report...."

*Federal Times, "DoD Budget Cuts Aimed at Avoiding Termination Fees"*  
By Marcus Weisgerber  
February 21, 2012

"Although the costs associated with ending these efforts might not be that large, the amount of money already spent on them is substantial."

"Over the past 10 years, the Pentagon has spent about \$46 billion, using current dollar estimates, on development programs that were terminated and never entered production."

Now, I think we understand how some of this happens, but \$46 billion is a huge amount of money, a staggering amount of money. We simply have to do better than spending \$46 billion on things that are never, ever built.

I want to conclude with a quote from former Defense Secretary Robert Gates. In an interview on CBS' "60 Minutes" last year, he stated, and I quote: "The budget of the Pentagon almost doubled during the last decade, but our capabilities did not particularly expand. A lot of that money went into infrastructure and overhead and, frankly, I think a culture that had an open checkbook."

## Former Defense Secretary Gates on Defense Funding

"...[T]he budget of the Pentagon almost doubled during the last decade. But our capabilities didn't particularly expand. A lot of that money went into infrastructure and overhead and, frankly, I think a culture that had an open checkbook."

—Former Secretary of Defense Robert Gates  
Interview on CBS's *60 Minutes*  
May 15, 2011

Well, we cannot afford an open checkbook anymore. The culture simply has to change. As I said before, we need to ensure that every dollar going to defense is essential to advancing our national security interests.

With that, we will turn to Senator Sessions for his opening comments, and then we will go to our witnesses, and then we will open it to questions. Senator Sessions, thank you for helping organize this hearing.

### OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Mr. Chairman.

You know, as a percentage of our Government, our Nation's GDP, defense spending is maybe half what it was even in the 1980s, and I believe truly, having seen them perform, that our military is the most responsive agency of our Government. General Barno has been there, but you give the military a mission, they do it. They do not get paid overtime. They work 12-hour days, 7 days a week, away from their families in the most difficult conditions, and that is why we have created a certain contract with them that we treat them differently than we do normal civilian employees who, for the most part, can go home at 5 o'clock, and if they have to work, they get paid overtime and that sort of thing. So I am pleased to have our distinguished guests today.

In order to comply with the Budget Control Act, the President's budget contains historic cuts to the defense budget of \$259 billion over 5 years and \$487 over 10 years. Cuts of this magnitude mean that over the long term DOD's budget will be flatlined in inflation-adjusted dollars and average negative real growth over the President's budget window of 10 years.

The President's budget does not include now, the new budget that is submitted, the impact of the additional \$535 billion in cuts from the fallback sequestration, which most everyone—with maybe a few exceptions—including Secretary of Defense Panetta and General Dempsey, believe would be catastrophic to our military and the security of our Nation.

The sequester spending reductions I believe in general must go forward. It was an agreement to reduce spending by \$1.2 trillion. But all Government departments and agencies must tighten their belt, not just Defense. But the President's budget plan as he just submitted wipes out the entire sequester, thereby increasing spending immediately by \$1.2 trillion, then spends another \$400 billion, and raises taxes by \$1.8 trillion.

It increases spending, totally abandoning the BCA sequester reductions, and increases taxes to pay for even more spending. All the while, the President falsely asserts he is reducing spending. That was his announcement with the budget. So it is hard for me to see how a significant budget agreement can be reached when we are dealing with an administration that far off reality.

In August, we came to an agreement that \$2.1 trillion needed to be cut from our budget, and we need to stick to that goal. We can do that. But we should accomplish the required cuts with reductions in all areas of spending, not primarily defense.

Today entitlement spending makes up 60 percent of the budget while defense makes up less than 20 percent. Fifty year ago, 1963, we spent 48 percent of our budget on defense and 26 percent on entitlements. We should not allow the prospect of an additional \$500 billion in cuts to national security spending to continue while automatic entitlement spending continues relatively unscathed.

From 2008 through 2011, while the defense budget increased by 10 percent—that is what the base budget increased from 2008, about 3 percent a year—spending on food stamps grew 100 percent; Medicaid increased by 37 percent. Yet defense spending will receive 50 percent of the cuts under the fallback sequester. Food stamps and Medicaid are totally exempt, not a dime reduced in their spending. By 2030, the entitlement growth of spending will consume the entire projected revenue of the United States Government.

Compared to last year's request, the Budget Control Act would have defense spending, one-sixth of the budget, experience a 20-percent reduction in real dollars over 10 years. I think that is a mature way to analyze it. In inflation-adjusted dollars, how much will it impact? It will be a 20-percent reduction.

Nondefense spending, the other five-sixths of the budget, would experience a 50-percent increase over the same time. In order to bring proportional equity to the cuts, total nondefense spending would need to be cut an additional \$3 trillion over 10 years. At the same rate, everything else would have to be cut \$3 trillion. So we can all agree that defense can and should contribute to reducing our deficit, but not disproportionately and not at risk to our national security.

Additionally, from 2009 through 2010, the first 2 years of President Obama's term, nondefense discretionary education, welfare, personnel, environment—that spending increased 24 percent while

the base defense budget increased approximately 6 percent over those 2 years. Thus, the cuts that are falling on nondefense discretionary fall on a surged baseline. Also, the 2-percent cut to Medicare produces approximately \$117 billion. Thus, the nondefense discretionary cut is really not \$535 billion but about \$400 billion, and from the record higher levels. And this does not include any stimulus money. We are not counting stimulus money when we talk about this.

The point is the sequester cuts I think must be adjusted but not eliminated because we have to reduce spending. The most dangerous aspect of this budget is it does not alter the growing debt crisis. We remain on an unsustainable path. Instead, it maintains our current course and increases our gross Federal debt by another 75 percent over the next 10 years, from about \$15 trillion today to \$26 trillion in 2022. By 2018, 6 years from today, our interest payment on the growing debt of the United States will exceed our total spending on national defense. By 2022, our interest payments will exceed \$850 billion, more than we are spending on defense. We are spending about \$240 billion on interest today. So we are talking about another \$500 billion that will be sucked out of our budget year after year because we cannot control spending today and continue to run up debt.

Admiral Mullen once said, "Our debt is the greatest threat to our national security." This budget is proof of that. Under this budget the President—our course, I guess where we are heading, is proof that if you do not get spending under control and entitlements take up 100 percent of the budget by 2030, we are not going to be able to provide the defense we need to secure America's future.

So under the President's budget, he is ignoring the debt warning, and the administration is refusing to fight the largest national security threat the country faces, which is the debt.

Thank you, Mr. Chairman. We have an excellent panel, and I look forward to hearing from them.

Chairman CONRAD. Let me just say, we have places where we agree, places where we do not agree. I think for the purposes of this hearing, a place where we do agree is, as I hear you say it, we need the savings of the sequester, but the way it has been designed, I think we would both agree, on funders makes no sense. And we have to find a better way.

The other thing, I think, where we agree is long term we have to deal with mandatory spending. That has got to be a focus of what we do.

I also believe we have to deal on the revenue side. These are challenges we must face up to, and I also personally believe we are going to have to find some additional defense savings beyond what was in the Budget Control Act. I am not counting the sequester here. I think the sequester, \$535 billion, the way it has been done there and the amount would just be a mistake.

Senator SESSIONS. Thank you. One thing I am also looking at, Mr. Chairman, I just have to throw out, is the health care bill, the President's health care bill. That is going to cost probably \$700 billion more than expected. We have double-counted money. So as I look at the numbers, we are going to have to confront that. Just because we do not have the money, no matter whether we like it

or not, we have to strengthen the programs we have, Medicare, Social Security, put them on a sound basis before we do a new one. But that is another subject, and let us go to defense.

Chairman CONRAD. Let us do that. Obviously, this is a place where we have a disagreement. The Congressional Budget Office tells me with respect to the health care bill that in the second 10 years that reduces the deficit over \$1 trillion. So this is a place where obviously we have a disagreement.

Where we do not have a disagreement is that health care funding is the 800-pound gorilla, and it has got to be addressed. But today we are here to discuss defense. We will begin with our distinguished witnesses. Dr. O'Hanlon, thank you very much for being here. Please proceed.

**STATEMENT OF MICHAEL E. O'HANLON, PH.D., SENIOR  
FELLOW, THE BROOKINGS INSTITUTION**

Mr. O'Hanlon. Senators, it is a great honor to be here and I would like to talk about some options for additional possible reductions in defense, but again to establish the spirit in which I am laying these forth.

It is similar to what I have heard from both of you Senators so far in the sense that these are reluctant proposals, if you will. They are not proposals for additional reductions in defense spending that I think are somehow inherently desirable because they would make us leaner or meaner or more efficient per se. I think we are already seeing that dynamic in effect from the first round, first tranche of the Budget Control Act.

So these, in a sense, are reluctant proposals. But in the spirit, as Senator Sessions just said, about how debt itself has become a threat to our national security, if we get to a point of comprehensive deficit reduction, I think we may need to see more additional defense cuts of a modest amount. I do not support Simpson-Bowles or sequestration. I think those levels are excessive. But that is the spirit in which I want to lay out a few proposals.

In doing so, I would commend the administration for having put already a floor underneath certain capabilities. I think it was smart for the administration to say, for example, to friends, allies, neutrals, and potential rivals in Asia, we are not going to cut from Asia. Now, that can be read in slightly too technical of a way. I am not suggesting you have to keep every single Marine on Okinawa there indefinitely and so forth. But the basic notion of keeping capability in the Western Pacific and also the Persian Gulf, I think these should be viewed as irreducible, minimal requirements for our role in the world and we need to make sure that our current presence and our crisis responsibility remains essential what it has been, even as we look for other efficiencies. That is perhaps the single most important example that I would put forth of the kind of irreducible, minimal requirements we have to maintain.

But having said that, let me now, if I could, offer a few suggestions on where we may be able to reduce the programs or the weapons of acquisition plans or the budgets of the Department of Defense a bit more—a bit more—than has already been put on the table.

I have one more caveat, though, about this, which is that as I read the Obama budget, it may be slightly too optimistic. I am not sure that they have made enough program cuts and weapons program cuts to comply with the first tranche of the Budget Control Act. In other words, the ideas I am about to put forth, and you may have your own suggestions, of course, as well, some of these additional cuts in forces, in weapons, may be needed simply to comply with the \$487 billion ten-year target of reduction. I am not persuaded the administration has found \$487 billion in its ten-year plan under the reductions that I have seen.

For one thing, just to give an example, they posit the possibility of \$60 billion in efficiency cuts, which they do not explain. And, of course, these are notion, hopeful, potential reductions, and we always talk this way about defense. Back in the 1990s, we were going to privatize everything, remember, and that was going to save us 20 percent. And then look what privatization did. It had some benefits, but it also did not generate nearly the kind of savings that we hoped for and it had some consequences, as well. So I think those kind of numbers make me a little suspect that we actually have seen the administration come up with a ten-year plan that is going to comply with the ceilings.

So some of what I am about to put on the table, and I will now turn to those six very specific ideas, just tick them off and then look forward to my colleagues' presentations and your questions, some of these may be needed simply to comply with the \$487 billion requirement and not get us to any additional budgetary savings. Let me now quickly turn to what I am proposing.

On the ground forces, I think it is good that the ground forces are not going to be slashed the way that some people ten or 12 years ago were proposing. We could almost envision a post-ground force way of thinking about future American combat. So I am glad the cuts are not going too, too far.

On the other hand, the current Obama plan would keep the Army and Marine Corps in their active duty capabilities larger than they were in the 1990s, larger than four Secretaries of Defense, two of each party, supported during that period of time at a moment when Saddam Hussein continued to threaten the region. We still have plenty of problems in the Persian Gulf, but they have shifted more towards a maritime and an irregular kind of capability, I think, and less a classic overland invasion, and yet we still are planning to keep Army and Marine Corps active duty forces larger than they were in the 1990s.

Now, I am not in favor of huge additional reductions, but I think we can look to make the Army and Marine Corps in their active duty capabilities slightly smaller than they were in the 1990s. So that would be idea number one.

Idea number two, then, looks to the Navy and says the Navy is doing some wonderful things in terms of being more efficient and thinking of how they do their forward presence mission a little differently than they have in the past. But I would submit that it is time to ask the Navy to go to the next level of innovation. And the Navy itself has come up with these ideas. It is not just some Brookings analyst who is coming up with this concept, but the concept is called sea swap or crew swap.

As currently, the Navy likes to have one crew stay with one ship all the time. They form up a crew. They train a little bit in American waters. They go off and they do some short exercises and then they finally transit the ocean to spend a total of maybe four months on station in the Persian Gulf or the Western Pacific and then they come back home. When you do the mathematics on that, it takes the Navy about five ships in the fleet to maintain one on forward station at a time. It is a very inefficient way of doing force sizing.

Now, if you—granted, you can overstate the problem because the Navy also needs a certain size fleet for possible wars. It is not simply the forward presence mission that drives the size of the Navy. But they have been less efficient than they could be.

And what is now, I think, feasible and actually necessary is to start asking more than one crew to share a given ship. And so a crew could train on a ship in American waters and then fly overseas to relieve a crew that had already done a six-month tour, which would then fly home. So you would have two crews share two ships, for example, and the mathematics of this are pretty interesting. You get maybe 35, 40 percent more efficiency in terms of number of deployed days per ship. I am not suggesting that allows you to make the Navy 35 percent smaller, but it may allow you to make the Navy five or ten percent smaller and still maintain that capability in the Persian Gulf and in the Western Pacific.

I have four more ideas in 34 seconds, so let me speed up. In fact, let me just do a couple.

On nuclear forces, I would say the following—

Chairman CONRAD. Let me just say this to you. With the attendance that we have, I would prefer that you give us all the ideas—

Mr. O'Hanlon. Okay.

Chairman CONRAD. —that we get them, and we will provide additional time to the other witnesses, as well. Is that okay? And we are going to have plenty of time for members, as well.

Mr. O'Hanlon. I will still try to stay crisp, but thank you for the time.

Chairman CONRAD. I think it is very important we get all the ideas out on the table.

Mr. O'Hanlon. Let me turn to nuclear forces briefly. I think it is important that the United States retain strategic parity with Russia and retain a substantial strategic advantage over China in the coming years and decades. However, I do not think the composition of just how we deploy those nuclear forces matters as much as it did in the Cold War. The details of the single integrated operational plan do not matter as much. And I think there are ways to put 1,550 strategic warheads on a smaller number of platforms and save money.

I will give one example. As we have already reduced the ballistic missile submarine fleet from 18 to 14. We took four of those ships and converted them into cruise missile, special force carrying submarines. We may be able to do the same thing with four to six more submarines and deploy the Trident subs with the originally intended 192 warheads per submarine. So you could have eight submarines maintain the required capability instead of 14. It is the kind of idea that I would like to see us debate.

Also, the Lawrence Livermore Laboratory, as has, together with Los Alamos, been our primary nuclear weapons design laboratory for several decades, and we have had the idea that it is good to have competitive laboratories given the importance of this mission. I actually think that we need a little different approach towards warhead design these days.

I would do two things. I would actually make Livermore's role in nuclear warhead design much less, orient Livermore more around—or, excuse me, the energy, civilian energy challenge broadly defined, have its role in nuclear forces be less, and partly as a way to make sure that our force remains dependable and reliable, I would actually build a new kind of nuclear warhead, but it would actually not require testing. It would be built conservatively. The idea would be to have it be something that could reliably be depended upon even without testing.

It goes a little bit back to the debate we had a few years ago about the so-called reliable replacement warhead. That probably should never have been termed a new warhead and I probably should avoid that phraseology myself because that makes people think we are modernizing. I am talking about building something simpler and more dependable that does not require testing. And if you do that and you add that to the portfolio of existing designs, you can be a little bit more relaxed about pulling Livermore off the main task. And I think it is actually a prudent way to think about long-term stockpile stewardship in an era where I doubt we are going to test again no matter what.

A couple more ideas. On the F35 fighter program, I am a supporter of the F35. I think we need stealthy attack airplanes. But I think, also, that the last ten years have shown us we do not really need these kind of planes for most of the smaller and weaker foes that we face. We have so many ways of going against their air defenses, so many ways of attacking them from standoff range, of using drones, of using precision strike ordinance. I think the role for the F35 is less and it is primarily oriented around the possible China threat. I do not think there is a very high likelihood of U.S.-China war, but I think in order to maintain deterrence we do need to have a big enough F35 program to populate most of our major bases in the Western Pacific and Southeast Asia if we do wind up in a serious crisis with China.

But when I do the mathematics of all the different bases I think we could plausibly put F35s on land or at sea, I do not see a requirement for more than about 1,000 planes in dealing with the possible China threat. So I would roughly cut the F35 program in half, broad terms, half, 40 percent, allowing for an attrition reserve, allowing for some capability against an Iranian threat. I am not suggesting China is the only concern, but it is the major reason and the major way in which I think we could shape that program and size it. Really, the F35 program has been sized simply to replace existing airplanes. I do not think that is the best way to think about sizing a plan in this day and age.

And finally, let me just mention the Littoral Combat Ship. Again, it is an important program. We need shallow water, green water capability. I am not suggesting we end the Littoral Combat Ship

program, but it has been a somewhat troubled program. I think it has migrated into a more high-end program.

What I would suggest is that instead of buying the intended number of more than 50, that we buy a more modest number and view the LCS ships essentially as the central or mother ship in flotillas. That would involve buying a number of the new technology ships that are out there—I would mention the Stiletto or the Sea Hawk as a couple—that ride high in the water, that can go 60 knots, that are relatively stealthy, that are more expendable. And the LCS would then be essentially the mother ship in a flotilla that would have more capability. You may wind up with more ships, not less ships, but I think the overall cost would decline.

I think I will leave it at that, Senators. Thank you for the opportunity.

[The prepared statement of Mr. O'Hanlon follows:]

## DEFENSE BUDGETS AND AMERICAN POWER

Testimony before the Senate Budget Committee, March 6, 2012

Michael O'Hanlon, Brookings, [mohanlon@brookings.edu](mailto:mohanlon@brookings.edu)

Mr. Chairman, Mr. Ranking Member, other Members of the Committee, it is an honor to appear before the committee today. That is especially true for a Congressional Budget Office alum like myself who remembers well working for senators Domenici and Sasser and others some two decades ago, when the Cold war ended and we were collectively trying to reduce defense budgets responsibly.

That is again our challenge today. As former chairman of the joint chiefs, Admiral Mike Mullen, has persuasively argued, federal debt and with it the possible erosion of our national economic foundations have become national security threats themselves. I begin from the premises that the right dose of defense budget cutbacks, as part of comprehensive deficit reduction, can strengthen American power and influence over time. Put differently, it can be the least risky option—accepting some near-term, modest, and calculated reductions in military strength now to help shore up our longer-term economic prospects and with them our long-term national security.

As I argued in my 2011 book, *The Wounded Giant*, no great power in history has remained great while its economy eroded. Trillion dollar deficits are not compatible with U.S. economic health, as Brookings colleagues such as Alice Rivlin have convincingly shown, and thus they are not compatible with long-term American global leadership. And as another Brookings colleague, Robert Kagan rightly argues in his new book, there is no credible alternative to U.S. leadership at present. Absent such leadership, the general stability among major powers that we take for granted in today's world would no longer be such a given, and extremist states such as Iran and North Korea might feel further emboldened to assert themselves aggressively in their respective regions as well. The

trick is to get the balance right, and to combine defense budget reductions of the right magnitude and character with other measures of fiscal restraint and revenue increases.

The Obama administration's new defense strategy and budget plan, building on earlier cuts made by Secretary Gates during his tenure in office, is a good step in the right direction in my eyes. In fact it gets us, responsibly, most of the way towards where we need to go in defense—even if I would submit respectfully that neither the administration nor the Congress has done as well in regard to entitlement spending or tax reform. As a result of this budget, national security spending would decline from current levels of about 4.5% of GDP to just over 3%. (For comparison, norms were 8 to 10 percent of GDP in the 1950s and 1960s, 5 to 6 percent in the 1970s and 1980s, 3 percent by the end of the 1990s, and 4 percent during most of the Bush presidency). Looked at differently, U.S. defense spending as a share of the global total will decline from about 45 percent in recent years to 35 percent or so, and the American military edge over China might decline from roughly 4:1 today (using Pentagon estimates of China's actual military spending adjusted for purchasing power parity) to 3:1 within half a decade.

While the above statistics, especially defense spending as a percent of GDP, show that it would be wrong to view the Pentagon's budget as the main fiscal challenge facing the nation, I believe modest additional cuts are possible and could be helpful. Sequestration would be far too drastic and abrupt, and the law requiring sequestration to begin in January should be overturned sooner rather than later, as my colleague from AEI Mackenzie Eaglen and I have argued in a written article. But some further economies still seem possible (here of course I speak just for myself), beyond those currently proposed.

Some cuts in programs and forces will be needed, I estimate, simply to comply with the first tranche of cuts mandated by the Budget Control Act (that is, the \$487 billion in ten-year savings, or \$350 billion when scored against the CBO baseline). I believe the Obama force posture and weapons modernization plan is more expensive than the Pentagon believes, and that sustaining it will require more funding than presently allowed

under the Budget Control Act. Like most administrations before it, this one appears to have been optimistic in its assessments of how much its preferred force posture will cost.

But rather than couch my argument in those terms, I will use the rest of this testimony to identify additional changes in force structures and weapons plans and other military programs that could be considered, along with the rough ten-year savings that could result. One key warning is worth underscoring: I believe they would involve some modest national security risk. They would not amount simply to cutting waste, fraud, and abuse within the Pentagon budget. There is still fat at DoD, to be sure, but it is so marbled into the military's muscle that it is very hard to extricate the former without also damaging the latter. As such, cuts should in my view be made only if additional parts of the federal budget that have to date been largely spared are also brought into the deficit reduction efforts, and only if net revenues are also increased.

My recommended additional defense reforms and reductions are made from the starting point that there are certain irreducible U.S. defense requirements that should not be compromised under any foreseeable circumstances:

- Responsibly ending the nation's current war, with sustained modest commitments to Afghanistan thereafter for a potentially extended period.
- Deterring an assertive Iran in the broader Persian Gulf and Middle East.
- Helping keep confidence and stability in East Asia in the face of major structural change—notably the rise of China
- Keeping a sufficiently robust NATO alliance to provide some basis for global action by a community of democracies and lower whatever remote risks remain of Russia's again becoming disruptive.
- Maintaining enough combat capability to wage one substantial and extended regional war while also carrying out up to two smaller operations at a time, perhaps in support of the ongoing struggle against transnational extremism in the turbulent broader Middle East region.

- Retaining a reliable, safe nuclear deterrent that is the equal of Russia's and superior to China's, even as the United States pursues lower force levels through arms control.
- Maintaining a strong all-volunteer military.
- Retaining and promoting the world's best scientific and defense industrial base.
- Maintaining some capacity to help stop genocide as part of a coalition, since America's values are part of what help it hold together a large network of nations in common strategic cause.

This list of foundations upon which future U.S. defense capabilities should be based leads me to several specific suggestions of where further economies can be considered without jeopardizing the core elements of future American power or international stability. They go beyond those already planned by the administration (changes that are summarized at the end of my testimony):

**Sea Swaps** by which the Navy rotates crews using airplanes (having more than one crew share a given ship), allowing for a somewhat smaller Navy to maintain current forward presence requirements in the Western Pacific and Persian Gulf. At present, the Navy assigns a single crew to a single ship for vessels except minesweepers and ballistic missile submarines. But this practice leads to major inefficiencies in terms of time wasted in transit across the oceans. Typically, 5 ships are needed in the fleet to keep 1 on station with this traditional practice.

Sea swaps, also known as crew swaps, can make a given ship at least 35 percent more efficient (in terms of time on station per vessel), and allow the Navy to cut perhaps 20 to 30 ships from its fleet without a reduction in forward presence in the Pacific or Persian Gulf. I would not apply this concept to large aircraft carriers (or CVNs), at least at first, given their size and complexity, but I would also cut the carrier fleet by one ship (and rely on large-deck amphibious ships rather than the much larger and more expensive CVNs for missions in places like the Mediterranean).

**Modestly Smaller Active-Duty Army and Marine Corps Forces.** The Army and Marine Corps are slated to remain larger under President Obama's new plan than they were in the 1990s. That will be true even once the main phase of the Afghanistan war is over, and even with Iraq no longer a pressing overland threat to its neighbors as it was in the 1990s as well as earlier eras.

I believe the size of the active Army and Marine Corps can instead be slightly smaller than in that period, rather than slightly larger, with a net reduction of about 40,000 to 50,000 uniformed personnel in the active-duty force structure (and perhaps some modest growth in the National Guard).

**Smaller F35 Fighter Program.** A fundamental rethinking of the F35 fighter program is appropriate, in light of the dramatically increased effectiveness of drones and other new technologies and the large size and cost of this manned aircraft program.

Specifically, I would consider sizing the F35 program primarily to the possible China threat. Imagining a major deployment of F35s to the region around Taiwan, for example on land bases and on ships, might result in a halving of the program's size (with refurbishments of planes like F16s making up for the difference). In other words, it is hard to see how we could deploy more than 800 to 1,000 F35s to the vicinity of Taiwan even in such an extreme scenario—yet the F35 program currently envisions buying almost 2,500 planes.

**Dramatically Restructured LCS Program.** A rethinking of the troubled Littoral Combat Ship program is also sensible. This was supposed to be an inexpensive ship but has become in effect a small and rather costly frigate.

Rather than purchase some 55, I would consider buying only 15 to 20 (perhaps even purchasing the Coast Guard's National Security Cutter instead of the current LCS designs). This smaller number of vessels could serve as "mother ships" within flotillas that included "swarms" of less expensive ships such as the Sea Hawk (which captures its

own wake, rides high in the water, goes up to 60 knots, and costs less than \$20 million) for purposes such as mine warfare and countering irregular maritime threats by countries such as Iran.

**A More Economical Nuclear Force.** It is important to keep strategic nuclear parity with Russia, in my judgment, as well as a reliable, safe, and dependable inventory of nuclear warheads in the post-nuclear-testing era. But these goals can be achieved more economically.

Adequate warheads can be deployed on 8 SSBN submarines rather than 14, and on 250 ICBMs rather than 450. The bomber fleet, useful for conventional missions and thus almost cost-free as a complement for ICBMs and SLBMs, can be tasked with a higher proportion of the nuclear mission.

Within the Department of Energy, Livermore laboratory can, in my eyes, be reoriented increasingly around civilian energy as its central mission, with only Los Alamos remaining principally a nuclear design and stewardship laboratory (in addition to associated work at places like Sandia and the Nevada Test Site). A conservatively designed nuclear warhead, not requiring testing, can someday be added to the portfolio of warheads in the decades ahead to ensure a reliable and safe deterrent even without any future nuclear tests.

**An End to Commissaries and Exchanges.** On the benefits and compensation side of things, an end to military commissaries and exchanges should be seriously considered. These provide benefits unequally and somewhat anachronistically to military service members and their families, and it makes more sense to eliminate them than to consider further cuts in other forms of military compensation.

In rough terms, savings from the above ideas would be as follows. The adoption of sea swaps as standard practice within the major surface combatant fleet combined with the reduction in the carrier fleet could save about \$4 billion to \$5 billion annually. The

further reductions of the ground forces would save about \$10 billion a year once phased in. Cutbacks in the F35 and LCS programs would yield net savings of \$5 billion a year and \$1 billion a year. Elimination of exchanges and commissaries could save \$1.5 billion annually. Certain other ideas not discussed here could save money too, such as a scaling back of the V-22 Osprey and missile defense programs, to the tune of another \$2 billion a year. Altogether, as discussed in greater depth in my book, further savings of up to \$25 billion a year (eventually) could be found responsibly—though again, I hasten to add that some of these dollar savings could be needed simply to comply with the first tranche of Budget Control Act budget reductions, as the current Obama defense program will likely cost a good deal more than those caps will permit.

The United States is hardly yet in serious and inevitable decline. Not only does it remain the most competitive large economy in the world according to the World Economic Forum, not only does it have a diversified and gradually growing “melting pot” population, not only does it retain the world’s best scientific and high-technology manufacturing base, not only does it possess far and away the best military in the history of the planet. But it also leads the largest system of alliances and security partnerships ever seen, with some 70 countries collectively representing  $\frac{3}{4}$  of global GDP and military spending formally or loosely aligned with it. It is a giant, even if a wounded giant, and its long-term future prospects are at least as good as China’s.

Yet America is at a crossroads. Trillion dollar a year deficits are not only bad for our economy, if not fixed they portend doom for our role as the world’s key leader—and with it the prospects for a generally stable international system, as there is no clear alternative to American leadership. But with comprehensive deficit reduction, in which defense plays a key though not disproportionate part, the nation’s long-term economic pillars of power can be repaired and the country’s security protected. Defense cuts are not without costs and dangers. But if undertaken at the right size and pace, and as part of comprehensive fiscal reform, they represent the best way to minimize overall risks to American security and enhance the country’s future prospects and possibilities.

## APPENDIX: SUMMARY OF OBAMA DEFENSE CHANGES, 2012

The Obama strategy and budget has a number of key features and provisions:

- Reducing the respective sizes of the active-duty Army and Marine Corps to 490,000 and 180,000 uniformed personnel, roughly—down about 12 to 15 percent from their recent highs but still greater than typical 1990s levels
- Modifying the “two-ground-war” planning framework to something more like a “one-war plus” capability. Any second simultaneous land conflict would be fought with less ambitious goals, a longer time horizon, and more use of the Guard/reserves
- Focusing much less on large-scale counterinsurgency missions for planning and training
- Deferring a number of procurement programs to save money in the near-term budget, as with the F35 joint strike fighter
- Making targeted cancellations of certain generally smaller military systems (advanced versions of the Global Hawk unmanned aircraft, a new weather satellite, the C-27 passenger aircraft) but leaving most large programs unscathed
- Eliminating some older ships and airlifters from the force but in modest numbers
- Scaling back Air Force combat aircraft units by roughly 10 percent
- Making modest changes in military compensation, especially for retirees (in regards to health care and pensions), but targeting military compensation for only 1/9 of overall spending cuts even though it constitutes 1/3 of the defense budget, all told
- Carrying out further rounds of base closures if possible
- Bringing two of four Army brigades home from Europe, and relocating several thousand Marines now on Okinawa to Guam and Australia (and perhaps also stateside locations)

Not all changes would consist of cutbacks. Specifically, the administration is:

- Underscoring that the Western Pacific and Persian Gulf/Middle East are the top two areas of military interest and priority for the United States
- Making no cuts in the aircraft carrier fleet, large-deck amphibious fleet, attack submarine fleet, long-range bombers, nuclear forces, or missile defenses (beyond those made in previous years), and adding more special forces
- Making no near-term reductions in planned military pay raises
- And making no cuts whatsoever in Veterans Administration budgets (which are separate from defense budgets, and expected to rise from \$124 billion in 2012 to \$169 billion in 2017) or in any other benefits for deployed or wounded personnel

Chairman CONRAD. Thank you for the good ideas.  
General BARNO.

**STATEMENT OF LIEUTENANT GENERAL DAVID W. BARNO, USA  
(RET.), SENIOR ADVISOR AND SENIOR FELLOW, CENTER FOR  
A NEW AMERICAN SECURITY**

General BARNO. Mr. Chairman, Ranking Member Senator Sessions, members of the committee, thanks for allowing me to share some perspectives this morning on the Defense Department's fiscal year 2013 budget.

I am going to take a little bit of a different tack than Michael did, although I would be happy to come around and talk to the points he has advanced later in questions, I think the majority of which have a lot of merit, but we can defer that until a bit later.

Today, I think our discussion is, in a way, about a broader issue facing the people of the United States. When we are evaluating national defense, how much is enough?

This morning, we have an opportunity to comment on one of the most important national security decision points the United States has confronted, I think, in the last 50 years. These hard choices in front of us, as we put it in our Center for a New American Security Report last October, will shape not only the future of U.S. defense for decades to come, but in many ways will potentially reshape and redefine the role of the United States in a changing world of the 21st century.

The current debate that has seized our nation and our political leadership has to do not only with putting Americans back to work, reducing exploding debt and annual deficits, about entitlements and taxes, about living as a nation within our means, but it also fundamentally has to do with where the United States is going to fit into this new world.

Despite today's focus on the defense budget, many of us believe that the fiscal crisis facing the United States requires the Congress of the United States to address the deep structural problems of revenue and entitlement reforms that are central to balancing America's budget. To date, our fiscal liabilities have seemingly been both too large and too politically contentious to achieve bipartisan consensus on how to best address them. But these hard realities are going to reshape the U.S. Department of Defense, either by choice or by default. Our discussion today will address just how they are going to impact national defense in the near term.

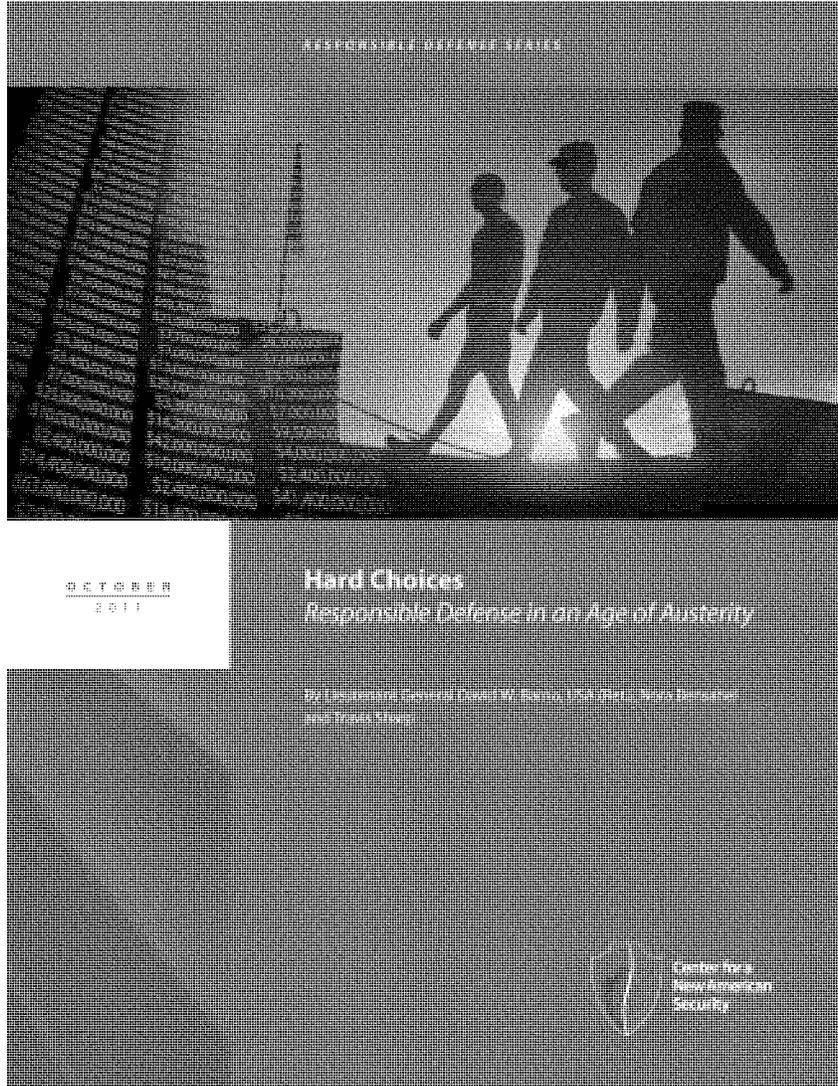
As we look around the world today, we see prospects for a slow but inexorable relative decline in U.S. global economic power over the coming decades. At the same time, during this same period, we Americans will continue to choose our military position in the world. Today, there is substantial risk that if we make ill-informed choices in defense spending over the next decade, we will electively choose to diminish our military capabilities at the very same time when we are involuntarily facing a decline in our global economic primacy.

To emphasize, we as a people alone decide our military investments and our strength, and we as a nation have always been willing to pay whatever it takes to secure our people and our freedoms. Yet today, driven in large measure by fiscal worries, we must ask

how much should the United States Government spend on defense to secure our people and how much risk are we willing to tolerate?

Since we published our October 2011 “Hard Choices” report, which I have submitted today for the record, the administration has published new strategic guidance in January and submitted its fiscal year 2013 budget last month. Both of these documents, in my judgment, are fundamentally sound. Each reflects the realities of our difficult fiscal position while acknowledging the necessity of maintaining America’s preeminence as a military power. Notably, both documents make choices and set priorities for focusing finite U.S. power and military investments.

[The information of General Barno follows:]



**About the Report**

David Chasenski is a senior manager for Risk Management Services at the Center for Non-Traditional Security (CNS). The report discussed here has been made available through a special access program. For more information, please contact the program manager at [casenski@nsa.gov](mailto:casenski@nsa.gov).

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By Lieutenant General David W. Barno, USA (Ret.), Nora Bensahel and Travis Sharp

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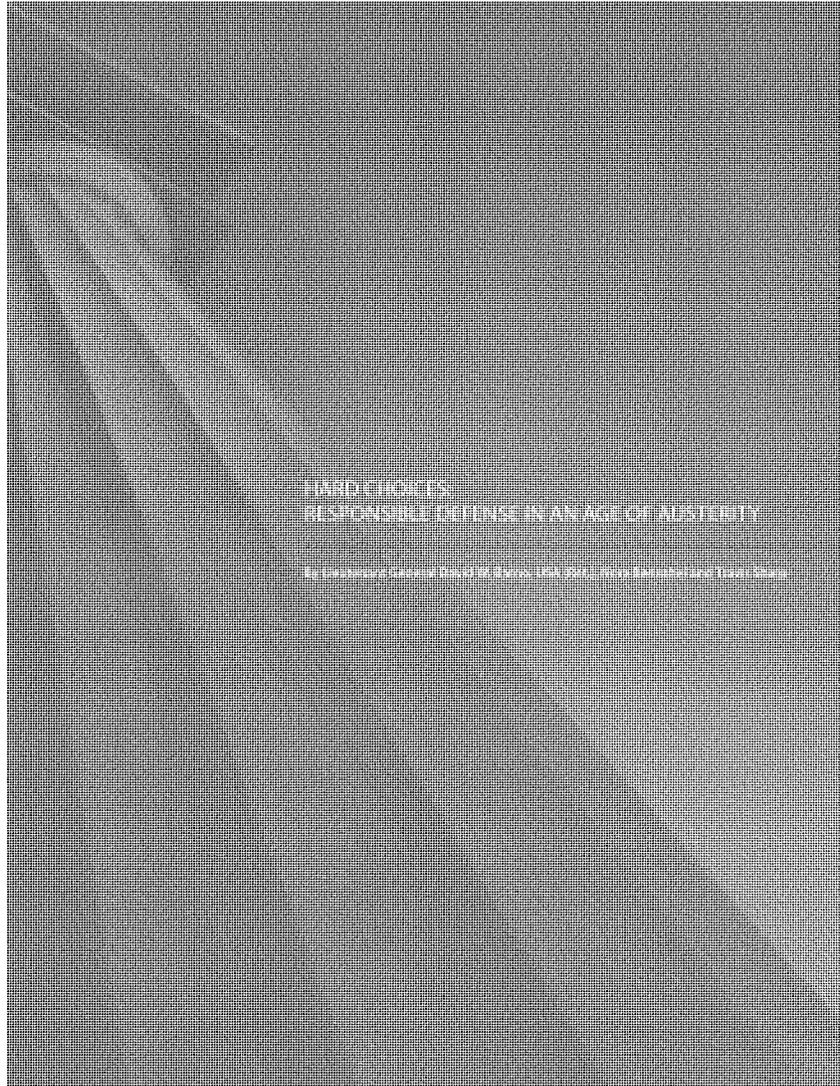
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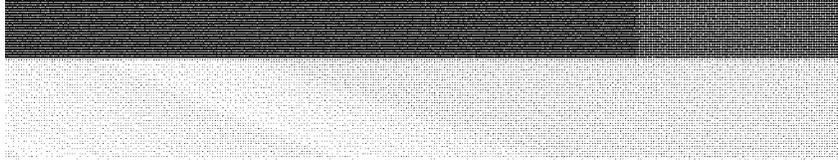
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## I. EXECUTIVE SUMMARY

By Lieutenant General David W. Barno, USA  
(Ret.), Nora Bensahel and Travis Sharp

The United States needs to rethink its defense strategy for an age of fiscal austerity. The Budget Control Act of 2011 requires the government to reduce spending dramatically over the next decade, and a congressional “super committee” is now seeking to cut expenditures by more than \$1 trillion beyond the substantial cuts already enacted this year.

Decisions made by Congress will affect the size, shape and capabilities of the U.S. military and the Department of Defense (DOD) for decades to come. As lawmakers debate their options, they must consider two questions: How much must the U.S. government spend on defense to secure its people and interests, and how much risk is it willing to tolerate?

To help answer these questions, this report – the first in the Center for a New American Security’s *Responsible Defense* series – outlines the ends, ways and means of U.S. defense strategy under a range of budgetary constraints. We acknowledge that these constraints are driving strategy, not the other way around, but accept this as an unavoidable reality in today’s political environment. Therefore, the report seeks to highlight the strategic consequences of these constraints, so that political leaders grasp the risks and trade-offs the cuts portend. We offer four scenarios for defense budget reductions, and identify what we think are the best possible ways to cut military force structure, end strength, procurement and overhead to reach the required levels of savings. We also consider the modified roles and missions, operational approaches and vulnerabilities that might result.

We believe that the United States should continue to pursue the ends of its longstanding global engagement strategy, but should do so using different ways and means than those codified in the Obama administration’s current national security plans. A new version of America’s global engagement strategy remains affordable, even in today’s fiscal environment, and pursuing it will help prevent and deter conflicts in the years ahead.

However, we judge that the U.S. military’s ability to execute America’s global engagement strategy,

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House Committee on Appropriations  
 Department of Defense and Military Construction

*We judge that the U.S. military's ability to execute America's global engagement strategy, as it is currently articulated, will be placed at high risk if total national defense cuts exceed \$500-550 billion over 10 years. This judgment could change if policymakers recalibrate America's global engagement strategy and/or generate savings by reforming military pay and benefits for future service members.*

as it is currently articulated, will be placed at high risk if total national defense cuts exceed \$500-550 billion over 10 years.\* This judgment could change if policymakers recalibrate America's global engagement strategy and/or generate savings by reforming military pay and benefits for future service members. Cutting beyond this range without such reform will force the U.S. military to reduce its force structure in ways that will impair its ability to protect vital American interests worldwide, engage key allies and modernize after a decade of grueling ground wars.

\* This range is calculated using the Congressional Budget Office's August 2011 baseline (excluding war costs), which sets future budget authority equal to the Fiscal Year (FY) 2011 appropriation adjusted for inflation. The pace of potential cuts also matters; gradual reductions would be easier to absorb than the sudden cuts that would occur under the Budget Control Act's automatic spending reduction process. "National defense" refers to budget function 050, which includes funding for DOD, nuclear weapons activities in the Department of Energy, and miscellaneous national security activities in non-DOD agencies. Function 050 is not the same as the "security" spending category that the Budget Control Act uses for its discretionary spending caps during FY 2012-2013.

## II. INTRODUCTION

The U.S. military faces significant budget cuts in the years ahead. Yet unlike the drawdown after the Cold War, the United States today is involved in major military operations abroad; fields a military force that needs modernizing despite a decade of soaring budgets; and suffers from a strikingly volatile global economy. Most importantly, the United States faces more serious security challenges than it did after the Soviet Union's collapse, with potentially aggressive regimes and transnational terrorism presenting clear threats to America and its allies.

Nonetheless, in the face of soaring budget deficits and ballooning national debt, the desire to cut government spending continues to gain momentum in the United States. The Budget Control Act (BCA), signed into law in August 2011 as part of negotiations over raising the U.S. debt ceiling, imposes discretionary spending caps from Fiscal Year (FY) 2012 to FY 2021. It also establishes a Joint Select Committee on Deficit Reduction to identify at least \$1.5 trillion in additional savings. If this super committee fails to craft a proposal that 1) cuts the deficit by at least \$1.2 trillion and 2) is enacted by Congress by January 15, 2012, a spending reduction process would automatically cut \$1.2 trillion in discretionary and mandatory spending from FY 2013 to 2021. These cuts would be divided evenly between defense and non-defense accounts, and the defense cut would fall almost entirely on DOD's base budget, which totaled \$530 billion in FY 2011.<sup>1</sup>

If implemented fully over the next decade,<sup>2</sup> the BCA's spending caps and automatic spending reduction process could cut national defense (function 050)<sup>3</sup> spending by up to \$1 trillion calculated using

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*If implemented fully over the next decade, the BCA's spending caps and automatic spending reduction process could cut national defense spending by up to \$1 trillion.*

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the Congressional Budget Office's (CBO) baseline for current plans. The exact amount is impossible to predict because it depends on future economic conditions and decisions by Congress. However, the Office of Management and Budget and the CBO have estimated a potential range from \$350 billion to \$850 billion over 10 years.<sup>4</sup> Any budget cuts initiated this winter will affect directly the U.S. military's management and planning because the Pentagon must comply with existing law.<sup>5</sup>

For the most part, the debate about budget cuts has downplayed both military strategy and the potential consequences for U.S. national security. The super committee probably will perpetuate this trend, given its short timeline and focus on overall spending reductions.<sup>6</sup> Yet a more complete examination of America's defense strategy and budget is urgently needed so policymakers understand the risks of cuts and the opportunities to create a more fiscally disciplined defense establishment that can still protect the nation.

This report outlines ends, ways and means for U.S. defense strategy under a range of budgetary constraints. We acknowledge that these constraints are driving strategy, not the other way around, but accept this as an unavoidable reality in today's political environment. Therefore, we seek to identify the strategic consequences of these constraints, so that political leaders grasp the risks and trade-offs that the cuts portend.

We provide four scenarios for defense budget reductions, each of which is consistent with cuts that Congress could implement over the next decade under the BCA's framework.

- Reposition and Reset: \$350-\$400 billion
- Constrained Global Presence: \$500-\$550 billion
- Selective Leverage: \$650-\$700 billion
- Focused Economy of Force: \$800-\$850 billion

The first scenario approximates the potential cuts resulting from the BCA's spending caps, and the fourth scenario approximates the potential cuts resulting from its automatic spending reduction process. We selected the second and third scenarios as incremental points in between. For each scenario, we attempt to present the optimal approach given the specified budgetary constraints. We identify what we believe are the best possible ways to cut military force structure, end strength, procurement and overhead to reach each required level of savings, and consider the modified roles and missions, strategic risks and trade-offs that might result.

Readers should note that the four scenarios exclude possible cost savings from reforming military pay and benefits. Personnel programs are fundamentally different from other types of defense costs, and reforming them can affect in unpredictable ways the choices that service members make about their careers.<sup>7</sup> Personnel reforms also face enormous political obstacles that make them difficult to achieve in the near term, even though spiking costs will probably make them necessary in the long term.<sup>8</sup> Policymakers could adopt such reforms to generate savings that would offset cuts in any of the scenarios or to achieve additional deficit reduction savings from DOD. We discuss this issue at the end of the report.

## The Defense Budget Cuts in Context

## POLITICAL CONTEXT

Most national security analysts think about how defense cuts will affect military capabilities, but it is important to recognize the broader political and economic considerations that will influence budgetary decisions. The House, House and members of Congress, including House Armed Services Committee Chairman Buckhorn, have announced publicly their opposition to defense cuts of a magnitude that would occur under the Budget Control Act's automatic spending reduction process.<sup>11</sup> A number of concerns underlie this resistance, but one political issue looms largest of all: job losses.

The economy and unemployment will likely be the most important issues in the 2012 election, and major cuts to military personnel and weapons programs will cause many people to lose their jobs. Although some studies show that defense expenditures create fewer jobs than other types of government spending,<sup>12</sup> officials of the Department of Defense (DOD) have said that if automatic reductions are triggered, the resulting defense cuts could increase unemployment nationwide by a half percentage point.<sup>13</sup> Depending on how and when the cuts are enacted, the Pentagon—the nation's largest employer—may have to start reducing civilian and military personnel during the 2012 campaign season.<sup>14</sup>

Some observers argue that cutting military pay and benefits carries greater political risk than cutting weapons programs because low-

income voters are more likely to be a more influential constituency than the defense industry.<sup>15</sup> But as a senior DOD official told us, "Weapons programs can often be more political than personnel cuts. There's just a different kind of politics."<sup>16</sup> The aerospace and defense industry directly employs one million Americans nationwide, and many local economies heavily depend on defense dollars.<sup>17</sup>

More importantly, the post-Cold War drawdown and earlier cutbacks have demonstrated that once parts of the defense industrial base are closed away, they are extremely difficult to reconstitute even if the nation faces a dire security threat.<sup>18</sup> The U.S. government could purchase foreign military sales and support contracts to help ease the defense industrial base during a budget drawdown.

## DEFENSE FINANCIAL CONTEXT

The Pentagon plans consistently outpace available resources.<sup>19</sup> The Congressional Budget Office estimated that to execute its current base budget program from fiscal year (FY) 2012 to FY 2021, it will need \$400 billion, or \$60 billion per year, in additional funding beyond what it would receive over that decade if the FY 2011 budget is closed only at the rate of inflation each year.<sup>20</sup> This gap will widen if the defense budget declines in real terms and DOD does not scale back its plans—resulting in a U.S. military establishment that increasingly will struggle to execute its strategies.

Politicians should not be fooled into thinking that cutting defense

spending of the levels outlined in previous areas will support similar job and force levels. Because of systematic cost growth, the amount of money spent on the U.S. military in 2011 would not be enough to afford the same force today. The Pentagon's operations and maintenance, personnel, military and civilian compensation, military health care and procurement costs have grown significantly on a per personnel basis since 2001. These costs will continue to grow through the end of the decade if DOD's current plans are implemented.<sup>21</sup> Military health care costs alone have grown by 85 percent in real terms over the past 10 years.<sup>22</sup>

The ever-growing cost of maintaining the U.S. military during two wars has contributed to DOD's failure to procure large quantities of new aircraft, ships and combat vehicles over the past decade.<sup>23</sup> These new weapons systems are also quite expensive, making it harder to buy them in sufficient quantities. Compared with the late 1980s, the U.S. Air Force today has approximately 2,900 fewer aircraft, and the U.S. Navy has fewer than half the number of ships.<sup>24</sup> Many of the aircraft, ships and military services are decades old and need upgrade or replacement. The U.S. military also faces considerable costs to refurbish equipment battered in Afghanistan and Iraq.<sup>25</sup> For example, the Army and Marine Corps have estimated that together they will need more than \$30 billion to repair and replace equipment worn in both wars.<sup>26</sup> Thus, keeping equipment needs unaddressed at a time when the Pentagon's budget is expected to shrink

### III. CHANGES TO U.S. DEFENSE STRATEGY

The United States has pursued a remarkably consistent military strategy over the past 65 years, although different American leaders have adopted varying approaches to national security.<sup>25</sup> This strategy, which we refer to as "global engagement," has involved security cooperation with allies, the maintenance of a military presence in key regions, selective engagement in armed conflicts and the pursuit of American military and economic primacy to protect U.S. interests. This strategy generally has served the United States well and has broadly sought to achieve the following objectives:<sup>26</sup>

- Guard the U.S. homeland against territorial invasion or attack by another country.
- Deter potential adversaries from attacking the United States and its allies.
- Protect trade routes and access to global energy supplies on which the U.S. and allied economies depend.
- Help secure the global commons of sea, air, space and cyberspace, on which the U.S. and global economic systems rely.
- Defend the United States against transnational security threats, such as nuclear proliferation and international terrorism.
- Support international laws and norms which help bolster peace and security.

Today's U.S. military continues to pursue these objectives, but it does so in a strategic context that has changed considerably in recent years. American leaders seek dramatic new constraints on U.S. government spending due to concern about deficits that are larger relative to the economy than any time since 1945. National debt held by the public now surpasses \$10 trillion – equal to 67 percent of America's gross domestic product.<sup>27</sup> Additionally, the U.S. withdrawal from Iraq, the

death of Osama bin Laden, the accelerating draw-down in Afghanistan, the so-called Arab Spring and China's continued rise present an evolving global environment that is different from what the Obama administration faced when it released its National Security Strategy in May 2010.

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*American leaders seek dramatic new constraints on U.S. government spending due to concern about deficits that are larger relative to the economy than any time since 1945. National debt held by the public now surpasses \$10 trillion – equal to 67 percent of America's gross domestic product.*

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In light of the significant budget cuts now being considered, civilian leaders should not ask the military to execute the expansive defense plans codified in the Obama administration's National Security Strategy, Quadrennial Defense Review (QDR) and National Military Strategy. These documents did not adequately address the possible effects of budgetary constraints. In fact, congressional legislation prohibits the QDR from addressing such constraints.<sup>28</sup>

Given today's fiscal constraints, we believe that the United States should continue to pursue the ends of its long-running global engagement strategy, but should do so using different ways and means. We are convinced that a new version

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 The U.S. Military in an Age of Austerity

of America's military strategy remains affordable, even in today's fiscal environment. The United States can pursue global engagement in alternate ways, some of which do not require the same forces, bureaucracy,<sup>29</sup> infrastructure and expenses<sup>30</sup> called for in current plans.

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*The U.S. military should focus on the Western Pacific and Indian Ocean and broaden engagements along the Pacific Rim, largely through a stronger maritime and air presence as well as the strategic use of ground forces to support key allies.*

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should pursue a more limited defensive military posture focused on limiting nuclear proliferation, preventing a major Indo-Pakistani conflict and disrupting terrorists capable of striking the United States.

The U.S. military should consider Europe a tertiary priority as NATO's and its member states' military capabilities decline. Other areas of the world – especially Africa and Latin America – should be the lowest priority, and the U.S. military should focus only on deterring and addressing specific threats to U.S. vital interests in those regions.

Constrained resources require U.S. civilian and military decisionmakers to prioritize key geographic regions more effectively. The U.S. military should focus on the Western Pacific and Indian Ocean and broaden engagements along the Pacific Rim, largely through a stronger maritime and air presence as well as the strategic use of ground forces to support key allies.

The Middle East and Mediterranean Basin should remain an area of vital interest, second only to East Asia. In this region, the United States should pursue a defensive strategy designed to contain potentially hostile regimes and dismantle terrorist networks while ensuring an uninterrupted flow of energy supplies.

While the United States should remain engaged with key allies in South and Central Asia, it

#### IV. GUIDING PRINCIPLES

This report's four budget scenarios reflect these regional priorities in a manner consistent with today's resource constraints. Each scenario presents examples of specific budgetary changes guided by four principles.

**First, naval and air forces will grow increasingly important in the future strategic environment.**

As a result, the Pentagon should prioritize these forces and not distribute the expected defense cuts evenly across the services, something it has done historically by adhering to the "golden ratio," the near equal division of its budget among the military services.<sup>31</sup> The U.S. military needs to bolster its influence in the Asia-Pacific region and should do so by engaging more with key allies and by developing long-range and precision weapons, particularly as potential adversaries like China further develop anti-access capabilities. Large active-duty ground forces will be needed less as the United States continues to withdraw from Afghanistan and Iraq, though the nation will still need them to deter aggression by hostile nations and to advise and assist U.S. allies facing regional instability. Cutting the number of ground forces may incur less risk than canceling naval and air modernization programs because the U.S. military can build up additional ground forces more quickly than it can acquire additional naval and air forces once production lines have closed.<sup>32</sup>

**Second, the U.S. military should strive to increase interdependence across the four services and to strengthen the continuum of service between the active and reserve components.**

The U.S. military is over-invested in expensive and often redundant capabilities that discourage interdependence among the services. All four military services currently operate their own air forces, with limited sharing of aircraft. Some services have acquired substantial assets beyond the

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*The U.S. military is over-invested in expensive and often redundant capabilities that discourage interdependence among the services.*

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requirements of their core mission. For instance, the U.S. Marine Corps – the smallest U.S. service – today boasts more tanks, artillery, fixed-wing aircraft and uniformed personnel than the entire British military.<sup>33</sup> Given the changing operational environment, today's force has too many heavy armored formations, short-range strike fighters, amphibious capabilities and manned aircraft. While some redundancy provides a useful hedge against risk, today's extensive overlap among and within each service is unnecessary and no longer affordable, especially when joint interdependencies – such as Army helicopters flying off Navy carriers or Air Force C-130s supporting Marines – can yield comparable warfighting effectiveness at less expense. The Army and Marines, in particular, should transfer more of their expensive heavy capabilities – such as armor, artillery and fixed-wing aircraft – to their reserve components to save money and maintain a strategic hedge in the event of a large ground war.<sup>34</sup> Implementing this change will require DOD and Congress to continue improving the policies that support an operational reserve component.<sup>35</sup>

**Third, the U.S. military should generate requirements for new weapons systems based on realistic assessments of likely threats, not on the pursuit of maximalist capabilities.**<sup>36</sup> Throughout the Cold War, defense plans were built mostly around specific assumptions about the threat posed by the

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Soviet Union. Since the end of the Cold War, however, the military has tried to prepare for a wider range of potential threats and to design capabilities for unknown but presumably potent future adversaries. This uncertainty has encouraged the military services to develop weapons systems requirements that are often unmoored from either technological limits or defined enemy capabilities.<sup>37</sup> In 2009, then-Defense Secretary Robert Gates criticized this proliferation of "exquisite" requirements that are tailored for a limited number of niche missions and too often ignore affordability.<sup>38</sup> Given that the defense budget is likely to remain constrained for years to come, DOD should return to a more restrictive planning and acquisition system that applies limited resources to the most serious threats to U.S. vital interests.

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*The U.S. military should increase investments in certain research and development programs to discover breakthrough technologies, such as stealthy, long-range, combat-capable unmanned aircraft systems, along with unmanned submersibles.*

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**Fourth, in the absence of major near-term threats, the Pentagon should pursue research and development to build a bridge between current weapons systems and highly capable future systems. The U.S. military should increase investments in certain research and development**

programs to discover breakthrough technologies, such as stealthy, long-range, combat-capable unmanned aircraft systems (UASs), along with unmanned submersibles. Technological advances deliver capabilities today that were unimaginable 20 years ago, when many of the replacement systems for legacy weapons systems were conceived. Prioritizing research and development will require new funds, which can be generated by limiting or eliminating purchases of expensive, highly specialized weaponry. The default model for many acquisition dilemmas confounding all four military services should be to accept higher risk absent a proximate short-term threat and invest in more targeted threat-focused research and development programs over the long term.

## V. FOUR BUDGET SCENARIOS

Without considering the specific trade-offs necessitated by defense spending reductions, it is hard for policymakers to grasp the risks incurred. The details of each budget scenario are discussed below, and are described fully in the appendix along with the projected cost savings. Readers should consider these estimates approximate and sometimes conservative, because they do not always capture cascading savings that would result from policy changes.<sup>39</sup>

All four scenarios share several features. They:

1. Prioritize investment in breakthrough technologies for stealthy, long-range sea- and ground-based combat UASs, along with unmanned submersibles, to ensure American dominance in the next generation of warfare.<sup>40</sup>
2. Preserve current plans for Special Operations Forces, which will play a vital role in future military operations.
3. Retire six CG-47 cruisers and reduce the planned procurement of Littoral Combat Ships (LCS), and, depending on the scenario, reinvest some of the savings into DDG-51 destroyers equipped with Aegis missile defense systems.
4. Reduce the planned procurement of stealthy F-35 short-range strike fighters and, depending on the scenario, reinvest some of the savings into improved EA-18 E/Fs, F-16s and development of advanced UASs.
5. Trim the U.S. strategic airlift fleet from 316 to 301 aircraft, which would involve retiring 15 C-5As and reducing related infrastructure and personnel.<sup>41</sup>
6. Shrink Army and Marine Corps end strength in accordance with the decreasing operational demand for ground forces as the United States transitions out of Afghanistan and Iraq. To hedge against risk, the scenarios make greater strategic and operational use of the National Guard and Reserves.<sup>42</sup>
7. Cancel or significantly delay several ground forces programs, including the Army's Ground Combat Vehicle (GCV), the Joint Light Tactical Vehicle (JLTV) and the Joint Tactical Radio System (JTRS).
8. Avoid cutting next-generation nuclear delivery vehicles within DOD's budget because the current procurement schedule offers relatively little savings over the next decade.<sup>43</sup> Instead, the scenarios defer several investments within the National Nuclear Security Administration's budget.
9. Reduce personnel and defense overhead, beyond the efficiencies initiative that DOD has already adopted, to preserve more combat capability.
10. Shut down the Joint Improvised Explosive Device Defeat Organization (JIEDDO) in FY 2017. This would give JIEDDO several years after the expected departure of most U.S. combat troops from Afghanistan in which to integrate its most promising technologies into the military services' broader development activities.
11. Prioritize operational activities tied to theater missile defense programs, such as the Aegis sea-based system, and provide less funding for experimental national missile defense programs.

### Scenario 1: Reposition and Reset

#### STRATEGIC OVERVIEW

Scenario 1 preserves current U.S. defense plans to the greatest extent possible in an effort to minimize potential vulnerabilities that could occur by changing those plans too extensively or too rapidly. It enables DOD to pursue a "High-Low-New" modernization plan, in which DOD would purchase high-technology weapons systems to replace older platforms, lower-technology (but still sophisticated) upgrades to existing systems, and innovative new



Scenario 1 sustains but realigns the naval and air power projection forces required to face future threats. The Navy and Air Force would field fewer planned next-generation systems such as the LCS and F-35, but would retain a potent mix of new platforms – such as the Ford-class carrier, Virginia-class submarine, F-22 and F-35 – and highly capable existing platforms like advanced F/A-18s and DDG-51s. This force mix is capable of deterring or, if necessary, defeating any potential U.S. adversary.

Despite buying additional DDG-51s, Scenario 1's truncation of the LCS program in FY 2017 will result in a smaller overall fleet of surface vessels. Fewer vessels means less forward presence, but alternative forward basing and crew rotation models could mitigate the impact on operations.<sup>46</sup>

Scenario 1's 25 percent cut to each F-35 variant's planned quantity may cause U.S. allies to abandon the jet even though they have invested in its development and plan to buy it. The cuts will assuredly increase unit costs for the remaining buyers. Allies who drop out may buy other, less capable fighters from the United States or overseas, or may simply tolerate risks and expect that the United States will provide support in extremis. They also may be less likely to collaborate with the United States on weapons systems in the future.

Starting in FY 2015, Scenario 1 reduces Army end strength from the planned permanent level of 520,000 to 482,000, and reduces Marine end strength from the planned permanent level of 187,000 to 175,000. These reductions are connected to planned reductions in the ground forces' operational tempo, particularly after 2014, when most U.S. troops are expected to be out of Afghanistan. The need to bolster U.S. influence in the Asia-Pacific and Middle East regions suggests that ground forces will play a less central role in the projection of U.S. military power in the next decade than in the last. That said, the

unpredictable nature of combat over the last 60 years means that future ground threats may arise unexpectedly, which requires more rapid access to reserve forces. A smaller Army and Marine Corps would return both to the active-duty force size and approximate readiness of the 1990s. We judge that this will be adequate for current and anticipated global threat scenarios given today's budgetary constraints.

Scenario 1's cancellations or reductions to the GCV, JLTV and JTRS programs would upend several long-delayed programs designed to modernize Army and Marine Corps ground vehicles and communications assets for 21st-century warfare. The ground forces would be forced to rely on existing systems, which, though capable and numerous, may not perform as well in the complex combat scenarios that planners foresee.<sup>47</sup> That said, we judge that improving current systems will adequately meet projected needs for the next decade.<sup>48</sup> However, the Army and Marine Corps should continue to pursue research and development so that they are prepared to meet the challenges that will arise in the 2020s and beyond.

#### Scenario 2: Constrained Global Presence STRATEGIC OVERVIEW

In Scenario 2, the United States can use advanced naval and aerial weapons platforms and a sizable expeditionary ground capability to fulfill its global missions. However, it would field fewer platforms and fewer troops to execute its global engagement strategy. Scenario 2 prioritizes protecting U.S. interests in the Western Pacific, Indian Ocean, Middle East, Arabian Gulf and the Mediterranean Basin. It takes greater risk and accepts longer response times in other parts of the world. It emphasizes modernization and upgrades for outdated equipment to ensure that the U.S. military remains capable of deterring or defeating a wide range of security challenges.

Scenario 2 adopts all of the cuts included in Scenario 1, but also reduces the carrier fleet, the

SCENARIO 2: CONSTRAINED GLOBAL PRESENCE

The details of this budget scenario are fully described in the appendix along with the projected cost savings in billions.

SUMMARY OF PROGRAMMATIC CHANGES (\$500-\$550 BILLION IN TARGET SAVINGS)			
PROGRAM	SAVINGS	PROGRAM	SAVINGS
<b>NAVAL FORCES</b>		<b>DEFENSE-WIDE ACTIVITIES</b>	
Aircraft Carrier (CVN)	210	Base Support and Facilities Modernization	329.0
Amphibious Ship	---	Biogas	56.4
Attack Submarine	---	EOC Challenge	346.4
Flight Deck class SSN-798	---	EOC Retail Programs	99.7
Cruiser (Theodore Roosevelt class CG-47)	53.3	Headquarters Construction	315.3
Destroyer (Arleigh Burke class DDG-51)	18.4	Infrastructure	679.8
Lincoln County class LPD-17	27.0	Joint Information Operations Device Contract Organization	11.2
<b>AIR FORCES</b>		<b>NON-DOD ACTIVITIES</b>	
F-35 Joint Strike Fighter	216.0	"Joint Effect" Unmanned Aircraft	613.0
MQ-4C Global Hawk Maritime Surveillance Unmanned Aircraft System	34.0	Missile Defense	337.5
Strategic Airlift	52.8	Operations for Commercial Activities	60.0
F-22 Raptor	27.0	Prime Procurement	311.5
<b>GROUND FORCES</b>		Research and Development	
Army and Marine Corps Brat Strength	341.4		615.0
Ground Combat Vehicle (M1A2)	37.0	Public Energy Defense Activities	316.0
Joint Light Tactical Vehicle (JLTV)	311.3	Other Defense Related Activities	96.7
Joint Tactical Radio System (JTRS)	115.0		
Ground Mobile Radio (GMR)	---	<b>TOTAL</b>	<b>3501.7</b>

Areas of reinvestment

Marine Corps V-22 Osprey, the Navy's MQ-4C and the F-35 program. Like Scenario 1, however, it reinvests some savings into existing platforms such as DDG-51s. Scenario 2 maintains the same Army and Marine end strength levels as Scenario 1.

RISKS OF PROGRAMMATIC CHANGES

The risks associated with this scenario are significant but acceptable. This scenario prioritizes areas where vital U.S. interests are at stake, and takes risks in other parts of the world. It focuses on sustaining

U.S. military power across the Pacific Rim while protecting U.S. interests in the Middle East, and it maintains substantial power projection and ground force capabilities as a hedge against unexpected threats. Scenario 2 allocates 2 percent of its total cuts to ground forces, 7 percent to air forces, 15 percent to naval forces, 72 percent to defense-wide activities and 4 percent to non-DOD activities.

Scenario 2 permanently reduces the number of aircraft carriers from 11 to 10. The Navy can

partially offset the risks of a reduced carrier presence by altering forward basing models focused on Hawaii and the Western Pacific, and by extending the presence of other naval platforms such as submarines and destroyers. The scenario takes risks by accepting fewer deployments (aside from transits) to the Mediterranean, Africa and South America. The scenario's main effort for naval deployments centers on protecting U.S. interests in the Western Pacific, Indian Ocean, Middle East and Arabian Gulf, along with connecting sea lanes. Policymakers should continue to explore new basing locations, such as in Australia, to support increased forward naval platform availability and to shorten costly transit times.

Scenario 2's reductions in the planned V-22 fleet starting in FY 2016 carry greater risk for the Marine Corps. While Scenario 2 recommends buying additional CH-53Ks in the future to provide rotary lift, these helicopters do not have the V-22's speed and flight ceiling, assets that could prove valuable during an amphibious assault scenario.<sup>49</sup> Yet when used in concert with V-22s, we judge that CH-53Ks offer more than adequate survivability, range and capacity for the variety of missions that U.S. forces may be asked to undertake.

Scenario 2 significantly reduces F-35 procurement by 50 percent but offers a more cost-effective mix of stealthy and non-stealthy manned strike aircraft while accelerating development of combat UASs. This scenario maintains all three versions of the F-35 (albeit in smaller numbers) and increases purchases of high-end F/A-18s and F-16s to provide a mix of highly capable platforms for the majority of scenarios in which a 100 percent stealthy fleet is not required.

This scenario takes particular risks during the first 72 hours of combat in a highly sophisticated air defense environment in which stealthy capabilities are in great demand. However, we judge that even a reduced number of stealthy F-35s – complemented

by B-2s, next-generation bombers and cruise missiles supported by an advanced intelligence, surveillance and reconnaissance (ISR) network – will provide sufficient capabilities to reduce any potential enemy's air defense capability within days, permitting non-stealthy aircraft to then enter the fight.<sup>50</sup> Accelerating stealthy unmanned long-range strike capabilities may reduce this risk further in the future.

Scenario 2 reduces the Navy's costly MQ-4C Broad Area Maritime Surveillance (BAMS) UAS platform. But it continues development and procurement of other maritime surveillance capabilities, including the P-8A Poseidon aircraft.

#### Scenario 3: Selective Leverage STRATEGIC OVERVIEW

Scenario 3 preserves the ability of the U.S. military to deter and defeat adversaries while further reducing redundancy throughout the force, promoting more interdependence among the services, diminishing single service self-reliance, and reducing or eliminating lower-priority capabilities and weapons systems. Yet the additional budget cuts required in this scenario would create substantially more risk than those in the first two scenarios. Scenario 3 still focuses on protecting U.S. interests in the Middle East and Arabian Gulf, as well as in the Indian Ocean and the Western Pacific, but takes greater risks and reduces the U.S. presence in less vital regions.

Scenario 3 adopts all of Scenario 2's cuts, plus it reduces the planned procurement of Virginia-class attack submarines and amphibious ships. It purchases more F-35s than Scenario 2, but it does not replace canceled F-35s with F-16s and F/A-18s on a one-to-one basis, thus resulting in a smaller overall inventory. It also cancels the Navy's MQ-4C. In some cases, the cuts to these next-generation systems are offset by purchases of more cost-effective platforms. Scenario 3 cuts Army and Marine Corps end strength to 460,000 soldiers and 162,500 Marines.

SCENARIO 3: SELECTIVE LEVERAGE

The details of this budget scenario are fully described in the appendix along with the projected cost savings in billions.

SUMMARY OF PROGRAMMATIC CHANGES (\$650-700 BILLION IN TARGET SAVINGS)			
PROGRAM	SAVINGS	PROGRAM	SAVINGS
<b>NAVAL FORCES</b>		<b>DEFENSE-WIDE ACTIVITIES</b>	
Aircraft Carrier (CVN)	370	Base Support and Facilities Maintenance	362.5
Amphibious Cargo	113.0	Defense	76.8
Arctic Submarine	120.0	DOD Children	163.1
Flight-class SSBN (SSBN)		DOD Postal Activities	507
Cruiser (Tomahawk-class CG-40)	55.5	Headquarters Construction	126.4
Destroyer (Arleigh-class DDG-51)	-11.4	Healthcare	106.2
Destroyer Escort (MEC-20)	57.0	Joint Independent Explosive Damage Defeat Capabilities	21.2
<b>AIR FORCES</b>		<b>NON-DOD ACTIVITIES</b>	
F-35 Joint Strike Fighter	1,200.0	Leap Ahead: Unmanned Systems	-115.0
M2-B Combat and Maritime Surveillance	116.0	Missile Defense	237.5
Unmanned Aircraft System		Operations for Commercial Facilities	167.4
Standalone R&D	12.4	Other Procurement	219.4
R-51 Training	17.5	Research and Development	203.7
<b>GROUND FORCES</b>			
Army and Marine Corps Brd Strength	900.0	Atomic Energy Defense Activities	131.0
Ground Combat Vehicle (GCV)	37.0	Other Defense-Related Activities	17.7
Joint Light Tactical Vehicle (JLTV)	318.5		
Joint Tactical Radio System (JTRS)	115.0		
Ground Mobile Radio (GMR)			
		<b>TOTAL</b>	<b>3664.8</b>

Areas of reinvestment

In sum, Scenario 3 reduces the number of naval vessels central to executing a forward presence strategy across the Pacific and in other maritime areas. It further reduces next-generation manned airpower, thus taking near-term risk while investing in leap-ahead unmanned technologies. It further reduces the number of soldiers and Marines in the active force, using the reserves to hedge against unanticipated ground wars.

RISKS OF PROGRAMMATIC CHANGES

We judge that the risks associated with this approach are high, unless policymakers alter the U.S. global engagement strategy significantly or generate savings by reforming military pay and benefits in order to reverse some of the programmatic cuts described here. This scenario seeks to maintain a strategy focused on the Pacific Rim and Middle East, but it lowers the number of naval and air assets central to that strategy. It also draws

down Army and Marine Corps end strength, reducing the nation's ability to respond quickly and with sufficient force to rapidly defeat adversaries in unexpected contingencies demanding ground forces. Scenario 3 allocates 8 percent of its total cuts to naval forces, 7 percent to air forces, 14 percent to ground forces, 67 percent to defense-wide activities and 4 percent to non-DOD activities.

Scenario 3's budget cuts would force further cuts in the number of naval vessels, reducing U.S. forward maritime presence and making America's global engagement strategy much more difficult to execute. Building two additional destroyers would not overcome the cut to LCS, the decommissioned carrier and a reduced attack submarine fleet illustrated in Scenario 3. Policymakers might partially offset these reductions through forward basing, crew rotation, longer times at sea and redeploying additional assets from lower-priority areas.

Scenario 3 cancels the procurement of several Marine Corps amphibious ships in light of both their expense and the military's current over-investment in amphibious assault capabilities when compared to actual demand for the full complement of ships over the past 60 years. The remaining Expeditionary Strike Group (ESG) capabilities can maximize their reach and forward presence through combinations of forward basing, forward rotation of Marines, and reducing selected ESGs from three amphibious ships to two, complemented by surface combatants, as the full capabilities of San Antonio-class amphibious ships come on line. Despite these operational changes, the reduction in amphibious ships will shrink the U.S. military's ability to conduct humanitarian assistance and disaster relief operations worldwide.

The smaller strike fighter inventory outlined in Scenario 3 would leave the U.S. military less able to conduct combat operations in multiple theaters. Reducing the number of F-35s could increase risks during the opening days of an air campaign

by having fewer stealthy strike fighters available to penetrate a sophisticated enemy air defense network. However, although the overall quantity of aircraft would be lower, the larger weapons-carrying capacity of the F-35 would enable total weapons-delivery capacity of the strike fighter fleet to remain largely what it was in 2009.<sup>31</sup> In many scenarios the remaining F-35s – in conjunction with other strike capabilities – should prove adequate.

Scenario 3 cancels the Navy's MQ-4C UAS. Instead, UASs currently in the Air Force inventory might be converted to maritime ISR specification, but would continue to be operated by the Air Force and deployed to strategically important bases around the world.

Starting in FY 2015 Scenario 3 shrinks the Army and Marine Corps to 460,000 and 162,500 troops, respectively, with elements of the reduced end strength, especially heavy forces, transferring into the reserves. Although this cut in active-duty strength yields considerable savings, it imposes substantial additional risk. This reduction may be acceptable if planned troop withdrawals from Afghanistan are realized by the end of 2014. Still, a smaller Army and Marine Corps, even if supported by a capable reserve component, would be less able to respond promptly and with decisive force should an intense ground war erupt over the next decade. If the United States sought to deploy a large ground force overseas, it might have to implement a large-scale activation of the reserves and other costly measures to expand the active force.

As previously noted, cuts to the ground forces are more easily reversed than cuts to naval and air modernization programs, which take decades to develop and procure. However, because personnel reductions will not occur until FY 2015, there is a significant risk that the BCA's automatic spending reduction process will disproportionately target procurement and research and development before then.

#### Scenario 4: Focused Economy of Force

##### STRATEGIC OVERVIEW

Scenario 4 requires the most significant overall cuts across all four services and DOD to reach the required level of savings. It goes beyond Scenario 3's cuts by canceling the Marine Corps F-35B, ending LCS in FY 2013, and further reducing Army and Marine Corps end strength. Scenario 4 aims to maintain a modernized force that can conduct high-intensity warfare against adversaries that directly threaten core U.S. interests, while taking substantially greater risks in all other missions. The programmatic changes therefore aim to preserve air and naval capabilities as much as possible at the expense of ground force structure.

Scenario 4 incurs substantially greater risk than the other three scenarios. It saves money by eliminating redundancy across the joint force, but also greatly diminishes the protection that redundancy provides against single-point failure. If an unexpected technical problem or adversary capability neutralizes the F-35, for example, most of the tactical air fleet would suddenly become ineffective, and too few other types of aircraft would be available to provide a reliable substitute. Reducing the Army's active-component heavy capabilities and eliminating most of the Marines' heavy capabilities makes sense when the greatest threats to U.S. interests lie in the air and on the sea, but ground threats have often arisen unexpectedly. Major ground operations would require significant time for mobilizing reserves. The U.S. military might not be able to respond quickly with enough ground force capacity to prevent an adversary from seizing territory, which could potentially trigger U.S. involvement in a longer, bloodier and more costly fight to regain lost ground than it would have otherwise faced.

Scenario 4 saves a great deal of money, but it also significantly limits the options of U.S. policymakers and forces them to make painful choices. The major cuts to ground forces and strike fighters in this scenario risk sending a message of receding U.S. power in a dangerous world.

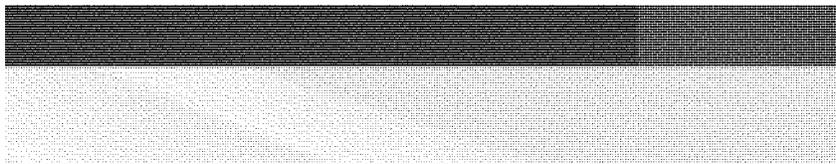
##### RISKS OF PROGRAMMATIC CHANGES

We judge the risks associated with this scenario to be very high, unless policymakers alter the U.S. global engagement strategy significantly or generate savings by reforming military pay and benefits in order to reverse some of the programmatic cuts described here. This scenario includes more cuts to naval and air assets than Scenario 3, which curtails America's ability to protect its interests in Asia and the Middle East. By cutting to 430,000 soldiers and 150,000 Marines, this scenario further reduces the nation's ability to rapidly defeat adversaries in ground combat. Scenario 4 allocates 8 percent of its total cuts to naval forces, 8 percent to air forces, 16 percent to ground forces, 64 percent to defense-wide activities and 4 percent to non-DOD activities.

Scenario 4 cancels the LCS in FY 2013, leaving the Navy without the mine hunting and clearing capabilities it plans to gain from the initial production run of ships. The United States would have to rely on its allies to conduct these critical operations. This scenario also does not procure any additional DDG-51s to offset the cuts to LCS.

Scenario 4 significantly restructures procurement plans for the F-35. It eliminates future procurement of current-generation tactical aircraft (F-16s or F/A-18s), and cancels the short takeoff, vertical landing (STOVL) F-35B as part of the Marine Corps force structure changes.

The loss of the Marine STOVL F-35B effectively eliminates the fixed-wing strike capability for the Marine Corps once the F/A-18 and AV-8B Harrier II are retired. The reduced number of future amphibious ships would carry only helicopters, thereby limiting their role as offshore strike platforms. Amphibious ships would instead provide primary transport for Marine assault forces with a secondary mission to support humanitarian assistance and disaster relief. This would require the Marines to rely on close air support from attack helicopters and



SCENARIO 4: FOCUSED ECONOMY OF FORCE

The details of this budget scenario are fully described in the appendix along with the projected cost savings in billions.

SUMMARY OF PROGRAMMATIC CHANGES (\$800-850 BILLION IN TARGET SAVINGS)					
PROGRAM		SAVINGS	PROGRAM		SAVINGS
<b>NAVAL FORCES</b>					
Amphibious Command Ship		\$70			
Amphibious Ship		\$130			
Attack Submarine		\$268			
Destroyer-class SSN (DDG)					
Cruiser/Destroyer-class DDG (DDG)		\$5.5			
Destroyer (Destroyer-class DDG)					
Armed Escort Ship (ES)		\$14.2			
<b>AIR FORCES</b>					
F-35 Joint Strike Fighter		\$42.8			
F-35 Joint Strike Fighter		\$13.0			
Unmanned Aircraft System					
Strategic Air Force		\$2.4			
F-22 Raptor		\$7.9			
<b>GROUND FORCES</b>					
Armored Main Battle Tank (M1)		\$10.1			
Armored Combat Vehicle (ACV)		\$7.0			
Joint Light Tactical Vehicle (JLTV)		\$18.9			
Army Tactical Battle Group (ATBG)		\$13.0			
Ground Mobile Battle Group					
<b>DEFENSE-WIDE ACTIVITIES</b>					
Base Support and Facilities Maintenance		\$39.0			
Depot		\$4.4			
DOD Contract		\$72.3			
DOD Retail Activities		\$8.1			
Headquarters Contract		\$15.5			
Intelligence		\$10.2			
Joint Integrated Exploitive Data Defense Organization		\$1.2			
Logistics					
“Line of Sight” Automated Systems		-\$15.0			
Missile Defense		\$17.5			
Procurement for Commercial Activities		\$8.0			
Other Procurement		\$47.2			
Research and Development		\$112.5			
<b>NON-DOD ACTIVITIES</b>					
Atomic Energy Defense Activities		\$15.7			
Other Defense Related Activities		\$8.3			
<b>NET SAVINGS</b>					
		\$800			\$800

Area of reinvestment

armed UASs, or from Navy or Air Force fixed-wing strike aircraft flying from carriers or ground bases. Eliminating fixed-wing STOVL aircraft from big deck amphibious ships would diminish an important, but not vital, component of their current power projection capabilities. Accelerating combat UASs based on big deck amphibious assault ships could make these ships even more capable future strike platforms that could operate at much greater range from their targets.

Scenario 4 reduces active-duty Army end strength to 430,000 personnel, largely by trimming non-combat positions and shrinking the Army’s heavy capabilities, thereby reducing its ability to operate in a high-intensity ground war without accepting high casualties. The Army would need to keep some armor and artillery units on active duty in case of conflict on the Korean Peninsula, but few other threats are likely to require an overwhelming heavy ground

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response in the foreseeable future. The bulk of active-duty Army forces would therefore focus on rapid response/forcible entry (airborne and helicopter assault) and on the lower end of the conflict spectrum, such as advising and assisting foreign forces and conducting irregular warfare. The overall lack of manpower would make large protracted commitments much more difficult, and most remaining heavy forces would be moved into the reserve component.

This scenario also reduces the size of the Marine Corps to 150,000 personnel.<sup>53</sup> The scenario eliminates the heavy capabilities that the Marines have added in the past decade to fight recent wars, and refocuses the Marines on serving as an expeditionary force partnered with the Navy for crisis response and forward engagement. It would be a rapidly deployable force, but one that relies on coordinated air support from the Navy and Air Force.

Scenario 4 would require U.S. policymakers to make much more cautious choices about how and when to use force. Leaders would have to prioritize global missions and objectives far more clearly than they have in the past, and accept that a smaller and less capable U.S. military may be less able to engage in significant combat without high casualties. Moreover, it is unlikely that this force would be able to engage in more than one major conflict simultaneously. Policymakers could, for example, choose to assign most U.S. forces to serve in high-priority areas in the Asia-Pacific and the Middle East, and assign few or even no forces to Africa, Europe, and Latin and South America, perhaps with a commensurate reduction in military headquarters for those regions. Or they might decide not to intervene after a humanitarian disaster or an ethnic conflict, no matter how high the degree of human suffering, because doing so could potentially tie up too many military capabilities for too long.

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This scenario could also increase the risks of instability and regional conflict in Asia. The United States currently guarantees the security of many Asian allies and partners, either by treaty or by default. To the extent that U.S. defense cuts lead these countries to question the credibility of that guarantee, they are more likely to build up their militaries in a manner that might destabilize the region, or perhaps forge closer ties with China, which would become the region's dominant power in the wake of reduced American involvement.<sup>54</sup>

## VI. REFORMING MILITARY PAY AND BENEFITS

All four scenarios generate savings by cutting end strength, force structure, procurement and overhead. To the extent that Congress and DOD want to preserve more of these capabilities, they can maintain the same level of overall savings by finding reductions in other areas. The Pentagon could work with Congress to initiate another round of BRAC, for example, which has saved money in the past and will almost certainly be necessary if any of the options for major end strength reductions are selected.<sup>54</sup> It will be difficult to generate considerable savings without addressing military personnel costs, which include not only salaries but also a range of retirement and health care benefits. Taken together, these expenditures consume about 34 percent of DOD's annual base budget.<sup>55</sup>

If DOD cancels a procurement program, it can usually calculate how much money will be saved and what capabilities will be lost. By contrast, altering personnel benefits involves also altering the incentives and decisionmaking of current and prospective service members. As a result, changing these benefits may affect recruiting, retention, length of service and morale in ways that may be difficult to anticipate. Additionally, the U.S. military remains at war in Afghanistan and American troops will go into battle every day for at least the next few years. Not breaking faith with the men and women who continue to put their lives on the line demands that these Americans retain the benefits that they have signed up for and earned.

Developing specific options for reducing personnel costs and estimating their long-term effects falls beyond the scope of this report. As a result, we do not discuss potential reforms to military compensation, although studies show that such reforms would generate significant cost savings.<sup>56</sup>

However, we do provide examples of reform in two significant areas – health care and retirement benefits – which illustrate the types of cost saving measures that policymakers might consider if they choose to forego cuts to end strength, force structure, procurement and overhead included in the four scenarios.

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*It will be difficult to generate considerable savings without addressing military personnel costs, which include not only salaries but also a range of retirement and health care benefits. Taken together, these expenditures consume about 34 percent of DOD's annual base budget.*

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### Example 1: Health Care Benefits

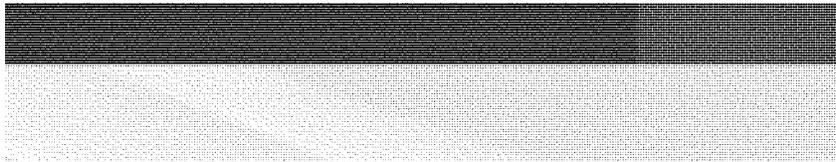
TRICARE is the military health care program for active-duty and retired personnel, as well as their dependents and survivors. TRICARE spending more than doubled from 1999 to 2009 in real terms, in part because retirees under age 65 have increasingly chosen to stay on TRICARE rather than pay for civilian health care plans that can be far more expensive.<sup>57</sup> In 1999, 55 percent of military retirees and their dependents enrolled in other health insurance plans, but by 2009, that figure was only 29 percent.<sup>58</sup>

A recent CBO report examined four ways to save money by reforming TRICARE, which

TABLE 1: CONGRESSIONAL BUDGET OFFICE OPTIONS FOR REFORMING TRICARE

OPTION	DETAILS	10-YEAR COST SAVINGS
Increase costs of prescription drugs	<ul style="list-style-type: none"> <li>Act as Army beneficiaries are willing to pay for generic drugs.</li> <li>Capas costs for generic drugs at 50% for other drugs at military pharmacies.</li> <li>Capas costs for drug purchases from retail or mail-order pharmacies increase for all beneficiaries.</li> </ul>	\$2.6 billion
Increase fees and deductibles for retirees and post-9/11s for Medicare	<ul style="list-style-type: none"> <li>Annual enrollment fee for TRICARE Transition from \$200 to \$250 for individual coverage and from \$400 to \$450 for family coverage.</li> <li>TRICARE Part B payments of civilian providers increase from \$11 to \$25.</li> <li>Annual fee for TRICARE Extra or Standard established and deductibles increase.</li> </ul>	\$20.1 billion
Introduce maximum deductibles for TRICARE for Life (TFL)	<ul style="list-style-type: none"> <li>In Fiscal Year 2012, TFL would not cover the first \$500 of Medicare copayments, and would cover 50 percent of the first \$4,000 of Medicare copayments - a total maximum of \$4,500.</li> <li>In FY13 and beyond, the annual maximum would be indexed to growth in average Medicare costs.</li> </ul>	\$40 billion
Limit TRICARE benefits for non-covered dependents	<ul style="list-style-type: none"> <li>Dependents without dependent would no longer be eligible for TRICARE Prime.</li> <li>Those who enroll in TRICARE Standard would pay a monthly fee set at 30% of the average cost of covering that person for medical care.</li> <li>In FY13, annual maximum out-of-pocket limit reset to the 2010 limit of \$7,500 per family.</li> <li>In FY14 and beyond, the annual maximum would be indexed to growth in average Medicare costs.</li> </ul>	\$75.2 billion

Source: Congressional Budget Office, *Reducing the Deficit* (March 2011): 19, 78-83.



**Defense Business Board Concludes About Military Retirement**

The Defense Business Board (DBB) recently released conclusions about the military retirement system. According to the DBB, the system:

- Has not changed significantly for more than 50 years – even before the adoption of the all-volunteer force – even though the spots have grown longer, military pay is more competitive with civilian pay and many officers now pursue second careers in the private sector.
- Provides benefits that are more generous and more costly than private sector benefits.
- Is unfair, because 61 percent of all service members serve for fewer than 20 years and therefore receive no retirement benefit at all.
- Is unsustainable, because costs are rising sharply. The current system will be liable for \$2.7 trillion by fiscal year (FY) 2034 and could be liable for almost \$1.2 trillion by FY 2026.<sup>61</sup>

The DBB recommends adopting a defined contribution plan, where the U.S. government contribution would be based on a percentage level comparable to the highest end of a private sector pension plan.<sup>62</sup> The contribution would double during years that the service member served in a combat zone or in a high-risk area, and could also increase by an amount that would change funding from a flat dollar contribution to a limit of \$19,500 per year and an additional \$5,500 “catch-up” contribution per year for personnel aged 50 and older, which is roughly comparable to the dollar limits on IRA contributions. It would also allow members of the armed forces serving in a designated war zone to contribute less than the average

into up to an annual maximum of \$4,500. The plan would not offer more than five years of service, and would be available to age 60 to 63 or the Social Security age, if that were to increase.<sup>63</sup>

The DBB estimates that if all current active-duty personnel remain on the current plan and all new recruits participate in the revised plan, the retirement trust fund will be liable for \$1.8 trillion by FY 2034 – saving \$480 billion over 25 years if all current military personnel immediately transition to the new system without losing any accrued benefits. The retirement trust fund would be liable for \$1.2 trillion by FY 2034 – saving \$1.5 trillion over 25 years. If the trust fund liability would drop below the total cost to the government over the period covered by FY 2005,<sup>64</sup>

are summarized in the table on the previous page. These options are not mutually exclusive. Policymakers could choose to adopt any combination of them, or all of them at the same time.<sup>65</sup> The cost savings for each option range from \$26.1 billion to \$105.2 billion over the next 10 years.

**Example 2: Retirement Benefits**

The Defense Business Board recently sponsored a task force that reviewed the current structure and function of the military retirement system. It found that the costs of military retirement are “rising at an alarming rate,” and that “[a]ction must be taken to contain these spiraling costs or they will undermine future warfighting

capabilities.”<sup>66</sup> As discussed in the text box above, it then recommended a mandatory defined contribution plan, based on the current Thrift Savings Plan, which could save \$900 billion to \$1.5 trillion over the next 25 years.<sup>67</sup>

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Hard Choices  
Responsible Continuation of the Army

## VII. CONCLUSION

Based on extensive analysis and interviews with leading defense officials, we judge that the U.S. military's ability to execute America's global engagement strategy, as it is currently articulated, will be placed at high risk if total national defense cuts exceed \$500-\$550 billion over 10 years. This judgment could change if policymakers recalibrate America's global engagement strategy and/or generate savings by reforming military pay and benefits for future service members. Reductions beyond this range would cut too many air and naval assets and risk America's ability to protect its vital interests in Asia and the Middle East, while the cuts in Army and Marine Corps end strength would jeopardize the ability of the United States to prevail against determined adversaries in unexpected ground force contingencies without potentially incurring heavy casualties.

Determining "how much is enough" for defense requires both art and science, subjective judgment and objective analysis. Such a calculus is difficult in today's world of unprecedented technological change, economic dislocation and rapidly evolving threats. Yet the U.S. government's fundamental responsibility is to provide security to its citizens.

Any cuts to the defense budget should be made with a clear view of the strategic risks they entail. This report suggests specific, strategically grounded ways to achieve significant savings while protecting U.S. vital interests. A different set of choices would produce a much different blueprint, potentially taking greater risk in any scenario. Policymakers planning defense cuts should carefully weigh trade-offs, judge both confidence and risk, and ultimately choose what is necessary to ensure that the American people and the global priorities they value remain safe and secure.

## ENDNOTES

1. The Budget Control Act does not constrain funding for Overseas Contingency Operations (OCO). The defense portion of its automatic cuts would fall on national defense (function 050), not the "security" spending category that the act uses for its discretionary spending caps during FY 2012–2013. For thorough analysis, see Todd Harrison, *Defense Funding in the Budget Control Act of 2011* (Washington: Center for Strategic and Budgetary Assessments, August 4, 2011).
2. The Budget Control Act does not affect Congress's constitutional power to appropriate funds or change laws. In the future, Congress could revoke the act's framework for deficit reduction – something it has done in the past. See Heidi Przybyla, "Debt Plan Includes Spending-Cut 'Trigger' With a Long History of Failure," *Bloomberg* (July 29, 2011).
3. Budget function 050 includes funding for the Department of Defense (DOD), nuclear weapons activities in the Department of Energy, and miscellaneous national security activities in non-DOD agencies.
4. The spending caps would cut about \$350 billion (White House estimate) and the automatic spending reduction process would cut an additional \$492 billion (Congressional Budget Office estimate) from national defense (function 050) budget authority, totaling a potential reduction of approximately \$842 billion through FY 2021 compared to Congressional Budget Office baselines. As noted, these estimates are sensitive to future economic conditions and decisions by Congress, and therefore may not come to fruition as projected. See Jack Lew, "Security Spending in the Deficit Agreement," *OMBlog* (August 4, 2011); Congressional Budget Office, *Estimate Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act* (September 12, 2011); 3; Bill Heath Jr., Elizabeth Rybacki and Shannon M. Mahan, *The Budget Control Act of 2011* (Washington: Congressional Research Service, August 19, 2011); and Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011).
5. Authors' meeting with DOD officials (August 2011). Of course, DOD does prepare contingency plans as a hedge against uncertainty. It undoubtedly has some ideas about what it would do if the super committee fails.
6. Charles Riley, "Pentagon Sweats Out Budget Upheaval," *CNN Money* (September 9, 2011).
7. For an older but still useful overview of the possible unintended consequences of military health care reform, for example, see Congressional Budget Office, *Reforming the Military Health Care System* (January 1988): 29–34.
8. Off-the-record meeting at the Center for a New American Security, "Changes to the DOD: Revisiting Roles and Missions" (August 3, 2011).
9. The White House, "Press Briefing by Press Secretary Jay Carney" (August 1, 2011); Nathan Hodge and Adam Entous, "Panetta Sounds Alarm on Defense-Cut Trigger," *The Wall Street Journal* (August 5, 2011); and House Armed Services Committee, "McKeon Statement on the Debt Ceiling Compromise" (August 1, 2011).
10. Robert Pollin and Heidi Garrett-Peltier, "The U.S. Employment Effects of Military and Domestic Spending Priorities: An Updated Analysis," Political Economy Research Institute, University of Massachusetts, Amherst (October 2009).
11. Phil Stewart, "Defense Cuts Could Worsen Unemployment: Pentagon," *Reuters* (September 15, 2011).
12. Hodge and Entous, "Panetta Sounds Alarm on Defense-Cut Trigger."
13. Off-the-record meeting at the Center for a New American Security, "Changes to the DOD: Revisiting Roles and Missions" (August 3, 2011).
14. Authors' meeting with DOD officials (August 2011).
15. See Jeremy Lemer, "US Defence Sector Attacks Further Cuts," *Financial Times* (September 14, 2011); and Rebecca U. Thorpe, "The Role of Economic Reliance in Defense Procurement Contracting," *American Politics Research* 38 (June 2010): 636–675.
16. M. Thomas Davis and Nathaniel C. Fick, "America's Endangered Arsenal of Democracy," *Joint Force Quarterly* 62 (3rd Quarter 2011): 89–95.
17. As the Congressional Budget Office noted last year, "the projections in the [future Years Defense Program] are problematic in assuming that the administration's defense plans can be conducted at the costs or prices that DOD has assumed." See Congressional Budget Office, *Long-Term Implications of the Fiscal Year 2010 Defense Budget* (January 2010): 6–7.
18. Congressional Budget Office, *The Budget and Economic Outlook: An Update*: 17.
19. Congressional Budget Office, *Long-Term Implications of the 2012 Future Years Defense Program* (June 2011): vii, 7. For charts that show growing defense costs on a per troop basis, see Stephen Daggett, submitted testimony before the House Armed Services Committee (November 18, 2009): 2, 4, 5, 7.
20. Todd Harrison, *Analysis of the FY 2012 Defense Budget* (Washington: Center for Strategic and Budgetary Assessments, July 15, 2011): 19.
21. Stephen Daggett, submitted testimony before the House Armed Services Committee: 10.
22. Kim Holmes and Mackenzie Eaglen, "Avoiding a Hollow Force," *Washington Times* (December 28, 2007).
23. Readers should note that the nature of these costs is a matter of ongoing dispute. For an overview, see Amy Belasco, *The Cost of Iraq, Afghanistan, and Other Global War on Terror Operations Since 9/11* (Washington: Congressional Research Service, March 29, 2011): 50–55.
24. Nathan Hodge, "Geriatric U.S. Arsenal Needs Expensive Face-Lift," *The Wall Street Journal* (September 15, 2011).
25. For similar assessments, see G. John Ikenberry, "An Agenda for Liberal International Renewal," in *Finding Our Way: Debating American Grand Strategy*, eds. Michèle A. Flournoy and Shawn Brimley (Washington: Center for a New American Security, June 2008); and Christopher Layne, *The Peace of Illusions*:

*American Grand Strategy from 1940 to the Present* (Ithaca, NY: Cornell University Press, 2006).

26. For similar assessments, see Iliac Ferguson, *Colossus: The Price of America's Empire* (New York: Penguin Press, 2004): 169-199; and Michael Mandelbaum, *The Case for Goliath: How America Acts as the World's Government in the 21st Century* (New York: PublicAffairs, 2005): xiv-xxii, 187-226.

27. Congressional Budget Office, *The Budget and Economic Outlook: An Update*: 1, 24.

28. Pursuant to 10 U.S.C. 116b, each Quadrennial Defense Review (QDR) shall be conducted so as "to make recommendations that are not constrained to comply with the budget submitted to Congress by the President." This stipulation was added in the FY 2007 National Defense Authorization Act. An internal Pentagon "red team" led by General James Mattis, now commander of U.S. Central Command, and Andrew Marshall, director of the Office of Net Assessment, told Pentagon leaders that the 2010 QDR's budgetary assumptions were too optimistic, but their critique could not be addressed because of the congressional restriction. See Sebastian Sprenger, "Red Team" Found 2010 QDR Had Too-Rosy Economic Assumptions," *Inside the Army* (April 25, 2011); and Stephen Daggott, *Quadrennial Defense Review 2010: Overview and Implications for National Security Planning* (Washington: Congressional Research Service, May 17, 2010): 34-38.

29. The Defense Business Board identified an explosion of overhead work typified by a lack of regulation and an immense increase in the number of contractors and uniformed military working in non-combat positions. See Arnold Punaro, "Reducing Overhead and Improving DoD's Business Operations" (July 22, 2010), <http://dtbb.defense.gov/pdf/ArnoldScriptAsBelievedat07-22BoardMeeting.pdf>.

30. Travis Sharp, *The Sacrifice Ahead: The 2012 Defense Budget* (Washington: Center for a New American Security, 2011): 6.

31. Raymond Pritchett, "Rep. Paul Ryan's Budget Sets Stage for Much Needed Defense Reforms," *Information Dissemination* (April 7, 2011).

32. Restarting production lines that have closed is also expensive. For example, RAND found that "Shutdown and Restart" was the most expensive of four options for maintaining a future F-22A industrial capability. See Obaid Younossi et al., *Ending F-22A Production: Costs and Industrial Base Implications of Alternative Options* (Santa Monica, CA: RAND Corporation, 2010): xv.

33. International Institute for Strategic Studies, *The Military Balance 2011* (London: Routledge, 2011): 61-63, 157-161.

34. The 2010 QDR concluded that effective use of the National Guard and Reserves "will lower overall personnel and operating costs, better ensure the right mix and availability of equipment, provide more efficient and effective use of defense assets, and contribute to the sustainability of both the Active and Reserve components." See Department of Defense, *Quadrennial Defense Review Report* (February 2010): 53.

35. John D. Winkler, "Developing an Operational Reserve: A Policy and Historical Context and the Way Forward," *Joint Force Quarterly* 59 (4th Quarter 2010).

36. Off-the-record meeting at the Center for a New American Security, "Changes to the DOD: Revisiting Roles and Missions" (August 3, 2011).

37. *Ibid.*

38. See, for example, Secretary of Defense Robert M. Gates, remarks at the Army War College in Carlisle, Pennsylvania (April 16, 2009), <http://www.defense.gov/transcripts/transcript.aspx?transcriptid=4404>.

39. This problem exists in many types of policy analysis. For example, researchers have struggled to identify the relationship between the readiness of military units and DOD's operation and maintenance budget. See Congressional Budget Office, *Linking the Readiness of the Armed Forces to DoD's Operation and Maintenance Spending* (April 2011).

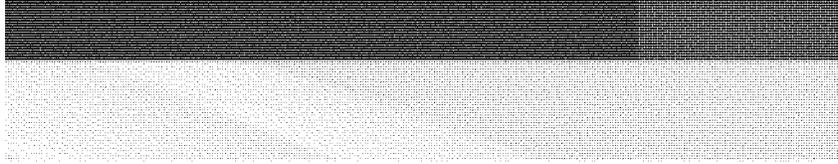
40. While the U.S. military is already making such investments, defense industry representatives suggest that the demand signal coming from DOD is not as strong as one might hope. Off-the-record meeting at the Center for a New American Security, "Scalpel or Chainsaw? Defense Budget Options for the 'Super Committee'" (September 14, 2011).

41. Congress currently requires the Air Force to maintain at least 316 aircraft, and it has procured 43 more C-17s than the Air Force said it needed. This over procurement has created excess capacity, and DOD has formally requested that the requirement be lowered based on the results of its revised Mobility Capabilities and Requirements Study released in 2011. See General Duncan McInabb, testimony before the Senate Armed Services Committee, Subcommittee on Seapower (July 13, 2011).

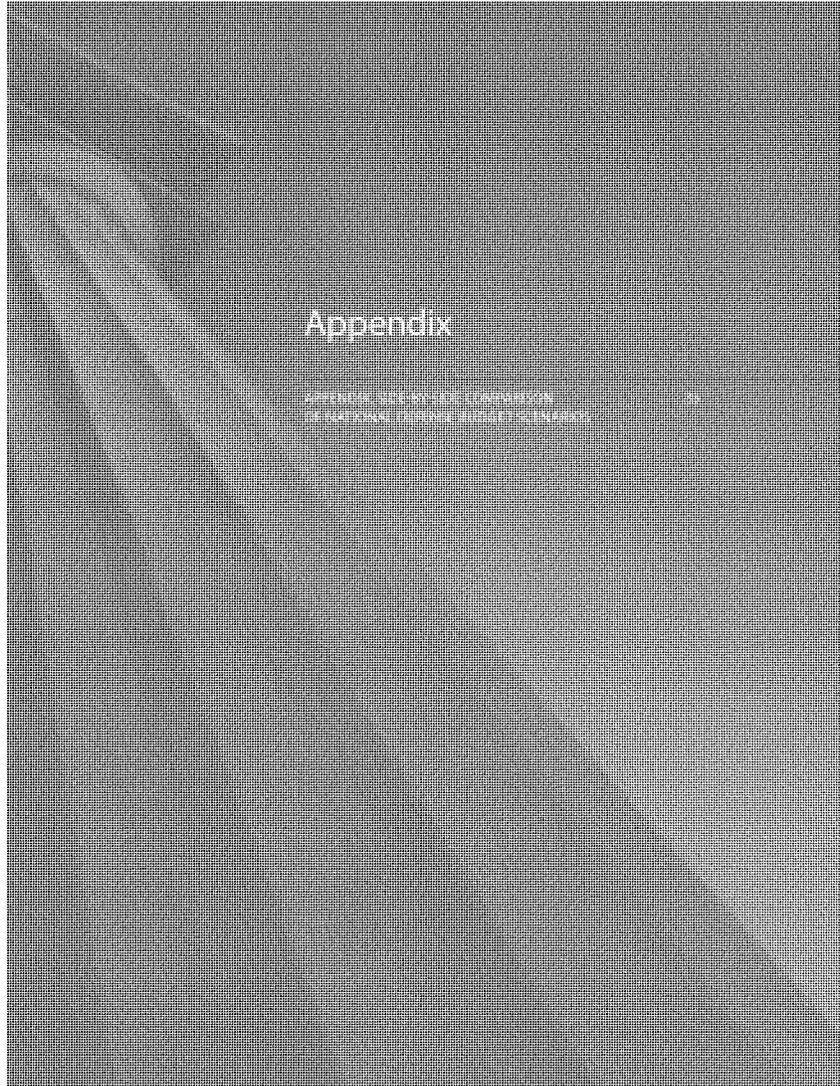
42. Although most experts agree that making greater use of the reserve component will save money overall, they continue to debate the precise savings involved. As a result, this report's illustrative scenarios do not include any savings generated from transferring forces to the reserve component. For an overview of the debate, see John Nagl and Travis Sharp, *An Indispensable Force: Investing in America's National Guard and Reserves* (Washington: Center for a New American Security, September 2010): 26-27.

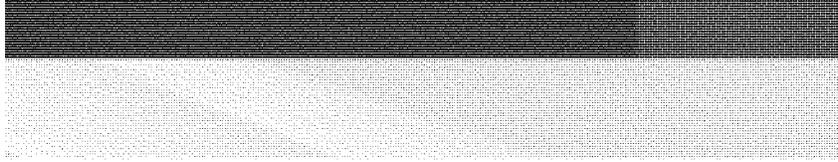
43. The authors acknowledge that the costs of maintaining the current and future nuclear triad are enormous, for a rough estimate of expected 10-year costs, see Ploughshares Fund, "What We Spend on Nuclear Weapons" (September 14, 2011). However, most of DOD's expenditures to procure and maintain the next generation of ballistic missile submarines, bombers and intercontinental missiles will occur after the 10-year time frame examined in this report. Additionally, the authors believe that a decision to significantly reduce any nuclear triad forces should not be made without reevaluating U.S. deterrence requirements – a process now underway at DOD – and involving other nations via legally-binding arms control agreements. Because these two processes have not yet provided reliable information about potential nuclear reductions beyond New START, any estimates of cost savings from pruning the nuclear triad would be speculative.

44. This objective is consistent with the planning process that drove the 2010 QDR. See Kathleen Hicks and Samuel Brannen, "Force Planning in the 2010 QDR," *Joint Force Quarterly* 59 (4th Quarter 2010): 139.



45. In FY 2001, Army end strength was 481,000 and Marine Corps end strength was 173,000. See Department of Defense, *National Defense Budget Estimates for FY 2012* (March 2011); Table 7-5.
46. For analysis of the current health of the fleet, see Rear Admiral James McManamon, "The 'Bridge' to the Fleet: Material Readiness Key to Warships Ready for Tasking," Naval Sea Systems Command (February 15, 2011).
47. Off-the-record meeting at the Center for a New American Security (November 16, 2010).
48. The Army has lost fewer light, medium and heavy tactical vehicles than it expected from battle losses, maintenance washouts and the abandonment of vehicles in theater. See Department of the Army, *Army Truck Program, Tactical Wheeled Vehicle Acquisition Strategy, Report to the Congress* (June 2010): 18.
49. Congressional Budget Office, *Budget Options* (February 2005): 30-31.
50. For analysis of such a campaign, see Jan van Tol et al., *Air/Sea Battle: A Point-of-Departure Operational Concept* (Washington: Center for Strategic and Budgetary Assessments, 2010): 40-41.
51. According to the Congressional Budget Office (CBO), the weapons capacity of 2009 can be matched by purchasing 850 F-35As, 480 F-35 B/Cs and 57 F/A-18s. See Congressional Budget Office, *Alternatives for Modernizing U.S. Fighter Forces* (May 2009): 28.
52. In FY 2001, Marine Corps end strength was 173,000. See Department of Defense, *National Defense Budget Estimates for FY 2012*; Table 7-5.
53. For studies of these security dynamics in East Asia, see Zhu Feng, "An Emerging Trend in East Asia: Military Budget Increases and Their Impact," *Asian Perspective* 33:4 (2009); Richard A. Bittinger, "A New Arms Race? Explaining Recent Southeast Asian Military Acquisition," *Contemporary Southeast Asia* 32:1 (2010); and Robert J. Art, "The United States and the Rise of China: Implications for the Long Haul," *Political Science Quarterly* 125:3 (2010).
54. Daniel H. Elze and David E. Lockwood, *Military Base Closures: Highlights of the 2005 BRAC Commission Report and Its Additional Proposed Legislation* (Washington: Congressional Research Service, October 2006): 2.
55. Todd Harrison, *Analysis of the FY 2012 Defense Budget*; vii.
56. For example, see Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011): 76-77.
57. For example, in 2009 DOD estimated that a typical retiree and his or her family would pay approximately \$860 a year through TRICARE Prime whereas a similar retiree and his or her family enrolled in an HMO would pay approximately \$5,200 a year for comparable coverage. See *ibid.*: 78.
58. *Ibid.*
59. On September 19, 2011, President Obama presented a plan for promoting economic growth and reducing the deficit that included two changes to TRICARE: initiating annual fees for enrolling in TRICARE for Life, and increasing TRICARE pharmacy benefit copayments. See Office of Management and Budget, *Living Within Our Means and Investing for the Future* (September 2011): 20-21.
60. The Congressional Budget Office's calculations assume that DOD had increased some copayment requirements before considering this option. If that assumption proves wrong, total savings would be higher.
61. Defense Business Board, "Modernizing the Military Retirement System" (July 21, 2011); slide 9.
62. *Ibid.*: slides 9, 21, 23.
63. *Ibid.*: slides 4-9, 20.
64. *Ibid.*: slide 13.
65. *Ibid.*: slides 13, 19.
66. *Ibid.*: slides 21, 23.





APPENDIX: SIDE-BY-SIDE COMPARISON OF NATIONAL DEFENSE  
BUDGET SCENARIOS (DOLLARS IN BILLIONS)

The four scenarios consider budget authority for national defense (function 050), which includes funding for the Department of Defense (DOD), atomic energy defense activities, and other defense-related activities. The scenarios exclude savings related to Overseas Contingency Operations (OCO). Readers should note that function 050 is not the same as the "security" spending category that the Budget Control Act uses for its discretionary spending caps in Fiscal Years (FY) 2012-2013. The estimated savings were calculated using the Congressional Budget Office (CBO) August 2011 baseline, which sets future budget authority equal to the FY 2011 appropriation adjusted for inflation.

Readers should consult the endnote accompanying each policy change for additional information about the proposed change.

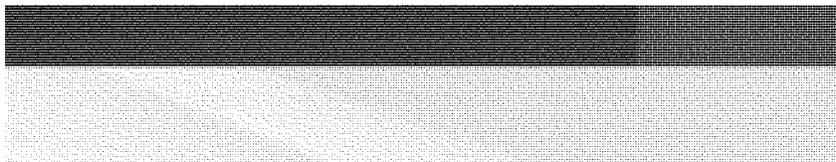
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**Board Choices**  
 Departmental Information on Agency Activities



NARRA PROGRAMS					
Component	1. REINVESTMENT AREAS		2. CONSTRAINED GLOBAL PERSONNEL		
Target number FY2011	2000-400		2000-550		
	PROGRAM	POLICY CHANGE	SAVINGS	POLICY CHANGE	SAVINGS
	Aircraft Carrier (CVA)	---	---	Reinvestment purchase CVA Fleet from 11 to 10, active-duty savings from 11 to 9 and 2,000 sailors for military base O&M Savings Reinvestment is 200	200
	Amphibious Ship	---	---		
	Attack Submarine (SSN-774)	---	---		
	Cruiser (CG-90)	Reduce to 10	55.5	Reduce to 10 years 1	55.5
	Destroyer (DDG-51)	Place one in additional flight EA ships beyond current plans	46.4	Place one in additional flight EA ships beyond current plans	46.4
	Destroyer Escort (DE-21)	End program in FY11 after 17 total ships have been procured	100	End in 10 years 1	100
	MISC TOTAL		50.1		516.5

Areas of reinvestment

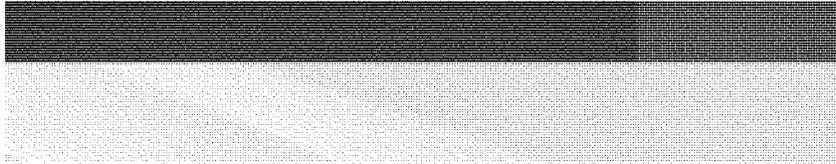


RISK FORCES				
3. STRUCTURAL LEVERAGE		4. POLICY LEVERAGE OF FORCE		
USD \$B		USD \$B		
POLICY CHANGE	SAVINGS	POLICY CHANGE	SAVINGS	SCENARIO
Same as Scenario 2	37.0	Same as Scenario 2.3	37.0	UBO*
Cancel non-EMR and those LBOs scheduled for procurement during FY14-21	113.4	Same as Scenario 3	113.4	Estimate based on Force Sustain Defense Program (FSDP) and UBO*
Hold procurement to one per year, reducing planned May from 19 to 12 acquisitions FY14-21	12.6	Same as Scenario 3	12.6	Estimate based on FSDP and UBO*
Same as Scenario 1.2	33.3	Same as Scenario 1.2.3	33.3	Estimate based on FSDP*
Provide for additional flight EA after beyond camera plans	34.3	No additional procurement	---	UBO*
Same as Scenario 1.2	37.0	End program in FY13 after initial deployment	116.1	Estimate based on FSDP and Congressional Research Service (CRS)*
	551.0		662.9	

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**Hard Choices**  
 Report on the Defense Budget for FY2012

AIR FORCE									
PROGRAM	1. BUDGET REQUEST		2. COMBINED TO BBA POLICY		3. BUDGET REQUEST		4. POLICY BUDGET		SOURCES
	CHANGE	SAVINGS	CHANGE	SAVINGS	CHANGE	SAVINGS	CHANGE	SAVINGS	
<b>F-35 Joint Strike Fighter</b>	Reduce	\$1.5	Reduce	\$10.0	Cut F-35A from 173 to 850	\$13.0	Cancel F-35A from 173 to 850	\$13.0	Estimate based on Powell-Simpson and CBO*
<b>MPOAC Broad Area Maritime Surveillance (BAMS) Universal Aircraft System (UAS)</b>	---	---	Cancel	\$10.0	Cancel	\$10.0	Special Source 1	\$10.0	CBO*
<b>Strategic Airlift</b>	Reduce	\$2.4	Same as Scenario 1	\$2.4	Same as Scenario 1, 2	\$2.4	Same as Scenario 1, 2, 3	\$2.4	DOC*
<b>V-22 Osprey</b>	---	---	Cancel in FY11, operational retirement at 2014	\$1.3	Same as Scenario 2	\$1.3	Same as Scenario 2, 3	\$1.3	Estimate based on FYDP and CBO*
<b>TOTAL</b>		<b>\$1.5</b>		<b>\$20.7</b>		<b>\$26.7</b>		<b>\$26.7</b>	



J2/J3/J4/J5/J6/J7/J8/J9/J10/J11/J12/J13/J14/J15/J16/J17/J18/J19/J20/J21/J22/J23/J24/J25/J26/J27/J28/J29/J30/J31/J32/J33/J34/J35/J36/J37/J38/J39/J40/J41/J42/J43/J44/J45/J46/J47/J48/J49/J50/J51/J52/J53/J54/J55/J56/J57/J58/J59/J60/J61/J62/J63/J64/J65/J66/J67/J68/J69/J70/J71/J72/J73/J74/J75/J76/J77/J78/J79/J80/J81/J82/J83/J84/J85/J86/J87/J88/J89/J90/J91/J92/J93/J94/J95/J96/J97/J98/J99/J100									
Scenario	1. BUDGET		2. CONSTRUCTION		3. SELECTED		4. EXCLUDED		
Target Budget FY2021	C000-400		C000-500		M000-700		C000-800		
PROJECT NAME	PROJECT CHANGE	SURPLUS	PROJECT CHANGE	SURPLUS	PROJECT CHANGE	SURPLUS	PROJECT CHANGE	SURPLUS	SOURCE
Army and Marine Corps End Strength	Starting FY15, reduce Army active duty to 460,000. Marine Corps active duty to 175,000. End strength is 200,000.	\$41.8	Scenario 1	\$41.8	Starting FY15, reduce Army active duty to 450,000. Marine Corps active duty to 162,500. End strength is 192,500.	\$0.00	Starting FY15, reduce Army active duty to 450,000. Marine Corps active duty to 162,500. End strength is 192,500.	\$0.00	Estimate based on CBO*
Ground Combat Vehicle (GCV)	Deliver building and other support into upgrading Bradley Fighting Vehicles	\$7.0	Scenario 1	\$7.0	Scenario 1.2	\$7.0	Scenario 1.2	\$7.0	CBO*
Joint Light Tactical Vehicle (JLTV)	Cancel	\$10.9	Scenario 1	\$10.9	Scenario 1.2	\$10.9	Scenario 1.2	\$10.9	Estimate based on GAO* and CBO*
Joint Theater Battle System (JTBS) Ground Mobile Battle System	Uphold the decision to not buy from 06,000 to 11,000	\$15.0	Scenario 1	\$15.0	Scenario 1.2	\$15.0	Scenario 1.2	\$15.0	CBO*
<b>Total</b>	<b>\$74.7</b>	<b>\$74.7</b>	<b>\$74.7</b>	<b>\$74.7</b>	<b>\$33.7</b>	<b>\$33.7</b>	<b>\$33.7</b>	<b>\$33.7</b>	

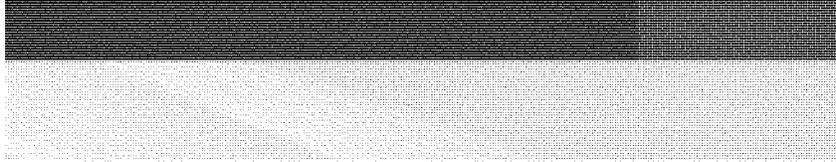
\*Government Accountability Office

OCTOBER 2011

**House Committee on Appropriations**  
**Department of Defense Budget Request**



DEFENSE WORK ACTIVITIES		
Category	REGISTRATION AND REPORT	
Target (Fiscal Year) FY12-21	2355-831	
	<b>POLICY CHANGE</b>	<b>SAVINGS</b>
Base Support and Facilities Maintenance	Fiscal FY12 to FY21 total spending 7.5% below FY11 level plus inflation.	\$43.5
Depots	Alter (e.g.) contracts for repairs, and base work lines on contracting for maintenance.	\$6.4
DCD Charters	Reduce the number of TRADOC employees by 75,000 over 10 years by not replacing retiree returns.	\$38.7
DCD Retail Activities	Consolidate DCD's commissary and exchange systems over the year.	\$6.1
Headquarters (Contractor)	Increase by 30% the previously announced 30% reduction in spending on contractor support services for headquarters staff.	\$41.2
Intelligence	Fiscal FY12 to FY21 total spending 7.5% below FY11 level plus inflation.	\$51.7
Joint Support and Executive News Defense Organization	Shut down 41 FY12.	\$1.3
"Leap Ahead" Unmanned Systems	Add \$1.3 billion per year in additional research and development funding.	\$13.8
Missile Defense	Cancel the Predator Tracking Space System (PTSS) program and reduce spending on related national missile defense program.	\$37.5
Overhead for Commercial Activities	Fiscal FY12 to FY21 total spending 7.5% below FY11 level plus inflation.	\$45.5
Other Procurement	Fiscal FY12 to FY21 total spending 7.5% below FY11 level plus inflation.	\$21.8
Research and Development	Fiscal FY12 to FY21 total spending 7.5% below FY11 level plus inflation.	\$38.1
<b>Subtotal:</b>		<b>\$474.8</b>

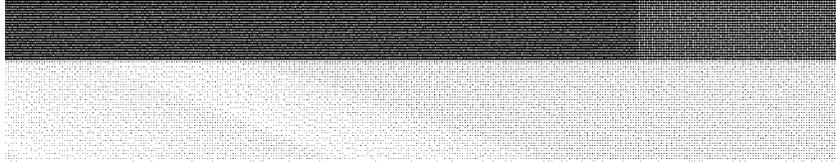


DEFENSE REVENUE ACTIVITIES	
POLICY CHANGE	
DOLLARS	
	\$ (MILLIONS)
From FY12 to FY13, total spending 37% below FY11 level plus inflation	130.0
Same as Scenario 1	10.4
Reduction in number of DOD civilian employees by 10,000 over 10 years by not replacing contracters	148.9
Same as Scenario 1	14.1
Increase by 15% the previously projected 32% reduction in spending on contract air support for homeland security	105.1
From FY13 to FY15, total spending 37% below FY11 level plus inflation	233.0
Same as Scenario 1	41.2
Same as Scenario 1	515.0
Same as Scenario 1	137.5
From FY13 to FY15, total spending 37% below FY11 level plus inflation	214.0
From FY13 to FY15, total spending 37% below FY11 level plus inflation	211.3
From FY13 to FY15, total spending 37% below FY11 level plus inflation	175.0
	1,288.8

OCTOBER 2011

**Board Charter**  
 Department of Defense and the Joint Chiefs of Staff

DEFENSE WORK ACTIVITIES		
Scenario	\$ MIL BIL FISCAL YEAR	
Baseline (FY12-21)	2000-700	
PROGRAM	POLICY CHANGE	SAVINGS
Base Support and Facilities Maintenance	From FY13 to FY21, hold spending 12.5% below FY13 level plus inflation.	\$12.5
Depots	Same as Scenario 1.2	\$6.8
DCDI Civilians	Reduce the number of 784,000 employees by 125,000 over 10 years by not replacing some attrition.	\$61.1
DCDI Special Activities	Same as Scenario 1.2	\$9.1
Headquarters (Contractor)	Increase by 20% the previously announced 30% reduction in spending on contractor support for headquarters staff.	\$39.4
Intelligence	From FY13 to FY21, hold spending 12.5% below FY13 level plus inflation.	\$88.5
Joint Experimental Explosive Device Defeat Capabilities	Same as Scenario 1.2	\$1.2
"Leap Ahead" Unmanned Systems	Same as Scenario 1.2	\$75.8
Mobile Defense	Same as Scenario 1.2	\$17.5
Overhead for Commercial Activities	From FY13 to FY21, hold spending 12.5% below FY13 level plus inflation.	\$67.4
Other Procurement	From FY13 to FY21, hold spending 12.5% below FY13 level plus inflation.	\$38.4
Research and Development	From FY13 to FY21, hold spending 12.5% below FY13 level plus inflation.	\$61.7
<b>TOTAL</b>		<b>\$442.2</b>



DEFENSE-WIDE ACTIVITIES		
A. FOCUSED/STRAICORP OR FORCE		
2020-2021		
POLICY CHANGE	SEVINGS	SOURCES
From FY13 to FY20, total spending 10% below FY11 level plus inflation	570.8	Estimate based on Bowles-Simpson*
Same as Scenario 1, 2, 3	58.4	CRS**
Reduce the number of TRICARE recipients by 100,000 over 10 years by not replacing some retirees	573.3	Estimate based on OMB and S&O†
Same as Scenario 1, 2, 3	50.1	CRS**
Increase by 20% the previously announced 30% reduction in spending on contract augmentation for headquarters staff	525.0	Estimate based on CRS**
From FY13 to FY20, total spending 10% below FY11 level plus inflation	519.1	Estimate based on OMB†
Same as Scenario 1, 2, 3	51.0	Estimate based on OMB†
Same as Scenario 1, 2, 3	-75.0	Estimate based on OMB†
Same as Scenario 1, 2, 3	513.5	CRS**
From FY13 to FY20, total spending 10% below FY11 level plus inflation	2,810	Estimate based on Defense Budget Base†
From FY13 to FY20, total spending 10% below FY11 level plus inflation	1,473	Estimate based on OMB†
From FY13 to FY20, total spending 10% below FY11 level plus inflation	1,133	Estimate based on FY11 appropriations†
	-553.8	

OCTOBER 2011

Board Chaired  
 Department Chairman in an Age of Austerity

NON-DOD ACTIVITIES										
PROGRAM	1. UNRESTRICTED AVAILABLE		2. CONSTRUCTED RESERVE FUNDING		3. RESTRICTED LEVERAGE		4. FUNDING TO BUDGET			
Target position FY12 est	2010-2011		2009-2010		2000-2001		2010-2011			
PROGRAM	POLICY CHANGE	SOURCES	POLICY CHANGE	SOURCES	POLICY CHANGE	SOURCES	POLICY CHANGE	SOURCES	SOURCES	
Energy	From FY10 to FY11 hold spend up 1.5% below FY11 budget plus inflation	412.4	From FY10 to FY11 hold spend up 1.0% below FY11 budget plus inflation	199.8	From FY10 to FY11 hold spend up 11.5% below FY11 budget plus inflation	521.8	From FY10 to FY11 hold spend up 1.0% below FY11 budget plus inflation	175.3	Estrada based on FY11 spend	
Defense	From FY10 to FY11 hold spend up 1.5% below FY11 budget plus inflation	34.0	From FY10 to FY11 hold spend up 1.0% below FY11 budget plus inflation	36.2	From FY10 to FY11 hold spend up 11.5% below FY11 budget plus inflation	17.7	From FY10 to FY11 hold spend up 1.0% below FY11 budget plus inflation	59.3	Estrada based on FY11 spend	
Other	From FY10 to FY11 hold spend up 1.5% below FY11 budget plus inflation	100.2	From FY10 to FY11 hold spend up 1.0% below FY11 budget plus inflation	100.0	From FY10 to FY11 hold spend up 11.5% below FY11 budget plus inflation	100.0	From FY10 to FY11 hold spend up 1.0% below FY11 budget plus inflation	100.0	Estrada based on FY11 spend	
<b>TOTAL</b>		<b>556.6</b>		<b>336.0</b>		<b>699.5</b>		<b>334.6</b>		

## ENDNOTES

1. In 2016, the USS *George Washington* (CVN-73) is scheduled to begin refueling and complex overhaul, a costly and time-consuming process. This policy change would save overhaul costs, along with operating and support costs from 2017 to 2021. However, the savings would be reduced by the additional costs to decommission the carrier. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011): 90-91.
2. The total amphibious fleet would decline significantly below the Department of the Navy's inventory goal of 33 ships as a result of this policy change. Authors' estimate based on the Department of the Navy's FY 2012 budget estimates; Congressional Budget Office, *An Analysis of the Navy's Fiscal Year 2012 Shipbuilding Plan* (June 2011): 6, 21; Ronald O'Rourke, *Navy Force Structure and Shipbuilding Plans: Background and Issues for Congress* (Washington: Congressional Research Service, April 13, 2011): 6; and Office of the Chief of Naval Operations, *Report to Congress on Annual Long-Range Plan for Construction of Naval Vessels for FY 2011* (February 2010): 22. Readers should note that according to RAND, policymakers can offset the removal of some LHA-6s from the fleet by substituting CH-53Ks for MH-22s, a change included in some of the scenarios. See Robert W. Button et al., *Maritime Prepositioning Force (Future) Capability Assessment* (Santa Monica, CA: RAND Corporation, 2010).
3. Authors' estimate based on the Department of the Navy's FY 2012 budget estimates. The same figure was estimated in Congressional Budget Office, *Budget Options* (February 2005): 16.
4. This policy change is offset to varying degrees in Scenarios 1-3 by procuring additional DDG-51 destroyers. Authors' estimate based on projected savings from eliminating modernization and operating and support costs for six CG-43s. For modernization costs, see the Department of the Navy's FY 2012 budget estimates. For operating and support costs, see Joseph R. McDonald, "An Analysis of CG-47 Cruiser Class Operating and Support Costs: Trends and Cost Relationship With Platform Age," Naval Postgraduate School (June 2011): 14-15.
5. Congressional Budget Office, *An Analysis of the Navy's Fiscal Year 2012 Shipbuilding Plan*: 18.
6. Authors' estimate based on the Department of the Navy's FY 2012 budget estimates; and Ronald O'Rourke, *Navy Littoral Combat Ship (LCS) Program: Background, Issues, and Options for Congress* (Washington: Congressional Research Service, April 29, 2011).
7. Readers should note that these figures are derived from existing estimates. Modeling updated policy options for the F-35 program was beyond the scope of this report. See National Commission on Fiscal Responsibility and Reform, "S200 Billion in Illustrative Savings" (November 10, 2010); Options 46 and 47; and Congressional Budget Office, *Alternatives for Modernizing U.S. Fighter Forces* (May 2009): 34-35.
8. This policy change would continue to support other maritime intelligence, surveillance and reconnaissance platforms, such as the P-8A Poseidon aircraft, and might convert some Air Force RQ-4 Global Hawks to maritime specification. Congressional Budget Office, *Policy Options for Unmanned Aircraft Systems* (June 2011): 13.
9. General Duncan McHabb, testimony before the Senate Armed Services Committee, Subcommittee on Seapower (July 13, 2011).
10. To offset the reduction in MW-22s, this policy change would procure additional CH-53Ks after FY 2021. CH-53Ks have three times the payload of MW-22s. Authors' estimate based on the Department of the Navy's and the Department of the Air Force's FY 2012 budget estimates; and Jeremiah Gertler, *V-22 Osprey Lift-Rotor Aircraft: Background and Issues for Congress* (Washington: Congressional Research Service, March 10, 2011). For analysis of the potential benefits of substituting CH-53Ks for MW-22s, see Robert W. Button et al., *Maritime Prepositioning Force (Future) Capability Assessment*.
11. In January 2011, then-Secretary Gates announced that starting in FY 2015, the Army's permanent active-duty end strength would decline from 547,000 to 520,000, and the Marine Corps's active-duty end strength would decline from 202,000 to 187,000. As a result, all four scenarios use baselines of 520,000 soldiers and 187,000 Marines so as not to count savings that are already reflected in the Future Years Defense Program. The proposed reductions would be spread out from FY 2015 to FY 2021. Authors' estimate based on Congressional Budget Office, *Budget Options Volume 2* (August 2009): 7. We thank our colleague Matt Irvine for developing this estimate.
12. This policy change would reinvest about \$7 billion of the savings generated from delaying the GCV into developing and purchasing upgrades for Bradley Fighting Vehicles, which will remain in the Army's inventory through at least 2025. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011): 94-95.
13. The JLTV program currently lacks finalized information related to procurement quantity, cost and accessories. The authors' estimate assumes the following: 1) the Government Accountability Office's estimated unit cost of \$800,000 per vehicle, which includes the base vehicle cost plus government-furnished equipment, armor kits, and general and administrative fees; and 2) the Congressional Research Service's estimated procurement quantity of 32,000 vehicles, of which 12,258 would be procured during FY 2012-2021 according to the authors' modeling of the current acquisition schedule. (The authors assume a low rate initial production of 1,086 vehicles per year from FY 2016 to FY 2018 -- assuming low rate initial production equals about 10 percent of the total buy -- and a full rate production of 3,000 vehicles per year from FY 2019 to FY 2021). Changing these assumptions would change the estimated savings. For unit cost, see Government Accountability Office, *Defense Acquisitions: Issues to Be Considered as DOD Modernizes Its Fleet of Tactical Wheeled Vehicles* (November 2010): 14, 18-19. For procurement quantity, see Andrew Feickert, *Joint Light Tactical Vehicle (JLTV): Background and Issues for Congress* (Washington: Congressional Research Service, March 10, 2011): 4-5. The authors' estimate also draws on the Department of the Army's and the Department of the Navy's FY 2012 budget estimates. For additional analysis, see Terrence K. Kelly et al., *The U.S. Combat and Tactical Wheeled Vehicle Fleets* (Santa Monica, CA: RAND Corporation, 2011); and Senate Appropriations Committee, "Department of Defense Appropriations Bill, 2012," Report 112-77 (September 15, 2011): 162.

14. Though the Army has already announced its decision to reduce the JTRS GMR buy, that decision is not reflected in the FY 2012 Future Years Defense Program. See Department of Defense, "June 2011 SAR Info Paper" (August 10, 2011).

15. This policy change would reduce spending on base support and facilities maintenance to reflect the cuts to the U.S. military's combat end strength. The policy change would achieve the spending reductions for base support, which includes activities such as cutting grass, by adopting best practices among the services. It would achieve the spending reductions for facilities maintenance by trimming expenditures as planned base closures move forward. The estimated savings from this policy change may be optimistic, but the authors believe that DOD can do much more to reform its business practices and reduce the inefficiencies that deplete its resources. See National Commission on Fiscal Responsibility and Reform, "S200 Billion in Illustrative Savings," Options 55 and 56. The savings estimate was prepared based on the approximate FY 2011 base budget appropriation inflated according to the Congressional Budget Office's August 2011 GDP price index.

16. Congressional Budget Office, *Budget Options* (February 2007): 33-34.

17. According to the Government Accountability Office, approximately 30 percent of DOD's civilian workforce will be eligible to retire by March 31, 2015. This policy change would spread the total reduction evenly over 10 years and rely on workforce-shaping tools – such as early retirement, voluntary separation incentives and retention bonuses – to maintain the critical human capital capabilities that DOD needs. Estimating the potential additional costs of these tools is beyond the scope of this report. Authors' estimate based on DOD's civilian pay and personnel trends since FY 2001. See Department of Defense, National Defense Budget Estimates for FY 2012 (March 2011); Tables 6-9 and 7-5. The figure on eligible retirees is from Government Accountability Office, *Human Capital: Further Actions Needed to Enhance DOD's Civilian Strategic Workforce Plan* (September 27, 2010): 1. For analysis of workforce-shaping tools, see Beth J. Asch, Steven J. Haider and Julie M. Zissimopoulos, "The Effects of Workforce-Shaping Tools on Retirement: The Case of the Department of Defense Civil Service," *Journal of Public Health Management and Practice* 15, Supplement 6 (November 2009). A related recommendation was included in Benjamin H. Friedman and Christopher Preble, "Budgetary Savings from Military Restraint," *Cato Institute Policy Analysis* No. 667 (September 23, 2010): 11.

18. This policy change would provide active-duty service members with a tax-free grocery allowance to offset the higher prices that would result from the proposed consolidation. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*: 84-85.

19. This policy change would further reduce funding for contractor augmentees on headquarters staffs to reflect the cuts to the U.S. military's combat end strength. Stephen Daggett, "Preliminary assessment of efficiency initiatives announced by Secretary of Defense Gates on August 9, 2010" (August 12, 2010): 3.

20. This policy change would achieve the spending reductions in part by having the Office of the Director of National Intelligence (ODNI) make greater use of its authority to eliminate unnecessary overlap and duplication. Authors' estimate based on FY 2010 intelligence spending of \$80 billion, of which approximately 80 percent goes to national defense (function 050).

The estimated savings from this policy change may be optimistic, but the authors believe that the intelligence community can do much more to reform its business practices and reduce the inefficiencies that deplete its resources. For the spending level, see ODNI, "ODNI Releases Budget Figure for 2010 National Intelligence Program" (October 28, 2010); and Department of Defense, "DOD Releases Military Intelligence Program 2010 Topline Budget" (October 28, 2010). On the portion of intelligence spending in function 050 and the ODNI's potential role in eliminating duplication, see Gordon Adams and Cindy Williams, *Buying National Security* (New York: Routledge, 2010); 120; and Domenico-Rivlin Debt Reduction Task Force, *Restoring America's Future* (November 17, 2010): 103. The savings estimate was prepared based on the approximate FY 2011 base budget appropriation inflated according to the Congressional Budget Office's August 2011 GDP price index.

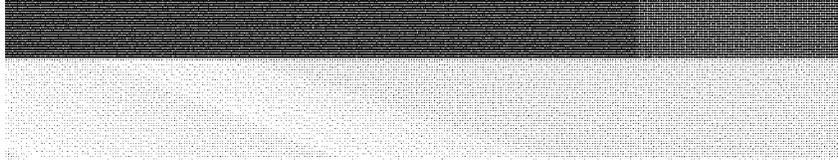
21. By delaying JIEDDO's closure until FY 2017, this policy change would give the organization five more years to aid ongoing military operations in Afghanistan and to transition its most promising technologies to the military services' permanent development activities. Most of JIEDDO's funds come from the Overseas Contingency Operations (OCO) budget, which the Budget Control Act does not constrain. The projected savings represent JIEDDO's estimated base budget funds from FY 2017 to FY 2021 based on the FY 2011 appropriation inflated according to the Congressional Budget Office's August 2011 GDP price index. See the Department of the Army's FY 2012 budget estimates.

22. This policy change would prioritize investment in breakthrough technologies for stealthy, long-range sea- and ground-based combat UASs, along with unmanned submersibles. Authors' estimate based on projected levels of spending. For related analysis, see Congressional Budget Office, *Policy Options for Unmanned Aircraft Systems*.

23. To offset the PTSS cancellation, this policy change would accelerate the Airborne Infrared (ABIR) system and data exploitation via overhead persistent infrared sensors (e.g. SBIRS). The House Armed Services Committee included this recommendation in its mark up of the FY 2012 National Defense Authorization Act. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*: 97; Congressional Budget Office, *Budget Options Volume 2*: 21; and House Armed Services Committee, "National Defense Authorization Act for Fiscal Year 2012," Report 112-78 (May 17, 2011): 81-82.

24. This policy change would reduce spending on commercial activities positions held by military personnel to reflect the cuts to the U.S. military's combat end strength. The estimated savings from this policy change may be optimistic, but the authors believe that DOD can do much more to reform its business practices and reduce the inefficiencies that deplete its resources. Authors' estimate based on Defense Business Board, "Reducing Overhead and Improving DoD's Business Operations" (July 22, 2010): 25. The savings estimate was prepared based on the approximate FY 2011 base budget appropriation inflated according to the Congressional Budget Office's August 2011 GDP price index.

25. "Other Procurement" includes funding for communications and electronic equipment, tactical vehicles, and other supports and spares. This policy change reduces spending on other procurement because of the gradual drawdown of U.S. forces in Afghanistan and the significant buildup of this type of equipment since FY 2001. However, policymakers should be aware that this reduction could potentially have a negative impact on the readiness of some



units. The savings estimate was prepared based on the actual FY 2011 base budget appropriation inflated according to the Congressional Budget Office's August 2011 GDP price index.

26. To help reshape DOD's research and development budget, this policy change would have the U.S. military prioritize East Asia and the Middle East, achieve greater interdependence among the services, and return to a more restrictive planning and acquisition system, as this report recommends. Though using a target percentage is a suboptimal way to estimate the potential savings, crafting a detailed plan for reshaping DOD's research and development budget was beyond the scope of this report. Lawmakers should recognize that because research and development funding is the key enabler of breakthrough technologies, reducing these expenditures entails risk for the U.S. military. The savings estimate was prepared based on the actual FY 2011 base budget appropriation inflated according to the Congressional Budget Office's August 2011 GDP price index.

27. This policy change would reduce funding for atomic energy defense activities by amounts that are consistent with its proportional share of function 050. The savings could be achieved by stretching past FY 2021 the National Nuclear Security Administration's work on the Chemistry and Metallurgy Research Replacement, Uranium Processing Facility, Mixed Oxide Fuel Fabrication Facility and Waste Solidification Building, and other programs. The savings estimate was prepared based on the actual FY 2011 appropriation inflated according to the Congressional Budget Office's August 2011 GDP price index. For analysis of the activities identified for potential delay, see Government Accountability Office, *Nuclear Weapons: NNSA Needs More Comprehensive Infrastructure and Workforce Data to Improve Enterprise Decision-making* (February 14, 2011); Government Accountability Office, *Nuclear Weapons: National Nuclear Security Administration's Plans for Its Uranium Processing Facility Should Better Reflect Funding Estimates and Technology Readiness* (November 19, 2010); Government Accountability Office, *Nuclear Nonproliferation: DOE Needs to Address Uncertainties with and Strengthen Independent Safety Oversight of Its Plutonium Disposition Program* (March 26, 2010); and Government Accountability Office, *DOD and NNSA Need to Better Manage Scope of Future Refurbishments and Risks to Maintaining U.S. Commitments to NATO* (May 2, 2011).

28. This policy change would reduce funding for other defense-related activities by amounts that are consistent with its proportional share of function 050. The savings estimate was prepared based on the actual FY 2011 base budget appropriation inflated according to the Congressional Budget Office's August 2011 GDP price index.

## About the Center for a New American Security

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General BARNO. Looking ahead, I would be very confident in the ability of the United States to maintain both our long-term highly successful global engagement strategy and our preeminent military position with this budget supporting the newly refined strategy.

The debate now focuses, in a sense, upon the trade space between the left limit of \$487 billion in defense cuts over ten years reflected in the fiscal year 2013 POM and the right limit of \$1 trillion in cuts mandated by the sequestration provisions of the Budget Control Act. Whereas I support the planning and strategy reflected in the \$487 billion in cuts, I judge the sequestration outcome, the right limit, unacceptable in both its size and its arbitrary application. In my opinion, that would place our ability to defend vital U.S. interests around the world at very high risk. I fully agree with Secretary Panetta in this regard and urge a speedy effort to revisit this looming problem.

Is there room for deeper cuts in defense beyond the \$487 billion reflected in the fiscal year 2013 POM? That question cannot be answered simply by assessing the financial costs and benefits of different budget options. Instead, it is a fundamentally strategic question about the level of risk we are willing to accept. We must clearly understand that further cuts—what further cuts could actually mean to the U.S. military's capabilities, to our successful engagement strategy, and to our ability to respond to unanticipated national security threats.

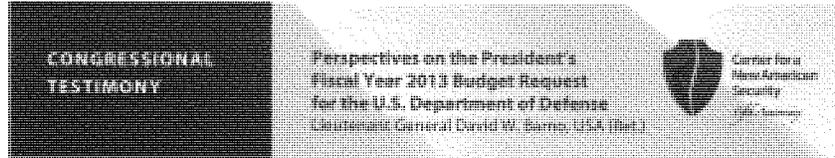
This is not simply a numbers game and any sound assessment will ultimately have to involve a combination of both art and science, subjective judgment and objective analysis. I look forward to having that conversation, and I think Michael's comments and suggestions this morning are worthy of some serious discussion on our part.

Finally, I think it is important to close with some thoughts about the people who will bear the primary burden of these impending changes in U.S. defense. Hundreds of thousands of young American men and women have borne the brunt of over ten years of war that continues still today. Tens of thousands have been wounded and over 6,000 killed. They will continue to fight at the behest of our nation for many years to come, going into battle literally every single day in miserable conditions around the world, separated from their friends, their families, their homes. Hundreds will not come back alive.

Any changes to the defense budget must keep faith with them, with their courage, with their sacrifices and their valor. They have carried the nation's water while the other 99.5 percent of us back here at home have gone about our daily lives unmarked and largely unaffected by these wars. Any defense drawdown must respect those who have served and continue to serve and both shield and honor the deep sacrifices that these warriors have made. We as a nation owe them at least that much gratitude. They have more than earned it.

Thank you very much for giving me an opportunity to share some thoughts with you this morning on these difficult choices and I look forward to some more detailed questions as we get into the follow-on session. Thank you.

[The prepared statement of General Barno follows:]



Tuesday, March 6, 2012

**Testimony before the Senate Budget Committee**

*Prepared Statement of Lieutenant General David W. Barno, USA (Ret.)  
Senior Advisor and Senior Fellow, Center for a New American Security*

Mr. Chairman, ranking member Senator Sessions, members of the committee, thanks for allowing me to share some perspectives this morning on the Defense Department's FY13 budget. In some ways, today's discussion is really about the broader question for the people of the United States: when evaluating our national defense, how much is enough?

This morning we have the opportunity to comment on one of the most important national security decision points the United States has confronted in the last fifty years. These "Hard Choices" as we put it in our Center for a New American Security report last October, will shape not only the future of U.S. defense for decades to come – but in many ways will potentially reshape and redefine the role of the United States in the rapidly changing world of the 21<sup>st</sup> Century.

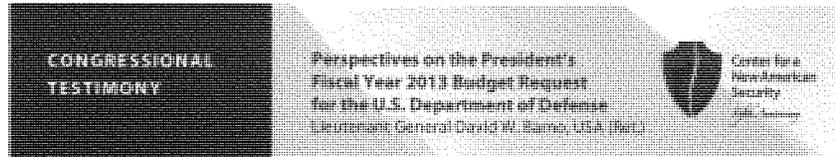
The current debate that has seized our nation and our political leadership has to do not only with putting Americans back to work, about reducing exploding debt and annual deficits, about entitlements and taxes, about living, as a nation, within our means – but it also fundamentally has to do with where the United States is going to fit in this new world.

Despite today's focus on the defense budget, many of us believe that the fiscal crisis facing the United States requires the Congress of the United States to address the deep structural problems of revenue and entitlement reforms that are central to balancing America's budget. To date, our fiscal liabilities have seemingly been both too large and too politically contentious to achieve bipartisan consensus on how best to address them. But these hard realities are going to re-shape the U.S. Department of Defense, either by choice or by default. Our discussion today will address just how they are going to impact national defense in the near term.

As we look around the world, we see prospects for a slow but inexorable *relative* decline in U.S. global economic power over the coming decades. Yet at the same time, we Americans actually will continue to *choose* our military position in the world. Today, there is substantial risk that if we make ill-informed choices in defense spending over the next decade, we will electively choose to *diminish* our military capabilities – at the very same time when we are involuntarily facing a decline in our global economic primacy.

To emphasize: we alone as a people decide our military investments and strength. And we as a nation have always been willing to pay whatever it takes to secure our people and our freedoms. Yet today, driven in large measure by fiscal worries, we must ask: how much must the United States government spend on defense to secure our people, and how much risk are we willing to tolerate?

Since we published our October 2011 "Hard Choices" report, which I have submitted today for the record, the Administration has published new strategic guidance in January, and submitted its FY13 budget last



month. Both of these documents, in my judgment, are fundamentally sound. Each reflects the realities of our difficult fiscal position while acknowledging the necessity of maintaining America's preeminence as a military power. Notably, both documents make choices and set priorities for focusing finite U.S. power and military investments.

Looking ahead, I would be very confident in the ability of the United States to maintain both our long-term highly successful global engagement strategy and our pre-eminent military position with this budget supporting the newly refined strategy.

The debate now focuses in a sense upon the "trade space" between left limit of \$487 billion in defense cuts over ten years reflected in the FY13 POM, and the right limit of \$1 trillion in cuts mandated by the sequestration provisions of the Budget Control Act. Whereas I support the planning and strategy reflected in the \$487 billion in cuts, I judge the sequestration outcome in both size and arbitrary application as an unacceptable cut that in my opinion would place our ability to defend U.S. vital interests around the world at very high risk. I fully agree with Secretary Panetta in this regard, and urge a speedy effort to revisit this looming problem.

Is there room for deeper cuts in defense beyond the \$487 billion reflected in the FY13 POM? That question cannot be answered simply by assessing the financial costs and benefits of different budget options. Instead, it is a fundamentally strategic question about the level of risk we are willing to accept. We must clearly understand what further cuts could actually mean to U.S. military capabilities, to a successful 65-year strategy of global engagement, and to our ability to respond to unanticipated national security threats. This is not simply a numbers game, and any sound assessment will ultimately involve a combination of both art and science, subjective judgment and objective analysis. I look forward to joining in that conversation.

Finally, it is important to close with some thoughts about the people who will bear the primary burden of these impending changes in U.S. defense. Hundreds of thousands of young American men and women have borne the brunt of the ten years of war that continues today. Tens of thousands have been wounded and over 6,000 killed. They will continue to fight at our behest as a nation for many years to come, going into battle literally every single day in miserable conditions around the world, separated from their friends, their families, their homes. Hundreds will not come back alive.

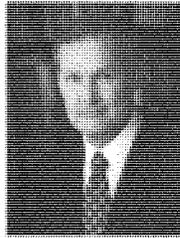
Any changes to the defense budget must keep faith with them -- with their courage, their sacrifices and their valor. They have carried the nation's water while the other 99.5% of us back here at home have gone about our daily lives unmarked and largely unaffected by these wars. Any defense drawdown must respect those who have served and continue to serve, and both shield and honor the deep sacrifices these warriors have made. We as a nation owe them at least that much gratitude. They have more than earned it.

Thank you very much for giving me an opportunity to share some thoughts on these difficult choices with you today. I look forward to your questions.



### Biography

#### **Lieutenant General David W. Barno, USA (Ret.) Senior Advisor and Senior Fellow, Center for a New American Security**



General Barno, a highly decorated military officer with over 30 years of service, has served in a variety of command and staff positions in the United States and around the world, to include command at every level. He served many of his early years in special operations forces with Army Ranger battalions, to include combat in both the Grenada and Panama invasions. In 2003, he was selected to establish a new three-star operational headquarters in Afghanistan and take command of the 20,000 U.S. and Coalition Forces in Operation Enduring Freedom. For 19 months in this position, he was responsible for the overall military leadership of this complex political-military mission, devising a highly innovative counterinsurgency strategy in close partnership with the U.S. embassy and coalition allies. His responsibilities included regional military efforts with neighboring nations and involved close coordination with the

Government of Afghanistan, the United Nations, NATO International Security Assistance Force, the U.S. Department of State and USAID, and the senior military leaders of many surrounding nations and numerous allies.

From 2006-2010, General Barno served as the Director of the Near East South Asia Center for Strategic Studies at the National Defense University. Concurrently, he was the Chairman of the Advisory Committee on Operation Iraqi Freedom and Operation Enduring Freedom Veterans and Families from 2007-2009. He frequently serves as an expert consultant on counterinsurgency and irregular warfare, professional military education and the changing character of conflict, supporting a wide-range of government and other organizations. General Barno is widely published and has testified before Congress numerous times. He is also a member of the Council on Foreign Relations and the International Institute of Strategic Studies.

A 1976 graduate of the U.S. Military Academy at West Point, General Barno also earned his master's degree in National Security Studies from Georgetown University. He is a graduate of the U.S. Army Command and General Staff College, and the U.S. Army War College. General Barno has received numerous awards for his military and public service.

Chairman CONRAD. Thank you, General Barno. And just for those who are listening, General Barno has a very distinguished record himself of service, having spent many of his early years in Special Operations Forces with Army Ranger battalions, including combat in both Grenada and the Panama invasions. In 2003, he was selected to establish a new three-star operational headquarters in Afghanistan and took command of the 20,000 U.S. and coalition forces in Operation Enduring Freedom and is given credit for devising a highly innovative counterinsurgency strategy with our partners.

So, General Barno, you have a very distinguished record, and when you said 99.5 percent of us and you said “us”—I noticed that—you could have—should have excluded yourself, because you have served and we deeply appreciate it.

General BARNO. Mr. Chairman, I should add, I have two sons in the family business, both Army Captains, one of whom is deployed right now, so their sacrifices are far more important than any I have made to date, and so it is a personal effort, as well.

Chairman CONRAD. Well, we appreciate that.

Dr. CARAFANO.

**STATEMENT OF JAMES JAY CARAFANO, PH.D., DIRECTOR, ALLISON CENTER FOR FOREIGN POLICY STUDIES, THE HERITAGE FOUNDATION**

Mr. CARAFANO. Thank you, sir. As background to my testimony, I would like to briefly discuss the general principles of defense planning.

I actually think that the best comparison for thinking about defense planning is insurance. In many ways, they are comparable, because in insurance, you do two things. On the one hand, you think about what do you have to do to mitigate risks, much as the military is really designed to prevent wars and conflict. And on the other hand, it is based on the value of what you are defending.

And for most of American history, Americans have actually been very common sense about their approach to defense planning, much like insurance. Insurance recognizes that we live in the real world, which is a complex, non-linear place, and that marginal adjustments do not mean very much. And so, for example, you do not change your homeowners' insurance because one hurricane season you do not have a lot of hurricanes because you anticipate that in the future, you might indeed have hurricanes, and there tends to be a certain amount of stability there. And I think that is true for defense planning, as well.

And so when you look over the vast run of American history, for most of American history, really from the American Revolution up to World War II, America's defense commitments are fairly consistent, now, except in wartime, of course, when they increase, but then after wartime they go back to a fairly common level.

Nineteen-forty-five comes around and America becomes a very different place after 1945. We were a very, very different country. We were simply the world's largest economy. We have—the American flag flies everywhere on the globe. We have global interests, global interests to protect and global concerns. That happens concomitant, though, with the outbreak of the Cold War, where we do

something that is absolutely totally unprecedented in American history. We go to spending, on average, about 7.5 percent of the entire nation's wealth on defense. We never did anything at that level in peacetime in our history and we did it for decades, and it masked the really, really important question, which is what is the new normal?

America is not the same country it was before 1945, so what is the normal now? Well, we know it is not 7.5 percent of GDP. Nobody thinks that you need a defense, to have a superpower rivalry with the Soviet Union. But we did not know what the new normal was. And so I would submit we spent the 1990s trying to find the new normal and the answer was less, and we went less and less and less.

And I would argue, at the end of the 1990s, we really found the basement. And as an officer serving in the Pentagon, I watched this firsthand. We had hearings much like this where my chief and the other chiefs would come in the room and they would talk about the readiness issues that they had, which were growing and very significant. We had the lack of modernization, where we had not really modernized on a grand scale since the end of the Cold War. The U.S. Army had difficulty responding to even minor contingencies like Kosovo. And we were certainly, certainly not ready for the challenges that we saw that we had to face in the post-9/11 world.

So my number one concern is this budget and the future budgets that this President anticipates is basically taking us back to a military of the size and relative capabilities that we had in the 1990s, a military that we knew then was too small to protect our interests.

And I want to be very clear here. Sequester is not the problem. I think there is a mood in Washington that if we could just get by sequester, we will have dodged a bullet. I do not think that is true. To me, sequester is like the doctor coming in and saying, "You are not going to die of a heart attack, but you are going to die of cancer." The military that we have programmed for the future, I do not believe is adequate to meet our national security needs.

So in my statement today, I try to address five issues. One is I address these concerns.

Second is I try to highlight where real savings are, and we did a very, very extensive review and we identified five areas where we think that there really are potentials for real serious savings in defense. They are in health care and compensation reform; removing extraneous items from the defense budget; and looking through the DOD's plan sufficiency programs and where there are areas where you could actually make serious reductions, including in the size of the DOD staff; moving to what is called performance-based logistics, which has tremendous potential savings in defense, far more than I think than marginal cuts in procurement or marginal cuts in changes and operating capability; and then, finally, in the area of auditing, where we do think that if we move towards a best practices model on private sector auditing systems we could garner significant savings. We have done detailed reports on these. I would be happy to submit them to you or submit them for the record. I have brought them with me here today.

# WebMemo



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February 3, 2011

## Taking a Scalpel to the Defense Budget

*Mackenzie Eaglen*

In anticipation of Congress receiving the President's defense budget request for fiscal year (FY) 2012 on February 14, Members would be wise to carefully review the House and Senate versions of the pending FY 2011 defense appropriations bills. This would help Congress gain valuable insight into what defense funding may be supported by another federal agency and what defense projects may not warrant funding in a military bill or any federal agency at all. Congress must reduce overall federal spending, and part of its due diligence will demand that it examine each defense program to ensure that it directly supports the overall mission of the Department of Defense (DoD) in support of the President's *National Security Strategy*.

**Tackling Waste, Fraud, and Abuse.** Eliminating waste, fraud, and abuse is a fundamental obligation of government. Taxpayers deserve prudent spending and critical oversight. Washington should spend only what is necessary to provide for the common defense—no more, no less. The government has many tools to root out bad practices in government. However, initiatives to target waste—while they have historically improved defense management and achieved savings—have often not substantially reduced defense costs.

One oversight tool is the Federal Acquisition Regulation, an initiative by President Ronald Reagan to make government contracting policies uniform. It involves virtually every acquisition by federal agencies and governs each step of the process. All government departments must abide by dozens of standard terms and conditions dictated by the regulation—many of them non-negotiable. Mandatory

federal conditions also include imposing standards of ethical conduct on contractors.

The DoD retains the authority to audit contractors' costs incurred, profits, progress, and performance during the agreement period and up to three years after that period. The government can also take contractors to task through the contracting agency's inspector general, the Special Inspector General for Iraq Reconstruction, the Army Audit Agency, the Defense Contract Audit Agency, or the Government Accountability Office.

Additionally, Congress and DoD have at their disposal a range of investigative tools. Virtually all federal agencies have internal law enforcement components, and the military services have criminal investigation divisions. The Department of Justice can also support efforts to uncover criminal activity on the part of contractors and government employees. Contractors that fail to abide by ethical standards or contract requirements can face civil litigation or criminal prosecution, as can civilian employees of the U.S. government. Military personnel are subject to the Uniform Code of Military Justice and, in some cases, can be tried in civilian courts.

**Projects in the Defense Bill That Should Be Examined for Funding Elsewhere or Eliminated Altogether.** Using the latest defense spending bills

This paper, in its entirety, can be found at  
<http://report.heritage.org/wm3132>

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aid or hinder the passage of any bill before Congress.

## Programs in the Department of Defense Bill That Should Be Considered for Funding Elsewhere in the U.S. Government

Title	Defense Account	Description	Project Amount
Critical infrastructure cyber operations simulation	RDT&E, Air Force	Develop a U.S. Air Force cyber security emulation system at Idaho National Laboratory that provides a synthetic operational environment for training, testing, and exercising capabilities to protect critical infrastructure with a realistic simulation of infrastructure environments and infrastructure control systems.	\$1.9 million
Terrorist threat detection system for shipping containers	RDT&E, Defense-wide	A set of advanced prototype C-Scout threat detection systems will be fabricated against a broad set of threats by Nevada Nanotech Systems. Further performance characterization includes units installed in shipping containers and monitored during transport at sea.	\$3 million
Overseas Humanitarian Assistance Shared Information System	RDT&E, Defense-wide	Overseas Humanitarian Assistance Shared Information System enables Humanitarian Assistance offices—including embassy staff, country team members, Combatant Command leads, and DSCA—to visualize projects on a Web-based map display, automate report generation, and perform a variety of analyses.	\$290,000
State counter-drug and eradication efforts	Other DoD Programs	Example: \$4 million for Kentucky National Guard marijuana eradication efforts to rid the Daniel Boone National Forest of this illegal crop.	\$36.6 million
Central Intelligence Agency retirement and disability system fund	Related Agencies	This appropriation provides payments of benefits to qualified beneficiaries. This is a mandatory account.	\$292 million
Military personnel unemployment benefits	Overseas Deployments and Other Activities	For the payment of unemployment benefits to ex-servicemembers discharged or released under honorable conditions.	\$270 million
Army and Air National Guard support to the southwest border	Overseas Deployments and Other Activities	Military supplementation to Border Patrol operations along the U.S. southern border with Mexico in Operation Jump Start.	\$31 million
<b>TOTAL</b>			<b>\$635 million</b>

Source: FY 2011 Senate Defense Appropriations Report (111–295).

Table 1 • WM 3132  heritage.org

as an illustrative example, Members should look for projects in the defense budget that—while they may be wholly legitimate—should be considered for funding in another spending bill under a more appropriate federal agency. Examples are abundant.

One is a project for the air force to develop a cyber system that provides capabilities to protect critical infrastructure. This is surely an important task of government but possibly one better suited for the Department of Homeland Security (DHS), which, along with the private sector, is in charge of protecting the nation's critical infrastructure. Another example is a program to develop advanced

prototype threat detection systems for eventual installation inside shipping containers to monitor them during transport at sea. Again, this may or may not be a worthy project. Yet either way, it is more appropriate for Congress to fund this under a DHS spending bill, since DHS is charged with defeating threats to maritime cargo.

Other examples include funding for various state national guard units to eradicate marijuana from national forests or critical unemployment benefits for former servicemembers that should have likely been funded with all other government unemployment benefits.

**Defense Programs That Warrant Further Scrutiny.** As part of its constitutional mandate, Congress wields the “power of the purse” over the annual budget requests made by the President. The section of the U.S. Constitution commonly referred to as the Appropriations Clause stipulates that “No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time.”

This clause provides Congress “with a mechanism to control or to limit spending by the federal government. The Framers chose the particular language of limitation, not authorization, for the first part of the clause and placed it in Section 9 of Article I, along with other restrictions on governmental actions to limit, most notably, executive action.”<sup>1</sup> The Constitution also gives Congress the power to provide for the common defense of the United States, to raise and support armies, and to make rules for the government and regulation of the land and naval forces.

As Justice Joseph Story wrote:

Congress may appropriate money ... in aid of canals, roads, and other institutions of a similar nature, existing under state authority. The only limitations upon the power are those prescribed by the terms of the Constitution, that the objects shall be for the common defense, or the general welfare of the union. The true test is whether it be of a local character, and local use; or, whether it be of general benefit to the states. If it be purely local, Congress cannot constitutionally appropriate for the object. But, if the benefit be general, it matters not, whether in point of locality it be in one state, or several; whether it be of large, or small extent. Its nature and character determine the right, and Congress may appropriate money in aid of it; for it is then in a just sense for the general welfare.<sup>2</sup>

There is no question that the “nature and character” of spending to “provide for the common defense” is always of benefit to the nation as a whole, so it is always constitutional and appropriate for DoD. All other spending within the defense bill should be scrutinized by Congress to determine whether it should be moved to another agency or removed as wasteful spending.

This final say in how taxpayer funds are spent is crucial for more effective government. Congress does not just take the executive branch at its word. Members can and should regularly question the spending priorities and analysis behind those decisions when the annual defense budget request is made. Too often, the statement that “the Pentagon doesn’t want it” becomes a blank check for the executive branch when Congress has proven time and again that its Members have an important voice in setting the spending priorities of government.

History highlights plenty of examples where Congress has authorized policy or funding initiatives that DoD has strongly opposed, and in retrospect, Congress was right. Former Senator Sam Nunn (D-GA), for example, wanted the Air Force to buy more F-117s when the service wanted to stop purchases. Later it turned out that the F-117 was critical to establishing air dominance over Iraq in Operation Desert Storm. Another example is Congress continuing the Marine Corps’s V-22 program and prohibiting the retirement of U-2s and B-52s, which have proven their relevance in current operations Iraq and Afghanistan.

Nevertheless, there are examples of potentially wayward spending priorities within the defense bill that demand additional attention as defense budgets shrink. For example, Congress should carefully examine a series of social science grants known as the Minerva Research Initiative, which is presumably helping produce helpful research. The Pentagon estimates the total amount of the awards to amount to as much \$50 million over five years.

1. Gary Kepplinger, “They Can’t Spend What You Don’t Approve: Rethinking the Appropriations Clause,” Heritage Foundation Report No. 7, January 24, 2011, at <http://www.heritage.org/Research/Reports/2011/01/They-Cant-Spend-What-You-Dont-Approve-Rethinking-the-Appropriations-Clause>.
2. Joseph Story, *Commentaries on the Constitution of the United States*, Chapter XXVI, Section 632, 1833.

## Defense Spending Priorities That Demand Further Examination and Oversight

Title	Defense Account	Description	Project Amount
Native American document conversion program	Air Force O&M	For Interim Information Technology Company in South Dakota to promote military readiness and provide employment opportunities on Native American reservations and homelands by integrating U.S. military technical data into a single data format.	\$3 million
Joint Safety Climate Assessment System	DoD-wide O&M	Online survey to assess safety culture of the services.	\$2 million
Rule of Law	DoD-wide O&M	Office for Rule of Law and International Humanitarian Policy to "guide policy on emerging non-traditional military activities like compliance with the rule of law, humanitarian emergencies, and human rights."	\$1.5 million
Major equipment, OSD	DoD-wide Procurement	Example: \$1.4 million for Enterprise Portals Program eBusiness Center capabilities for the office of the Under Secretary of Defense for Acquisition, Technology and Logistics.	\$124 million
University research initiatives, Army	RDT&E, Army	Example: \$9.5 million for a National Security Human Rights Strategy for the University of Connecticut to support human rights initiatives within the Department of Defense.	\$91 million
University research initiatives, Navy	RDT&E, Navy	Example: \$4 million for the Center for Assured Critical Application and Infrastructure Security at the University of Illinois to establish the center, which will address the development of trust validation tools for critical computer infrastructures, namely defense applications, financial systems, and electrical power, to ensure public confidence in these systems.	\$108 million
University research initiatives, Air Force	RDT&E, Air Force	Example: \$2.5 million for "BattleSpace: Reducing Military Decision Cycles, Phase II" at the University of Nebraska to design collaboration software for USSTRATCOM to facilitate rapid and effective decision-making based on multiple data inputs for battlefield management, war games, exercises, and other defense planning activities. Example: \$4 million for "Institute for Advanced Energy Studies" for University of North Dakota to develop innovative technological solutions to promote the use of clean, reliable, affordable, and efficient energy technologies. Example: \$2 million for University of New Mexico's Partnership for Emerging Energy Technologies to support research in the areas of energy conversion, storage, and power generation.	\$136 million
University and industry research centers	RDT&E, Army	Example: \$3.5 million for "Partnership for National Security" at University of North Carolina-Chapel Hill to provide Army and Marine Special Forces with relevant, pre-deployment education modules, degree programs, and deployment "reach-back" access. The program would (1) create a Physician Assistant Program for Special Operations Medics at the Joint Special Operations Medical Training Center at Fort Bragg; (2) create and deliver an accelerated National Security Studies degree program; (3) develop a National Security Reach Back Network to respond to deployed Civil Affairs Special Forces queries focused on agriculture, rural development and economics; and (4) create a Center of Excellence in Human Performance through the development of novel nutritional supplements and human performance strategies, designed to optimize warfighter training gains with reduced risk of injury, illness, and muscle soreness. Example: \$3.5 million for University of Nevada's DC Air Conditioner Suitable for PV Solar Air Conditioning Using Novel VSD Technology and Commercial AC Compressors.	\$98 million
Combat vehicle and automotive advanced technology	RDT&E, Army	Alaska's Alkan Shelter LLC to build a future tactical truck composite shelter.	\$2 million
Joint Space Operations Center (JSPOC) Mission System "Karmac" study	RDT&E, Air Force	This study will improve JSPOC capabilities to include non-traditional data and three-dimensional modeling and simulation.	\$6 million
Air Force support systems development	RDT&E, Air Force	\$40 million for alternative energy research and integration and \$3 million for Freedom fuels/coal fuel alliance.	\$49 million
U.S. Army Minerva Research Initiative	RDT&E, Army	Awards to academic institutions to perform scholarly research in the social sciences and build bridges between DoD and the social science community.	\$21.6 million

(continued on next page)

Source: FY2011 Senate Defense Appropriations Report (111-295).

Table 2 • WM 3132  heritage.org

## Defense Spending Priorities That Demand Further Examination and Oversight (continued)

Title	Defense Account	Description	Project Amount
Navy "technical information services"	RDT&E, Navy	Provides support to achieve affordability in the development of navy systems and reduce life-cycle costs through the facilitation of advanced technology associations between U.S. industry and the navy.	\$18 million
Basic research	RDT&E, Defense-wide	Includes \$47 million in funding for Defense Threat Reduction Agency university strategic partnership basic research; \$328 million for defense research sciences; \$3.4 million for government/industry cosponsorship of university research; and \$109 million for national defense education program.	\$487 million
Human, social, and culture behavior modeling	RDT&E, Defense-wide	Advanced development to help DoD "understand the social and cultural terrain and the various dimensions of human behavior within those terrain."	\$9.5 million
Regional international outreach and partnership for peace information management systems	RDT&E, Defense-wide	OSD initiative to deploy a common information technology platform to improve international partner outreach and collaboration efforts in a federated environment.	\$2.2 million
Support to Information Operation capabilities	RDT&E, Defense-wide	Coordinated effort to integrate Information Operation (IO) test and evaluation capability to assess IO technologies and tactics in a representative operational environment against realistic targets.	\$31.5 million
Defense health program R&D	Other DoD Programs	Includes \$150 million for peer-reviewed breast cancer research program, \$10 million for peer-reviewed ovarian cancer research program, and \$80 million for peer-reviewed prostate cancer research program.	\$240 million
<b>TOTAL</b>			<b>\$1,430 million</b>

Source: FY 2011 Senate Defense Appropriations Report (111-295).

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These grants need to be cross-examined with the plethora of other funding by the DoD on research initiatives at universities in the United States. The army requested \$91 million on its University Research Initiatives in FY 2011; the navy \$109 million; and the air force \$136 million. Additionally, the DoD requested \$98 million for University and Industry Research Centers in the 2011 budget.

**Due Diligence with Defense.** Congress should examine federal spending on its merits and decide whether it is both constitutional and necessary. Members should also be aggressive in their efforts to eliminate waste in all federal agencies including DoD.

As part of an effort to reexamine defense spending priorities, Congress should carefully review last year's defense spending bills to identify areas worthy

of further scrutiny. This would ensure that taxpayer dollars are being spent wisely and that necessary funds are dedicated to the appropriate federal agency while unnecessary projects are cut from the overall federal budget to reduce spending.

Conducting due diligence in the defense budget is a critical step toward helping the military reach its goals of reprioritizing funds to bolster modernization plans after a decade of war and wear and tear on equipment.

—*Mackenzie Eaglen is Research Fellow for National Security in the Douglas and Sarah Allison Center for Foreign Policy Studies, a division of the Kathryn and Shelby Cullom Davis Institute for International Studies, at The Heritage Foundation.*

# Backgrounder

No. 2507  
January 10, 2011



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## How to Save Money, Reform Processes, and Increase Efficiency in the Defense Department

Mackenzie Eaglen and Julia Pollak

**Abstract:** *After the sweeping cuts in the FY 2010 defense spending bill and with the proposed reductions in FY 2011, further defense cuts would jeopardize long-standing core capabilities that comprise the foundation of American military strength. Nevertheless, policymakers should relentlessly pursue greater efficiencies within defense operations and eliminate waste and duplication in the defense budget. The responsible defense efficiency reform package laid out in this paper could realize more than \$70 billion (possibly up to \$90 billion) in annual savings. Congress should allow the military to use any savings that it generates to pay for urgent priorities, such as modernization of each of the services' inventories. This will bolster the incentive to improve efficiency while directly strengthening the U.S. military.*

The need for a strong defense dates back to America's founding. Robust defense has been a priority because the U.S. Constitution mandates that the federal government "provide for the common defense."<sup>1</sup> This enduring responsibility, both in times of tranquility and in times of war, ultimately allows all Americans to enjoy their many freedoms in safety. Furthermore, maintaining a strong defense is the most practical approach because preparing for war often helps to keep the peace. Economic growth is required to fully fund a strong defense, yet policymakers need not spend a penny more than is necessary to protect Americans, maintain a strong military, and uphold core defense capabilities that comprise U.S. military superiority.

### Talking Points

- Congress should ask what is required to protect the nation and fund an adequate defense to accomplish this—no more, no less.
- Congress must seek to increase efficiency within the large defense budget and help the Pentagon to operate more effectively, reform processes, and eliminate waste.
- Congress should allow the military to reinvest any realized savings to pay for urgent priorities, especially modernization of each service's inventory. Failure to reinvest the savings will seriously undermine core defense capabilities.
- Careful implementation of the reform package presented in this paper could save more than \$70 billion while improving the efficiency and effectiveness of the military and the Pentagon. Furthermore, reinvesting the savings in the military would fund much-needed procurement of new equipment.
- Reform and wise reinvestment in the U.S. military are essential to maintaining a strong defense and keeping the peace.

This paper, in its entirety, can be found at:  
<http://report.heritage.org/bg2507>

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Nevertheless, Congress can and must pursue efforts to find greater efficiencies within the large defense budget and help the Pentagon to operate more effectively, reform processes, and eliminate waste. The 112th Congress should use the reform and efficiency agenda presented in this paper as a starting point to conduct rigorous oversight. Congress should also allow military leaders to reinvest all of the funds recovered from eliminating bureaucratic overhead to pay for the more important priority of modernization, including purchasing new sets of equipment for all of the military services.

### The Challenge Facing the 112th Congress

Members of 112th Congress will be under increasing pressure to cut defense spending, which comprises almost one-fifth of the federal budget. The annual federal deficit is running at about 10 percent of gross domestic product (GDP), and the ratio of public debt to GDP could reach 100 percent by the end of the decade. This debt burden will continue to swell as entitlement spending skyrockets.

Reducing America's debt burden is a particularly high priority for congressional Republicans, many of whom were elected by voters outraged at profligate federal spending. Robust national defense is also a high priority for many Members of Congress because the U.S. Constitution mandates that a primary responsibility of the federal government is to "provide for the common defense."<sup>1</sup>

Funding a strong defense is fiscally responsible over the long term. Preparing for war often helps to keep the peace, whereas allowing the military to atrophy and then rebuilding it costs far more than simply maintaining defense spending at adequate levels in the first place. Thus, maintaining a robust national defense has not only a strong constitutional basis,<sup>2</sup> but also a fiscal rationale. As President George Washington told the American people in his farewell address, "[T]imely disbursements to prepare for danger frequently prevent much greater disbursements to repel it."<sup>3</sup>

As Washington observed, rebuilding a hollowed-out military and restoring denigrated capabilities and skills is far costlier when disaster strikes than maintaining adequate defense spending and a ready force, even during peacetime. Moreover, keeping defense budgets stable and predictable saves taxpayers money by promoting efficient build rates and healthy economies of scale in equipment purchases. Policymakers should ensure that they provide what is necessary to protect Americans, maintain a strong military, and uphold the core defense technologies and capabilities that comprise U.S. military superiority.

Policymakers should simultaneously pursue greater efficiencies in defense by reforming cumbersome processes, eliminating waste and duplication, and streamlining operations. Members of Congress can support a strong defense; eliminate waste in government agencies, including the Department of Defense (DOD); and demand reform and efficiency from the national security bureaucracy. A responsible defense efficiency reform package as laid out in this paper could generate between \$70 billion and \$90 billion in annual savings.

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***As President George Washington told the American people in his farewell address, "[T]imely disbursements to prepare for danger frequently prevent much greater disbursements to repel it."***

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The Obama Administration has already implemented many sweeping defense cuts and has proposed further reductions for fiscal year (FY) 2011. Secretary of Defense Robert Gates, the President's National Commission on Fiscal Responsibility and Reform, and many public policy research institutes have also proposed numerous additional defense cuts and suggestions. Some of these proposals are radical and arbitrary and would harm core defense capabilities. Other proposed reforms are more prudent and realistic and promise to eliminate waste.

1. U.S. Constitution, preamble.
2. Jim Talent, "A Constitutional Basis for Defense," Heritage Foundation *America at Risk* Memo No. 10-06, June 1, 2010, at <http://www.heritage.org/research/reports/2010/06/a-constitutional-basis-for-defense> (December 28, 2010).
3. George Washington, "Farewell Address," September 17, 1796.

Still others would transfer nonessential DOD activities to outside organizations to enable the military to focus exclusively on protecting the nation.

Critical to any defense reform and efficiency drive should be the goal of bolstering funding for modernization, the military's purchase of next-generation equipment, which Secretary Gates has said is urgently required. Many policymakers find it hard to believe that defense could be under-resourced during a time of war, but the problem began before 9/11:

Since the end of the Cold War, administrations of both political parties have underfunded the military, first harvesting a "peace dividend" by reducing the size of the force and then repeatedly postponing investments needed to replace worn out equipment and preserve the technological advantages that have been a traditional source of American strength.<sup>4</sup>

Further, the size of the U.S. military has declined by one-third in the past 20 years, while the number and scope of missions tasked to the U.S. military has grown substantially. Strained, aging platforms have reached the point at which they cannot carry out the desired missions.

The solution identified by a bipartisan blue-ribbon panel led by William J. Perry, former Secretary of Defense under President Bill Clinton, and Stephen J. Hadley, former National Security Adviser to President George W. Bush, is to spend more on military modernization. Specifically, the panel recommended that Congress fund a "force structure that gives us a clear predominance of capability in any given situation."<sup>5</sup> A fleet of at least 313 ships—the U.S. Navy's current baseline—is the minimum size needed to match capabilities to commitments.

The panel recommended expanding the Navy to roughly 350 ships.

In addition to the growing challenges and need for continued presence and access in Asia, the report noted the stresses placed on the force over the past 15 years and the additional missions the military has assumed: "[I]t is unlikely that the United States can make do with less than it needed in the early 1990s, when Americans assumed the world would be much more peaceful post Cold War."<sup>6</sup>

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***Cutting defense is "not an inherent good," but "a process of taking calculated risk in military accounts" to improve government stewardship of taxpayer dollars, bolster the U.S. economy, and enhance national security over the long term.***

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The panel's report also identified the urgent need to modernize the inventory of all of the services. The Navy needs to begin developing a next-generation cruiser and buy additional submarines. The Air Force needs to increase its deep-strike capability, acquire more long-range platforms, and obtain a new tanker and additional lift capability. The Army needs to recapitalize its inventory of tracked combat vehicles.<sup>7</sup>

The five areas of reform discussed in this paper show particular promise in producing realistic and achievable savings within the defense budget and appear to involve minimal risk to the military's missions, capabilities, and readiness.

As Congress reviews these recommendations, Members should heed the warning that cutting defense is "not an inherent good," but "a process of taking calculated risk in military accounts" to try to improve government stewardship of taxpayer dollars,

4. American Enterprise Institute, The Heritage Foundation, and the Foreign Policy Initiative, "Defending Defense: Setting the Record Straight on U.S. Military Spending Requirements," October 2010, at <http://www.heritage.org/research/reports/2010/10/defending-defense-setting-the-record-straight-on-us-military-spending-requirements>.

5. Quadrennial Defense Review Independent Panel, *The QDR in Perspective: Meeting America's National Security Needs in the 21st Century*, 2010, p. v, at <http://www.usip.org/files/qdr/qdrreport.pdf> (December 28, 2010).

6. *Ibid.*

7. Jim Talent and Mackenzie Eaglen, "Shaping the Future: The Urgent Need to Match Military Modernization to National Commitments," Heritage Foundation *Backgrounder* No. 2488, November 4, 2010, at <http://www.heritage.org/Research/Reports/2010/11/Shaping-the-Future-The-Urgent-Need-to-Match-Military-Modernization-to-National-Commitments>.

bolster the U.S. economy, and enhance national security over the long term.<sup>8</sup> These defense reforms should be implemented incrementally and with utmost care. Policymakers should monitor the results and mitigate any unforeseen risks at each step of implementation, making adjustments as necessary.

### Recent Defense Budget Cuts

Since taking office, the Obama Administration has pursued massive defense cuts that will reshape America's military and jeopardize core defense capabilities that many have come to take for granted. The President requested cuts in nearly 50 major defense programs in FY 2010. Although many Members of Congress disagreed with the Administration's assessments, Congress broadly approved the President's defense cuts, significantly departing from them in only a few cases.<sup>9</sup>

President Barack Obama reduced the missile defense budget by \$1.4 billion in FY 2010 and reversed the Bush Administration's decision to deploy missile defense components in Poland and the Czech Republic. The Obama Administration also scaled back the planned number of ground-based midcourse defense interceptors in Alaska and California from 44 to 30, ended the Multiple Kill Vehicle program for defeating multiple ballistic missiles, deferred the purchase of a second Airborne Laser aircraft, killed the Kinetic Energy Interceptor program for intercepting ballistic missiles in boost phase, and eliminated funding for the space test bed for missile defense.

Many other programs were cut as part of the 2010 defense budget, including the F-22 fifth-generation fighter, the VH-71 helicopter, the Air Force's combat search and rescue (CSAR-X) helicopter, and the ground combat vehicle portion of the Army's Future Combat Systems. In the past two years, the

Administration has also ended purchases of the next-generation DDG-1000 destroyers, extended construction of the next carrier from four years to five, killed the MPF-A large-deck aviation ship and its mobile landing platform, and delayed indefinitely the Navy's next-generation cruiser (CG-X).

After the sweeping defense budget cuts in FY 2010, little was left to cut from next-generation equipment in FY 2011. As a result, the President's FY 2011 budget request proposes canceling a few new defense programs. However, it is notable for proposing few initiatives to replace capabilities lost in the FY 2010 cuts.<sup>10</sup>

More recently, in November 2010, the Bipartisan Policy Center's Debt Reduction Task Force proposed sweeping defense cuts that would reduce the military's budget to the peacetime levels of 2000, despite two ongoing significant overseas operations, the growing challenge of radical Islamic terrorism, North Korean and Iranian nuclear proliferation, and

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***Since taking office, the Obama Administration has pursued massive defense cuts that will reshape America's military and jeopardize core defense capabilities that many have come to take for granted.***

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modernization and expansion of the Chinese and Russian militaries. Specifically, the task force proposes freezing defense spending for five years through statutory spending caps, enforceable through automatic across-the-board cuts in all defense programs.<sup>11</sup> By around 2017, the plan would reduce the defense budget to the peacetime levels of 2000 and cap it at 3 percent of GDP thereafter.<sup>12</sup> Under such a plan, military modernization

8. Michael E. O'Hanlon, "Defense Budget and American Power," *The Washington Times*, November 17, 2010, at [http://www.brookings.edu/opinions/2010/11/17\\_defense\\_budget\\_ohanlon.aspx](http://www.brookings.edu/opinions/2010/11/17_defense_budget_ohanlon.aspx) (December 28, 2010).

9. U.S. Office of Management and Budget, *Terminations, Reductions, and Savings, Budget of the United States Government, Fiscal Year 2011* (Washington, D.C.: U.S. Government Printing Office, 2010), at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/trs.pdf> (December 28, 2010).

10. For a detailed list of the President's requested defense cuts and congressional responses, see Appendices A and B.

11. Bipartisan Policy Center, *Restoring America's Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System*, November 2010, pp. 19–20 and 96–107, at <http://bipartisanpolicy.org/sites/default/files/FINAL%20DRTF%20REPORT%2011.16.10.pdf> (December 4, 2010).

would suffer a disproportionate share of the cuts,<sup>13</sup> and the military's fighting capability would be severely diminished.

In the same month, the co-chairmen of the President's National Commission on Fiscal Responsibility and Reform presented a package of debt reduction proposals.<sup>14</sup> While the commission proposed many sensible efficiency reforms, it also recommended extensive procurement cuts that could produce a repeat of the disastrous 1990s "procurement holiday" and hollow out the military. This would be particularly dangerous piled on top of the past two decades of defense budgets, which build fewer and fewer new systems to replace the military's inventory of ships, planes, and vehicles.

Within the Defense Department, numerous reform processes are already underway. In August 2010, Secretary Gates announced a series of efficiencies initiatives to generate an estimated \$100 billion in savings within the defense budget through FY 2015.<sup>15</sup> He is undertaking this initiative to reduce waste, eliminate redundancy, and reprioritize defense investments into modernization. Most of the plans are designed to improve effectiveness or achieve the same capabilities with fewer people and fewer resources. The proposals include reducing the number of contractors and civilian personnel and consolidating duplicative infrastructure.<sup>16</sup>

In addition, throughout the past decade, the DOD has been busy implementing various recommendations to close redundant military installations and realign defense forces to reduce expenditures on operations and maintenance, improve efficiency, and meet defense needs for the

next 20 years. These include undertaking the fifth round of Base Realignment and Closure (BRAC) initiatives. This BRAC round was the biggest, most complex, and most costly ever, involving 182 recommendations on 800 defense locations. The BRAC statute requires the DOD to complete all recent closures and realignments by September 15, 2011, so the Pentagon is busy with plans to close unnecessary facilities, build new installations, and transfer thousands of military personnel.<sup>17</sup>

As a result of BRAC and other extensive transformation initiatives, over the past 10 years, the DOD has been:

- Permanently relocating approximately 70,000 military personnel to the U.S. from overseas bases,
- Transforming the Army's force structure from a division-based organization to an organization based on brigade combat teams,
- Increasing the active-duty end strength of the Army and Marine Corps by 92,000 members, and
- Drawing down combat forces in Iraq while increasing the U.S. military presence in Afghanistan.

In addition, numerous DOD offices are implementing reforms proposed by internal boards and commissions and by agencies such as the Government Accountability Office (GAO). For example, the Pentagon has made numerous changes in its financial operations. The Defense Finance and Accounting Service, which provides accounting and financial services for the military and defense agen-

12. *Ibid.*, p. 97.

13. Mackenzie Eaglen, "U.S. Defense Spending: The Mismatch Between Plans and Resources," Heritage Foundation *Backgrounder* No. 2418, June 7, 2010, at <http://www.heritage.org/research/reports/2010/06/us-defense-spending-the-mismatch-between-plans-and-resources>.

14. Alan Simpson and Erskine Bowles, "\$200 Billion in Illustrative Savings," National Commission on Fiscal Responsibility and Reform, November 12, 2010, at [http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative\\_List\\_11.10.2010.pdf](http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf) (December 28, 2010).

15. Robert M. Gates, "Defense Efficiencies Initiative," U.S. Department of Defense, August 9, 2010, at [http://www.defense.gov/home/features/2010/0810\\_effinit](http://www.defense.gov/home/features/2010/0810_effinit) (December 28, 2010).

16. For a summary of these initiatives and the estimated savings, see Appendix C.

17. Brian J. Lepore, "Military Base Realignments and Closures: DOD Is Taking Steps to Mitigate Challenges but Is Not Fully Reporting Some Additional Costs," U.S. Government Accountability Office, GAO-10-725R, July 21, 2010, at <http://www.gao.gov/new.items/d10725r.pdf> (December 28, 2010).

cies, has become more efficient, reducing costs to the military by \$317 million since 2001. Other financial reforms have prevented duplicate payments, saving as much as \$452 million in FY 2005 alone. Finally, audits have saved the DOD several

***Within the Defense Department, numerous reform processes are already underway.***

billion dollars.<sup>18</sup> Of course, much more must be done to help the Department of Defense achieve a full and clean financial audit in the years ahead—a legitimate source of criticism and an urgent priority of policymakers.

Plans to conclude U.S. operations and reduce the number of military personnel in Iraq and Afghanistan will also eventually yield savings, although the reset needs of the Army and Marine Corps will be significant even after the major combat operations end. Brookings Institution scholar Michael O'Hanlon notes that Congress can expect to reduce total annual defense spending by about \$150 billion annually from current levels once the wars are mostly over. O'Hanlon suggests that the drawdowns to 10,000 troops in Iraq and 25,000 in Afghanistan by 2013 or 2014 could significantly reduce defense spending on overseas contingency operations.<sup>19</sup>

In summary, the Department of Defense and the services are already implementing a large number of initiatives to reduce overhead; trim waste, fraud, and abuse; cut unnecessary programs; consolidate facilities; and make defense dollars stretch further.

Nevertheless, Congress and the Department of Defense can always do more to spend the defense budget wisely. The 112th Congress should continue to expect potential savings from defense, with the following caveats:

- As the department trims more of the fat, it will become increasingly difficult to reduce military spending without cutting into defense muscle and thereby jeopardizing core functions.

- For best results, reforms should be introduced incrementally, using pilot projects or phased approaches when reasonable.
- Congress will need time to evaluate the outcomes of each reform properly to determine which initiatives to expand or replicate and which to alter or abandon.

With so many changes being made at once, Congress should be supportive and patient in allowing the services to realize savings.

### **Five Viable Reform Packages**

The 112th Congress should use the best recommendations from various proposals and continue to pursue savings from within the defense budget in order to reinvest funds into modernizing all of the services. Five select packages of reforms promise to generate significant fiscal savings and government efficiencies while minimizing the increases in risk to national security:

1. Continuing and expanding select efficiencies initiatives undertaken by Secretary Gates,
2. Implementing and expanding select reforms recommended by the Fiscal Commission co-chairmen,
3. Expanding the use of public-private partnerships for performance-based logistics,
4. Modernizing base operations and the maintenance and supply systems, and
5. Reducing wear and tear on military equipment and increasing the use of multiyear contracts and block upgrades.

Making defense operations more efficient will not automatically produce savings, allowing further reductions in defense budgets. Whereas managers generally have incentives to improve efficiency in the private sector, there are typically fewer incentives for efficiency and good management in government.

For example, between FY 2002 and FY 2005, man-days of ship depot maintenance and days out

18. Office of the Under Secretary of Defense (Comptroller), "Improving Financial Performance," at <http://comptroller.defense.gov/improving.html> (December 28, 2010).

19. O'Hanlon, "Defense Budget and American Power."

of service per ship declined dramatically. The improvement in efficiency should have allowed the Navy to reduce maintenance manpower, save more than 12 percent of its maintenance budget, and redirect these savings toward procurement or some other urgent priority. However, analysts note that changes in efficiency norms do not appear to have entered the budgeting process. Instead of decreasing to reflect greater efficiency, the maintenance budget increased each year during that period.<sup>20</sup>

This example shows how implementing defense efficiency efforts does not inevitably lead to immediate defense savings. Budgets may fail to reflect vast improvements in efficiency until DOD leaders identify better ways to reward managers and offices that improve efficiency, report improvements, and reduce their operating expenses accordingly.

Each of the following efficiency initiatives will likely yield savings only if Secretary Gates creates strong incentives for robust management and can assure the military service chiefs that they will be allowed to reinvest a large portion of the savings that they produce. The five reform packages detailed below lay out a program of responsible reform that could generate more than \$70 billion in annual savings within defense.

**Reform Package #1: Continue and expand select efficiencies initiatives proposed by Secretary Gates.**

The DOD efficiencies initiatives that were announced on August 9, 2010, and expanded upon in January 2011, include recommendations to close duplicative offices and agencies, streamline the

number of flag and general officers, reduce regulatory and oversight burdens, close the U.S. Joint Forces Command, and reduce contractors by 30 percent.<sup>21</sup>

Some of these recommendations seem arbitrary, risky, and less likely than advertised to produce savings. In particular, the DOD's ability to make the proposed reductions in contractor support is doubtful according to some analysts, including Todd Harrison, who believes they will be "difficult to achieve."<sup>22</sup> Even if the DOD succeeds in cutting the proposed number of contractors, that reduction is unlikely to yield the desired level of savings, although that does not mean the effort is unworthy or should not be undertaken, particularly when the Congressional Research Service (CRS) estimates that "phasing in elimination of 10,000 positions per year would save about \$600 million in FY 2011, \$1.8 billion in FY 2012, \$3.0 billion in FY 2013, and \$3.6 billion per year in subsequent years."<sup>23</sup>

However, most of the Secretary of Defense's recommendations appear to be both prudent and promising. In particular, Congress should pursue and possibly expand the following recommendations:

- *Freeze the number of Office of the Secretary of Defense (OSD) positions, defense agency positions, and Combatant Command (COCOM) billets at FY 2010 levels for the next three years.* After FY 2011, the DOD should also stop creating new full-time positions to replace contractors in these organizations. According to a preliminary CRS assessment, a 50 percent reduction in the growth of the OSD, defense agency, and COCOM billets could save \$2.4 billion per year.<sup>24</sup>

20. Jino Choi, Omer Alper, James Jondrow, John Keenan, Richard Sperling, and Michael Gessner, "Improving Navy's Buying Power Through Cost Savings," Center for Naval Analyses, October 2006, at <http://www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA462205&Location=U2&doc=GetTRDoc.pdf> (December 28, 2010).
21. Robert M. Gates, "DOD News Briefing with Secretary Gates from the Pentagon," U.S. Department of Defense, August 9, 2010, at <http://www.defense.gov/transcripts/transcript.aspx?transcriptid=4669> (December 28, 2010) and Robert M. Gates, "DOD News Briefing with Secretary Gates from the Pentagon: Statement on Department Budget and Efficiencies," U.S. Department of Defense, January 6, 2011, at <http://www.defense.gov/Speeches/Speech.aspx?SpeechID=1527>.
22. Todd Harrison, "The Fiscal Commission and Defense: Strategy in an Age of Austerity," Center for Strategic and Budgetary Assessments *Background*, November 2010, p. 2, at [http://www.csbaonline.org/4Publications/PubLibrary/B.20101123.The\\_Fiscal\\_Commiss/B.20101123.The\\_Fiscal\\_Commiss.pdf](http://www.csbaonline.org/4Publications/PubLibrary/B.20101123.The_Fiscal_Commiss/B.20101123.The_Fiscal_Commiss.pdf) (December 28, 2010).
23. Stephen Daggett, "Preliminary Assessment of Efficiency Initiatives Announced by Secretary of Defense Gates on August 9, 2010," Congressional Research Service, August 12, 2010, p. 3, at <http://www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA526227&Location=U2&doc=GetTRDoc.pdf> (December 28, 2010).

**Heritage Defense Efficiency Reform Package: Part 1**

Selected Efficiency Initiatives Started by Secretary Gates	Estimated Annual Savings
Freeze the number of OSD, Defense Agency, and combatant command positions at the FY 2010 levels for the next three years	\$2.4 billion
Freeze the number of senior civilian DOD employees at FY 2010 levels	\$30 million
Cut the number of civilian positions in OSD by 600 billets	\$72 million
Consolidate information technology assets	\$5.5 billion
Freeze the number of DOD-required oversight reports and cut funding for advisory studies by 25 percent	\$21 million
Eliminate unnecessary boards and commissions and cut overall funding for studies tasked by the remaining boards and commissions by 25 percent in FY 2011	\$19 million
Eliminate duplicative or unnecessary organizations	<ul style="list-style-type: none"> <li>• Office of the Assistant Secretary of Defense for Networks and Information Integration and the Joint Staff's J6 Command, Control, Communications and Computer Systems: \$95 million-\$115 million in FY 2010</li> <li>• Business Transformation Agency: \$116 million-\$340 million in FY 2010</li> <li>• Joint Forces Command: \$240 million-\$703 million</li> </ul>
<b>Total Estimated Annual Savings</b>	<b>\$8.5 billion to \$9.2 billion</b>

Sources: Robert M. Gates, "Reform Initiatives," U.S. Department of Defense, August 9, 2010, at [http://www.defense.gov/home/features/2010/0810\\_effinit](http://www.defense.gov/home/features/2010/0810_effinit) (December 7, 2010); Stephen Daggett, "Preliminary Assessment of Efficiency Initiatives Announced by Secretary of Defense Gates on August 9, 2010," Congressional Research Service, August 12, 2010, at <http://www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA526227&Location=U2&doc=GetTRDoc.pdf> (December 4, 2010); and Heritage Foundation calculations. For more details, see Appendix C.

Table I • B 2507  heritage.org

- *Freeze at FY 2010 levels the number of civilian senior executives, flag and general officers, and PAS positions; cut at least 50 general and flag officer positions and 150 senior civilian executive positions over the next two years.* According to the CRS, freezing the number of civilian senior executives, general and flag officers, and PAS (appointed by the President with Senate confirmation) positions would save an additional \$30 million per year.
- *Build on the freeze by reducing the number of OSD civilian positions by 600 billets to roughly pre-9/11 levels.* Over the past decade, active-duty end strength has grown by less than 4 percent despite a protracted war with operations in Iraq and Afghanistan. Congress approved active-duty military end strengths of 1,382,242 in FY 2001 and 1,425,000 in FY 2010.<sup>25</sup> Over the same decade, the number of civilians working in the OSD increased by almost 47 percent from roughly 1,500 to more than 2,200. Cutting 600 positions at an estimated average of \$120,000 per position per year would save \$72 million annually. By implementing both of the previous recommendations and expanding Secretary Gates's cuts in the number of civilian positions in the OSD, Congress could achieve \$2.5 billion in annual savings.
- *Consolidate information technology (IT) infrastructure.* Secretary Gates recommended the consolidation of IT facilities to allow the DOD to increase its use of common functions and improve its ability to defend DOD networks against cyber threats. A CRS report concluded that estimating savings would require further research but noted that private companies have achieved significant savings through IT consoli-

24. *Ibid.*

25. See Public Law 106-398, § 401, and Public Law 111-84, § 401.

dition: up to \$900 million in annual savings for a \$25 billion company such as IBM.<sup>26</sup> If the Defense Department realized comparable savings, it would save \$20 billion out of a \$550 billion budget.

However, it is highly unrealistic to assume that IT consolidation in the DOD would achieve such a high rate of savings. IBM would likely achieve higher percentage savings because its business is more IT-oriented. IT consolidation will also likely have diminishing marginal returns, saving a \$25 billion company 4 percent but saving a larger company considerably less. A more realistic estimate suggests that IT consolidation could save the DOD approximately 1 percent (\$5.5 billion) of its core budget.

- *Freeze the number of boards, commissions, advisory studies, and oversight reports; eliminate unnecessary boards and commissions; and cut overall funding available for studies tasked by the remaining boards and commissions by 25 percent in FY 2011.* Recognizing the enormous cost and imposition of excessive oversight, Secretary Gates plans to freeze the number of DOD-required oversight reports, cut funding for advisory studies by 25 percent, and eliminate unnecessary defense boards and commissions. Congress must still approve these efforts as part of the President's FY 2012 defense budget request.

According to the Congressional Research Service, "the OSD funds 65 boards and commissions at an annual cost of \$75 million" and spends up to \$84 million for contractors to prepare studies and reports for various audiences, most often Congress.<sup>27</sup> Congress can expect Secretary Gates's initiatives to save a significant percentage of those expenditures. Cuts of 25 percent in each area would yield up to \$40 million in annual savings.

- *Close duplicative organizations and reassign their functions and responsibilities.* Secretary Gates has proposed eliminating the Office of the Assistant

Secretary of Defense Networks Integration and Information and reassigning its functions to the Defense Information Systems Agency to save \$100 million annually; eliminating the Business Transformation Agency and reassigning its responsibilities to the Deputy Chief Management Officer to save \$100 million to \$340 million annually; and closing the Joint Forces Command and reassigning its functions to the Joint Staff to save \$240 million to \$703 million annually. Closing these three organizations is expected to produce between \$480 million and \$1.14 billion in annual savings. Congress should pursue these reforms only if it agrees that these are wise decisions supported by adequate analysis and if the critical responsibilities will truly be retained elsewhere within the Defense Department. However, maintaining important functions and moving them elsewhere within the department could reduce the potential projected savings.

#### **Reform Package #2: Implement and expand select reforms recommended by the Fiscal Commission co-chairmen.**

In November 2010, Alan Simpson and Erskine Bowles, co-chairmen of the National Commission on Fiscal Responsibility and Reform, presented a package of deficit reduction proposals, including defense cuts of more than \$100 billion in the FY 2015 budget and cumulative cuts accounting for even more from within the defense budget.<sup>28</sup> Their draft plan begins by recommending that Congress apply all savings achieved through Secretary Gates's efficiencies initiatives to deficit reduction. However, the secretary has motivated the services to become more efficient in part by allowing them to use the savings that they generate to fund their own priority programs. Removing the reward for efficiency would likely discourage implementation of efficiency reforms.

Some of the co-chairmen's other recommendations—including reducing overall procurement by 15 percent, canceling the V-22 Osprey, terminating

26. Daggett, "Preliminary Assessment of Efficiency Initiatives," p. 3.

27. *Ibid.*, p. 4.

28. Simpson and Bowles, "\$200 Billion in Illustrative Savings."

the Expeditionary Fighting Vehicle, canceling the Marine Corps version of the F-35 Joint Strike Fighter, cutting Air Force and Navy F-35 procurement by half, and reducing the number of military personnel stationed in Europe and Asia by one-third—would directly affect U.S. military strength. Each of these measures would threaten vital military capabilities, jeopardize America's current defense strategy, and contribute to weakening America's role in the world.

Congress should pursue only those recommendations that do not pose direct or immediately identifiable risks to America's defense posture. It should reject those recommendations that would further atrophy core military capabilities or harm readiness. Congress should consider some of the commission co-chairmen's proposals, including the following recommendations, which seem most practical and achievable:

- **Freeze federal salaries, bonuses, and other compensation for the DOD civilian workforce for three years.** The federal government "will spend an estimated \$180 billion on wages and salaries for civilian federal employees in fiscal year 2011, and another \$64 billion on benefits—a total compensation of \$244 billion."<sup>29</sup> By including DOD civilian employees in the President's recent proposal to freeze federal workforce pay, President Obama predicts a total government-wide savings of \$5 billion through 2012. Over a longer period, the DOD civilian workforce pay freeze would generate an estimated \$5.3 billion in defense budget savings in FY 2015 for a five-year total of \$15.5 billion.<sup>30</sup>

- **Replace military personnel performing commercial activities with DOD civilians.** According to the Defense Business Board, about 340,000 military personnel serve in commercial activities that are not inherently governmental—such as trash collection, fire prevention, supply, transportation, and communications services—at a cost of over \$54 billion per year.<sup>31</sup> The board suggests that the military performs too many "non-military" functions and should eliminate some of them or reassign them to civilian functions. The commission co-chairmen proposed eliminating 88,000 military positions in which servicemembers are performing commercial activities and replacing them with 62,000 lower-cost civilian billets at an estimated savings of \$5.4 billion in FY 2015.<sup>32</sup>

The Congressional Budget Office (CBO) has outlined similar findings.<sup>33</sup> However, Congress should take care when implementing such recommendations to ensure that the overall result improves the military's "tooth-to-tail" ratio and reduces or eliminates overhead from combat or direct support positions.

The U.S. Navy provides a useful case study for Congress. A 2006 study by the Center for Naval Analyses (CNA) indicated that the Navy could save \$750 million annually and reduce Navy end strength by about 21,700 by shifting some military functions to civilians, such as basic supply, food service, and ships' services on all surface combatants. The Navy could save \$390 million annually by applying the same model to aircraft carriers. Further, the Navy could save \$280 million per year by

29. James Sherk, "How Americans Are Overtaxed to Overpay the Civil Service," Heritage Foundation *Center for Data Analysis Report* No. CDA10-05, July 7, 2010, at <http://www.heritage.org/Research/Reports/2010/07/Inflated-Federal-Pay-How-Americans-Are-Overtaxed-to-Overpay-the-Civil-Service>. See also U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2011*, p. 110, Table 10-3, at [http://www.whitehouse.gov/omb/budget/Analytical\\_Perspectives](http://www.whitehouse.gov/omb/budget/Analytical_Perspectives) (December 28, 2010). Figures exclude wages and salaries for uniformed military personnel and postal employees.

30. Simpson and Bowles, "\$200 Billion in Illustrative Savings," p. 17.

31. U.S. Department of Defense, Defense Business Board, "Reducing Overhead and Improving Business Operations: Initial Observations," July 22, 2010, at <http://www.globalsecurity.org/military/library/report/2010/100722-dbb-otg-report.pdf> (December 28, 2010).

32. Simpson and Bowles, "\$200 Billion in Illustrative Savings," p. 22.

33. Congressional Budget Office, *Budget Options*, Vol. 2, August 2009, p. 27, at <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> (January 3, 2011).

**Heritage Defense Efficiency Reform Package: Part 2**

Select Fiscal Commission Reforms	Estimated Savings in FY 2015
Freeze federal salaries, bonuses, and other compensation for the DOD civilian workforce for three years	\$5.3 billion
Replace military personnel performing commercial activities with civilians	\$5.4 billion
Expand proposal to civilianize commercial activities by more aggressively implementing across the services	\$12 billion–\$22.4 billion
Reduce spending on base support	\$2 billion
Reduce spending on facilities maintenance	\$1.4 billion
<b>Total Estimated Savings in FY 2015</b>	<b>\$26.1 billion–\$36.5 billion</b>

Sources: National Commission on Fiscal Responsibility and Reform, "\$200 Billion in Illustrative Savings," November 12, 2010, pp. 17 and 22–23, at [http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative\\_List\\_11.10.2010.pdf](http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf) (December 4, 2010), and Heritage Foundation calculations. For more details, see Appendix D.

Table 2 • B 2507  heritage.org

partially "de-crewing" surface ships during long overhauls and by contracting out select functions.<sup>34</sup>

In addition, the CNA projects that the Navy could save \$100 million annually, largely from in-house training costs, by converting 5,415 medical billets to civilian jobs. Reducing the number of medical residents and using contractor physicians instead could save an additional \$250 million annually.

Beyond altering the composition of ship crews and medical staff, the CNA recommends that the Navy change how it conducts business by applying civilian staffing practices to military crews. For example, the Navy could save \$410 million annually by reducing ship and shore manning by using more experienced, skilled, and specialized sailors and officers, encouraging sailors to lengthen their tours of duty, and reducing the time that technically trained sailors and aviators are assigned to jobs and functions outside their training. Employing a smaller, partially civilian staff would allow the Navy to reduce the number of military billets significantly. Overall, the CNA projects that these manning practices could cut the Navy's personnel compensation costs by 7 percent to 13 percent (\$3.7 billion to \$6.7 billion).

Given the CNA's analysis, the Fiscal Commission's savings estimate of \$5.4 billion in FY 2015 across all services may prove too conservative. If Congress aggressively implemented these reforms identified in the Navy and applied similar manning strategies in the Army and Air Force, savings could be much higher. In the military, direct personnel compensation totaled approximately \$156 billion in FY 2010. Achieving a 7 percent to 13 percent savings rate across all services would save between \$12 billion and \$22.4 billion in FY 2015. Congress must take exceptional care to ensure this not an arbitrary back door end strength cut.

The commission co-chairmen also proposed:

- **Reducing spending on base support.** The DOD could save up to \$2 billion in FY 2015 by reducing spending on base support activities, such as cutting grass and providing electricity, and by setting common pay standards and encouraging the services to regionalize and use civilians to provide some base support services. The costs vary greatly across the services, and standardization among the military departments is already underway within the Pentagon.<sup>35</sup> Congress will need to understand the

34. Choi et al., "Improving Navy's Buying Power Through Cost Savings."  
35. Simpson and Bowles, "\$200 Billion in Illustrative Savings," pp. 22–23.

efforts currently underway before attempting to reduce funding further.

- **Reducing spending on facilities maintenance.** The co-chairmen also believe that reducing the budget for facilities maintenance by \$1.4 billion in FY 2015 is warranted given that many bases have closed and the overall square footage of military installations has decreased substantially, but spending has grown by 18 percent in real terms.<sup>36</sup> Congress will need to examine these assumptions and ask the Department of Defense to determine whether they are reasonable and whether reducing spending would have a detrimental affect on military installations or the morale of uniformed personnel and their families.

**Reform Package #3: Expand the use of public-private partnerships for performance-based logistics.**

The U.S. military can and should operate more efficiently. As combat capabilities grow, the Defense Department's vast logistics system must adapt.

Performance-based logistics is an alternative approach aimed at improving the overall effectiveness of massive defense logistics. It is based on forging partnerships between DOD employees and defense industry staff at the military's logistical centers in the United States and abroad. The goal is to organize the logistics system around increasing combat capabilities, thereby generating large savings from increased efficiency. The system has been implemented successfully at select military depots, but Congress has limited its rollout. A recent Heritage Foundation study examines the benefits of performance-based logistics and explains why and how Congress should support this more effective and efficient military logistical system.<sup>37</sup>

A 2009 Aerospace Industries Association (AIA) report estimates that implementing performance-based logistics could save \$25 billion to \$30 billion per year in five areas:

- **Life cycle product support.** Life cycle product support covers the logistics needed to maintain weapons and equipment while in use. This includes repairs, refurbishments, modifications, and upgrades. Performance-based logistics would expand the development of public-private partnerships in this area. According to the AIA, this could save between \$16 billion and \$21 billion annually.
- **Management of commodities.** Performance-based logistics improves the efficiency of the commodities supply network by ensuring rapid delivery of needed commodities and reducing storage and inventory costs, saving between \$2.8 billion and \$3.7 billion annually.
- **Mobility assets and supporting infrastructure.** Performance-based logistics would copy the best transportation practices of the commercial sector to support logistics and optimize the distribution process. This could save between \$1.1 billion and \$1.5 billion annually.
- **Theater services.** Theater services primarily support combat and humanitarian missions in regions around the world. These include opening ports; constructing, staffing, and operating in-theater facilities, such as storage and delivery depots; and distributing weapons and materiel to intermediate locations. Performance-based logistics would improve preplanning steps with host countries and contractors, most importantly the use of airfields and ports, and rely more heavily on contractors under prenegotiated contracts. This could save between \$2.4 billion and \$3.2 billion annually.
- **Logistics information systems.** A system as far-flung and complex as the military's logistical system could operate better and more efficiently when supported by state-of-the-art information technology and modern supply chain systems. This could save between \$1.9 billion and \$2.5 billion annually. If implemented, it could realize additional savings by eliminating various costs

36. *Ibid.*, p. 23.

37. Baker Spring, "Performance-Based Logistics: Making the Military More Efficient," Heritage Foundation Backgrounder No. 2411, May 6, 2010, at <http://www.heritage.org/Research/Reports/2010/05/Performance-Based-Logistics-Making-the-Military-More-Efficient>.

**Heritage Defense Efficiency Reform Package: Part 3**

Develop Public-Private Partnerships for Performance-Based Logistics	Estimated Annual Savings
Expand public-private partnerships in life cycle product support	\$16 billion-\$21 billion
Improve the efficiency of the commodities supply network	\$2.8 billion-\$3.7 billion
Apply commercial-sector best practices to commodities transportation system	\$1.1 billion-\$1.5 billion
Preplan theater services, relying more heavily on contractors under pre-negotiated contracts	\$2.4 billion-\$3.2 billion
Modernize the IT structure supporting the logistical system	\$1.9 billion-\$2.5 billion
<b>Total Estimated Annual Savings</b>	<b>\$24.2 billion-\$31.9 billion</b>

Source: Aerospace Industries Association, "Modernizing Defense Logistics," June 25, 2009, at [http://www.aia-aerospace.org/assets/paper\\_v1\\_0\\_6\\_25\\_09\\_rrt.pdf](http://www.aia-aerospace.org/assets/paper_v1_0_6_25_09_rrt.pdf) (December 7, 2010).

Table 3 • B 2507 heritage.org

associated with maintaining the Pentagon's "Cold War logistics information infrastructure."<sup>38</sup>

Congress should promote transparency and accountability offered through performance-based logistics with "clear data reporting, performance metrics and incentives to drive positive performance." One example is the C-17 program contract "where the cost in dollars per flight hour was reduced by 28 percent over a five-year period ending in fiscal 2009."<sup>39</sup>

However, for performance-based logistics to continue to succeed, Congress will need to support additional contracts by helping the Pentagon to identify opportunities to expand its application and by establishing a pilot program to identify the barriers to expanded public-private logistical partnerships.

**Reform Package #4: Modernize base operations and the maintenance and supply systems.**

The military could realize significant savings by modernizing base operations and its maintenance and supply systems. Specifically, Congress should consider:

- **Consolidating DOD retail activities.** The DOD currently operates four retail systems: commissaries for groceries and three separate exchanges for retail goods. The Fiscal Commission co-chairmen recommended implementing a CBO recommendation to consolidate the retail systems into one network and eliminate the \$1.3 billion annual appropriation to the commissary system. Consolidating the exchanges would require upfront investments but would eventually save about \$200 million annually.

Overall, the CBO estimates that canceling the subsidy and consolidating the exchanges and commissaries would save \$1.7 billion per year, but it would also increase military families' annual grocery expenses by about \$300.<sup>40</sup> The DOD could more than offset this increase by using a portion of the \$1.7 billion to give military families an annual \$600 grocery allowance.<sup>41</sup> The remaining \$830 million would represent annual savings for the DOD.

According to the CBO, one advantage of the grocery allowance is that "it could be targeted to

38. Aerospace Industries Association, "Modernizing Defense Logistics," June 25, 2009, p. 5, at [http://www.aia-aerospace.org/assets/paper\\_v1\\_0\\_6\\_25\\_09\\_rrt.pdf](http://www.aia-aerospace.org/assets/paper_v1_0_6_25_09_rrt.pdf) (December 28, 2010).

39. Marion C. Blakey, "DOD Efficiency: Charting a Course to Savings," remarks at the Air Force Association, September 15, 2010, p. 4, at [http://www.aia-aerospace.org/assets/speech\\_09152010.pdf](http://www.aia-aerospace.org/assets/speech_09152010.pdf) (December 28, 2010).

40. Congressional Budget Office, *Budget Options*, pp. 28 and 29-30.

41. Simpson and Bowles, "\$200 Billion in Illustrative Savings," p. 23.

**Heritage Defense Efficiency Reform Package: Part 4**

Modernization of Base Operations and Maintenance and Supply Systems	Estimate Annual Savings
Consolidate DOD retail systems and give military families a \$600 annual grocery allowance	\$830 million
Change the depot pricing structure for equipment repairs to a dual structure	\$250 million
Ease restrictions on contracting for depot maintenance	\$390 million
<b>Total Estimated Annual Savings</b>	<b>\$1.5 billion</b>

Sources: Todd Harrison, "The Fiscal Commission and Defense: Strategy in an Age of Austerity," Center for Strategic and Budgetary Assessments *Backgrounder*, November 2010, p. 2, at [http://www.csbaonline.org/Publications/PubLibrary/B.20101123.The\\_Fiscal\\_Commiss/B.20101123.The\\_Fiscal\\_Commiss.pdf](http://www.csbaonline.org/Publications/PubLibrary/B.20101123.The_Fiscal_Commiss/B.20101123.The_Fiscal_Commiss.pdf) (December 4, 2010); Congressional Budget Office, *Budget Options*, Vol. 2, August 2009, pp. 32–33, at <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> (December 7, 2010); 10 U.S. Code § 2466; and Heritage Foundation calculations.

Table 4 • B 2507  heritage.org

specific pay grades or groups, with larger allowances given to enhance retention or to benefit junior enlisted members with large families, for example."<sup>42</sup> One disadvantage is that military retirees who shop at exchanges on military bases could see the costs of their groceries increase by about \$200 per year, yet they would not be receiving the grocery allowance. Congress would need to examine this option for savings carefully and explore ways to offset the adverse effects on military retirees.

- **Reforming the maintenance system.** According to the same CBO report, the DOD could save \$250 million annually by changing the depot pricing structure for equipment repairs.<sup>43</sup> This would involve changing the pricing structure at defense depots to a two-part structure, similar to that used by utility companies. Under the new pricing policy, depots would levy an annual flat fee for overhead costs but charge unit commanders for the incremental costs of repairs upon each visit. As a secondary effect, this would reduce the cost of each additional visit, with savings compounding over time, and give unit commanders greater incentives to send equipment to central maintenance depots instead of using their own

facilities, which costs the DOD more in the long run. Allowing depots to charge for the costs associated with a specific maintenance activity could also encourage commanders to use the depots even more, potentially saving an additional \$1 billion in outlays over five years.<sup>44</sup>

- **Relaxing the restrictions on contracting for depot maintenance.** The CBO estimates that this would save \$390 million annually.<sup>45</sup> Currently, the "50/50 rule" specified by law allows the DOD to contract out only half of its depot maintenance appropriations.<sup>46</sup> Relaxing the 50/50 rule to a 60/40 split would allow private-sector bidders to compete for more of the work, saving at least 20 percent of the costs. However, Congress needs to evaluate this proposal carefully to ensure that depot maintenance workers are retained at adequate levels within operational units. Further, Congress should not expect to realize these savings in the near term.

**Reform Package #5: Reduce wear and tear on military hardware and increase the use of multi-year procurement contracts and block upgrades.**

By making slight adjustments in how hardware is used and maintained, the military could reduce

42. Congressional Budget Office, *Budget Options*, p. 30.

43. *Ibid.*, pp. 32–33.

44. *Ibid.*

45. *Ibid.*

46. 10 U.S. Code § 2466.

costs while improving readiness. Congress and the DOD should:

- **Fully fund corrosion prevention and control activities.** Corrosion is defined as the unintended deterioration of a material due to interaction with the environment. Rusting, pitting, galvanic reaction, mineral buildup, degradation due to sun or rain exposure, and mold and other forms of organic decay are types of corrosion. Corrosion can negatively affect military readiness by taking critical systems out of service and by degrading equipment, sometimes even causing fatal accidents. Many analysts believe the military could generate significant efficiencies by slowing the corrosion of major equipment and platforms, thereby allowing each plane or ship to stay in service longer and saving money by delaying the need to buy new equipment.

In a July 2009 report, the Pentagon estimated that corrosion costs the military more than \$22 billion each year.<sup>47</sup> In its corrosion funding report, the Corrosion Office estimated that corrosion prevention and control (CPC) requirements for FY 2011 totaled \$47 million, but the FY 2011 budget request identified only \$12 million for CPC. Based on the report, the DOD's unfunded CPC requirements could be as high as \$35 million. The Pentagon could feasibly reduce wear by fully funding CPC activities, which would save \$1.4 billion annually, according to the GAO.<sup>48</sup>

- **Adopt standards for less-taxing platform use.** The services could also reduce wear and tear by changing how they employ certain equipment. For example, the CNA suggests that the Navy

could save \$200 million and reduce the rate of aircraft procurement if it reduced the rate of wear on aircraft by restricting some transport activities to simpler forms of flying and by shifting some air-to-air combat training hours to attack training.<sup>49</sup> The Navy could hedge against the risk posed by modest reductions in air-to-air training time by training some pilots to specialize in air-to-air combat.

The CNA report suggests that the Navy could save an additional \$300 million annually by reducing flight hours in early training.<sup>50</sup> The Navy records three different categories of flight hours: hours required to achieve readiness for surge and deployment, hours required for operations, and hours that fall in neither category but are mandated by minimum flight hour requirements. Unless the third category produces some otherwise unaccounted benefit, the Navy conceivably could reduce a portion of the minimum flight hour requirements, which would reduce wear on Navy aircraft and reduce maintenance and recapitalization costs. In total, these two measures would save \$500 million annually, which is more than 1 percent of total Navy procurement costs.<sup>51</sup>

If the DOD can achieve the same rate of savings in the Army and Air Force through similar methods, the Army would save \$240 million, and the Air Force would save \$420 million,<sup>52</sup> for a total DOD savings of \$1.16 billion per year.

- **Increase the use of multiyear procurement (MYP) contracts.** MYP is a special contracting method, authorized under current law, that allows the government to enter into procurement contracts

47. Eric Herzberg, "The Annual Cost of Corrosion for DoD," paper presented at the 2009 DoD Corrosion Conference, at <https://www.cordefense.org/Technical%20Papers/THE%20ANNUAL%20COST%20OF%20CORROSION%20FOR%20DOD.pdf> (December 28, 2010).

48. U.S. Government Accountability Office, "Observations on DOD and Service Fiscal Year 2011 Requirements for Corrosion Prevention and Control," briefing for the Subcommittee on Defense, Committee on Appropriations, U.S. Senate, GAO-10-608R, April 2, 2010, at <http://www.gao.gov/new.items/d10608r.pdf> (December 28, 2010).

49. Choi *et al.*, "Improving Navy's Buying Power Through Cost Savings," pp. 32–34.

50. *Ibid.*

51. U.S. Department of Defense, "Fiscal Year 2011 Budget Request: Overview," p. 8-2, at [http://comptroller.defense.gov/defbudget/fy2011/FY2011\\_Budget\\_Request\\_Overview\\_Book.pdf](http://comptroller.defense.gov/defbudget/fy2011/FY2011_Budget_Request_Overview_Book.pdf) (January 3, 2011).

52. Heritage Foundation calculations based on procurement numbers in *ibid.*

**Heritage Defense Efficiency Reform Package: Part 5**

Reduce Wear and Tear on Military Hardware and Increase Use of Multiyear Contracts	Estimate Annual Savings
Fully fund corrosion prevention and control activities.	\$1.4 billion
Reduce maintenance and recapitalization costs by introducing less taxing methods of platform use in all services	\$1.16 billion
Aggressively expand the use of multiyear procurement contracting	\$9.6 billion
Increase the use of block upgrades	TBD
<b>Total Estimated Annual Savings</b>	<b>\$12.2 billion</b>

Sources: U.S. Government Accountability Office, "Observations on DOD and Service Fiscal Year 2011 Requirements for Corrosion Prevention and Control," briefing for the Subcommittee on Defense, Committee on Appropriations, U.S. Senate, April 2, 2010, at <http://www.gao.gov/new.items/d10608r.pdf> (December 4, 2010); Aerospace Industries Association, "Ways to Reduce Costs Immediately," August 17, 2010, at [http://www.aia-aerospace.org/assets/aia\\_dod\\_10\\_efficiencies\\_8-17.pdf](http://www.aia-aerospace.org/assets/aia_dod_10_efficiencies_8-17.pdf) (December 4, 2010); and Heritage Foundation calculations.

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for up to five years.<sup>53</sup> Although the government does not appropriate all the money for a program at once, it commits to purchase all of the items specified when the contract is signed, including those to be produced and paid for in subsequent years.

Multiyear contracting can reduce unit costs and sustain a healthy industrial base by allowing contractors to make up-front investments and plan for more efficient production. According to a recent AIA study, multiyear procurement allows industry to "strike more favorable deals with subcontractors and encourages industry to make investments that reduce future costs." It also reduces the "[a]dministrative costs for annual proposals, audits, fact finding, and negotiations."<sup>54</sup>

Recently, Congress wisely approved a multiyear contract to purchase 124 F/A-18s and E/A-18s from 2011 to 2013. According to Under Secretary of Defense for Acquisition, Technology, and Logistics Ashton Carter, this MYP contract will "yield over \$600 million in savings."<sup>55</sup> The pur-

chase, originally projected to cost \$8.5 billion, is now expected to cost \$7.9 billion—a savings of about 7 percent. This savings rate is in line with recent trends. The median MYP savings rate for aircraft candidate programs was 10.7 percent in the 1980s and 7.2 percent in the 1990s and 2000s.<sup>56</sup>

Expanded use of MYP contracts could dramatically improve the efficiency of defense acquisition. Not all DOD programs will be able to save 10 percent, but even a 5 percent reduction in a multibillion-dollar purchase would save hundreds of millions of dollars. Congress should encourage more widespread use of MYP contracts but ensure that the DOD provides appropriate oversight and guidance. Based on the performance of MYP contracts to date, savings could reach an estimated 7 percent of the procurement budget (\$137 billion in FY 2011<sup>57</sup>), saving approximately \$9.6 billion per year.

- *Increase the use of block upgrades.* Block upgrades are used periodically to introduce multiple product improvements into major weapons

53. 10 U.S. Code § 2306b.

54. Aerospace Industries Association, "Ways to Reduce Costs Immediately," August 17, 2010, at [http://www.aia-aerospace.org/assets/aia\\_dod\\_10\\_efficiencies\\_8-17.pdf](http://www.aia-aerospace.org/assets/aia_dod_10_efficiencies_8-17.pdf) (December 28, 2010).

55. Blakey, "DOD Efficiency," p. 4.

56. U.S. Government Accountability Office, *Defense Acquisitions: DOD's Practices and Processes for Multiyear Procurement Should Be Improved*, GAO-08-298, February 2008, p. 4, Table 3, at <http://www.gao.gov/new.items/d08298.pdf> (December 28, 2010).

systems. Although new program starts are necessary to accommodate changing military requirements, it is often “more efficient and cost-effective to upgrade existing systems rather than starting fresh with an entirely new program.”<sup>58</sup>

Through the block upgrade process, multiple new capabilities are developed in parallel and then inserted into a new block simultaneously. As a result, all products within a given block have basically the same configuration. This reduces the requirements for training and equipment maintenance and allows for more predictable and efficient outlays. Greater predictability also allows defense companies to match their workforces to their expected workloads, indirectly reducing costs to the government when they bid on contracts.

Block upgrades have been used on programs ranging from the C-17 and F-16 to the Virginia-class submarine and Aegis ballistic missile defense systems. According to the AIA, “programs like the F-16 and Virginia-class submarine have proven that the use of block upgrades—which reduce risk—promotes cost efficiencies.”<sup>59</sup> Increasing the use of block upgrades could save billions of dollars each year. Congress should demand additional analysis to establish a more concrete savings estimate.

### Conclusion

Right now, a vast number of reforms are taking place within the Department of Defense, and many more will be debated in the 112th Congress. As Congress considers the panoply of proposals, Members should focus on those that promise to provide achievable savings and to strengthen the DOD’s abilities to fulfill its core defense functions rather

than those that would decimate the military’s building-block capabilities and undermine the military’s ability to support the broader national security strategy.

None of the reform packages proposed so far is ideal, but Congress can design a robust reform, efficiency, and savings agenda by picking and choosing the best reforms and expanding the most successful ones. Finally, by allowing the military to reinvest all of the identified savings to meet current and future needs, Congress will save the taxpayers money and bolster national security in the long run.

As Congress reviews these recommendations, Members should heed the warning offered by Brookings Institution defense expert Michael O’Hanlon that cutting defense is “not an inherent good” but rather “a process of taking calculated risk in military accounts” for the sake of improving government stewardship of taxpayer dollars, shoring up America’s fiscal position, bolstering America’s economic strength, and enhancing national security over the long term.<sup>60</sup> The defense reforms discussed in this paper should be implemented incrementally, only after review, and with the utmost care. Congress should also solicit the input of those most directly affected: those in uniform, their families, and DOD civilians, retirees, and veterans. DOD leaders should monitor the results and mitigate any unforeseen risks at each step of implementation.

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57. U.S. Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2011* (Washington, D.C.: U.S. Government Printing Office, 2010), Table 5.1, at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/hist.pdf> (December 28, 2010).

58. Aerospace Industries Association, “U.S. Defense Modernization: Today’s Choices for Tomorrow’s Readiness,” August 2008, p. 37, at [http://www.aia-aerospace.org/assets/report\\_modernization\\_aug08.pdf](http://www.aia-aerospace.org/assets/report_modernization_aug08.pdf) (December 27, 2010).

59. Blakey, “DOD Efficiency,” p. 4.

60. O’Hanlon, “Defense Budget and American Power.”

**APPENDIX A**  
**MAJOR DEFENSE CUTS PROPOSED IN THE PRESIDENT'S FY 2010 BUDGET REQUEST**

Proposed Cuts <sup>61</sup>	Projected Savings
Terminate C-17 production and shut down the production line.	\$3 billion per year
Terminate the Air Force Combat Search and Rescue (CSAR-X) helicopter program.	\$11.5 billion in total program costs
Terminate the F-22 program after production of 187 aircraft.	\$3.5 billion per year
Eliminate the Future Combat Systems (FCS) manned ground vehicles.	\$22.9 billion in program costs
Cancel funding for the alternate engine program for the Joint Strike Fighter (JSF).	\$1 billion in the near term
Terminate the Multiple Kill Vehicle (MKV).	\$4 billion between FY 2010 and FY 2015
Defund the Next Generation Bomber program and end plans to develop a new long-range bomber for deployment in 2018.	Several hundred million dollars between FY 2010 and FY 2013
Terminate the VH-71 Presidential Helicopter replacement program and start a new replacement program.	\$13 billion in net program costs
Terminate the Air Force's Transformational Satellite (TSAT) program.	\$1.5 billion to \$2.5 billion between FY 2010 and FY 2015
Terminate the second Airborne Laser (ABL) prototype.	Unknown
Extend construction of the aircraft carrier CVN-79 by one year from 2012 to 2013 and reduce advance procurement funding for the carrier.	Unknown
Reduce spending on contractor services.	\$0.9 billion in net program costs
Reduce the planned number of deployed Ground-Based Midcourse Defense interceptors from 44 to 30.	Unknown
Delay construction of the Transport Dock and Mobile Landing Platform Ship (LPD-17) by one year.	\$3 billion in FY 2010
Delay the Next Generation Cruiser CG(X) beyond 2015 and cancel plans to procure the first CG(X) in 2011.	\$150 million in FY 2010
Reduce spending on military recruiting and retention.	\$800 million in FY 2010

61. U.S. Department of Defense, "Overview of the DOD Fiscal 2010 Budget Proposal," at <http://www.defense.gov/news/2010%20Budget%20Proposal.pdf> (January 4, 2011), and U.S. Department of Defense, Office of the Under Secretary of Defense (Comptroller), "DoD Request," Web site, at <http://comptroller.defense.gov/Budget2010.html> (January 4, 2011).

For the most part, Congress approved President Obama's FY 2010 defense budget request. However, it made several significant changes. Specifically, Congress added:

- \$2.5 billion to purchase 10 additional C-17s and to keep the production line open for one additional year,
- \$465 million to continue development and initial procurement of the alternative engine for the JSF,
- \$1.7 billion to buy a second DDG-51 destroyer,
- \$1.5 billion to buy equipment for the National Guard and service reserves,
- \$50 million to increase ground-based missile interceptor production,
- \$57.6 million for six additional Standard Missile 3 block 1 interceptors,
- \$35 million in development money for future models of Standard Missiles,
- \$41 million in advance procurement funding for THAAD missile radars,
- \$82.8 million for a program with Israel to develop short-range Arrow interceptors, and
- \$44.8 million for development of the VH-71 Presidential Helicopter.<sup>62</sup>

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62. See press release, "Summary: FY 2011 Department of Defense Appropriations Bill," Committee on Appropriations, U.S. Senate, September 14, 2010, at <http://appropriations.senate.gov/news.cfm?method=news.view&id=5d9a8abc-c3ee-4c49-9649-1f1311286566> (December 4, 2010), and Committee on Appropriations, U.S. House of Representatives, "Summary: FY2010 Defense Appropriations," December 15, 2009, at [http://appropriations.house.gov/index.php?option=com\\_content&view=article&id=290%3Afy2010-defense-appropriations-bill-summary&catid=55&Itemid=18](http://appropriations.house.gov/index.php?option=com_content&view=article&id=290%3Afy2010-defense-appropriations-bill-summary&catid=55&Itemid=18) (December 28, 2010).

**APPENDIX B  
DEFENSE CUTS PROPOSED IN THE PRESIDENT'S FY 2011 BUDGET REQUEST**

<b>Proposed Cuts<sup>63</sup></b>	<b>Projected Savings</b>
Terminate C-17 production and shut down the production line.	\$2.5 billion in FY 2011
Terminate the EP-X Manned Airborne Intelligence, Surveillance and Reconnaissance Aircraft.	\$12 million in FY 2011
Terminate the JSF alternate engine program.	\$465 million in FY 2011
Terminate the Next Generation Cruiser CG(X) program.	\$46 million in FY 2011
Terminate the Net Enabled Command Capability (NECC) program.	\$9 million in FY 2011
Terminate the Third Generation Infrared Surveillance (3GIRS) program.	\$73 million in FY 2011
Delay procurement of the Command Ship Replacement (LCC-R) beyond 2015.	\$3.8 billion between FY 2011 and FY 2015
Delay procurement of the Expeditionary Fighting Vehicle (EFV) by one year.	\$50 million in FY 2011
Tailor cell phone calling plans for Air Force personnel to actual usage.	\$10.4 million between FY 2011 and FY 2014
Expand the effort to validate former soldiers' unemployment compensation requests.	\$15 million per year; \$76 million between FY 2010 and FY 2014
Streamline administrative support on Navy ships and simplify the detachment process using electronic personnel records.	Unknown

63. U.S. Department of Defense, "Fiscal Year 2011 Budget Request."

**APPENDIX C  
DEFENSE EFFICIENCIES INITIATIVES PROPOSED BY SECRETARY GATES**

Defense Efficiencies Initiatives <sup>64</sup>	CRS Savings Estimates
Reduce funding for support contractors by 10 percent per year for each of the next three years. Stop automatically replacing departing contractors with full-time personnel.	\$600 million in FY 2011 \$1.8 billion in FY 2012 \$3.0 billion in FY 2013 \$3.6 billion per year in subsequent years
Freeze the number of OSD, Defense Agency, and combatant command positions at the FY 2010 levels for the next three years. Except for changes planned for FY 2010, create no more full-time positions in these organizations to replace contractors, with some exceptions in critical areas such as the acquisition workforce.	\$2.4 billion per year
Conduct a clean-sheet review to determine what military personnel should be doing, where, and at what ranks in keeping with the DOD's most critical priorities with the reviews due by November 15, 2010.	
Freeze the number of senior civilians, general and flag officer, and PAS positions at FY 2010 levels.	\$30 million per year
Authorize each military department to consider consolidation or closure of excess bases and other facilities.	
Seek ideas, suggestions, and proposals from outside normal official channels, including think tanks, industry, and the DOD's external boards.	
Launch an online contest within the DOD to solicit and reward creative ideas to save money and use resources more effectively.	
Conduct a series of assessments of DOD organization and operations to inform the FY 2012 budget request.	
Consolidate IT assets to take advantage of economies of scale, thereby reducing acquisition, sustainment, and manpower costs.	Unknown
Freeze the number of DOD-required oversight reports and immediately cut funding for advisory studies by 25 percent.	A percentage of \$84 million
Eliminate unnecessary boards and commissions and cut overall funding available for studies tasked by the remaining boards and commissions by 25 percent in FY 2011.	A percentage of \$75 million, the annual cost of the 65 boards and commissions funded by OSD
Immediately reduce funding for advisory and assistance contractors in intelligence by 10 percent.	\$3.2 billion in FY 2011
Freeze the number of senior executive positions in defense intelligence organizations. Eliminate needless duplication in the department's intelligence missions, organizations, and relationships.	A percentage of \$75 billion, the estimated cost of intelligence activities

(continued on next page)

Defense Efficiencies Initiatives <sup>64</sup>	CRS Savings Estimates
Eliminate organizations that perform duplicative functions or have outlived their original purposes, including the Office of the Assistant Secretary of Defense for Networks and Information Integration and the Joint Staff's J6 function. Assign the department's Chief Information Officer function to the Defense Information Systems Agency.	Unknown
Eliminate the Business Transformation Agency and shift its responsibilities to the Deputy Chief Management Officer.	\$143.4 million to \$340 million
Close the Joint Forces Command and assign its management and sourcing functions to the Joint Staff.	\$240 million to \$703 million

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64. Gates, "Defense Efficiencies Initiative."

**APPENDIX D**  
**RECOMMENDATIONS BY THE CO-CHAIRMEN OF THE FISCAL COMMISSION**

Proposals <sup>65</sup>	Projected Savings in FY 2015
Apply the overhead savings promised by Secretary Gates to deficit reduction.	\$28 billion
Freeze federal salaries, bonuses, and other compensation for the DOD civilian workforce for three years.	\$5.3 billion
Freeze noncombat military pay at 2011 levels for three years.	\$9.2 billion
Double Secretary Gates's cuts in defense contracting.	\$5.4 billion
Reduce procurement by 15 percent:	\$20 billion
• End the V-22 Osprey.	• \$1.1 billion
• Cancel the Expeditionary Fighting Vehicle.	• \$650 million
• Substitute F-16s and F/A-18Es for half of the Air Force's and Navy's planned F-35 procurement.	• \$2.3 billion
• Cancel the Marine Corps version of the F-35.	• \$3.9 billion
• Cancel the Future Maritime Prepositioning Force.	• \$1.0 billion
• Cancel the new Joint Light Tactical Vehicle, Ground Combat Vehicle, and Joint Tactical Radio.	• \$2.3 billion
• Reduce planned levels for "Other Procurement."	• \$8.5 billion
Reduce military personnel stationed at overseas bases in Europe and Asia by one-third.	\$8.5 billion
Modernize TRICARE, DOD health.	\$6 billion
Replace military personnel performing commercial activities with civilians.	\$5.4 billion
Reduce spending on research, development, testing, and evaluation by 10 percent.	\$7 billion
Reduce spending on base support.	\$2 billion
Reduce spending on facilities maintenance.	\$1.4 billion
Consolidate DOD retail activities.	\$800 million
Integrate children of military personnel into local U.S. schools.	\$1.1 billion

65. Simpson and Bowles, "\$200 Billion in Illustrative Savings."

# BACKGROUND

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## Improving Health Care and Retirement for Military Service Members and Their Families *Baker Spring*

A part of the Heritage plan  
*Saving the*  
 **AMERICAN DREAM**

### Abstract

*The military's health care and retirement systems have serious structural problems. Simply tinkering around the edges will leave military personnel and taxpayers paying more for less service. Instead, as The Heritage Foundation proposes, Congress should transform the military health care and retirement systems into defined-contribution plans that maximize individual choice. This would enable military personnel to tailor their benefits to match their individual circumstances while saving the Department of Defense \$39.424 million in five years.*

**T**he men and women who serve and have served in uniform and their families deserve quality health care and retirement benefits. U.S. service members should not be forced to choose between volunteering and quality health care.

Delivering first-class care, particularly in time of war, is a daunting challenge. Furthermore, care for military members, retirees, and their families should be portable. However, the Pentagon has built a system that is becoming increasingly flawed. At a press conference on January 6, Secretary of Defense Robert Gates admitted that he had no solution for “the department’s unaffordable health costs, and in particular the benefits provided to working-age retirees under the TRICARE program.”<sup>1</sup>

While some argue that increasing military personnel’s contributions and scaling back military health and retirement in the existing systems would be sufficient, more substantial reforms are needed. The Department of Defense (DOD) outlined the increased contributions and reduced benefits approach in its fiscal year (FY) 2012 budget request.<sup>2</sup> As with other federal entitlement programs for health care and retirement, the military clearly cannot provide the

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### TALKING POINTS

- Reforms of the military’s health care and retirement systems must honor the country’s obligation to service members, retirees, and their dependents.
- The military’s health care and retirement systems need to be updated to meet the changing demands for sustaining the all-volunteer force and to free resources to develop new weapons and equipment.
- The military’s compensation system, including health care and retirement benefits, must change to adjust to the increasingly labor market.
- The Heritage Foundation’s *Saving the American Dream* fiscal plan proposes changes in health care coverage and retirement for the American population as a whole.
- As applied to military service members, retirees, and their dependents, the Heritage plan replaces existing defined-benefit plans with defined-contribution plans that maximize choice.
- Current retirement balances must meet military and civilian plans, so special transition arrangements are needed to smooth the transition to the Heritage plan.

promised benefits to its personnel and their dependents.

Pretending that the best approach is to preserve the existing military health care system is wrong. This “less of the same” approach is also an “all pain and no gain” approach for military service members and their families. There is a better way that would offset a portion of the future limits on health care and retirement benefits with selective increases in cash compensation.

This better way is to transform the military health care and retirement systems from the existing defined-benefit structures into a defined-contribution system. Under a defined-contribution approach, military service members and their families have much more flexibility to structure their health care and retirement in ways that best suit their preferences and needs. Ultimately, this approach makes the system fairer, more efficient, and less costly while preserving the military’s ability to recruit and retain high-quality personnel.

The Heritage Foundation’s fiscal plan *Saving the American Dream* would take exactly this approach. It would ensure continued recruitment and retention of top-quality personnel, honor the country’s obligations to members of its armed forces, and use taxpayer resources more efficiently and effectively to address veterans’ concerns and needs.<sup>2</sup> This systemic approach would also free resources for reinvestment

in military modernization, which would achieve a better internal balance in the defense budget between the operational and modernization accounts. These reforms of the military health care and retirement systems could reasonably be expected to achieve \$39,424 million in savings over five years.

### **The Need to Reform Military Benefits**

The Heritage reform plan recognizes that the military provides health care coverage and retirement benefits inefficiently and corrects this by restructuring military health care and retirement coverage as defined-contribution plans as opposed to just tinkering with the existing defined-benefit plans. During the change over to the new system, Congress will need to take into account the unique features of existing military health care and retirement coverage and tailor rules to smooth the transition from the existing structures to the new structures.

In Section 711 of the National Defense Authorization Act for Fiscal Year 2007, Congress recognized this problem in health care coverage and the implication that the military health care system is not sustainable.<sup>3</sup> This law established the DOD Task Force on the Future of Military Health Care.

The core problem is that the military health care system offers military personnel few options for

obtaining health coverage that is tailored to meet their individual circumstances and preferences, and it provides little incentive for them to take responsibility for their own health care needs. As a general rule, a system that assumes that all of its participants have largely the same needs will inevitably be wasteful because it provides the range of benefits provided to everyone, whether or not they are needed or desired, while refusing to tailor coverage to individual preferences and needs. By providing health care more efficiently and by taking advantage of a whole-of-life approach to health coverage, tailored approaches can slow the growth in health care outlays by the Department of Defense while continuing to provide quality health care to service members and their dependents.

Congress has demonstrated less awareness of the inefficiencies in the military retirement system. It provides generous retirement benefits, but in a way that makes only relatively modest contributions to improving recruitment and morale. Its inflexible defined-benefit plan provides service members with few options for tailoring the system to their retirement preferences, particularly for employment beyond active-duty service.

### **The Military Health System**

The Military Health System (MHS), also referred to as the Unified Medical Program, provides

1. Robert Gates, quoted in Donna Miles, “Health Plan to Remain Free for Troops, Officials Emphasize,” U.S. Air Force, January 10, 2011, at <http://www.af.mil/news/story.asp?id=123237418> (November 1, 2011).

2. U.S. Department of Defense, *Fiscal Year 2012 Budget Request: Overview*, February 2011, pp. 3-2-3-4, at [http://comptroller.defense.gov/le/budget/fy2012/fy2012\\_Budget\\_Request\\_Overview\\_Book.pdf](http://comptroller.defense.gov/le/budget/fy2012/fy2012_Budget_Request_Overview_Book.pdf) (March 14, 2011).

3. Stuart M. Butler, Alison Acosta Fraser, and William W. Beach, eds., *Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity*, The Heritage Foundation, 2011, at <http://savingthedream.org/about-the-plan/plan-details/>.

4. Public Law 109-364, § 711.

TABLE 1

**Overview of Savings on Military Health and Retirement**

FIGURES ARE IN MILLIONS OF DOLLARS FOR FISCAL YEARS 2012-2016.

**Net Savings to the O50 Budget Account, With Opt-In Savings**

	2012	2013	2014	2015	2016	5-Year Total
<b>Active Duty Personnel</b>						
Tricare Program Savings	\$180	\$502	\$1,060	\$1,627	\$2,542	\$5,911
Tricare For Life Savings	\$503	\$1,183	\$2,091	\$2,840	\$3,832	\$10,449
Changed Tricare Focus	\$18	\$50	\$106	\$163	\$254	\$591
2% Payraise Cost	-\$37	-\$93	-\$176	-\$253	-\$367	-\$925
<b>Reserve Personnel</b>						
Tricare Program Savings (Reserve Select)	\$25	\$43	\$67	\$88	\$116	\$339
Tricare For Life Savings	\$155	\$364	\$643	\$873	\$1,178	\$3,213
Focus MHS on Military Personnel Care	\$5	\$13	\$25	\$37	\$53	\$133
2% Payraise Cost	-\$5	-\$14	-\$26	-\$38	-\$54	-\$137
Opt-In Savings	\$569	\$539	\$463	\$394	\$265	\$2,231
<b>Subtotal 1—Total Savings</b>	<b>\$1,413</b>	<b>\$2,587</b>	<b>\$4,253</b>	<b>\$5,731</b>	<b>\$7,819</b>	<b>\$21,804</b>

**Retirement Proposal Savings Summary for Department of Defense**

	2012	2013	2014	2015	2016	5-Year Total
<b>Active Duty Personnel</b>						
Cost of 15% Fund Contribution for New Entrants	-\$280	-\$723	-\$1,417	-\$2,112	-\$3,187	-\$7,719
Savings from Eliminating Retirement Accrual (32.7%)	\$611	\$1,576	\$3,089	\$4,604	\$6,948	\$16,828
<b>Reserve Personnel</b>						
Cost of 10% Investment Fund Contribution for New Entrants	-\$28	-\$72	-\$140	-\$209	-\$315	-\$764
Savings from Eliminating Retirement Accrual (24.3%)	\$67	\$174	\$341	\$508	\$766	\$1,856
Change in Indexing of Benefits	\$1,340	\$1,311	\$1,247	\$1,191	\$1,076	\$6,165
<b>Subtotal 2—Total Savings</b>	<b>\$1,710</b>	<b>\$2,266</b>	<b>\$3,120</b>	<b>\$3,982</b>	<b>\$5,288</b>	<b>\$16,366</b>

**Additional Retirement Proposal Savings for DOD Derived from Current Personnel Opting In**

	2012	2013	2014	2015	2016	5-Year Total
<b>Subtotal 3—Savings</b>	<b>\$292</b>	<b>\$291</b>	<b>\$264</b>	<b>\$238</b>	<b>\$170</b>	<b>\$1,254</b>

Sources: Heritage Foundation calculations based on data from the U.S. Department of Defense.

health care to more than 9.5 million beneficiaries worldwide, including active and Reserve military personnel, other uniformed services personnel,<sup>5</sup> military retirees, and their families.<sup>6</sup> The MHS cost nearly \$49 billion in 2010 and employed 135,000 military and civilian personnel to provide health care services.<sup>7</sup>

**MHS PROGRAM COSTS HAVE INCREASED 14 PERCENT IN JUST THREE YEARS, FROM \$43 BILLION IN 2007 TO \$48.9 BILLION IN 2010, LARGELY DUE TO INFLATION AND INCREASED PROGRAM UTILIZATION.**

The FY 2010 DOD report on TRICARE identifies four key mission elements for the program: "(1) maintaining Casualty Care and Humanitarian Assistance, (2) creating and sustaining a Healthy, Fit and Protected Force, (3) promoting Healthy and Resilient Individuals, Families and Communities, and (4) sustaining Education, Research and Performance Improvement."<sup>8</sup>

This report also shows that MHS program costs have increased 14 percent in just three years, from \$43 billion in 2007 to \$48.9 billion in 2010, largely due to inflation and increased program utilization. The costs have also gone from 7 percent to 9.2 percent of the DOD budget. The Congressional Budget Office

has projected that military medical spending will grow by more than 80 percent in real terms by 2024.<sup>9</sup>

### **The Saving the American Dream Plan**

The Heritage Foundation's Saving the American Dream plan provides tremendous advantages to the American people over the current systems for health care coverage and retirement. Among other advantages, it encourages Americans to build wealth, spurs economic growth, and puts the federal government's financial house in order. Military service members and their dependents should have the same opportunity to benefit from these advantages that their civilian and private-sector peers enjoy. The plan achieves this through four major provisions: comprehensive tax reform, tax-deferred savings, a defined-contribution approach to Medicare, and a restructured Social Security program.

**Provision #1: Tax Reform for Obtaining Family Health Coverage.** The Heritage fiscal plan calls for comprehensive tax reform. It replaces the existing Byzantine tax code, including payroll taxes, with a simple flat tax system designed to collect up to 18.5 percent of gross domestic product (GDP). It also fundamentally changes how the federal tax code treats savings and expenditures for health coverage.

These latter provisions of the plan provide all Americans, including military service members and their dependents, with a full array of options for health care coverage. This system permits military service members to exercise greater control of their health care coverage and obtain the coverage that best suits their unique needs and preferences.

The Heritage plan accomplishes this by ending the existing tax exclusion for employee compensation in the form of employer-sponsored health insurance. This means that the value of employer-paid health insurance premiums is included in the employee's total taxable compensation. Today's system excludes employer-sponsored health insurance from income and payroll taxes, effectively giving upper-income workers in high-tax brackets a relatively large tax benefit.

The Heritage plan replaces the health insurance tax exclusion with a uniform, nonrefundable federal tax credit (\$2,000 for an individual and \$3,500 for a couple or family) to assist people in purchasing health insurance. Employers and employees decide whether the employer will continue to buy coverage or the employee will cash out the existing coverage in the form of higher cash income. Either way, the tax break for coverage is changed from an exclusion to a credit.

5. The uniformed services include the Army, Navy, Air Force, Marine Corps, Coast Guard, Public Health Service, and National Oceanographic and Atmospheric Administration.

6. For more information on TRICARE, see Appendix A. For more information on the existing military retirement system, see Appendix B. For a thorough examination of the military health care system, see U.S. Department of Defense, *Task Force on the Future of Military Health Care: Final Report*, December 2007, at [http://www.dcoe.health.mil/Content/Navigation/Documents/103-06-2-Home-Task\\_Force\\_FINAL\\_REPORT\\_122007.pdf](http://www.dcoe.health.mil/Content/Navigation/Documents/103-06-2-Home-Task_Force_FINAL_REPORT_122007.pdf) (October 19, 2011).

7. U.S. Department of Defense, *Evaluation of the TRICARE Program: Fiscal Year 2010 Report to Congress*, February 28, 2010, p. 5, at [http://www.tricare.mil/Amr/downloads/TRICARE201002\\_28\\_10v7.pdf](http://www.tricare.mil/Amr/downloads/TRICARE201002_28_10v7.pdf) (October 24, 2011).

8. *Ibid.*, p. 2.

9. Don J. Jansen, "Military Medical Care: Questions and Answers," *Congressional Research Service Report for Congress*, May 14, 2009, p. 9, at <http://www.fas.org/sgp/crs/trisc/RL33537.pdf> (January 10, 2011).

Under the Heritage plan, this credit can be used to offset the cost of coverage offered through the workplace or to buy insurance outside the workplace. For most middle-income working families, the value of the credit is similar to the tax relief that they receive from health insurance tax exclusion. The credit is advanceable, assignable, and available on a prorated basis. This means that the credit is available when premiums are due, enabling families to claim the credit for premiums paid before the end of the tax year. An assignable credit allows a family to assign their tax credit to a health plan in return for a dollar-for-dollar lower premium, eliminating the need to claim it on their own tax forms. Individuals and families with limited or no tax liability would receive direct financial assistance equivalent to the tax credit.

**TODAY'S SYSTEM EXCLUDES EMPLOYER-SPONSORED HEALTH INSURANCE FROM INCOME AND PAYROLL TAXES, EFFECTIVELY GIVING UPPER-INCOME WORKERS IN HIGH-TAX BRACKETS A RELATIVELY LARGE TAX BENEFIT.**

**Provision #2: Tax-Deferred Savings for All Purposes Including Retirement.** The basic structure of the Heritage tax plan is simple. With its single rate, it uniformly taxes all income sources that are spent on consumption. This means that taxable income includes all labor compensation and net borrowings. The amount put aside in savings, including for retirement, is then subtracted to determine net taxable income.

Thus, the more individuals or families save, the less they pay in taxes. Moreover, for tax purposes, it does not matter which goods or services are purchased, whether health care, education, retirement, or simple consumption goods. Further, the funds within these savings accounts may be transferred to heirs tax-free unless the heirs spend the money. Thus, the savings system permits tax-free intergenerational transfer of wealth.

**Provision #3: Defined-Contribution Approach to Medicare.** While the Heritage plan's tax credit option for obtaining health care coverage provides lifetime advantages, including during retirement, Medicare remains in place for military retirees and their spouses. However, the plan recognizes the need to reform the existing Medicare system.

The Heritage plan accomplishes this by transforming Medicare from an open-ended and unsustainable defined-benefit entitlement into a properly budgeted program that focuses Medicare subsidies on those who need them most. The new Medicare program looks much more like the Federal Employees Health Benefits Program (FEHBP), the health care system for Members of Congress and federal civilian employees.<sup>10</sup>

Over a five-year period, the plan transforms Medicare into a defined-contribution system with stronger health security for the poor and less healthy and guarantees new protections against catastrophic costs for all enrollees. Today's traditional fee-for-service Medicare program provides no protection against catastrophic costs. Because of this gap,

90 percent of seniors buy supplemental health coverage to protect themselves against the financial devastation of catastrophic illness. This means that seniors pay an extra set of premiums and often incur high out-of-pocket costs for both premium and non-premium medical expenses.

When the changes are fully phased in, seniors will enroll in the health plans of their choice and receive a defined contribution (premium support) toward the cost of their plans, much as Members of Congress and millions of federal civilian employees and retirees do through the FEHBP. Unlike today, all plans will include catastrophic protection. Thanks to the structure and insurance rules in Medicare, the premium support is sufficient for seniors to afford an adequate level of benefits, regardless of age or health care condition.

The range of choices in the transformed system includes Medicare premium-based fee-for-service insurance as well as other fee-for-service plans, Medicare Advantage plans, managed care plans, association plans, and Taft-Hartley Act and employer-based plans. Existing health savings accounts (HSAs) can also be carried into retirement.

Medicare's basic rules for insurance are retained, together with an improved risk-adjustment mechanism to offset any adverse selection. Under the reformed system, Medicare's Center for Drug and Health Plan Choice, which is tasked with identifying abuse and overseeing marketing rules for Medicare Advantage and Medicare drug plans, carries out that function for all plans in the transformed system.

10. For a summary description of the existing FEHBP, see U.S. Office of Personnel Management, "Federal Employees Health Benefits Program," at <http://www.opm.gov/insure/health/index.asp> (January 11, 2011).

Beyond retaining the Medicare insurance rules, the reform provides for fiscal solvency and reserve requirements for all health plans to ensure that plans have the financial resources to pay insurance claims. It also provides marketing rules to protect consumers against fraud and a requirement that benefits be described in plain English without surprises or denials in fine print. By increasing choice and competition, the reformed Medicare program delivers better care and provides true health care security for less money than under current projections.

**TODAY'S TRADITIONAL FEE-FOR-SERVICE MEDICARE PROGRAM PROVIDES NO PROTECTION AGAINST CATASTROPHIC COSTS.**

The cash value of premium support is reduced for upper-income seniors and eventually phased out for those with the highest incomes. However, all seniors have access to the same Medicare system with no need to buy a separate plan to cover catastrophic expenses, and poor seniors would remain eligible for Medicaid assistance. Paralleling reforms in Social Security in the Heritage plan, Medicare's eligibility age is increased to 68 in 10 years and is indexed thereafter for increases in longevity.

During the five-year transition period, Medicare's traditional fee-for-service system also changes. A new premium payment system for upper-income retirees would offset Part A costs. The premiums for Parts B and D rise according to income.

The highest-income seniors pay an unsubsidized premium for Parts B and D during the transition.

**Provision #4: Ensuring That Social Security Provides Protection Against Poverty.** As with Medicare, the Heritage plan restructures Social Security to preserve it for future retirees, including future military retirees. The centerpiece of the new Social Security system involves a gradual transition to a flat benefit that pays workers who qualify for a full Social Security check. This amount is well above the income level that the Census Bureau says an American over the age of 65 needs to avoid poverty.

Thus, the new system guarantees that no retiree falls into poverty because of insufficient income and ensures a reasonable income for seniors. Under today's system, workers can pay Social Security taxes for 35 years and still receive a benefit that is below the poverty level, forcing some workers to go on welfare. The new system corrects this serious flaw.

The flat benefit is the equivalent of about \$1,200 per month in 2010 dollars when the reform is complete. This is both higher than today's average Social Security retirement benefit payment (\$1,164 per month) and well above the 2009 poverty level for a single adult over age 65 (\$857 per month). To ensure that future retirees do not slip back into poverty, the flat benefit level is indexed for wage growth.

**The Transition to the New Plan**

While the *Saving the American Dream* plan applies to all Americans, the existing health care and retirement systems for military service

members and their dependents are quite different from those for other Americans. Accordingly, an orderly transition from the existing systems to the new ones will require making careful arrangements to phase out TRICARE and the military retirement systems.

**Transforming Military Health Care.** The transition to the new health care system for service members and their dependents:

1. **Allows current service members and their dependents to continue with TRICARE.**
2. **Allows service members to purchase insurance through the FEHBP.** Current service members who opt for the new system, new recruits, and their dependents are provided access to private health insurance services through the FEHBP.<sup>11</sup> Alternatively, they can choose to buy insurance outside the FEHBP.
3. **Increases service member pay to compensate for forgone TRICARE benefits.** Service members under the new system receive a significant pay increase in lieu of the health care benefits they would otherwise have received under TRICARE.
4. **Enables MHS and the Veterans Affairs system to specialize in military medicine.** The MHS network and the Veterans Affairs system continue to provide medical services to eligible and enrolled former service members. This enables them to specialize even more in military medicine

11. The Heritage Foundation first proposed using the FEHBP to provide health coverage to military dependents and retirees under the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) in 1995. See Scott A. Hodge, ed., *Rolling Back Government: A Budget Plan to Rebuild America* (Washington, D.C.: The Heritage Foundation, 1995), p. 67.

and in meeting the unique medical needs of former service members with service-related injuries or diseases.

**Continuing TRICARE for Current Service Members and Dependents.** Such a far-reaching change in health coverage system for service members and their dependents cannot take place overnight, nor should it. All new recruits enter under the new system, but current members can choose to continue with TRICARE or to enter the new system. Relatively young service members are more likely to choose the new system. As new recruits replace current members, TRICARE gradually phases out.

**Leveraging Private Health Insurance.** The Heritage plan provides access to private health insurance services to military service members and their dependents through the FEHBP, the same system used by federal civil servants. Premiums for the insurance coverage vary according to the specific plans, and the federal government, as the employer, and the civil servant make payments to cover the premiums.

However, the FEHBP system as applied to military service members and their dependents differs from what is offered to civil servants in two critical ways. First, the service member pays the entire premium in accordance with the Heritage fiscal plan because the tax preferences are transferred from the employer to the individual. Second, a service member is free to buy insurance outside the FEHBP.

**A Significant Pay Increase.**

Under the new system, service members in the new system no longer receive health care benefits under TRICARE and are responsible for paying for health insurance for themselves and their dependents, including premiums and cost sharing. Accordingly, they receive higher gross pay than their colleagues who remain under TRICARE.

According to the Congressional Budget Office, the Department of Defense paid roughly \$3,000 in health care costs per person for service members and their dependents in 2007.<sup>12</sup> To maintain an internally balanced defense budget, the DOD must reduce per capita costs. Therefore, the pay increase for service members in the new system must be less than \$3,000 per person. Furthermore, the increased efficiency of the new health care system cannot justify this level of pay increase.

On this basis, the Heritage plan recommends increasing the cash pay for service members by 2 percent above any general pay increases provided to colleagues of similar rank and time of service who remain under TRICARE. This creates a two-tiered pay system in the military for a time, but it eventually disappears as service members retire.

**Focusing on Military Medicine.**

The MHS is a network of 59 hospitals and 364 clinics that operate under the Department of Defense to provide a wide array of health services to service members, former service members, and their family members.<sup>13</sup> The MHS mandate is overly broad, but the new system of health care coverage narrows this mandate

to allow the MHS to focus more on meeting the unique needs of military medicine and less on providing a broad range of medical services to former and current service members and their dependents.

The Heritage plan anticipates that all active-duty service members, including Reserve personnel on active service, retain the option of using the MHS free of charge. They also retain the option of seeking medical services outside the MHS, for which they could pay directly through their private insurance plan or through a combination of the MHS and private insurance. In this context, the private insurance company would offer insurance plans through the FEHBP that are tailored to active-duty service members who have access to the MHS while on active duty.

**THE MHS IS A NETWORK OF 59 HOSPITALS AND 364 CLINICS THAT OPERATE UNDER THE DEPARTMENT OF DEFENSE TO PROVIDE A WIDE ARRAY OF HEALTH SERVICES TO SERVICE MEMBERS, FORMER SERVICE MEMBERS, AND THEIR FAMILY MEMBERS.**

With private health care coverage providing medical services to dependents and routine care to service members, the MHS could specialize in military medicine and make its hospitals and clinics centers of excellence in providing this kind of care. For example, MHS facilities would care for a service member who is wounded in battle or needs

12. Congressional Budget Office, "The Effects of Proposals to Increase Cost Sharing in TRICARE," June 2009, p. 8, at <http://www.cbo.gov/ftpdocs/102xx/doc10261/TRICARE.pdf> (October 19, 2011).

13. U.S. Department of Defense, "TRICARE Facts and Figures," at [http://www.tricare.mil/pressroom/press\\_facts.aspx](http://www.tricare.mil/pressroom/press_facts.aspx) (October 19, 2011).

vaccinations for deployment to a particular theater of operation. However, for more routine medical services and those that are less related to military medicine, the service member's best care option would likely be outside the MHS. While a service member's primary incentive for carrying private insurance is to have insurance after active-duty military service, he or she will have the additional incentive to carry it for greater access to superior care outside the MHS while still on active duty.

**THE VA OFFERS A WIDE RANGE OF MEDICAL SERVICES TO ELIGIBLE AND ENROLLED FORMER SERVICE MEMBERS THROUGH A NETWORK OF MORE THAN 1,400 HOSPITALS AND CLINICS.**

The Reserve component personnel not on active duty retain access to the MHS, but not free of charge. In this case, the MHS hospital or clinic would charge rates equivalent to rates for the same service provided in a civilian hospital or clinic. The reservists would depend on private insurance or direct payments to cover these costs. In all likelihood, these service members would tend to use civilian hospitals or clinics.

In contrast to the current system, the qualifying dependents of military personnel cannot access the MHS system unless they are accompanying the service member to hardship posts where access to health care services outside the MHS is unreliable. As with Reserve component personnel, these services are subject to fees at rates equivalent to those

charged by civilian service providers, and the cost of services is covered by the private insurance plans and out-of-pocket payments.

The VA offers a wide range of medical services to eligible and enrolled former service members through a network of more than 1,400 hospitals and clinics.<sup>14</sup> Because VA facilities and services are not funded through the defense budget, they are not the focus of this paper. Nevertheless, the health coverage provided to service members through the Department of Defense under the Heritage plan would affect VA operations because it is designed to be available to the service member for life. In this context, it should permit the VA and the MHS to focus on meeting the unique medical needs of former service members with service-connected injuries or diseases.

**Transforming the Military Retirement System.** Much like the transition to the new health care system, the transition to the new military retirement system:

**1. Allows current military personnel to retire under the existing retirement system.** The Heritage plan replaces the existing defined-benefit structure for military retirement with a defined-contribution plan. Accordingly, no service member who is already in the military and has planned for his career, both in the military and beyond, on the basis of the existing retirement system should have it taken away. Thus, he or she has the option of continuing with the current system or joining the new one.

**2. Provides special pay and bonuses that are earmarked for retirement accounts.** To maximize recruitment and retention under the new system, the military should be free to offer incentive payments to service members as long as the member commits to contributing the designated special pay and bonuses to his retirement account. For example, the military could offer a long-term bonus package for contribution to a service member's retirement account to encourage the member to make a full career of the military. On the other hand, a more immediate bonus package could encourage a prospective recruit to enlist for a shorter time.

**3. Gradually expands the Thrift Savings Plan (TSP).** The savings options provided under the Heritage plan, in essence, are an expanded version of the existing TSP.

**4. Adjusts existing retirement benefits for inflation.** The Heritage plan's proposal for Social Security changes how Social Security benefits are adjusted for inflation because cost-of-living adjustments (COLAs) do not accurately reflect the impact of inflation on retirees. Benefits for military retirees are currently adjusted on a similar basis as Social Security benefits using the Consumer Price Index (CPI). This transition arrangement preserves this link<sup>15</sup> and means that future military retirees are covered under the existing defined-benefit structure in which COLAs

14. U.S. Department of Veterans Affairs, "VA Health Eligibility Home," at <https://www4.va.gov/healtheligibility/> (October 21, 2010).

15. Military retirees who choose the reduced annuity formula (Redux) for retirement receive benefit adjustments based on the "CPI minus 1," which is slightly different from the CPI that applies to Social Security recipients.

TABLE 2  
**Net Savings to the 050 Budget Account**

IN MILLIONS OF DOLLARS FOR FISCAL YEARS 2012-2016

	2012	2013	2014	2015	2016	5-Year Total
<b>Active Duty Personnel</b>						
Tricare Program Savings	\$180	\$502	\$1,060	\$1,627	\$2,542	\$5,911
Tricare For Life Savings	\$503	\$1,183	\$2,091	\$2,840	\$3,832	\$10,449
Changed Tricare Focus	\$18	\$50	\$106	\$163	\$254	\$591
2% Payraise Cost	-\$37	-\$93	-\$176	-\$253	-\$367	-\$925
<b>Reserve Personnel</b>						
Tricare Program Savings (Reserve Select)	\$25	\$43	\$67	\$88	\$116	\$339
Tricare For Life Savings	\$155	\$364	\$643	\$873	\$1,178	\$3,213
Focus MHS on Military Personnel Care	\$5	\$13	\$25	\$37	\$53	\$133
2% Payraise Cost	-\$5	-\$14	-\$26	-\$38	-\$54	-\$137
<b>Total Outlay Savings</b>	<b>\$844</b>	<b>\$2,048</b>	<b>\$3,790</b>	<b>\$5,337</b>	<b>\$7,554</b>	<b>\$19,574</b>

Sources: Heritage Foundation calculations based on data from the U.S. Department of Defense.

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are based on the more accurate Chained Consumer Price Index (C-CPI-U).

- 5. Provides disability retirement coverage through the VA and, if necessary, a reformed Social Security system.** The Heritage plan eliminates the existing disability military retirement for new entrants but reforms Social Security, including its disability system, and new recruits would have access to this system. Specifically, the plan recognizes that some workers, including disabled service members, are physically unable to work until retirement age. It therefore includes an improved disability system to ensure that

those who are unable to work receive a quick and accurate decision on their benefit application rather than facing today's long delays. It also improves today's often arbitrary decision-making process. Disability retirement has an accrual cost of less than 1 percent of basic pay. This amount should be easily offset by enhancing VA programs if required.

#### Cost Savings to the National Security Account

The Heritage proposals to reform military health care coverage and retirement will produce substantial net savings to the national security account (050) in the federal budget.<sup>16</sup> However, the level of savings cannot

be calculated precisely because of the grandfathering of existing elements to allow current military personnel to choose between joining the new plans and keeping their existing coverage. Nevertheless, it is possible to calculate the base level of savings with new recruits.

#### Health Care Coverage Savings.

Applying the Saving the American Dream plan to new recruits would save almost \$20 billion<sup>17</sup> over the five years from FY 2012 through FY 2016 from the four elements of the reform proposal:

- **TRICARE savings.** These savings result from replacing TRICARE for new recruits and their dependents. This element saves an estimated \$6 billion from the active component

16. This reform proposal would also affect elements of the federal budget outside of the 050 account: namely, federal revenues and Medicare. However, these effects are outside the scope of this paper and are therefore not addressed here.

17. This estimate of the base level of savings excludes additional DOD savings from forgoing its employer contributions to the Medicare system for service members who opt to leave the Medicare system. These savings are impossible to calculate precisely because how many service members will opt to leave Medicare cannot be predicted. However, it is reasonable to assume that the Department of Defense will save some \$1.5 billion over the five-year period.

TABLE 3  
**Net Savings to the O50 Budget Account, With Opt-In Savings**

IN MILLIONS OF DOLLARS FOR FISCAL YEARS 2012-2016

	2012	2013	2014	2015	2016	5-Year Total
<b>Active Duty Personnel</b>						
Tricare Program Savings	\$180	\$502	\$1,060	\$1,627	\$2,542	\$5,911
Tricare For Life Savings	\$503	\$1,183	\$2,091	\$2,840	\$3,832	\$10,449
Changed Tricare Focus	\$18	\$50	\$105	\$163	\$254	\$591
2% Payraise Cost	-\$37	-\$93	-\$176	-\$253	-\$367	-\$925
<b>Reserve Personnel</b>						
Tricare Program Savings (Reserve Select)	\$25	\$43	\$67	\$88	\$116	\$339
Tricare For Life Savings	\$155	\$364	\$643	\$873	\$1,178	\$3,213
Focus MHS on Military Personnel Care	\$5	\$13	\$25	\$37	\$53	\$133
2% Payraise Cost	-\$5	-\$14	-\$26	-\$38	-\$54	-\$137
Opt-In Savings	\$569	\$539	\$463	\$394	\$265	\$2,231
<b>Total Outlay Savings</b>	<b>\$1,413</b>	<b>\$2,587</b>	<b>\$4,253</b>	<b>\$5,731</b>	<b>\$7,819</b>	<b>\$21,804</b>

Sources: Heritage Foundation calculations based on data from the U.S. Department of Defense.

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TABLE 4  
**Retirement Proposal Savings Summary for Department of Defense**

IN MILLIONS OF DOLLARS FOR FISCAL YEARS 2012-2016

	2012	2013	2014	2015	2016	5-Year Total
<b>Active Duty Personnel</b>						
Cost of 15% Fund Contribution for New Entrants	-\$280	-\$723	-\$1,417	-\$2,312	-\$3,187	-\$7,719
Savings from Eliminating Retirement Accrual (32.7%)	\$611	\$1,576	\$3,089	\$4,604	\$6,948	\$16,828
<b>Reserve Personnel</b>						
Cost of 10% Investment Fund Contribution for New Entrants	-\$28	-\$72	-\$140	-\$209	-\$315	-\$764
Savings from Eliminating Retirement Accrual (24.3%)	\$67	\$174	\$341	\$508	\$766	\$1,856
Change in Indexing of Benefits	\$1,340	\$1,311	\$1,247	\$1,191	\$1,076	\$6,165
<b>Total Savings</b>	<b>\$1,710</b>	<b>\$2,266</b>	<b>\$3,120</b>	<b>\$3,982</b>	<b>\$5,288</b>	<b>\$16,366</b>

Sources: Heritage Foundation calculations based on data from the U.S. Department of Defense.

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TABLE 5  
**Additional Retirement Proposal Savings for DOD Derived from Current Personnel Opting In**

IN MILLIONS OF DOLLARS FOR FISCAL YEARS 2012-2016

	2012	2013	2014	2015	2016	5-Year Total
<b>Savings</b>	<b>\$292</b>	<b>\$291</b>	<b>\$264</b>	<b>\$238</b>	<b>\$170</b>	<b>\$1,254</b>

Sources: Heritage Foundation calculations based on data from the U.S. Department of Defense.

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and \$339 million from the Reserve component over five years.

- **TRICARE for Life savings.** Eliminating the accrual payments for future TRICARE benefits for current personnel who retire and become Medicare recipients saves somewhat less than \$10.5 billion over five years from the active component and slightly more than \$3.2 billion from the Reserve component. Rather than TRICARE, military veterans participate in the new defined-contribution Medicare plan for all Americans.
- **Changed focus for the military health care system.** Permitting the military health care system to focus on military medicine saves almost \$600 million from the active component and a little more than \$130 million from the Reserve component.
- **Increased outlays for the selective pay increase.** The 2 percent pay increase to participating service members partially offsets the gross savings to the budget account. Over five years, the pay increases are expected to cost more than \$900 million for the active component and almost \$140 million for the Reserve component.

Applying the same four elements of the reform proposal to current military personnel produces additional savings, although the exact level will depend on how many of them choose the new plan over TRICARE. Assuming that 10 percent of currently serving military personnel with six or fewer years of service choose the new plan in FY 2012, the DOD would save a total of nearly \$22 billion. (See Table 3.)

**Retirement Savings.** DOD savings from the recommended reforms for the military retirement system can be calculated in a similar manner. If only future recruits are brought into the proposed systems, the DOD would save \$16 billion over five years. (See Table 4.) However, a significant number of younger service members may opt into the new system. If only 10 percent of currently serving military personnel with six or fewer years of service opt into the new system in FY 2012, the DOD could save an additional \$1.2 billion over five years. (See Table 5.)

In addition, adjusting retirement annuities with the Chained CPI achieves additional savings from service members who are not participating in the new system. Because this covers the large majority of service members, the savings will be significant.

### Impact on Retention Rates

Such a significant change in compensation could affect personnel retention. However, because this proposal applies only to new entrants and other personnel who voluntarily opt in, and because the DOD has extreme flexibility in determining payments to individuals, any such impacts are expected to be minimal.

On the other hand, the more flexible retirement system gives the military a powerful tool that allows it to direct retirement compensation in ways that will actually improve recruitment and retention. For example, recruitment for positions that assume short-term careers in the military could be enhanced by providing special pay and bonuses that are earmarked for retirement account contributions by the member shortly following recruitment, such as between two years and four years into the service period. The military could improve retention in longer-term specialties by providing earmarked special pay and bonuses that require longer military careers, such as after 15 or 20 years of service.

### Conclusion

Trying to save money by tinkering around the edges of the Military Health System and the military retirement system is unwise because both systems have serious structural

problems. These problems mean that the current system does not serve the best interests of either military members and their dependents or taxpayers. First, these systems do not allow military service members and their dependents to take responsibility for their health care and retirement by tailoring their coverage to their preferences. Second, this same inflexibility leads to inefficient use of scarce defense funding, which is a disservice to taxpayers.

However, systemic reform of the Military Health System and military retirement system can give military service members and their dependents the ability and financial means to choose coverage plans that best meet their preferences. With the recommended reforms, fewer taxpayers' dollars will purchase more health care and retirement benefits for service members and their dependents. The key to these reforms is to replace

existing systems with new systems that treat service members and their dependents as individuals with individual health care needs and preferences rather than as members of a class with identical needs and preferences.

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## Appendix A Summary of TRICARE

TRICARE is a group of medical care options for military personnel, military retirees, and their families. This section summarizes the major options available under the system.

**TRICARE Prime.** TRICARE Prime is the principal component of this system. It is essentially a DOD-run health maintenance organization that provides medical care to military personnel and their dependents. Care is generally provided in Military Treatment Facilities as well as by affiliated civilian facilities and providers. Enrollment in TRICARE Prime is required for active-duty service members, including Reserve personnel on active duty under federal orders for more than 30 days. Enrollment is optional for family members of active-duty personnel, who are also eligible for TRICARE Standard and TRICARE Extra. TRICARE Prime charges no premiums to active-duty service members or their family members. However, participating military retirees pay co-pays for most services.

**TRICARE Standard and TRICARE Extra.** TRICARE Standard is the military equivalent of a health insurance plan for active-duty family members and military retirees and their dependents. Participants have an annual deductible and co-payments but no premiums. TRICARE Standard provides participants with greater health care choices than are available under TRICARE Prime. TRICARE Extra is similar to TRICARE Standard except that beneficiaries' co-pays are reduced when they use designated network providers.

**TRICARE Reserve Select.** TRICARE Reserve Select is a premium-based plan available to selected Reserve personnel and their families. (Reservists injured or sickened in the line of duty receive free line-of-duty care for their needs.) Coverage is similar to TRICARE Standard and TRICARE Extra. Reservists enrolled in or eligible to participate in the FEHBP may not participate in TRICARE Reserve Select. The government subsidy for

TRICARE Reserve Select is set at 72 percent, the same as the subsidy for the FEHBP.

**TRICARE Retired Reserve.** TRICARE Retired Reserve is a premium-based plan for retired Reserve members who have qualified for Reserve retirement but have not reached the age requirement (age 60) for a retirement annuity. (This group is commonly referred to as "gray area" retirees.) Personnel eligible for the FEHBP cannot participate in this program. Rates are quite high (nearly \$1,000 per month for the member and family in 2010) because there is no government subsidy for this program. After reaching age 60, eligibility ends, and retired Reserve members may participate in TRICARE Prime, Standard, or Extra.

**TRICARE for Life (TFL).** TFL provides additional coverage for TRICARE beneficiaries, regardless of age, who also have Medicare Part A and Part B coverage. TFL acts as a secondary payer and reduces beneficiaries' out-of-pocket expenses.

**Transitional Assistance Management Program (TAMP).** TAMP provides transitional health care benefits to certain personnel separating from federal active duty, including active-duty personnel involuntarily honorably separated from duty, Reserve component personnel separating after at least 30 days active duty in support of a contingency operation, personnel separating from active duty after being retained under "stop-loss" for a contingency operation, personnel separating from active duty after voluntarily staying on active duty for less than one year in support of a contingency operation, and personnel separating from active duty to become a Selected Reserve member without a break in service. TAMP provides health benefits for 180 days under the same rules for regular active-duty personnel and family members. After TAMP benefits expire, a premium-based Continued Health Care Benefit program can provide up to 36 months of coverage.

## TRICARE Benefit Examples:

**Example 1: A service member who serves one tour on active duty and then pursues a civilian career.**

During active duty, the member is required to enroll in TRICARE Prime. The service member's family can use TRICARE Prime, Standard, or Extra. Upon leaving the service, neither the service member nor the family is eligible for further TRICARE benefits unless the service member falls into one of the categories of eligibility for TAMP benefits, which provides time-limited eligibility for continued TRICARE benefits.

**Example 2A: A service member who serves 10 years on active duty and then transfers to a Reserve component as a Selected Reserve member.** While on active duty, enrollment options are the same as in Example 1. A member who transfers immediately to a Reserve component is eligible for TAMP TRICARE benefits for 180 days. During or after that period, if not FEHBP-eligible, the member can enroll in TRICARE Reserve Select for continued TRICARE benefits after TAMP coverage ends.<sup>18</sup>

**Example 2B: A service member who retires from active duty and then transfers to a Reserve component as a Selected Reserve member.**

While on active duty, enrollment options are the same as in Example 1. As a military retiree, the member maintains TRICARE eligibility and may participate in TRICARE Prime, Standard, or Extra. Because the member has other TRICARE coverage, he or she is not eligible for TRICARE Reserve Select.

**Example 3: A Reservist and a National Guard member activated for federal service.** All Reserve component personnel activated for 30 days or more must participate in TRICARE Prime. If activated for less than 30 days, they continue their relevant TRICARE eligibility. Over half of the states provide continuation of health and life insurance benefits for activated National Guard members who are also state employees, allowing family members to continue any state health benefit coverage. A few states provide assistance with private insurance.<sup>19</sup>

18. DOD literature advises such personnel to enroll in TRICARE Reserve Select up to 60 days before but no later than 30 days after TAMP coverage ends to ensure benefit continuity.

19. National Governors Association, *State and Territorial Support for Members of the Military, Veterans and Their Families*, July 2011, at <http://www.nga.org/files/live/sites/NGA/files/pdf/11GUARDSURVEY.PDF> (October 19, 2011).

## Appendix B The Existing Military Retirement System

The military retirement system has several components:

**Defined Benefits.** The military retirement system provides non-disability, survivor, and disability payments to eligible persons. In 2009, it provided \$51.1 billion in benefits to 2.2 million retirees and survivors. The system is accrual-funded, which means that DOD pays the expected cost of retirement benefits for its personnel via contributions to the Military Retirement Trust Fund as a percentage of their basic pay. Military personnel make no direct contribution to fund their retirement benefits. Eligibility for immediate non-disability retirement pay requires a minimum of 20 years of service at any age. Reserve retirement generally requires 20 qualifying years of service, and benefits are based on a point system for drills and active-duty training and service, but retirement pay commences at age 60. A minimum of 50 points earned annually qualifies as a year that is creditable for Reserve retirement, whereas 360 points equals a full year of service in calculating the retirement annuity. Public Law 110-181 allows a 90-day reduction in the Reserve retirement age of 60 for every three months served in a contingency operation after its enactment.

**A “Cliff Vested” System.** Military retirement is a cliff-vested system because there is no vesting prior to 20 years of service for non-disability retirees. Disability retirement requires that the disability not be the result of the member’s intentional misconduct or willful neglect or have been incurred during an unauthorized absence. It also requires a disability rating of at least 30 percent on the VA rating scale and one of four other conditions, such as a disability that resulted from active duty.

**Three Non-Disability Benefit Formulas.** Three non-disability retirement benefit formulas apply to active-duty military personnel, depending on when they entered the military.

Personnel who first entered the military before September 8, 1980, receive retired pay equal to final basic pay times 2.5 percent for each year of service.<sup>20</sup>

For personnel who first entered service after September 8, 1980, and before August 1, 1986, the average of the highest three years of basic pay (Hi-3) is used to calculate annuities rather than final basic pay. This group accounts for an estimated 3.8 percent of personnel on the total basic payroll.

Personnel who entered the military on or after August 1, 1986, choose between the Hi-3 retirement annuity formula or a reduced annuity formula (Redux) in combination with a \$30,000 Career Status Bonus (CSB). The Redux annuity calculation includes lower multipliers for members retiring with less than 30 years of service. However, at age 62, retired pay is recomputed with the regular 2.5 percent multiplier. The CSB is paid at 15 years of service as a lump-sum or in installments. Members who serve less than 20 years forfeit part of the \$30,000 CSB.

**Inflation-Adjusted Benefits.** Military retirement and survivor annuities are adjusted annually for inflation using the CPI. Retirees who entered the military before August 1, 1986, or who do not opt for Redux/CSB receive adjustments equal to the CPI increases. Those who opt for Redux/CSB receive adjustments equal to the CPI minus 1 percent for life (except when the CPI is 1 percent or less), with an annuity recomputation to a full CPI at age 62.

**VA Compensation.** In addition to military disability and non-disability retirement benefits, veterans may be eligible for compensation for certain disabilities through the VA. Historically, veterans compensation has been offset against any disability or non-disability retired pay because the payments result from the same military service. Members benefit more from VA benefits than they do from military retirement benefits because VA payments are exempt from federal income taxes. However, beginning in 2004, the offset has been steadily reduced by Congress to allow at least partial receipt of both military retirement and VA compensation. This is commonly referred to as “concurrent receipt.” The major significance of concurrent receipt for this analysis is that its cost is reflected in the accrual payments for military retirement. However, the Treasury, not the DOD, pays these costs. Thus, they are not covered in this paper.

**“Normal Cost” Payment System for DOD.** As noted earlier, the DOD pays the accrual or “normal cost” as a percent of basic pay (NCP) for retirement benefits for military personnel, except for the concurrent receipt cost. For active-duty personnel under Hi-3 and CSB/REDUX, the total weighted NCP is 32.7 percent for 2010. Of this, 30.9 percent is for non-disability benefits, 0.6 percent is for disability benefits, and 1.2 percent is for survivor benefits. For reservists (part-time personnel),

20. The DOD’s Actuary estimates that no personnel covered under final pay were still in service in FY 2010.

the corresponding NCPs are 22.6 percent, 0 percent, and 1.7 percent. Therefore, relatively little funding goes to disability and survivor benefits.

**The Thrift Savings Plan.** Military personnel also participate in the federal Thrift Savings Plan, a tax-deferred retirement savings plan originally limited to federal civilian employees, which operates much like 401(k) plans. Members may contribute any percentage of basic, special, and incentive pay and bonuses on a pre-tax basis up to a limit of \$16,500 for 2010—the same limit on 401(k) plans. Unlike federal employees covered by the Federal Employees Retirement System, the DOD generally does not match service members' contributions to their TSP accounts. The DOD has authority to match for critical occupations in exchange for a service commitment, but it is not currently using this authority. The Army had a TSP matching pilot program for new recruits in certain critical specialties that ran from 2006 through 2008. TSP funds are available to members for in-service loans without tax penalty to purchase general and primary residences.

TSP participants choose to invest in up to six different investment funds: the Government Securities Investment (G) Fund; Fixed Income Index Investment (F) Fund; Common Stock Index Investment (C) Fund; Small Capitalization Stock Index Investment (S) Fund; International Stock Index Investment (I) Fund; and Lifecycle (L) Fund. The Lifecycle Fund is a mix of the other five funds, designed to optimize returns based on a target retirement date and risk level. For example, participants further away from retirement can tolerate more risk in pursuit of higher returns, so a greater percentage of their assets is invested in the riskier funds such as the C, I, and S Funds. For a given risk level and time horizon, the L fund seeks an optimal mix of the G, F, C, S, and I Funds to provide the highest return. The G Fund is risk-free because the securities are backed by the U.S. government.

The TSP will add a Roth 401(k) feature in 2011, as authorized in recent legislation. Contributions would be made from after-tax income, but earnings and withdrawals at or after age 59.5 would be tax-exempt.

Examples Under the Current System for Active-Duty Members:

**Example #1: An active-duty member.** An active-duty member must serve a minimum of 20 years to qualify for an immediate lifetime annuity for non-disability retirement. (Disability retirement applies to those who are disabled as a result of service.) New personnel choose between a retirement annuity of 2.5 percent for each year of service based on Hi-3 or Redux for pre-30 years of service retirement combined with a \$30,000 Career Status Bonus (CSB). At age 62, Redux recipients' retired pay is recomputed with the regular 2.5 percent multiplier. Hi-3 retirees receive adjustments equal to the CPI increases. Redux/CSB retirees receive adjustments equal to the CPI minus 1 percent for life (except when the CPI is 1 percent or less), with an annuity recomputation to a full CPI at age 62.

**Example #2: A reservist.** Reserve retirement benefits are similar to those for active-duty personnel retiring under Hi-3 except that benefits generally commence at age 60 and are reduced proportionately using the points system to account for the part-time nature of Reserve service. A reservist must serve 20 creditable years to qualify for a retirement annuity. Any year in which the member earns at least 50 points through drills, active duty for training, and active duty is a creditable year, whereas 360 points equals a full year of service in calculating the retirement annuity. Thus, a reservist earning the 50-point minimum for 20 years receives a retirement annuity of 50/360 of the active-duty calculation. Reserve retirees also receive full CPI adjustments annually.

# BACKGROUND

No. 2658 | MARCH 1, 2012

## Obama's Budget Makes Protecting America Its Lowest Priority *Baker Spring*

### Abstract

*Despite Administration claims to the contrary, President Barack Obama's budget proposal for FY 2013 would reduce national defense to the lowest of the major budget priorities of the federal government. The combination of the budget request and the Budget Control Act of 2011 would reduce the military's personnel levels and force structure to the point that they could no longer protect U.S. vital interests and keep U.S. security commitments around the world. Under the Constitution, Congress has the obligation to pass a budget that maintains U.S. military capabilities.*

The Obama Administration is misleading Congress and the American people when it asserts that it plans to maintain a strong national defense. On February 13, 2012, President Barack Obama unveiled his fiscal year (FY) 2013 defense budget request.<sup>1</sup> The request comes on the heels of the January 5, 2012, release of a new strategic guidance outlining the nation's defense policy.<sup>2</sup> The numbers in the budget submission reveal that the nation's defense is the Administration's lowest budget priority among the major responsibilities of the federal government. The budget submission also reveals that the Administration has proposed defense funding levels that are inadequate to maintaining the U.S. military capabilities described in the defense strategic review.

To fulfill the Constitution's mandate to provide for the common defense, Congress will need to rewrite the Obama Administration's budget proposal, especially the section on defense. The Heritage Foundation's *Saving the American Dream* fiscal plan provides a template for this rewrite.<sup>3</sup> The plan points the way toward providing for a strong defense, while limiting the role of the federal government in the economy, keeping taxes low, and balancing

This paper, in its entirety, can be found at <http://report.heritage.org/bg2658>

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### TALKING POINTS

- The Obama Administration's FY 2013 defense budget request would put the federal government on the path to ranking defense the lowest priority among the four major components of the annual budget.
- This inadequate defense budget would undermine the ability of the U.S. to uphold longstanding security commitments to allies and on friends and allies around the world.
- The proposed budget would reduce the size of the military, defer important modernization programs, reduce the overall readiness of military forces, and undermine recruitment and retention of high quality military personnel.
- Accordingly, Congress needs to rewrite the Administration's defense budget and program. Rewriters should include deferring application of automatic spending cuts (sequestration) under the Budget Control Act and enacting a broader fiscal plan that contains the essential characteristics of Heritage's *Saving the American Dream* plan and that replaces the Budget Control Act.

the federal budget within 10 years. Accordingly, Congress should draft a bill on this basis and replace the Budget Control Act of 2011.

### **A Budget Proposal Inconsistent with Protecting Vital U.S. Interests**

Since World War II, the definition of U.S. vital national interests has remained relatively constant. This has led to a widely accepted set of security commitments that the government has made to the American people and U.S. friends and allies around the world. These commitments, which were described in the context of the existing international setting in an April 2011 Heritage study, include:

1. Safeguarding U.S. national security;
2. Preventing a major power threat to Europe, East Asia, or the Persian Gulf;
3. Maintaining access to foreign trade;
4. Protecting Americans against threats to their lives and well-being; and

5. Maintaining access to resources.<sup>4</sup>

The Obama Administration's proposed defense budget, within both the five-year and 10-year time frames, is simply too small to field a military that is capable of effectively defending these vital national interests and fulfilling the accompanying security commitments. Recognizing that neither Congress nor the American people would accept a defense policy that would redefine any of the interests listed above as no longer a matter of vital importance, the Administration has chosen to argue that it can continue to defend these interests with dramatically lower defense budgets. Understanding why this is not true requires examining the Administration's arguments, pointing out the weakness of these arguments. The following facts directly contradict Administration claims.

### **Fact #1: The proposed budget's lower defense spending caps are not just about eliminating waste and inefficiency in the Pentagon.**

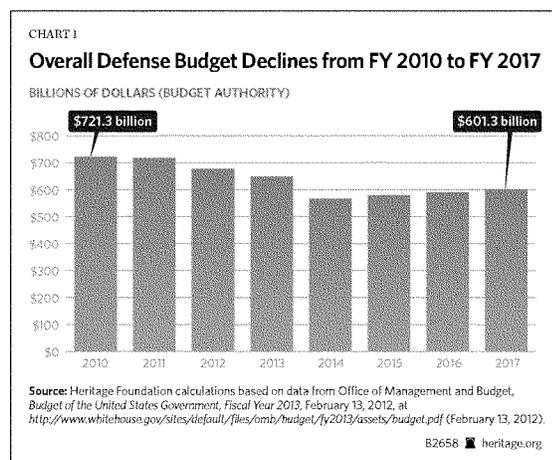
President Obama would like the American people to believe that his lower spending caps on defense are only about eliminating waste at the

Pentagon. He expressed this idea quite succinctly during a White House press conference on June 29, 2011: "I, as Commander-in-Chief, have to have difficult conversations with the Pentagon saying, you know what, there's fat here; we're going to have to trim it out."<sup>5</sup>

### **BY THE ADMINISTRATION'S OWN ADMISSION, THE PRESIDENT'S DEFENSE BUDGET IS OVERWHELMINGLY ABOUT REDUCING U.S. MILITARY CAPABILITIES.**

Undoubtedly, there are areas of waste in the Department of Defense (DOD), but by the Administration's own admission, the President's defense budget is overwhelmingly about reducing U.S. military capabilities. Secretary of Defense Leon Panetta has stated that this budget will reduce defense spending by \$487 billion over 10 years, with \$259 billion of these cuts applied over the next five years against an undefined baseline.<sup>6</sup> Of the \$259 billion in savings over the five years, be acknowledged that only \$60 billion would come from increasing efficiency in the Department of Defense.<sup>7</sup> Thus, according to Secretary Panetta's

1. U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2013* (Washington, D.C.: U.S. Government Printing Office, 2012), at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/budget.pdf> (February 13, 2012).
2. U.S. Department of Defense, "Sustaining U.S. Global Leadership: Priorities for 21st Century Defense," January 2012, at [http://www.defense.gov/news/Defense\\_Strategic\\_Guidance.pdf](http://www.defense.gov/news/Defense_Strategic_Guidance.pdf) (January 30, 2012).
3. Stuart M. Butler, Alison Acosta Fraser, and William W. Beach, eds., *Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity*, The Heritage Foundation, 2011, at <http://www.heritage.org/research/reports/2011/05/saving-the-american-dream-the-heritage-plan-to-fix-the-debt-cut-spending-and-restore-prosperity> (February 14, 2012).
4. The Heritage Foundation, "A Strong National Defense: The Armed Forces America Needs and What They Will Cost," Heritage Foundation Special Report No. 90, April 5, 2011, at <http://www.heritage.org/research/reports/2011/04/a-strong-national-defense-the-armed-forces-america-needs-and-what-they-will-cost> (February 6, 2012).
5. Barack Obama, "Press Conference by the President," The White House, June 29, 2011, at <http://www.whitehouse.gov/the-press-office/2011/06/29/press-conference-president> (February 2, 2012).
6. Leon Panetta, "Major Budget Decisions Briefing from the Pentagon," U.S. Department of Defense, January 26, 2012, at <http://www.defense.gov/transcripts/transcript.aspx?transcriptid=4962> (February 6, 2012).
7. *Ibid.*



statement, less than a quarter of the proposed savings over the next five years will come from increasing efficiency and more than three-quarters will come from reducing military capabilities.

Further, it is unclear whether these proposed savings would result from eliminating actual or fictitious inefficiencies. For example, the secretary proposes to achieve savings by reducing contract services, but it is unclear why using public employees rather than contractors to perform these services would be more efficient. By any measure, the level of

inefficiency at the Department of Defense is less than what President Obama would like the American people to believe.

**Fact #2: The proposed budget would shrink the defense budget, not just slow the rate of growth.**

In a speech on the new defense strategic review on January 5, 2012, President Obama stated: "Over the next 10 years, the growth in the defense budget will slow, but the fact of the matter is this: It will still grow, because we have global

responsibilities that demand our leadership."<sup>8</sup>

This assertion is factually incorrect. According to the Office of Management and Budget (OMB), the total national defense budget, including funding for overseas contingency operations (OCO), was \$721.3 billion in budget authority for FY 2010.<sup>9</sup> The Administration's proposal for the same 050 budget function is \$647.4 billion in current dollars (not adjusted for inflation) for FY 2013 and \$566.3 billion for FY 2014.<sup>10</sup> In fact, the defense budget proposal would not return to FY 2010 spending levels for the entirety of the 10-year projection.<sup>11</sup> The Administration's defense budget front-loads the reductions into the first five years (FY 2011–FY 2014). Only then would the defense budget be permitted to grow slowly, starting from this low point thereafter and only in terms of current dollars. (See Chart 1.)

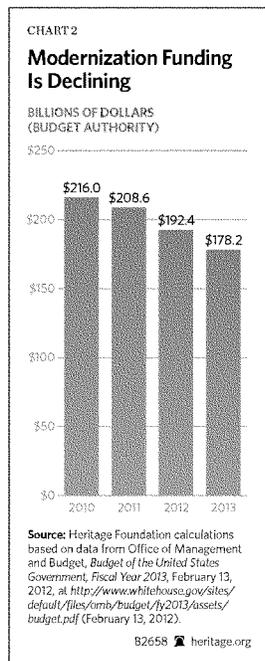
Including OCO expenditures in this comparison is appropriate because existing historical descriptions of defense expenditures have included them. Including them therefore permits direct comparisons. Further, excluding OCO expenditures in this comparison would, for the sake of consistency, require excluding them from comparisons elsewhere in this paper regarding the structure of the overall federal budget. In these other instances, it would be inappropriate to exclude OCO from the broader defense account.

8. Barack Obama, "Remarks by the President on the Defense Strategic Review," The White House, January 5, 2012, at <http://www.whitehouse.gov/the-press-office/2012/01/05/remarks-president-defense-strategic-review> (February 6, 2012).

9. U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2013: Historical Tables* (Washington, D.C.: U.S. Government Printing Office, 2012), p. 103, at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/hist.pdf> (February 14, 2012).

10. *Ibid.*

11. U.S. Office of Management and Budget, supplemental materials for *Budget of the United States Government, Fiscal Year 2013: Analytical Perspectives* (Washington, D.C.: U.S. Government Printing Office, 2012), February 13, 2012, Table 32-1, at [http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/32\\_1.pdf](http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/32_1.pdf) (February 14, 2012).



**Fact #3: The budget drove the defense strategic review, not the other way around.**

President Obama would like the American people to believe that the defense strategic review, which was undertaken to determine the optimal means for defending the vital national interests of the United States, and

his proposed defense budget followed from the findings of this review. In the cover letter accompanying the review, the President wrote: "I therefore directed this review to identify our strategic interests and guide our defense priorities and spending over the coming decade."<sup>12</sup>

Unhappily for the President, the calendar refutes his assertion about strategy driving the defense budget. His proposed budget reductions match the spending caps in the Budget Control Act of 2011, which he signed into law on August 2, 2011. The defense strategic review was not released until January 5, 2012, some five months later. By his reckoning, it is pure coincidence that the defense strategic review determined that the optimal means to provide for the national security require a defense budget that matches the spending caps in the Budget Control Act and that the earlier enactment of that law had no influence on the review process.

While the Administration will likely repeat this misrepresentation about the defense budget and the spending caps in the Budget Control Act in the coming months, the sequestration process established by the same act will impose much lower levels of defense spending. The President has made it clear that he will veto any bill that would eliminate or alter the sequestration process. Undoubtedly, the President will attempt to explain how the strategy outlined in the review can still be executed under these much lower levels of defense spending.

**Fact #4: The proposed defense budget is inadequate to preserve the U.S. lead in weapons technology.**

President Obama has stated that he supports sustaining the U.S. lead in weapons technology. Specifically, in his cover letter to the defense strategic review, he stated: "In particular, we will continue to invest in the capabilities critical to future success, including intelligence, surveillance, and reconnaissance; counterterrorism; countering weapons of mass destruction; operating in anti-access environments; and prevailing in all domains, including cyber."<sup>13</sup>

The problem is that the President's budget does not provide the resources to preserve the overwhelming U.S. technological lead in advanced weapons and equipment. In FY 2010, the Department of Defense provided \$216 billion in budget authority to the modernization accounts, compared with just \$178.2 billion proposed for FY 2013. This is an almost \$38 billion (17 percent) reduction in the budget authority in just three years without accounting for inflation. (See Chart 2.)

Programmatically, the Administration's defense budget curtails advancements in a number of weapons systems. It would slow the acquisition of the F-35 Joint Strike Fighter aircraft, the Army Ground Combat Vehicle, and a system for defending against land-attack cruise missiles. It reduces the Joint Air-to-Ground Munition program, and it delays the Army's helicopter modernization program. It terminates

12. U.S. Department of Defense, "Sustaining U.S. Global Leadership."

13. *Ibid.*

the Global Hawk Block 30 and the Defense Weather Satellite System. Finally, the budget also delays a large-deck amphibious ship, a new *Virginia*-class submarine, and a helicopter modernization program by three to five years.

In addition, the Administration has consistently been unenthusiastic about other programs that have continued to receive inadequate support. These include the Airborne Laser program, the development of a new Navy cruiser, space-based missile defense interceptors, ground-based missile defense interceptors for countering long-range missiles, anti-satellite systems, and the combat search and rescue helicopter.

**Fact #5: The proposed budget will lead to a military force that is too small.**

In asserting that the size and structure of the U.S. military force of the future will be driven by strategy and not budget considerations, President Obama wants the American people to believe that the military will not become too small under his policies. Specifically, he said: "That's why I called for this comprehensive defense review—to clarify our strategic interests in a fast-changing world, and to guide our defense priorities and spending over the coming decade—because the *size and the structure* of our military and defense budgets have to be driven

by a strategy, not the other way around."<sup>14</sup>

In fact, the President's defense budget is significantly reducing the military's personnel levels and force structure. On the personnel side, the active Army would decline to 490,000 soldiers, down from the current 562,000—a reduction of 72,000 (13 percent). Similarly, the active Marine Corps would decline to 182,000 persons from the current 202,000—a reduction of 20,000 (10 percent).<sup>15</sup>

These personnel reductions will result in an active Army and Marine Corps that are simply too small to meet the full range of military responsibilities assigned to them under a policy and strategy that assume the continuation of existing national and international security commitments. For example, U.S. military forces "will no longer be sized to conduct large-scale, prolonged stability operations."<sup>16</sup> Accordingly, U.S. policy assumes that the nation will never again need to undertake a "surge" of the sort that turned the tide in Iraq. Likewise, the smaller ground forces raise questions about the military being able to sustain two combat operations of significant size that overlap. The Department of Defense describes the residual capability in its January 26, 2012, budget preview document only as denying enemy objectives or imposing unacceptable costs, not as being

able to prevail in the second operation.<sup>17</sup> This language is reminiscent of Secretary of Defense Les Aspin's ill-fated "win-hold-win" proposal during the Clinton Administration. Yet in this case, the department is not even bothering with the pretension of promising the later win. Budget considerations are the only plausible explanation for the loss of these vital capabilities.

However, the reductions are not limited to personnel. The force structure would also shrink. The President's proposed budget would:

- Eliminate eight brigade combat teams in the Army;
- Eliminate six Air Force tactical fighter squadrons and one training squadron;
- Reduce airlift by 130 airlift aircraft (C-5As, C-130s, and C-27s); and
- Retire nine ships from the Navy and slow the acquisition of new ships, leaving in doubt the Navy's ability to meet its target fleet of 313 ships.

These force structure cuts raise questions about whether the U.S. military could meet essential security commitments to Europe and an expanded commitment under the Administration's new strategy for

14. Obama, "Remarks by the President on the Defense Strategic Review" (emphasis added).

15. Panetta, "Major Budget Decisions Briefing from the Pentagon."

16. U.S. Department of Defense, "Sustaining U.S. Global Leadership," p. 6.

17. U.S. Department of Defense, "Defense Budget Priorities and Choices," January 2012, p. 7, at [http://www.defense.gov/news/Defense\\_Budget\\_Priorities.pdf](http://www.defense.gov/news/Defense_Budget_Priorities.pdf) (February 8, 2012).

the Asia-Pacific region. In particular, Chairman of the House Seapower Subcommittee Todd Akin (R-MO) has raised serious questions about the wisdom of the Administration's decision to delay the construction of new ships for the Navy.<sup>18</sup>

**Fact # 6: President Obama is abandoning his commitments to sustain a robust U.S. nuclear deterrent.**

President Obama made a slew of commitments to the Senate during its debate on the New Strategic Arms Reduction Treaty (New START) with Russia. The most important of these were enshrined in presidential certifications signed by President Obama, which were required by the Senate's resolution of ratification to New START.

One presidential certification states: "I intend to (a) modernize or replace the triad of strategic nuclear delivery systems: a heavy bomber and air-launched cruise missile, an ICBM [intercontinental ballistic missile], a nuclear-powered ballistic missile submarine (SSBN) and SLBM [submarine-launched ballistic missile]; and (b) maintain the United States rocket motor industrial base."<sup>19</sup>

A preview of the defense budget provided by Secretary Panetta on January 26, 2012, revealed that the

Department of Defense will delay acquisition of the new submarine.<sup>20</sup> Despite assurances to the contrary, this delay could be an initial step in walking away from the submarine acquisition program altogether and a future initiative to build a new SLBM.

A second certification states: "I intend to (a) accelerate, to the extent possible, the design and engineering phase of the Chemistry and Metallurgy Research and Replacement (CMRR) building and the Uranium Processing Facility (UPF); and (b) request full funding, including on a multi-year basis as appropriate, for the CMRR building and the UPF upon completion of the design and engineering phase for such facilities."<sup>21</sup>

When the Senate gave its advice and consent to New START, it expected President Obama to honor his own certification. Yet the Administration proposes deferring the construction of the CMRR for at least five years and cutting the funding by 83 percent in FY 2013 compared with the FY 2012 enacted level. The Senate's consent to the ratification of New START was contingent upon preserving a critical capability at the CMRR. Since President Obama is ignoring his own certification and effectively abandoning what the certification acknowledged is a critical part of the U.S. nuclear weapons

infrastructure, the Senate should respond by insisting on U.S. withdrawal from New START.

Finally, President Obama's budget policies call into question his entire commitment to the nuclear weapons enterprise. During Senate consideration of New START, President Obama pledged to provide the National Nuclear Security Administration with \$79 billion for nuclear infrastructure modernization in FY 2013.<sup>22</sup> The current defense budget proposes providing just \$7.6 billion for the same accounts in FY 2013.<sup>23</sup>

**PRESIDENT OBAMA'S BUDGET POLICIES CALL INTO QUESTION HIS ENTIRE COMMITMENT TO THE NUCLEAR WEAPONS ENTERPRISE.**

Finally, the other shoe on the question of nuclear modernization has yet to drop. Deputy Secretary of Defense Ashton Carter made this clear during a January 26, 2011, press conference previewing the defense budget proposal. In response to a question, he stated:

The White House—and we're obviously working under their direction—are considering the size and shape of the nuclear arsenal in the future. So when

18. "Asia-Pacific Strategy Exposes Navy Shipbuilding Plan to Criticism," *Defense Daily International*, February 3, 2012, at <http://www.defensedaily.com/publications/ddi/16635.html> (February 8, 2012).

19. Barack Obama, "Message from the President on the New START Treaty," The White House, February 2, 2011, at <http://www.whitehouse.gov/the-press-office/2011/02/02/message-president-new-start-treaty-0> (February 9, 2012).

20. U.S. Department of Defense, "Defense Budget Priorities and Choices," p. 8.

21. Obama, "Message from the President on the New START Treaty."

22. The White House, "Fact Sheet: An Enduring Commitment to the U.S. Nuclear Deterrent," November 17, 2010, at <http://www.whitehouse.gov/the-press-office/2010/11/17/fact-sheet-enduring-commitment-us-nuclear-deterrent> (February 14, 2012).

23. U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2013*, p. 104.

those decisions come, we'll factor them into our budget.<sup>24</sup>

Carter's statement virtually admitted that the White House is directing changes in the nation's nuclear posture to advance President Obama's cherished cause of U.S. nuclear disarmament. Accordingly, the current defense budget proposal excludes impending cuts in that portion of the budget pertaining to the nuclear weapons program. It is now clear that the scope of these cuts is quite large. The Obama Administration is looking at a force of as few as 300 to 400 warheads.<sup>25</sup>

In addition, Administration supporters in Congress have already introduced a bill to cut the nuclear weapons budget by \$100 billion for 10 years.<sup>26</sup> It is hard to imagine that this legislation would have been introduced unless the Obama Administration, at a minimum, sees it as an effective stalking horse for the forthcoming proposal to which Deputy Secretary Carter alluded.

#### **Insufficient Compensation for Military Personnel**

President Obama is perhaps most fervent in saying that his policy will provide properly for the nation's military service personnel. On several occasions he has spoken on this issue. In his cover letter to the January 2012 defense strategic review, he wrote: "Most importantly, we will keep faith with our troops, military families and veterans who have

borne the burden of a decade of war and who make our military the best in the world."<sup>27</sup>

There is little reason to doubt that President Obama sincerely wants to stand by the men and women in uniform. Nevertheless, Congress and the public need to examine the DOD's proposal to limit future pay raises beginning in 2015, increase fees and co-payments for health coverage for retirees, and appoint a commission to review the structure of the military retirement system for ways to reduce costs.<sup>28</sup>

Regarding cash compensation, the Administration is wrong to move to limit future pay increases because overall military compensation is already weighted heavily in favor of benefits over cash compensation compared with civilian and private-sector compensation.<sup>29</sup> If anything, military service members should receive more generous pay raises to restore balance in the overall compensation structure.

Neither the President nor the DOD deserves criticism for exploring options to address the rapidly growing cost of military health coverage and retirement under the defense budget. While this cost growth serves as a warning against cutting the overall defense budget—which the President is ignoring—examining the issue is entirely appropriate. However, the President and DOD leaders' proposal to preserve the existing top-down, one-size-fits-all, and overly socialized structures for

military health coverage and retirement is misguided.

On health care, the President and his Administration seem to be wearing blinders while trying to reform the system. Military service members and their families already suffer under a system that contains the worst attributes of the new health care law that the Administration is imposing on the entire country. The driving philosophy behind these policies is the belief that the American people, including service members, are incapable of making decisions about their own health care and that government can and should make these decisions for them and should preclude any other practical options. This top-down approach has led the Department of Defense to embrace a proposal that would impose higher fees and co-payments on retirees, without options that would allow service members and their dependents to explore alternatives that would better meet their needs. Essentially, this would mean "less of the same" and "all pain and no gain" for current and future military retirees.

On the retirement side, the proposed commission's mandate would limit it to tinkering around the edges of the existing system to limit future cost growth. Making marginal changes to existing systems of military health coverage and retirement is not the way to stand by the men and women in uniform. Instead, the Administration should systemically reform both health coverage and

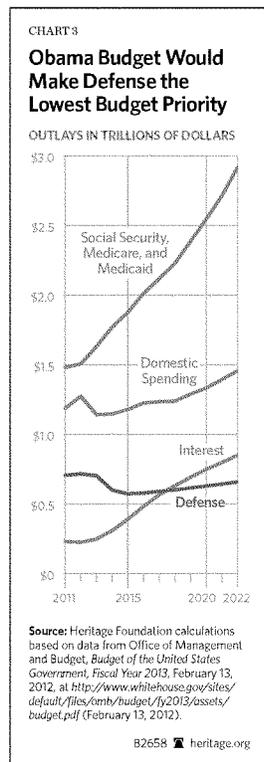
24. U.S. Department of Defense, "Major Budget Decisions Briefing at the Pentagon," January 26, 2012, at <http://www.defense.gov/transcripts/transcript.aspx?transcriptid=4963> (February 9, 2012).

25. Bill Gertz, "Nuking Our Nukes," *The Washington Free Beacon*, February 14, 2012, at <http://freebeacon.com/nuking-our-nukes/> (February 16, 2012).

26. News release, "Markey Introduces SANE Act to Cut Bloated Nuclear Weapons Budget," Office of U.S. Representative Ed Markey, February 8, 2012, at <http://markey.house.gov/press-release/markey-introduces-sane-act-cut-bloated-nuclear-weapons-budget> (February 9, 2012).

27. U.S. Department of Defense, "Sustaining U.S. Global Leadership."

28. U.S. Department of Defense, "Major Budget Decisions Briefing from the Pentagon."



retirement in a way that dramatically expands the options available to military service members and their families.

### Misleading Congress and the American People About Defense

The Obama Administration's description of defense within its FY 2013 budget proposal is about appearances. It is a phantom proposal that pretends that defense is a major contributor to the federal government's enormous deficits and debt. It falsely asserts that preserving defense funding will require tax increases. It moves to sequester part of the defense budget, while denying that it supports this step. It manipulates the defense budget baseline to maximize defense spending reductions. In sum, it takes these and other steps while trying to hide their harm to national security from the American people.

**Defense Spending and the Federal Deficit and Debt.** In his 2010 State of the Union Address, President Obama stated:

By the time I took office, we had a one-year deficit of over \$1 trillion and projected deficits of \$8 trillion over the next decade. Most of this was the result of *not paying for two wars, two tax cuts, and an expensive prescription drug program.*<sup>29</sup>

In fact, defense spending, including paying for the two wars, is a relatively small share of the overall federal budget. Defense has been a lower share of overall federal spending in every year since FY 1992.<sup>30</sup> Indeed, under Obama Administration budget policies, defense will become the lowest priority among the major categories of spending in the federal budget. (See Chart 3.) Shortly before he left office, even Secretary of Defense Robert Gates challenged President Obama's assertion that defense is a major contributor to the deficit: "For starters, I have long believed—and I still do—that the defense budget, however large it may be, is not the cause of this country's fiscal woes."<sup>32</sup>

**The President's False Assertion About Defense and Raising Taxes.** In his 2012 State of the Union Address, the President stated:

Do we want to keep these tax cuts for the wealthiest Americans? Or do we want to keep our investments in everything else—like education and medical research; *a strong military* and care for our veterans? Because if we're serious about paying down our debt, we can't do both.<sup>33</sup>

Since the conclusion of the "deficit deal" that produced the Budget Control Act, the Obama

29. Congressional Budget Office, "Evaluating Military Compensation," June 2007, p. 32, at <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/82xx/doc8271/06-29-compensation.pdf> (February 23, 2012).

30. Barack Obama, "Remarks by the President in the State of the Union Address," The White House, January 27, 2010, at <http://www.whitehouse.gov/photos-and-video/video/2010-state-union-address> (February 13, 2012) (emphasis added).

31. Baker Spring, "The FY 2012 Defense Budget Proposal: Looking for Cuts in All the Wrong Places," Heritage Foundation *Backgrounder* No. 2541, April 5, 2011, at <http://www.heritage.org/research/reports/2011/04/the-fy-2012-defense-budget-proposal-looking-for-cuts-in-all-the-wrong-places> (February 13, 2012).

32. Robert M. Gates, speech at the American Enterprise Institute, Washington, D.C., May 24, 2011, at <http://www.defense.gov/speeches/speech.aspx?speechid=1570> (February 15, 2012).

33. Barack Obama, "Remarks by the President in the State of the Union Address," January 24, 2012, at <http://www.whitehouse.gov/the-press-office/2012/01/24/remarks-president-state-union-address> (January 25, 2012) (emphasis added).

Administration has used the defense budget as a political battering ram to force Congress into raising taxes. While this may be a useful tactic for the Administration, maintaining an adequate defense does not require raising taxes. As pointed out earlier, the Administration's budget policies will make defense the lowest priority among the major components of the federal budget. In contrast, the Heritage Foundation's *Saving the American Dream* fiscal plan achieves a balanced budget in 10 years, while simultaneously keeping tax rates low under a flat tax structure and providing significantly more money for defense over the same period than even the President's FY 2012 defense request.<sup>34</sup> The FY 2012 request preceded the President's April announcement of a revised and reduced defense request and the imposition of the spending caps in the Budget Control Act in the summer.

**The Administration's Policy to Support Sequestration.** The sequestration provision of the Budget Control Act could impose additional defense budget reductions of \$500 billion or more over the next nine years. Administration officials have asserted that Administration policy does not support the sequestration of the defense budget under the Budget Control Act. However, the President's words and actions contradict these assertions.

In a blog post on August 4, 2011, OMB Director Jack Lew stated: "Make no mistake: the sequester

is not meant to be policy."<sup>35</sup> Lew's statement was not just about appearances, but a statement designed to fool the American people between enactment of the Budget Control Act and the beginning of sequestration in January 2013 into believing that President Obama does not favor such a draconian reduction of the defense budget and that sequestration will not happen. In fact, President Obama adopted a policy of not funding defense in excess of the sequestration level the moment he signed the Budget Control Act. The Budget Control Act is the law of the land. It, more than anything else, governs policy, and the President's defense budget is an initial step toward capping defense spending at the sequestration level.

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**DURING A WHITE HOUSE APPEARANCE ON NOVEMBER 21, 2011, PRESIDENT OBAMA STATED: "I WILL VETO ANY EFFORT TO GET RID OF THOSE AUTOMATIC SPENDING CUTS TO DOMESTIC AND DEFENSE SPENDING."**

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The Joint Committee's failure to adopt an alternative deficit reduction plan means that the sequestration of the defense budget will happen if things remain as they stand now. The only way to avoid sequestration is to overturn the Budget Control Act, and the President is precluding that option. During a White House appearance on November 21, 2011,

President Obama stated: "I will veto any effort to get rid of those automatic spending cuts to domestic and defense spending."<sup>36</sup>

**The President's Defense Reductions Are Not About Reducing the Deficit.** In the past, President Obama has sought to convince the American people that his proposed limits on the defense budget are to reduce the deficit and address the nation's debt crisis. However, he has since changed his tune and is now pointing to new domestic spending. In his statement accompanying the new defense strategic review, he stated:

At the same time, we must put our fiscal house in order here at home and renew our long-term economic strength. To that end, the Budget Control Act of 2011 mandates reductions in federal spending, including defense spending.<sup>37</sup>

The earlier assertion about defense spending reductions contributing to deficit reduction is now revealed to be misleading. President Obama admitted in his 2012 State of the Union address that he plans to use at least a portion of the defense budget reductions to increase spending on construction projects that in essence constitute yet another stimulus package. Specifically, he said during the speech: "Take the money we're no longer spending at war, use half of it to pay down our debt, and use the rest to do

34. Butler et al., *Saving the American Dream*.

35. Jack Lew, "Security Spending in the Deficit Agreement," U.S. Office of Management and Budget, August 4, 2011, at <http://www.whitehouse.gov/blog/2011/08/04/security-spending-deficit-agreement> (January 24, 2012).

36. Barack Obama, "Statement by the President on the Supercommittee," The White House, November 21, 2011, at <http://www.whitehouse.gov/the-press-office/2011/11/21/statement-president-supercommittee> (January 24, 2012).

37. U.S. Department of Defense, "Sustaining U.S. Global Leadership," p. 1.

some nation-building right here at home.”<sup>38</sup>

Even more damaging, the President’s budget proposal demonstrates that he has no intention to curtail the rate of growth of the major entitlements—Social Security, Medicare, and Medicaid—to any significant degree. (See Chart 3.) The proposal reveals that outlays for these entitlement programs will increase by more than 90 percent over current levels by FY 2022.

**Manipulating the Defense Baseline.** President Obama is manipulating the tool for comparing defense “cuts” in the budget to refute accurate charges that his budget policies are damaging national security. This tool is called the “baseline,” which projects the cost of today’s defense program into the future. The President wants the power to define this baseline at whim so that he can assert that he is reducing the deficit when he wants to appear to the public as a deficit hawk and later assert that he is not cutting the defense budget when he wants to appear as a national security hawk.

This is how the manipulation works. When President Obama wants to assert that he is a deficit hawk, he projects a high baseline and then claims he is making large-scale cuts in the defense budget to reduce the deficit. By themselves these assertions would be accurate, except as noted earlier, he plans to use these savings to increase domestic spending, not to cut the deficit. When he wants to appear as a national security hawk, he implies that his own, much lower defense budget request is the baseline and that he has imposed

no reductions whatsoever on the defense program.

In one extraordinary statement at a press conference on June 29, 2011, the President attempted to apply this manipulation in both directions simultaneously: “And I promise you the preference of the Pentagon would [be] not to cut any more, because they feel like they’ve already given.”<sup>39</sup> In keeping with his desire to appear as a deficit hawk, the President tried to convey the message that he planned to “cut” the defense budget below an undefined baseline. It is implicit, but nevertheless clear in this same statement that he rejected the assertion by Pentagon officials that the defense program had already been cut in his earlier budget submissions, including his original FY 2012 budget request of February 2011 and his revised and lower defense budget request of April 2011. Silly them, they expected the President to honestly use a fixed defense budget baseline when comparing his budget submissions. What the President was describing in this press conference was his assertion to these same officials that their acceptance of his budget submissions, including any revisions, did not constitute defense budget cuts at all because his budget proposal, which he may revise at any time, is the starting point or the baseline for calculating cuts to the defense budget.

This manipulation, more than anything else, is what makes President Obama’s recent defense budget submission a phantom proposal. It is all about illusions, smoke and mirrors, and hiding essential facts from the public. The facts are

that he is neither a deficit hawk nor a national security hawk. He is not a national security hawk precisely because he intends to impose the low defense spending caps. He is not a deficit hawk because he plans to use the savings from the defense cuts to increase spending on domestic programs.

#### What Congress Should Do

Under Obama Administration budget policies, the nation is facing a crisis in sustaining both an effective defense program and its broader national security policy. The consensus behind the existing foreign policy has been strong and has endured since the end of World War II. The policy has encompassed the requirements for meeting the defense needs of the American people and defending vital U.S. interests around the world. Defending vital U.S. interests has included preventing hostile powers from dominating East Asia, Europe, or the Persian Gulf and providing the security foundation to bolster global trade and access to resources.

Both Congress and the American people would reject the proposition that, for example, the U.S. should no longer view a hostile power that dominates the Persian Gulf as a challenge to vital U.S. interests. Likewise, a proposal for the U.S. to abandon its “second to none” policy on nuclear posture would not be popular. Finally, there is little doubt that the American people would reject the assertion that the Department of Defense need make only a half-hearted effort in fielding missile defense capabilities to protect them

38. Obama, “Remarks by the President in the State of the Union Address,” January 25, 2012.

39. Obama, “Press Conference by the President.”

against missile attack. These are just three examples and the list of similar propositions is potentially quite long. Nevertheless, President Obama's defense budget is more consistent with such dubious propositions than the currently accepted tenets of U.S. national security policy.

Accordingly, Congress cannot afford to stand idly by and watch the erosion of the military capabilities that sustain its foreign policy. Instead, Congress needs to undertake a combination of short-term and long-term actions to maintain a strong national defense. These include:

- Deferring sequestration of defense spending,
- Replacing the Budget Control Act,
- Maintaining the size of the military,
- Increasing modernization funding,
- Reforming the military compensation system, and
- Reducing inefficiency in the Defense Department and reinvesting the savings in defense.

**Deferring Sequestration of Defense Spending.** The most glaring threat to the nation's defense posture is the sequestration process under the Budget Control Act. Under the sequestration process, the existing spending caps will be lowered further, imposing \$500 billion

or more in additional cumulative defense spending reductions over the next nine years. Even Secretary Panetta, who otherwise supports President Obama's budget policies, acknowledges this would be a disaster for defense. In a November 14, 2011, letter to Senator John McCain (R-AZ), he wrote, "The impacts of these [sequestration] cuts would be devastating for the Department [of Defense]."<sup>40</sup>

Under the Budget Control Act, sequestration will begin in January 2013 unless the congressional joint committee (the "supercommittee") finds alternative deficit reduction measures. This joint committee acknowledged that it failed to find such alternatives in late 2011. Thus, unless the law is changed to defer or repeal sequestration, the cuts will begin on schedule.

While repealing sequestration entirely would be preferable given the urgency of the matter, the most practical approach would be to defer it for FY 2013. Two such bills have been introduced: H.R. 3662, sponsored by Chairman of the House Armed Services Committee Buck McKeon (R-CA), and S. 2065, sponsored by Senator Jon Kyl (R-AZ). Both bills would defer the sequestration process by one year by offering an alternative means of deficit reduction based on reining in spending on the federal civilian workforce.

**Replacing the Budget Control Act.** Deferring the sequestration process under the Budget Control Act is only an immediate step to prevent irreparable damage to the nation's defense. If allowed to take effect, the

provisions of the Budget Control Act, including the sequestration process, will damage defense. Congress needs to replace this law with an alternative fiscal plan, namely the Heritage Foundation's *Saving the American Dream* plan. Under the Heritage plan, the nation would not only be able to maintain a strong defense, but also balance the budget in 10 years, while keeping taxes low and total federal spending within reasonable limits. While many approaches could be taken in order to translate the Heritage plan into law, it must first eclipse the Budget Control Act.

**Maintaining the Size of the Military.** As described earlier, the Defense Department is already proposing a number of steps to shrink the military. These include reducing both force structure and personnel levels, particularly in the Army and the Marine Corps.

As a first step,<sup>41</sup> future defense authorization and appropriations measures should seek to preserve the current force structure and personnel levels, including maintaining:

- An active Army of 562,000 persons;
- An active Marine Corps of 202,000 persons;
- An Air Force of 510,900 persons;
- 45 Army Brigade Combat Teams;
- 60 Air Force tactical fighter squadrons and the training squadron that the Pentagon plans to jettison;

40. Leon Panetta, letter to Senator John McCain, November 14, 2011, at [http://mccain.senate.gov/public/index.cfm?FuseAction=PressOffice.PressReleases&ContentRecord\\_id=a4074315-fd3e-2e65-2330-62b95da3b0e9](http://mccain.senate.gov/public/index.cfm?FuseAction=PressOffice.PressReleases&ContentRecord_id=a4074315-fd3e-2e65-2330-62b95da3b0e9) (February 10, 2012).

41. For The Heritage Foundation's recommendation on the total force structure for the long term, see The Heritage Foundation, "A Strong National Defense," pp. 25-26.

- A fleet of 316 airlift aircraft by building new C-17s and C-27s as C-5As and C-130s are retired; and

- An interim strategic nuclear force of at least 420 ICBMs, 280 SLBMs, and 65 nuclear-coded strategic bombers.

In addition, Congress should:

- Rapidly achieve the Navy's objective fleet of 313 ships, while maintaining a balanced mix of ships, and
- Increase the number of ground-based midcourse missile defense interceptors fielded on U.S. territory from 30 to 44 and the number of Standard Missile 3 (SM-3) missile defense interceptors deployed on ships to 341.

#### **Increasing Modernization**

**Funding.** The Administration's military modernization funding request of \$178.2 billion for FY 2013 is simply inadequate. Congress should immediately preempt this proposed reduction. Specifically, Congress should propose an alternative that would restore budget authority for research and development (R&D) to \$80 billion, the level for FY 2010. Furthermore, FY 2013 budget authority should maintain roughly the 1.5 ratio between procurement and R&D in the Administration's proposal. This ratio would permit procurement to be funded at levels that allow efficient absorption of the technologies generated by research and development. Given the

proposed \$80 billion in R&D budget authority, procurement should be funded at \$120 billion.

Beyond FY 2013, R&D funding should increase somewhat faster than inflation, and procurement should increase even faster until the procurement/R&D ratio is about 1.7 to build a larger force than what the Administration is proposing over the next five years and beyond.

**Reforming the Military Compensation System.** The Department of Defense is wrong to propose scaling back future pay increases to military service members. While the Department of Defense needs to explore options for reforming the health coverage and retirement system, such options should expand the choices available to service members and their families.

The Department of Defense should examine systemic proposals for reforming the entire military compensation system. For example, the Heritage Foundation has recommended a combination of steps that selectively increases military pay while providing service members and their families with defined-contribution plans for health coverage and retirement. This approach is designed to bring service members and their families eventually under the broader health coverage and retirement proposals contained in the *Saving the American Dream* fiscal plan.<sup>42</sup>

**Reducing Inefficiency in the Defense Department and Reinvesting the Savings in Defense.** The American taxpayers

expect the Department of Defense to make every effort to eliminate waste and inefficiency. While the scope of waste and inefficiency is likely smaller than they perceive, it is there and can be reduced.

The question remains what to do with the savings from reducing waste and inefficiency. The proper answer is to reinvest these savings in the defense program to improve U.S. military capabilities. President Obama, however, wants to use defense savings to fund domestic spending programs that are at least as inefficient as the defense programs that would be reformed or eliminated to obtain the savings.

#### **Conclusion**

The Preamble of the Constitution states that providing for the common defense is among the highest priorities of the federal government. Obama Administration budget policy seeks to make it the lowest priority. The Preamble also directs the federal government to "secure the Blessings of Liberty." Since the end of World War II, U.S. leaders have recognized that sustaining American liberty is all but impossible if America is an island of liberty in a world dominated by aggressive authoritarian and totalitarian nations. Accordingly, after the unhappy experiences of the first half of the 20th century, the U.S. has sought to expand security and liberty around the world by establishing a system of alliances in key regions and backing this system with an array of security commitments.

In sharp contrast, the Obama Administration's budget policies are

42. Baker Spring, "Saving the American Dream: Improving Health Care and Retirement for Military Service Members and Their Families," Heritage Foundation Backgrounder No. 2621, November 17, 2011, at <http://www.heritage.org/research/reports/2011/11/saving-the-american-dream-improving-health-care-and-retirement-for-military-service-members>.

reducing America's military capacity so drastically that upholding these commitments will become impossible over time. A conservative Congress, which as the name implies should focus on preserving essential American values, institutions, and commitments, would necessarily reject the Obama Administration's defense budget proposal.

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# Backgrounder

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## Performance-Based Logistics: Making the Military More Efficient

*Baker Spring*

**Abstract:** *The military should—and can—operate more efficiently. One area that has potential for major savings is logistics. As combat capabilities grow, the logistics system must adapt. Performance-based logistics is an approach that organizes logistics around these increasing combat capabilities, offering huge savings (up to \$32 billion a year) in the process. But despite successful implementation of performance-based logistics at select military depots, there remains a bias against private contractors among some in Congress, and there is only a very limited application of the new performance-based approach, which is managed by well-functioning public-private partnerships. Heritage Foundation national security policy expert Baker Spring explains why and how Congress should support an effective and efficient military logistical system. It matters both to America's taxpayers and to the men and women in uniform who risk their lives to defend them.*

One area in which the United States military can operate more efficiently, possibly providing large-scale dollar savings, is in logistics. The Department of Defense would be able to plow the savings into its strapped modernization accounts and build the next generation of weapons and equipment for the soldiers, sailors, airmen, and Marines that will fight the nation's wars in the future. A report from the Aerospace Industries Association estimates that the savings could amount to as much as \$32 billion a year.<sup>1</sup>

The more efficient approach to improving the overall effectiveness of logistics is referred to as per-

### Talking Points

- Performance-based logistics can increase the efficiency and lower the cost of the military's logistical system through well-designed partnerships between government-run depots and private contractors.
- Congress should encourage both the use of performance-based logistics and the expansion of public-private partnerships at the depots.
- Congress should hold hearings that highlight the advantages of performance-based logistics, abandon the anti-contractor bias in debates over military acquisition reform, and establish a pilot program at the Letterkenny Army Depot in Pennsylvania for identifying ways to expand the use of performance-based logistics.
- Congress and the Defense Department should recycle the savings from an improved logistics system back into the defense budget to procure the next generation of weapons systems.
- Performance-based logistics should not become an excuse for either the Obama Administration or Congress to cut the defense budget. The primary objective should be a stronger and more cost-effective military.

This paper, in its entirety, can be found at:  
<http://report.heritage.org/bg2411>

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formance-based logistics. It is based on forging partnerships between Department of Defense employees and defense industry staff at the military's logistical centers in the U.S. and abroad. It seeks to organize the logistics system around increasing combat capabilities.

For performance-based logistics to continue to succeed, however, Congress will need to lend its support. Specifically, Congress will need to:

- Explore opportunities for the expanded application of performance-based logistics,
- Reinforce the partnerships between contractors and the depots in the performance of logistical work for the Department of Defense,
- Establish a pilot program for identifying the barriers to expanded public-private partnerships in logistics, and
- Ensure that the realized savings are kept in the defense budget.

#### **Performance-Based Logistics: How It Works**

Performance-based logistics changes the metric by which the effectiveness of the logistics system is gauged in order to drive an alternative approach to managing the system.<sup>2</sup> The traditional approach has been to measure outcomes in the logistics system by raw industrial output, including such things as the number of weapons and platforms repaired, the tons of matériel moved, the hours of services provided, and the number of replacement parts acquired. Performance-based logistics measures the outcomes in terms of how the system meets desired performance parameters. Specifically, these performance parameters include the efficient identification of warfighter needs, the delivery of the needed matériel to the warfighters, and the timely delivery of goods and services to the warfighters.

Performance-based logistics is managed through a system of contracts called performance-based agreements. The need for such agreements is determined by program managers who conduct a business case analysis that reveals that a new support

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***The public-private partnerships are directed by the requirements of the performance-based agreements to focus on achieving the best performance outcome for the warfighter.***

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arrangement either can deliver the same level of performance to the warfighter at less cost than the existing arrangement or can increase the level of performance at the same cost as the existing arrangement. The requirement that performance goals be met is imposed on the supplier but is of sufficient duration and flexibility to permit the supplier to adapt his enterprise to meeting the goals.

Organizationally, the performance-based logistics system works best under partnerships between the government-controlled depots and logistical centers and the private contractors (usually the contractors that produced the weapons or equipment to be sustained and supported). These public-private arrangements are called outcome-based partnerships.

Current law requires that not more than 50 percent of funds that Congress makes available for depot-level maintenance may go to private contractors. The public-private partnerships established under performance-based logistics permit greater contractor involvement in the public depots, sometimes including private investment in infrastructure upgrades in these facilities, under the requirements of the law. Most important, the public-private partnerships are directed by the requirements of the performance-based agreements to focus on achieving the best performance outcome for the warfighter.

#### **Performance-Based Logistics in Action**

In its May 2009 report, the Aerospace Industries Association identified five areas in which the concept of performance-based logistics is being applied. Each area represents a broad swath of the Department of Defense's total logistical enterprise, but the current scope of performance-based logistic activities within each one is modest. As a result, potential

1. Aerospace Industries Association, "Modernizing Defense Logistics," May 26, 2009.

2. For an overview of performance-based logistics, see Daniel Gouré, "Performance-Based Logistics: A Primer for the New Administration," The Lexington Institute, April 2009.

program improvements and cost savings would be quite large if performance-based logistics was applied more widely.

The five areas identified by the Aerospace Industries Association are as follows:

**Area 1: Life Cycle Product Support.** Life Cycle Product Support covers logistical activities related to maintaining the weapons and equipment already in operation. These include repairs, refurbishments, and modifications and upgrades.

The 2009 Aerospace Industries Association report identifies 18 military systems in this area where the necessary support work is being performed through public-private partnerships. The savings range from just more than 1 percent to more than 50 percent among the identified systems.<sup>3</sup> The calculated savings fall between \$16 billion and \$21 billion annually if performance-based logistics was applied across all applicable Department of Defense weapons and equipment in the support area.<sup>4</sup>

**Area 2: Management of Commodities.** The military's logistical system is responsible for maintaining access to an enormous list of commodities that are used to perform maintenance and upgrades to weapons and equipment. Performance-based logistics improves the efficiency of the commodities supply network by insuring the rapid delivery of the needed commodities and reducing storage and inventory costs.

In this case, the potential annual savings to the Department of Defense is estimated by the Aerospace Industries Association to range from \$2.8 billion to \$3.7 billion.<sup>5</sup>

**Area 3: Mobility Assets and Infrastructure.** Related to the management of commodities is the operation of the transportation system that delivers commodities to the places where they are needed. In the case of the military, performance-based logistics would copy the best practices of the commercial

sector in operating its transportation system to support logistics. Most of the savings in this area would result from optimizing the distribution process.

The Aerospace Industries Association estimates that the annual cost savings in this area if the reform is applied across the distribution network would be between \$1.1 billion and \$1.5 billion.<sup>6</sup>

**Area 4: Theater Services.** Theater Services are logistical capabilities to support combat and humanitarian missions that are located in the theater of operation. Their purpose is to provide the necessary nodes in theater to assure the flow of weapons and matériel to support an operation. They exclude, however, the final step in this delivery process, which is the immediate delivery of weapons and matériel to the personnel that use them directly. This step is covered under the area of Mobility Assets and Infrastructure (Area 3). Theater Services also do not extend to supporting "forced entry" operations to establish a presence in the applicable theater.

The activities that are covered under this area are the construction and manning of in-theater facilities, such as storage and delivery depots; the operation of these facilities; and the distribution of the weapons and matériel to an intermediate station. The efficiencies are achieved in this area by the pursuit of pre-planning steps with host countries and contractors, most importantly regarding the use of airfields and ports, and heavier reliance on contractors under pre-negotiated contracts.

In the case of this area, the Aerospace Industries Association estimates that savings would be between \$2.4 billion and \$3.2 billion annually.<sup>7</sup>

**Area 5: Logistics Information Systems.** Any system as far-flung and complex as the military's logistical system will operate better and more efficiently when it is supported by state-of-the-art information technology. Performance-based logistics demands that the information technology infra-

3. Aerospace Industries Association, "Modernizing Defense Logistics," p. 14.

4. *Ibid.*, p. 16.

5. *Ibid.*, p. 19.

6. *Ibid.*, p. 22.

7. *Ibid.*, p. 26.

structure to support the logistical system be thoroughly modernized.

Further, the modernization effort must be tied to an effective administration and management structure. This can be achieved by contractors having the authority to undertake development of the applicable information technology systems, with the government contracting for the use of these systems. The government gains efficiencies by paying only for the information technology systems and services it uses.

The Aerospace Industries Association estimates that the annual savings in this area would be between \$1.9 billion and \$2.5 billion.

#### **Potential for Savings in Operations and Maintenance Accounts**

If the Department of Defense broadened the application of performance-based logistics in each of the five areas identified above, the annual direct savings to the department could be as high as \$32 billion annually, according to the Aerospace Industries Association.<sup>8</sup> Achieving this level of savings requires five steps.<sup>9</sup>

1. The first step is to broaden the application of performance-based logistics at all levels of the logistical system, specifically the component level, the subsystem level, and the system level.
2. The second step is for the Department of Defense to expand its use of commercial supply chains.
3. The third step is for the Department of Defense to use outcome-based partnerships in order to transfer best practices for distribution from the commercial sector to the public component of the logistical system.
4. The fourth step is to expand the opportunities for establishment of outcome-based partnerships in theater-based logistics.

5. The fifth step is to expand access to commercial managed services to provide information technology to the logistical system.

The bulk of these savings would occur in the operations and maintenance accounts of the Department of Defense budget. Reducing these costs will

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***If the maintenance costs incurred for the support of existing weapons can be reduced, the savings can be channeled into the acquisition of new weapons that will be less expensive to maintain.***

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permit the Department of Defense to break the "death spiral" in the acquisition system, broadly defined to include the full life-cycle costs of weapons systems. The acquisition death spiral, as described by then-Under Secretary of Defense Jacques Gansler in 1998, is a cycle where aging weapons and inefficiencies in the support programs for existing weapons divert defense dollars to the maintenance accounts, which results in deferral of the procurement of new weapons, which in turn results in older and more expensive-to-maintain weapons.<sup>10</sup>

If the maintenance costs incurred for the support of existing weapons can be reduced, the savings can be channeled into the acquisition of new weapons that will be less expensive to maintain. While this step will require larger overall defense budgets for the core defense program, it can help to initiate a reverse dynamic that will permit the death spiral to become a recovery spiral.<sup>11</sup>

#### **Letterkenny Army Depot**

It is reasonable for the Department of Defense and Congress to be cautious about promised large-scale savings in defense accounts from industry. This is why an accurate assessment of the estimated savings provided by industry requires a review of how performance-based logistics works at the local

8. *Ibid.*, p. 31.

9. *Ibid.*, p. 34.

10. George Cahlink, "Gansler: DoD in a 'Death Spiral,' Program Terminations Likely," *Defense Daily*, September 3, 1998, at <http://www.defensedaily.com/articles/dd/1998/dd0903981.html> (May 3, 2010).

11. Baker Spring, "The 2011 Defense Budget: Inadequate and Full of Inconsistencies," *Heritage Foundation Backgrounder* No. 2375, February 22, 2010, at [http://ohf\\_media.s3.amazonaws.com/2010/pdf/bg2375.pdf](http://ohf_media.s3.amazonaws.com/2010/pdf/bg2375.pdf) (May 3, 2010).

level, including the depots where most activities take place.

One example is the Letterkenny Army Depot in Chambersburg, Pennsylvania. The Letterkenny depot has undertaken a number of partnerships with defense industry in providing logistical support to the Army. Prominent among these is its partnership with Lockheed Martin to support the JAVELIN anti-tank weapon.

The JAVELIN program at Letterkenny provides 24-hour, seven-day-a-week support to the weapon through a subcontract derived from the JAVELIN Joint Venture office, which includes defense contractors Lockheed Martin and Raytheon. The support effort is concentrated on providing repair services for circuit card assemblies within the weapon's Command Launch Unit and maintaining the weapon's rounds of ammunition. Industry assesses the cost-benefit improvement derived from the performance-based logistics approach for the JAVELIN program to be 10 percent.<sup>12</sup> Both management and labor representatives at Letterkenny seem to recognize this improvement.<sup>13</sup>

The JAVELIN program is not the only beneficiary of performance-based logistics at Letterkenny. Another program is the Modernized Target Acquisition Designation Sight (M-TADS) program for the Apache helicopter.<sup>14</sup> The M-TADS system is installed on Apache helicopters to permit the crew to acquire targets through a multi-sensor package for missiles carried by the aircraft. This partnership at Letterkenny has included Lockheed Martin's direct investment of \$1.5 million for repair activities on the M-TADS system. The repair activity also fosters direct interaction between the contractor and depot personnel.

The direct interaction between contractor and depot personnel is something to which Congress should pay particular attention when assessing performance-based logistics. Some Members of Congress may perceive that the relationship between contractor personnel and depot personnel is an adversarial one, based on the assumption that depot personnel view the presence of contractor staff as a threat to job security. Such an assumption is misplaced. Robert Willits, a union steward at Letterkenny, when asked about the relationships between the public staffers of the depot and those who are employed with the private contractor, stated: "This works really well here, and we can adapt to the work that the contractor does."<sup>15</sup>

The depot's own employees also find that there are few difficulties stemming from the need for the managers of the depot and the private contractor to coordinate the activities of their respective employees. Again, Willits stated:

The depot and the contractor managers coordinate things effectively so that the depot managers can instruct their employees and contractor managers can instruct their employees in a way that avoids confusions, and I have been here for almost four years and have yet to run into a conflict in this area.<sup>16</sup>

This kind of management coordination appears to extend to private-contractor investments in the public depot, particularly in the area of training. While not directly knowledgeable about the management aspects of these investment programs, Willits explained, "I did participate in a training program at a Lockheed Martin facility. The cost of the training was shared between Lockheed Martin and the depot, but I felt very welcomed at the Lock-

12. Lou Kratz and Bradd A. Buckingham, "Achieving Performance Based Life Cycle Management," Lockheed Martin Corporation, December 2008.

13. Author interview with Mark Sheffield, Manager, Letterkenny Army Depot, April 8, 2010, and author interview with Robert Willits, Union Steward, Letterkenny Army Depot, April 12, 2010.

14. Lou Kratz, Vice President for Logistics and Support, Lockheed Martin Corporation, "Partnering for Performance," September 9, 2009, and Letterkenny Army Depot, "New Workload Arrives at Letterkenny," Release No. 07-03, January 17, 2007.

15. Author interview with Robert Willits, Union Steward, Letterkenny Army Depot, April 12, 2010.

16. *Ibid.*

heed Martin facility, practically like I was one of their employees.<sup>17</sup>

Finally, Willits recognized that there is considerable room for expanding public-private partnerships even at Letterkenny Army Depot, which

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***The ultimate winners in these cooperative enterprises are the soldiers, sailors, airmen, and Marines serving in the military, as well as the American taxpayers.***

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appears to be relatively advanced in pursuing these partnerships. It is clear from the experience at Letterkenny that the private contractors are sensitive to the views of the public employees at the depot. The union representing the depot's employees is adapting to these structures and has acted responsibly by not seeking to put barriers between the public employees and the private contractors.

The ultimate winners in these cooperative enterprises are the soldiers, sailors, airmen, and Marines serving in the military, as well as the American taxpayers.

### **Where to Go from Here**

Initial experience with performance-based logistics indicates that it is a well-designed approach to improving the overall effectiveness and efficiency of the military's logistical system, particularly in the maintenance of weapons and equipment. On this basis, it is appropriate for Congress, the Department of Defense, the military services, private contractors, and the unions to consider the following recommendations.

**1. Congress should provide avenues for expanding the application of performance-based logistics.** As described earlier, the Aerospace Industries Association has estimated that the potential savings from an expansion of performance-based logistics could be as high as \$32 billion a year. This estimate derives from the assessment that performance-based logistics was applied rather narrowly across the logistical system, involving less than 10 percent of all work performed. The estimated sav-

ings are based on more than doubling the percentage of the total work across the logistical system that is performed under the performance-based approach.

Congress needs to encourage the Department of Defense to explore options for expanding the application of performance-based logistics and increasing the level of savings. This is not to say that Congress should simply mandate an expanded application of this approach to an arbitrary percentage of logistics programs. Congress must adopt a more careful approach because needless errors will only serve to undermine performance-based logistics.

This more careful approach starts with hearings by the House and Senate Armed Services Committees on the status of the performance-based effort. During the hearings, Members of Congress should seek to learn whether the reach of the performance-based approach extends to the components and subsystems of weapons systems. It is not sufficient to apply performance-based logistics at the system level alone. Rather, the effectiveness of the approach will be enhanced if it is extended to component and subsystem levels and to the services extended in support of weapons systems through the logistical system.

Accordingly, the hearings should serve to encourage the Department of Defense to expand the application of performance-based logistics vertically. Witnesses at these hearings should include depot managers, representatives of private contractors, and union representatives.

**2. Congress should reinforce the partnerships between contractors and the depots in the performance of logistical work for the Department of Defense.** The success of performance-based logistics stems from healthy working partnerships between private defense contractors and public servants operating the depots that support the military. In the vast majority of cases, the weapons systems and equipment that are being maintained and improved through the logistical system were built by private contractors who understand these weapons systems and pieces of equipment from the inside out. Performance-based logistics is designed

17. *Ibid.*

to bring the contractors inside the depots in order to provide their considerable expertise, complementing organic depot capabilities.

A political bias against private contractors, whether in the context of the initial procurement of weapons, equipment, and services or in the context of logistical support, will undermine the necessary public-private partnerships that make performance-based logistics work. Defense contractors are not, as some Members of Congress seem to believe, parasites feeding off the Department of Defense. They are businesses trying to run successful and prosperous enterprises in a market that happens to be dominated by the government on the consumer side. They should be rewarded, not punished, for servicing the government's defense needs as long as they provide top-quality goods and services at affordable prices.

Combating the anti-contractor bias is another reason for the House and Senate Armed Services Committees to hold hearings on performance-based logistics. The witnesses should come from both the contractor community and depots in order to explain how they use the performance-based approach to work together to rationalize and make more efficient the broader logistical system.

The hearings would serve to inform Members of Congress and the public about how the public-private partnerships work within the logistical system. More important, they would serve to help Congress identify the barriers that continue to stand in the way of strengthening these partnerships.

**3. Congress should establish a pilot program for identifying the barriers to expanding public-private partnerships in logistics.** The existing performance-based logistics approach is designed from the outset to be consistent with the requirements of Title 10 of the United States Code and the regulations derived from these statutes. Title 10 is the portion of the code that is devoted to organizing the armed forces. Accordingly, provisions within Title 10 necessarily serve to regulate the logistical system.

More regulation, however, does not necessarily mean better regulation. In fact, certain provisions of Title 10 and its accompanying regulations may obstruct the very public-private partnerships that

make performance-based logistics succeed. Identifying these barriers, however, is not easy and must be done carefully.

Exploring where the statutory and regulatory barriers to expanded performance-based logistics may reside is best done on a limited and tentative basis. Further, it must be done in a way that from

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***Certain provisions of Title 10 and its accompanying regulations may obstruct the very public-private partnerships that make performance-based logistics succeed.***

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the beginning requests input from defense contractors, the depot managers, depot union representatives, and senior management from the Department of Defense. The best approach for Congress is to include a provision in the fiscal year 2011 Department of Defense Authorization Bill to establish a pilot program for this purpose.

The applicable provision should permit the senior official at a specific depot to request a waiver from one or more specifically identified statutes under Title 10, as well as regulations applied through Title 10 exclusively for expanding opportunities for establishing public-private partnerships at the depot. The waiver request could be directed to the Deputy Under Secretary of Defense for Logistics and Matériel Readiness, but only after consultation by the senior manager of the depot with the relevant defense contractors and union representatives of depot employees.

The pilot program should extend for no more than five years, although already approved waivers could extend beyond this period. The presumption should be that the Deputy Under Secretary of Defense will grant the waivers as long as the specifics of how the waiver will expand the opportunities for public-private partnerships at the depot are provided, an explanation of how the waiver will increase efficiency and lower costs is included with the request, and the request certifies that the necessary consultations have been completed.

Because of the progress it has made in applying performance-based logistics, the logical location for

undertaking this pilot program is the Letterkenny Army Depot. Given its experience, Letterkenny is likely to be ahead of other depots in terms of identifying the statutory and regulatory barriers to more productive public-private partnerships and the expanded application of performance-based logistics. Further, the existing relationships between the depot's senior management, the contractors, and depot employees seem quite solid. These solid relationships will provide a good foundation for the pilot program as long as the program continues to strengthen and reinforce these relationships.

At the end of this pilot program, Congress will be in a better position to make informed decisions about adopting broadly applicable changes in Title 10 to enhance the efficiency of the logistics system by applying the performance-based logistics approach. It will not be legislating blindly on the matter.

**4. The Defense Department and Congress should plow savings from the logistical system back into procurement.** The military logistical system for sustaining the weapons and equipment already in use should not be viewed apart from the broader defense acquisition system. Even a properly organized logistical structure that operates efficiently and effectively cannot sustain aging weapons and equipment. At some point, the cost of maintenance will become unsupportable as the weapons and equipment age. These older systems must be retired and new systems brought in to meet necessary military requirements.

It is in the context of the need for a healthy acquisition system that Congress must understand the limits of the performance-based approach to logistics. Specifically, Congress needs to recognize that if the savings are removed from the defense budget, the defense acquisition system cannot escape the death spiral described by Under Secretary of Defense Gansler in 1998. Rather, the savings should be retained within the defense budget and channeled to fund the procurement of the next generation of weapons and equipment. Ultimately, the new weapons and equipment will provide an additional benefit to the logistical system because they

will be easier and less costly to maintain than the aged systems they replace. This need to reinvest in weapons was recognized by Roger Willits as a union steward at Letterkenny.<sup>18</sup>

The central purpose of adopting the performance-based logistics reforms within the Department of Defense should be to transform the death

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***Performance-based logistics should not become an excuse for either the Obama Administration or Congress to cut the defense budget.***

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spiral of defense acquisition into a recovery spiral. The recovery spiral will use the savings from the adoption of performance-based logistics to fund new purchases of weapons and equipment that will in turn relieve long-term cost growth pressures within the logistical system.

Performance-based logistics should not become an excuse for either the Obama Administration or Congress to cut the defense budget. The primary objective should be to create a stronger and more cost-effective military.

### **Conclusion**

The Department of Defense, the military services, and the taxpayers need a military logistical system that works effectively and efficiently. Experience suggests that the performance-based logistics that have been applied through public-private partnerships and pursued selectively at some of the nation's military depots can lead to marked improvements in the military logistics system. Nevertheless, the application of performance-based logistics remains limited.

Accordingly, Congress needs to reinforce the movement toward adoption of performance-based logistics. This starts with highlighting the successes that have been achieved to date. It continues with Congress recognizing that an anti-contractor bias does not serve the public interest. It concludes with Congress authorizing a limited pilot program for identifying provisions in the law and in regulations that are barriers to the expansion of performance-

18. *Ibid.*

based logistics and permitting the applicable laws and regulations to be waived under a careful process that involves the depot managers and employees, the private contractors, and the Defense Department leadership.

The efficiency and effectiveness of the military logistical system *can* be improved. Performance-

based logistics offers promising opportunities that Congress should recognize.

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Chairman CONRAD. We will make those part of the record.

Mr. CARAFANO. The third area that I addressed here is the imperative of investment recapitalization in the military, which has not gotten much discussed here today.

Fourthly, looking at maintaining capability and where we need to invest in new capabilities.

And fifth and most important is to come here today to advocate for your support for a budget that simply takes us in a different direction. I do think that this country and this Congress and this President can pass budgets that balance budgets in future years. I think that can be achieved in as little as ten years. I think it can significantly cut into the deficit. I think we can do that without raising taxes. I think we could do that in a manner that would leave every class of Americans better off than they are today. And I think we can do that with having sustainable, robust defense budgets for decades in the future.

Thank you, sir, and I look forward to your questions.

[The prepared statement of Mr. Carafano follows:]



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*CONGRESSIONAL TESTIMONY*

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**When Defense Becomes the Last  
Priority**

**Testimony before  
Senate Budget Committee**

**Tuesday, March 6, 2012**

**James Jay Carafano, Ph.D.,**

**Deputy Director, The Kathryn and Shelby Cullom  
Davis Institute for International Studies  
and Director, Douglas and Sarah Allison Center for  
Foreign Policy Studies,  
The Heritage Foundation**

My name is Dr. James Jay Carafano. I am the Deputy Director of the Kathryn and Shelby Cullom Davis Institute for International Studies and Director of the Douglas and Sarah Allison Center for Foreign Policy Studies at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Thank you for the opportunity to testify on the vitally important subject of providing our men and women in uniform with the resources they need to defend us. My assessment is that President Barack Obama's budget proposal for FY 2013 (in combination with automatic spending reductions required under the Budget Control Act of 2011) would reduce the capabilities of the armed forces to the point that they could no longer protect U.S. vital interests and keep U.S. security commitments around the world. This conclusion is based on an evaluation of global defense needs that The Heritage Foundation undertook just last year.<sup>1</sup> Our assessment quantified how current and projected capabilities align with legitimate defense requirements by describing the dangers that U.S. military forces will likely face and the capabilities needed to meet those dangers in five strategically important regions: Asia, the Middle East, Europe, the American homeland, and globally.

The capabilities and readiness posture that can be achieved under the President's vision fall far short of what is adequate.

In my testimony today, I would like to concentrate on what I see as the key issues that the Congress must consider in evaluating the President's FY 2013 defense budget request and its shortfalls: (1) How defense relates to addressing the nation's overall fiscal challenges, (2) how the President's proposal compares to strategic defense requirements, (3) the consequences of the President's proposal, (4) where real savings can be achieved, and (5) an alternative path forward for investing in defense.

#### A Legacy of Research and Service

I supervise all of The Heritage Foundation's research on public policy concerning foreign policy and national security. How government fulfills its fundamental obligation under the Constitution to "provide for the common defense" has long been a Heritage research priority. To meet the unique challenges of the post-9/11 world, the foundation has assembled over the past decade a robust, talented, and dedicated research team. I have the honor and privilege of leading that team.

Heritage analysts have studied and written authoritatively on virtually every aspect of defense affairs with particular emphasis on reforms and efficiencies, the reserve components, strategic arms and missile defense, homeland defense, the unified command plan, force structure, missions, regional security issues, science and technology, and the

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<sup>1</sup> The Heritage Foundation, "A Strong National Defense: The Armed Forces America Needs and What They Will Cost" April 5, 2011, at <http://www.heritage.org/research/reports/2011/04/a-strong-national-defense-the-armed-forces-america-needs-and-what-they-will-cost>.

defense budget. The foundation was an early proponent for many initiatives and reforms including conceptualizing the Strategic Defense Initiative and establishing the U.S. Africa Command. The results of all our research are publicly available on the Heritage website at [www.heritage.org](http://www.heritage.org).

We collaborate frequently with other institutions in the research community. In particular, we prize our collaborative efforts with the American Enterprise Institute and the Foreign Policy Initiative. Working together with these groups as part of the “Defending Defense” coalition, we have undertaken a concerted effort to raise awareness on the importance of maintaining the readiness and capabilities of the armed forces.

In addition, our analysts regularly interact with the War Colleges, federally funded research development centers, the armed services, and the Joint and Defense Department Staffs. Heritage analysts also serve on a variety of government advisory efforts including the National Academies Board on Army Science and Technology, the Department of the Army Historical Advisory Committee, and the Advisory Panel on Department of Defense Capabilities for Support of Civil Authorities, as well as institutions that support the armed forces such as the Marine Corps University Foundation.

Our research programs are nonpartisan, dedicated to developing policy proposals that will keep the nation safe, free, and prosperous. The concerns I express today rest on the foundation of that research.

#### The Road to Security and Prosperity

Cutting the capabilities of the armed forces and degrading readiness cannot be justified as a necessary austerity measure for reducing federal spending. It is an unrealistic strategy for achieving long-term savings.

First, there is little question that, even without the mandatory reductions in spending under the Budget Control Act of 2011, the Administration is cutting back on defense as its primary means for slowing the growth of federal spending. Defense, accounting for less than 20 percent of the federal budget, will absorb over 50 percent of the planned reductions in federal spending.

Under the Administration’s budget proposal defense would not return to FY 2010 spending levels for the entirety of the 10-year projection with reductions front-loaded in the first five years (FY 2011–FY 2014) and then growing slowly from the low point (in terms of current dollars).<sup>2</sup>

<sup>2</sup> U.S. Office of Management and Budget, supplemental materials for *Budget of the United States Government, Fiscal Year 2013: Analytical Perspectives* (Washington, D.C.: U.S. Government Printing Office, 2012), February 13, 2012, Table 32-1, at [http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/32\\_1.pdf](http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/32_1.pdf) (February 14, 2012). In calculating from President Obama’s second defense budget request for FY 2011, the administration lowered the defense budget baseline by about \$750 billion over 10 years. This then allowed the Administration to argue that it has not cut the defense budget, but only slowed the rate of growth. Further, the Administration blurred accountability through manipulating funding for overseas contingency

These reductions cannot be defended as being necessary to restore the nation's fiscal health and reining in government spending. The level of defense expenditures today is modest by historic standards. The United States spent on average about 7.5 percent of GDP on defense during the Cold War. Current levels of spending are about half that.

Further, even steep defense reductions will not stem the long-term growth of government. Social Security, Medicare, and Medicaid together already account for about 10 percent of GDP and 43 percent of federal spending. In a few decades, even if defense spending were to go to zero, the rising costs of sustaining these programs will consume all federal taxes. We are facing the consequences of generations of politicians from both political parties having promised millions of Americans certain services without regard to cost or how we will pay for them. The nation cannot be made safe or prosperous without addressing this core fiscal issue.

But it is not necessary to make Hobbesian choices. In 2011, The Heritage Foundation laid out a long-term budget proposal that would balance the budget in 10 years, significantly reduce the federal debt, leaves every class of Americans better off than they are now, does not raise taxes, and fully funds defense at adequate levels for decades.<sup>3</sup> The Heritage plan achieves these goals by reducing the federal government so that it is closer to its proper size and focused on performing its core responsibilities; and transforming entitlement programs to better meet the needs of today's and tomorrow's seniors while making them affordable; and holding down taxes while reforming our needlessly complex, burdensome, and highly unfair tax system. Under this plan, called *Saving the American Dream*, this nation can return to prosperity and government can meet its obligation to provide for the common defense.

In contrast, all this budget can do is ensure that defense becomes the nation's last priority.

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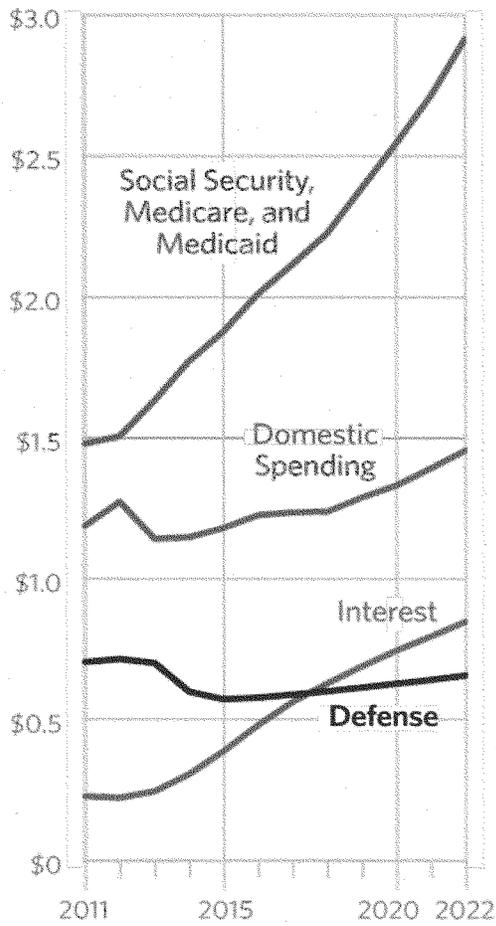
operations (OCO). Including OCO expenditures in any comparison is appropriate because existing historical descriptions of defense expenditures have included them.

<sup>3</sup> Stuart M. Butler, Alison Acosta Fraser and William W. Beach, *Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity*, The Heritage Foundation, 2011, at <http://www.heritage.org/research/reports/2011/05/saving-the-american-dream-the-heritage-plan-to-fix-the-debt-cut-spending-and-restore-prosperity>.

CHART 3

### Obama Budget Would Make Defense the Lowest Budget Priority

OUTLAYS IN TRILLIONS OF DOLLARS



Source: Heritage Foundation calculations

## Strategic Guidance and FY2013 Budget Proposals

The President's proposal was informed by the defense strategic guidance released to the public in January 2012.<sup>4</sup> The guidance, however, is not a credible assessment of future U.S. defense needs.

In 2010, the Administration released its Quadrennial Defense Review (QDR) which called for substantially more capability than would be funded under the President's current proposal. Furthermore, the congressionally chartered bipartisan Independent Panel tasked to review the finding of the QDR concluded that the report underestimated defense requirements. In his opening statement at hearings reviewing the findings of the panel Senator Carl Levin, Chairman of the Senate Armed Services Committee, pointed out "[t]he panel goes on to warn us about what it calls the 'growing gap' between what the military is capable of doing and what they may be called upon to do in the future."<sup>5</sup>

Yet, now the White House has declared that we can get by with dramatically less capability. All of which begs the question: What does the White House know now that it did not know when it signed off on the 2010 QDR report? The answer is, not much.

Early on in his tenure in office, President Obama clearly expressed his intent to get U.S. combat troops out of Iraq by 2011, and out of Afghanistan by 2014. Yet, back in 2010, there was no signal that the forces used to fight those wars would be scrubbed from the Pentagon's ranks.

Furthermore, little else in the global security environment is dramatically different. For example, Iran is still an aggressive, destabilizing power that is a proven state sponsor of terrorism and is actively seeking to gain nuclear weapons. The only real change in the situation is that North Korea now has a new leader – a young, untested, and unpredictable neophyte with his finger on the country's nuclear trigger. Russia is as restive as ever. Despite White House claims of successfully "resetting" relations with Moscow, there have been no real foreign policy breakthroughs or closer alignment with the Kremlin. Nor can the Administration claim it has made great strides in managing strategic competition with China. In fact, the strategic guidance calls for a "pivot" towards Asia for one reason – to keep pace with Beijing's efforts to erect an expanding sphere of influence that crowds out the United States. And then there remain the bugbears of Iraq and Afghanistan, where there are deep concerns over whether the U.S. can continue to secure its interests. In Iraq, government officials admit there is a potential for a resurgence of violence. There are also concerns over Iraq's political stability in a post-Coalition environment. At the same time in Afghanistan, U.S. and NATO intelligence assessments alike cast doubt on whether enough has been done to prevent the resurgence of an armed, anti-American Taliban. And when the Taliban returns, so will al-Qaeda – seeking to

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<sup>4</sup> Department of Defense, "Sustaining U.S. Global Leadership: Priorities for 21st Century Defense," January 2012, at [http://www.defense.gov/news/Defense\\_Strategic\\_Guidance.pdf](http://www.defense.gov/news/Defense_Strategic_Guidance.pdf).

<sup>5</sup> "Opening Statement of Senator Carl Levin, Senate Armed Services Committee Hearing on the Report of the Quadrennial Defense Review Independent Panel," August 3, 2010, at <http://www.levin.senate.gov/newroom/press/release/?id=b3442dde-da09-4b43-87ed-23464a2a8717>.

reestablish the operational base it had in the country before 2001. In other words, the world does not look all that different two years after the QDR. The White House, therefore, cannot argue that the Pentagon needs to change because the world has.

The Administration's strategic guidance is simply not a credible guide as a basis for the FY2013 defense budget.

#### Rhetoric-Reality Gap

Of additional concern is that several key initiatives proposed in the strategic guidance to mitigate security risks are not adequately addressed in the President's FY 2013 proposal.

- **Pivot to Nowhere.** The Administration's declaration to increase the U.S. capacity to defend its security interests in Asia is not reflected in budgetary commitments. Other than a promise for augmented rotational training of U.S. Marine and air forces in Australia, the Administration has not articulated any permanent increased military forces in Asia. U.S. officials privately comment that those forces will be "globally sourced" and not redeployed from existing forces in Okinawa. Rather than add capability, these new missions will only place greater strain on a smaller force. Further, new defense strategy could prevent the U.S. from fulfilling its existing treaty requirements. For example, the current war plan for responding to a North Korean invasion (OPLAN 5027) calls for the U.S. to deploy 690,000 ground troops, 160 destroyers, and 2,000 aircraft within 90 days. Doing so would require the entire U.S. Army and Marine Corps (after the planned reductions in these forces are complete).<sup>6</sup> Under the current plan, the U.S. can only pivot to Asia as part of a global Ponzi scheme that creates risks elsewhere.
- **Increased Strategic Risk.** The guidance declared that this force posture established conditions for even greater reduction in the U.S. arsenal. There is no reflection of this in the President's budget proposal. There is no increase in conventional capability that could hold strategic targets (counter-force targets) at risk nor does the Administration envision robust investments in missile defense that would offset the need for offensive nuclear weapons that could hold an enemy's military forces at risk.<sup>7</sup> A significant reduction in the U.S. arsenal and delivery systems will require U.S. targeting to shift to primarily "counter value" targets. This will shift U.S. nuclear policies to Cold War-style massive retaliation—a less credible and morally questionable approach to deterrence. Rather than reduce strategic risk, the Administration actions are increasing the dangers of nuclear confrontation.

<sup>6</sup> Adapted from Bruce Klingner, "The Missing Asia Pivot in Obama's Defense Strategy," Heritage Foundation WebMemo No. 3443, January 6, 2012, at <http://www.heritage.org/research/reports/2012/01/the-missing-asia-pivot-in-obamas-defense-strategy>.

<sup>7</sup> Baker Spring, "Congress Fails to Undo President Obama's Damage on Missile Defense," Heritage Foundation *Background* No. 2650, February 8, 2012, at <http://www.heritage.org/research/reports/2012/02/congress-fails-to-undo-president-obamas-damage-on-missile-defense>.

- **Trouble with Tricare.** The strategic guidance was unequivocal in expressing the Administration's commitment to providing properly for the women and men in the nation's armed forces. It is not clear that that commitment is fulfilled in the President's plan when it comes to DOD's proposal to limit future pay raises beginning in 2015 and increase fees and co-payments for health coverage. The Administration is wrong to move to limit future pay increases because overall military compensation is already weighted heavily in favor of benefits over cash compensation compared with civilian and private-sector compensation.<sup>8</sup> If anything, military service members should receive more generous pay raises to restore balance in the overall compensation structure. On health care the Department of Defense has embraced a proposal of marginal change that would mean "less of the same" and "all pain and no gain" for current and future military retirees. Its proposal would impose higher fees and co-payments on retirees, without options that would allow service members and their dependents to explore alternatives that would better meet their needs. Rather than enhance recruiting, retention, and quality of life for the men and women of the armed forces, these marginal adjustments are likely to achieve the opposite.
- **The Reversibility Problem.** The strategic guidance also called for adding "reversibility" to the force. Reversibility was described as the capacity to reconstitute military capabilities to respond to unforeseen military requirements. Reversibility is provided by the "generating force." The services already have substantial investments in the generating force, from a high of about half of the Navy to a low of a little less than 30 percent of the Army. Since the military is being further reduced under the President's plan, additional increases in "reversibility" can only be achieved by further reducing the "operating" force. This will leave even less forces available for current missions that the Administration currently projects in its budget proposal. Reversibility under the President's budget plan will drive risk up, not down because the military will be even less ready and capable to respond to near-term challenges or dissuade or deter adversaries for pursuing aggressive designs in the future.

In short, the "risk mitigation" measures trumpeted in the strategic guidance have not translated well into actual budget proposals.

#### Back to the Future

The consequences of the President's 2013 budget proposal are that the U.S. could well, in short order, experience the "hollow" military concerns that the armed forces faced before the Korean War, after Vietnam, and in the waning years of the Clinton presidency. A military force goes hollow when it lacks sufficient capabilities to undertake three fundamental tasks: maintain trained and ready forces; fulfill current missions and operations; and prepare for the future. If the armed forces cannot do all three of these

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<sup>8</sup> Congressional Budget Office, "Evaluating Military Compensation," June 2007, p. 32, at <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/82xx/doc8271/06-29-compensation.pdf> (February 23, 2012).

tasks it becomes a hollow force—one that may look adequate on paper, but in practice cannot fulfill the obligations to meet the nation’s national security needs.

The Congressional Research Service’s (CRS) recently prepared report, “A Historical Perspective on ‘Hollow Forces,’” offers an assessment of the criteria by which “hollowness” is measured. The CRS report points out that in several ways, the challenges the military faced in the post-Vietnam years differed from those the services confronted during the Clinton presidency. Similarly, the report notes that the issues confronting today’s military differ in key respects as well. The report concludes that, “given these conditions, it can be argued that the use of the term ‘hollow force’ is inappropriate under present circumstances.”

The CRS report, however, is cold comfort. What is critical to understand is that if a military can’t field trained and ready forces, conduct current missions, and prepare for future threats, it is inadequate. With the Pentagon facing a dramatic reduction in capability, it is irresponsible to suggest that this isn’t something worth worrying about.

While the President, Administration officials, and senior leaders in the Pentagon have assured the Congress that this won’t happen again, identical assurances were issued by political leaders (from both political parties) and senior military officials when the military went hollow in the past .

Further, as you well know, even the Administration’s budget proposals do not account for the additional cuts required under the Budget Control Act of 2011. The sequestration provision of the Budget Control Act could impose additional defense budget reductions of \$500 billion or more over the next nine years. Administration officials have asserted that Administration policy does not support the sequestration of the defense budget under the Budget Control Act. This is troubling. Even as Administration officials offer the most optimistic reassurances to justify the adequacy of their defense proposals—even they acknowledged that under automatic sequestration that support for the armed forces will be inadequate. Since the President’s defense cuts are front-loaded, combined with sequestration, in the short term there is potential significant degradation to military capabilities and readiness. As a result of the loss of human capital, disruptions to procurement, and deferred maintenance and training it could take the military many years and cost a great deal to recover. What is being championed as cost savings could in the end cost the nation a good deal.

#### Finding Real Defense Savings

The Administration has already claimed to have garnered significant savings in efficiencies. Indeed, even by the Secretary of Defense’s own admission three-quarters of the projected future cuts are reductions in capability, not cost-saving. The most effective cost-saving measures are not adequately reflected in the President’s defense budget—and as a first priority Congress should look to correcting this error.

- **Taking Care of the Force.** For starters, the President and the Pentagon should not be criticized for exploring options to address the rapidly growing cost of military health coverage and retirement under the defense budget. However, their proposals are simply and completely inadequate, serving only to preserve the existing top-down, one-size-fits-all, and overly socialized structures for military health coverage and retirement. What is needed are reforms that honor our commitments to our serving men and women; enhance recruiting and retention; promote “continuity of service” between the active and reserve forces; enhance the quality of life for service members, retirees, and their families; and are appropriate for a 21<sup>st</sup> century workforce. To that end, The Heritage Foundation has proposed comprehensive reforms for military service members, retirees, and their families that replaces existing defined-benefit plans with defined-contribution plans that maximize individual choice. This plan includes special transition measures to respect commitments made to those serving and who served the nation in the past. These reforms of the military health care and retirement systems could reasonably be expected to achieve at least \$39.4 billion in savings over five years.<sup>9</sup>
- **Performance-Based Logistics.** Performance-based logistics can increase the efficiency and lower the cost of the military’s logistical system through well-designed partnerships between government-run depots and private contractors, offering savings of up \$32 billion a year.<sup>10</sup>
- **Eliminating “Free Riders.”** Congress should purge from the defense budget spending on activities that may be supported by another federal agency and defense projects may not warrant spending by any federal agency at all. In the proposed FY 2012 budget The Heritage Foundation estimated significant potential savings.<sup>11</sup>
- **Following Through.** Careful implementation of a “real” reform package as outlined in this testimony could save more than \$70 billion while improving the efficiency and effectiveness of the military and the Pentagon.<sup>12</sup>
- **Real Financial Management Reform.** The DOD should manage its finances according to best practices. A more discriminating approach would add to the DOD’s overall ability to meet the American people’s demand that the federal government provide for their defense. The funds saved as a result of improved

<sup>9</sup> Baker Spring, “Saving the American Dream: Improving Health Care and Retirement for Military Service Members and Their Families,” Heritage Foundation *Backgrounder* No. 2621, November 17, 2011, at <http://www.heritage.org/research/reports/2011/11/saving-the-american-dream-improving-health-care-and-retirement-for-military-service-members>.

<sup>10</sup> Baker Spring, “Performance-Based Logistics: Making the Military More Efficient,” Heritage Foundation *Backgrounder* No. 2411, May 10, 2010, at <http://www.heritage.org/research/reports/2010/05/performance-based-logistics-making-the-military-more-efficient>.

<sup>11</sup> Mackenzie Eaglen, “Taking a Scalpel to the Defense Budget,” Heritage Foundation *WebMemo* No. 3132, February 3, 2011, at <http://www.heritage.org/research/reports/2011/02/taking-a-scalpel-to-the-defense-budget>.

<sup>12</sup> Mackenzie Eaglen and Julia Pollak, “How to Save Money, Reform Processes, and Increase Efficiency in the Defense Department,” Heritage Foundation *Backgrounder* No. 2507, January 10, 2011, <http://www.heritage.org/research/reports/2011/01/how-to-save-money-reform-processes-and-increase-efficiency-in-the-defense-department>.

audits by the Defense Contract Auditing Agency, which resulted in \$2.4 billion in savings from audits conducted in 2007 alone, offer significant savings.<sup>13</sup>

These savings are urgently needed to free up resources to reinvest in our military. The military is still on its post-Cold War “procurement holiday.” Exacerbating the challenge of sustaining the force into the future is the wear and tear in the wake of decade of operations in Iraq and Afghanistan. Reconstituting the military is an urgent priority. Without these proposed reforms—even with a higher “top line” for defense—there won’t be sufficient resources to do the job.

#### A Different Course

An addition to garnering real saving that the President’s proposals do not, the nation needs a fundamentally different approach to defense planning. Rather than masking growing risks, we should be investing to mitigate real ones.

Failure to prepare for potential threats is the best way to ensure that they will become real threats. The world is a dangerous place. The U.S. military is already pressed to meet its commitments because of the long-term effects of the “peace dividend” taken after the collapse of the Soviet Union. The demands on the U.S. military will likely not lessen in the mid term. Further cuts in U.S. force structure will only increase the risks to U.S. forces. Maintaining a military below minimum commonsense levels would limit the U.S. to undertaking only one major military operation at a time. If faced with domestic crises like Hurricane Katrina or unexpected overseas contingencies, the U.S. would be forced to choose between ongoing tasks or simply not responding.

Vital national interests tend to remain constant, but dramatic changes, such as the collapse of the Soviet Union and 9/11, can change strategic requirements. Such events are not always predictable. While leaders should try to be sufficiently flexible to adapt to rapid change, these shifts cannot serve as the basis for defense planning any more than winning the lottery should be part of a plan to balance the family budget. Making radical changes in forces, such as sharply cutting the number of fighters or reducing ballistic missile defense (BMD) requirements, may save money in the short term; but in the long run, it will increase both the costs and the risks by disrupting the sustained investment needed to maintain core defense capabilities.

Since the end of the Cold War, America’s military has operated at a far higher operational tempo than it did during the Cold War. However, while the military has been busier than ever, its size and strength have declined. The Air Force is smaller and its inventory is older than at any time since its inception in 1947. The Navy has fewer ships than at any time since 1916. All three services are 30 percent to 40 percent smaller than they were during Desert Storm. As a result, the National Guard and Reserves have been

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<sup>13</sup> Baker Spring, “Enforce Financial Management Requirements at the Department of Defense,” Heritage Foundation *WebMemo* No. 3423, November 29, 2011, at <http://www.heritage.org/research/reports/2011/11/improve-financial-management-system-at-the-department-of-defense>.

constantly mobilized, and a number of Army units are on their fifth or sixth deployment in Iraq and Afghanistan.

America depends on its existing forces to respond to both anticipated and unanticipated events. It cannot rely on a “just-in-time” industrial base or mass mobilization plans to meet unexpected challenges.

The best way to mitigate threats going forward is to sustain and modernize the current force.

#### What to Do

Adopting a different defense budget, one that does not endorse divesting the nation of needed military capability, begins with taking a different approach to the FY2013 budget.<sup>14</sup> The appropriate steps would include:

- **Deferring Sequestration of Defense Spending.** The most glaring threat to the nation’s defense posture is the sequestration process under the Budget Control Act.
- **Replacing the Budget Control Act** with a strong plan that actually tackles the biggest threat to the economy and budget, entitlement programs, as well as pares back spending in other areas. Deferring the sequestration process under the Budget Control Act is only an immediate step to prevent irreparable damage to the nation’s defense. Under the *Saving the American Dream* plan the nation would not only be able to maintain a strong defense, but also balance the budget in 10 years, while keeping taxes low and total federal spending within reasonable limits. While many approaches could be taken in order to translate the Heritage plan into law, it must first eclipse the Budget Control Act.
- **Maintaining the Size of the Military.** Future defense authorization and appropriations measures should seek to preserve the current force structure and personnel levels, including maintaining:
  - An active Army of 562,000 persons;
  - An active Marine Corps of 202,000 persons;
  - An Air Force of 510,900 persons;
  - 45 Army Brigade Combat Teams;
  - 60 Air Force tactical fighter squadrons and the training squadron that the Pentagon plans to jettison;
  - A fleet of 316 airlift aircraft by building new C-17s and C-27s as C-5As and C-130s are retired;
  - An interim strategic nuclear force of at least 420 ICBMs, 280 SLBMs, and 65 nuclear-coded strategic bombers;

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<sup>14</sup> This section is adapted from Baker Spring, “Obama’s Defense Budget Makes Protecting America its Lowest Priority,” Heritage Foundation Backgrounder No. 2658, March 1, 2012, at [http://www.heritage.org/research/reports/2012/03/obamas-defense-budget-makes-protecting-america-its-lowest-priority#\\_ftn29](http://www.heritage.org/research/reports/2012/03/obamas-defense-budget-makes-protecting-america-its-lowest-priority#_ftn29).

- Rapidly achieve the Navy’s objective fleet of 313 ships, while maintaining a balanced mix of ships, and
- Increase the number of ground-based midcourse missile defense interceptors fielded on U.S. territory from 30 to 44 and the number of Standard Missile 3 (SM-3) missile defense interceptors deployed on ships to 341.
- **Increasing Modernization Funding.** The Administration’s military modernization funding request of \$178.2 billion for FY 2013 is simply inadequate. Congress should immediately preempt this proposed reduction. Specifically, Congress should propose an alternative that would restore budget authority for research and development (R&D) to \$80 billion, the level for FY 2010. Furthermore, FY 2013 budget authority should maintain roughly the 1.5 ratio between procurement and R&D in the Administration’s proposal. This ratio would permit procurement to be funded at levels that allow efficient absorption of the technologies generated by research and development. Given the proposed \$80 billion in R&D budget authority, procurement should be funded at \$120 billion. Beyond FY 2013, R&D funding should increase somewhat faster than inflation, and procurement should increase even faster until the procurement/R&D ratio is about 1.7 to build a larger force than what the Administration is proposing over the next five years and beyond.

The Defense America Needs

In my military career I served through the hollow forces of the 1970s and the 1990s. Having witnessed what was done to undermine military preparedness twice in my lifetime, I fear for my country and the men and women under arms who could go through a similar experience in the world we live in today. The burden this Congress faces in considering this budget are grave and the consequences of getting it wrong are significant. Thank you for the opportunity to discuss this vital issue and I stand ready to answer your questions.

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Chairman CONRAD. Well, let me go right to, Dr. Carafano, the five areas that you have identified where there could be savings responsibly. Could you give us a couple of sentences, at least, on each of those areas, things that we should be looking at as a committee.

Mr. CARAFANO. Yes, sir. We were disappointed with the administration's proposals for adjustments in TRICARE in this budget because essentially what we are getting is marginal adjustments that are really all pain and no gain. And there is really nothing in it for the servicemember.

So we would argue that what we really need here is substantial reforms that move from a defined benefit system to a defined contribution system, and reforms particularly that would make servicemembers' benefits, particularly in health care and retirement, portable. We call this kind of the "rucksack approach," that somebody ought to be able to move from the National Guard to the Reserves to the active duty, and the one thing they should never have to worry about is what is going to happen to their health care, what is going to happen to their retirement benefits.

I think that is important not just for the potential savings in the growth of manpower costs, but I think continuum and continuity of service is going to be the single most robust thing we could do in order to increase recruiting and retention. We have a very mobile workforce. We have people staying longer, getting older. People should be able to serve when they want to, at their convenience, and not have to make difficult economic choices in order to volunteer for military service.

So rather than the past, we kind of incentivized active because we wanted people to stay for 20 years and we did not want to encourage them to leave and go into the Reserves or in the National Guard or take a time out in their career. Now, I think we want to facilitate that, because I think we have enough people in this country that have the propensity to want to volunteer, and if we make it easy for them to serve, they will come and be there for us when we need them, and I think we are going to deliver not just reforms that save DOD money, but we are going to deliver to servicemembers the kind of benefits that they think—that they are used to and they are appropriate for and they feel comfortable with in a 21st century workforce.

On the removing extraneous items, we have a list of what we did in last year's budget. We think it is instructive. You note, for example, that the Army R&D budget is 50 percent of that is earmarked. The Army does not decide what it does in 50 percent of its research plan, somebody else does. I think that is probably not right.

On the efficiencies, I think you did hit the nail on the head. I think we have grown DOD staff far too much. We took the concept of jointness, which was an operational concept, and we tried to make it an administrative concept. And the notion of having more jointness driven administratively as opposed to building joint operational capability is, I think, incorrect. I think we went too far. I think we can divest in DOD staff in terms of both operational and development of capabilities, divest many things back to the services.

Logistics-based performance is really a kind of a two-part exercise. One is—

Chairman CONRAD. Can you take a minute and explain to us—I was very intrigued by your reference there. Can you help us understand what your vision is there?

Mr. CARAFANO. On the defense staff?

Chairman CONRAD. No, logistics base.

Mr. CARAFANO. Yes, sir. So logistics base performance is really kind of a two-part exercise. The first part is, again, following best practices in the industry, shifting to metrics that actually measure valuable deliverables. So the important metric is does the service person in the field get what they need when they need it to get the job done. It is not gross terms of how much stuff I move from A to B. Adopting those kinds of metrics has helped companies like FedEx become incredibly efficient in how they do business.

The second part of that is really looking at partnerships between the depots and the private sector industry in managing and participating in dealing with life-cycle costs. So Letterkenney is a very good case study where they have partnered with industry early on and where they together manage life-cycle costs and have gained significant efficiencies.

Then the last area, again, is auditing. I am not an auditing expert, but I do know this: If you audit bad, you get to a bad place very quickly. So you can impose all kinds of auditing things, but if you audit like Enron, you are going to get to a bad place. So rather than have a mantra and drumbeat that says let us audit, let us audit, let us audit, let us audit correctly in a way that enhances efficiencies and does not detract from them. And, again, we think a strategy that is based more on private sector best practices will get us there.

You know, I do have to footnote all of this. We think that procurement in the military, buying the capabilities we need, which directly then impacts on readiness, so an aircraft, for example, where 80 percent of the cost of an aircraft is in the life-cycle costs of the aircraft, modernization and readiness are kind of twin pillars. We think that we have been underfunding that for about \$50 billion a year for well over a decade, and we all know that the large proponents, the increase in the costs in the last decades have gone for operations in Iraq and Afghanistan and elsewhere. We have under-recapitalized our force, and that butcher's bill is growing. And if all we do is look at current costs and we do not look at the neglect of the past, we do not really truly understand the cost of maintaining adequate capabilities.

So we would like to find significant savings. We would like to plow those back into really getting the modernization accounts back where they need to be. This administration, this budget has a 17-percent cut in procurement, which is dramatic considering the underprocurement that we have done for well over a decade.

Chairman CONRAD. You know, I find myself agreeing with you in part and disagreeing in part because when I see \$46 billion spent on systems that never were deployed, that is a big waste of money.

Mr. CARAFANO. All right, sir. And let us remember, part of that is because we canceled them

Chairman CONRAD. Let me just—yes, we canceled them for a reason. We canceled them because—

Mr. CARAFANO. Because the Government did not want to fund them.

Chairman CONRAD. Please. When you are the Chairman, you actually get a chance to make your statement without being interrupted by the witness. So, look, we cannot afford to spend money on things that we ultimately decide are not valuable to deploy.

With respect to audit, you cannot manage unless you can audit. You know, I have a business background. I do not know of any business that can manage without being able to audit.

Dr. O'Hanlon, I would like to go to you. You have given us six distinct areas where you think savings could be achieved. Do you have any idea how much could be saved in those six areas, what dollar amounts?

Mr. O'Hanlon. Thanks, Senator. Yes, I have ballpark estimates for each. For the ground forces, once phased in, this would be about a \$10 billion-a-year savings. Now, it would take time to phase that in, and these are above and beyond the reductions that are already planned. So over a 10-year period, even if we did this and made the Army and Marine Corps slightly smaller than in the 1990s—and obviously there is some debate on the panel about whether that would be advisable, but I think at this point in history it could be. Nonetheless, the savings are probably going to be \$50 to \$60 billion over 10 years.

On the same kind of thing with the Navy concept of Sea Swap, I think the potential savings here are at least \$5 billion a year. But, again, it is going to take the Navy some time to get to this concept. They are going to have to work out where they can do overseas maintenance of ships a little bit more than they do right now, for example. So I might anticipate \$40 billion in 10 years savings in a ballpark sense.

With the F-35 and the Littoral Combat Ship, for example, it depends, of course, whether you try to make the savings quickly and just slow down the rate of production and have it be a slower pace over a longer period of time, or once the F-35, for example, is up and running and looking good, do you just go ahead and buy all 1,200 or 1,300 or 1,400 planes and then be done with it? If you do the latter, you do not save any money in the 10 years. But it is probably better business practice in many ways because it drives down your unit cost and improves your chances of having the export markets stay in good shape.

So when I put all this together—and I also acknowledge that, again, the administration may not yet have generated enough program cuts to satisfy the \$487 billion requirement. I think when I add it all up, I am in the range of \$100 billion in additional budget savings over a 10-year period.

Chairman CONRAD. Let me just say that one place Dr. Carafano mentioned that I have seen for some time as replacing our legacy systems, it is real hard to see how we do that with the budgets that we have going forward. You know, if we look at our tanker, if we look at our bomber, if we look at our major ships, the time for re-capitalizing is unfortunately coming all at once. And my own belief has been we are going to have to have a different way of financing the acquisition of major systems, and we are going to have to spread costs over time. Right now we buy everything cash on the

barrel head, and there are some very good reasons to do that. But when you have lots of legacy systems needing recapitalization at the same time, it is very hard to see how that works.

General Barno, I wanted to give you a chance in terms of what you have heard here today from the other witnesses, anything you would want to respond to, something you feel strongly about or want the Committee to know?

General BARNO. Absolutely, Mr. Chairman, and I would like to start with some of Michael's points. But to your last point as well in terms of recapitalization of legacy systems, one of the things I worry about as I look at how we are planning to invest some of these dollars in systems is that we are building for yesterday instead of tomorrow. The tanker fleet might be an example to think about. Are we building a tanker fleet that is going to be predicated on having 2,400 F-35s, very short range manned strike fighters that I have to continue to refuel to get them to the target area as opposed to investing differently in putting a deeper investment now in unmanned long-range stealthy strike assets that could fly off of carriers or fly off of land bases that might not require the size of that tanker fleet?

So we are at a bit of a cross-point now in terms of what technology, particularly I think in the unmanned submersible and unmanned air systems, is giving us, and yet we are still looking through the lens of yesterday in a sense as how we buy what might be the last manned aircraft out there.

You know, to Mike's point on the F-35 specifically, I would agree, I think taking about a 50-percent cut in the total number of F-35s, ballpark, is an acceptable risk if you then invest in accelerating your development and your fielding of unmanned strike platforms and then perhaps filling in some of those gaps with a fourth-generation fighter.

So how you decide that mix is extraordinarily important, and I am concerned in some ways that we are building the best biplane in 1936 because we cannot see that 10 years later we are going to have the skies dominated by jet fighters. I see that in ship building, to some extent, and I certainly see that in some of our manned air platforms.

So to Michael's points across all those, I would say ground forces, I think we can go lower. I am not sure we want to go much deeper than the 1990s levels. That would be about 482,000 in the Army and about 175,000 in the Marines. I absolutely endorse the idea of crew rotations in the Navy for smaller vessels. You cannot do that with an aircraft carrier, but you can certainly do that with DDGs, destroyers, and things of that nature.

Nuclear forces, I think there is room for maneuver there, within New START, and there are places for some significant savings in that arena while maintaining a robust nuclear deterrent.

Then, finally, in Littoral Combat Ship, I also agree with that. I think that ship was built for a different era. It was built for a belief we are going to be in the Littorals where the threat would be different. And there have been a number of questions raised by the test community, some of which have been documented by the Congressional Research Service, on the survivability of the LCS. So whether we need to buy as many as we originally thought versus

making some other trade-offs, perhaps investing, in my view—and I think Mike wrote this as well, and James has written about it. The national security cutter in the Coast Guard performs a lot of those kinds of missions that the Navy does not buy because it is a Coast Guard vessel. Well, from a platform standpoint, it looks very good as a fit against that niche in the Navy, so we might be able to do some innovative thinking across two different departments of the Government there.

So those are just some quick thoughts from me.

Chairman CONRAD. All right. Senator Sessions.

Senator SESSIONS. Thank you. I will yield to Senator Johnson.

Senator JOHNSON. Thank you, Senator Sessions and Mr. Chairman. I would like to thank all the witnesses for coming here. It has been interesting testimony. I would particularly like to thank Dr. Carafano and General Barno for your service to the country.

General Barno, I particularly appreciate your comments about the sacrifice of the members of our military, and before I start my questions, I would like to acknowledge somebody who is in the audience. Out of sheer coincidence, Michael Johnson from Mayville, Wisconsin—no relationship to me at all—was scheduled to be an intern in my office, and I have the honor of joining Michael and his brother, Matt, and sister, Emily, and Andrew and Laura, his parents, as they laid their son, First Lieutenant David Johnson, to rest in Arlington on February 22nd. So it goes way beyond the sacrifice of the individual military members. It is the sacrifice of the families, and they pay a very heavy price. So, Michael, if you would just stand up and be acknowledged? Thank you.

[Applause.]

Senator JOHNSON. Let me first say, Dr. Carafano, you mentioned principles, and I think that is extremely important. In any budget I think you need to establish principles and priorities, and I guess I would like to ask all the witnesses, first of all, in terms of budget priorities, where would you place defense, defense spending? Dr. O'Hanlon?

Mr. O'Hanlon. Thank you, Senator. At the top, not necessarily the only one at the top, though. As Senator Conrad said, it is the preeminent obligation of the U.S. Government. I think it is certainly among the top two or three. I certainly think taking care of the infirm, I certainly think educating the next generation of Americans would be comparably important to me. And then making sure that our fiscal health is such that future generations can still aspire to the American dream. I do not put those too far behind national defense.

Senator JOHNSON. Okay.

Mr. O'Hanlon. But I am willing to see a lot of adjustments in a lot of the programs because I think they have gotten out of control.

Senator JOHNSON. General Barno?

General BARNO. Yes, I think it is the preeminent responsibility of the Government, I would agree with that. And if that goes away, nothing else can follow, so it is the most important aspect of our Government spending. How we do that, of course, is the ultimate question on sorting out our resources.

Senator JOHNSON. Dr. Carafano.

Mr. CARAFANO. The Constitution does say provide for the common defense. It also gives other—fair enough, it does give other requirements of Government, but if you actually—in the Constitution there are more enumerated powers on defense for the Congress and the President than any single other responsibility. So I think it is very difficult to argue anything other than that defense is the to priority.

And if I could submit another document for the record, in our paper analyzing the budget, we do make the argument, and we have a chart in there which argues that defense becomes by 2017 the last priority of the Federal Government. So entitlements is higher, other discretionary spending is higher. The deficit in 2017 becomes bigger than the defense budget, and in comparison, everything else the Americans are spending money on, defense will be their last priority.

[The document follows:]

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SPECIAL REPORT

# The Future of the Mortgage Finance System

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# The Future of the Mortgage Finance System

BY MARK ZANDI AND CRISTIAN DERITIS

**T**he nation's housing market has gone from boom to bubble to bust over the past decade, with a devastating impact on the global economy and financial system. Millions of bad mortgage loans were made—loans homeowners would have had difficulty repaying under the best of circumstances—and as a result, millions are now losing their homes. As the financial institutions with stakes in these bad loans buckled, credit stopped flowing and the U.S. economy experienced its worst recession in decades.

This was not supposed to happen. After the Great Depression, the federal government established the FHA, Federal Home Loan Banks, and Fannie Mae to prevent such wild swings in the housing market as well as promote homeownership. The system worked reasonably well for more than 60 years. The housing market suffered ups and downs, and foreclosures increased at times, but the problems were modest and manageable. As a consequence, the U.S. homeownership rate rose steadily from about 45% after the Depression to 65% by the mid-1990s.

During the 2000s, however, the mortgage finance system changed dramatically, pulled by the growth of private-label mortgage securitization. Securitization—the process of packaging mortgage loans into securities sold to investors—was not new: The FHA, Fannie Mae and Freddie Mac had been securitizing mortgages for more than 25 years. But as the new century began, securitization surged in both size and scope, incorporating a wider range of mortgages, including subprime and Alt-A loans. Securitization also grew more complex and opaque, so that even the most sophisticated investors had trouble evaluating deals.

Critically, moreover, no participant in private-label mortgage securitizations had the responsibility for ensuring that the pro-

cess worked. Mortgage banks and brokers originated loans but quickly sold them to investment banks, which packaged the loans into securities. Credit rating agencies assessed them, often using faulty information provided by the investment banks. Investors who purchased the securities took the ratings largely on faith. And government regulators provided little oversight, feeling the private market could regulate itself. Yet as the events of the past three years show, it clearly could not. Today, the private-label securities market is comatose.

The system's fault lines were stressed by the flood of capital that poured into the U.S. from China and other emerging economies. With trillions of dollars in reserves earned in trade with the U.S., investors in these economies found U.S. mortgage securities particularly alluring. They offered good returns, particularly given their brief historical credit performance. The easy monetary policies of central banks such as the Federal Reserve only added to the flood of global capital, which stretched the faulty securitization pipeline to the breaking point as it rushed through.

U.S. policymakers' aggressive pursuit of homeownership also contributed to the problem. Since the 1930s, single-family housing has received more government help than any other sector of the U.S. economy. Subsidies

are provided via the mortgage interest and property tax deductions, favorable capital gains treatment, and the lower mortgage rates and affordable housing mandates of Fannie Mae and Freddie Mac, among other channels. The Clinton and Bush administrations often pointed to the rising homeownership rate as evidence of their economic policies' success. With both parties set on this policy objective, many households that should not have received mortgage loans got them.

Once the system began to break, the process was exacerbated by the collapse of Fannie Mae and Freddie Mac. While these institutions had been small contributors to the housing bubble, they were too thinly capitalized for the risks they were taking and were thus overwhelmed by the housing downturn and subsequent rise in mortgage defaults. Yet Fannie and Freddie were much too big to fail; because of their size and importance to the global financial system, both were put into conservatorship in September 2008. A string of massive financial failures followed, which led to the near collapse of the financial system.

The government's takeover of Fannie and Freddie effectively nationalized the mortgage finance system. Today the two institutions, along with the FHA and VA, account for nearly all new mortgage loans. No one is comfortable with this, and a debate on the future of the

mortgage finance system has begun. There is general agreement that for the system to succeed, it must make reasonably priced mortgages available to qualified borrowers while limiting both risks and costs to taxpayers. The system should be resistant to the business cycle, so that mortgage credit remains ample during periods of market stress and is not excessive during periods of market hubris.

Maintaining the federal government's current domination of the mortgage finance system is one approach. Fannie and Freddie could be put into receivership and their activities subsumed into the federal government. Permanently nationalizing the system in this way would ensure that mortgage lending is not disrupted in bad times, but the cost to taxpayers could be enormous if the system is not well managed. There is also a reasonable concern that government would stifle innovation, preventing the development of mortgage products that could more efficiently meet borrowers' needs.

At the other end of the spectrum is complete privatization of the mortgage finance system. The federal government would still regulate, but Fannie and Freddie would be downsized and their activities restricted. Some form of private-label securitization would have to be revived. Yet given recent history, it is unclear how well a purely private system would do during periods of financial market stress. It is also unclear whether the too-big-to-fail risk would be significantly mitigated; if the system were to fail again, the federal government would have to step in, at significant cost to taxpayers.

A private system would also likely mean the end of the 30-year fixed-rate mortgage as a mainstay of U.S. housing finance. A privatized U.S. market would come to resemble overseas markets, primarily offering adjustable-rate mortgages. Based on the experience overseas, the fixed-rate share in the U.S. would decline to an average of between 10% and 20% of the mortgage market compared with a historical average of closer to 75%.<sup>1</sup> Reinforcing this likelihood are the limits placed on the use of prepayment penalties in the recently passed Dodd-Frank financial regulatory reform

legislation. Adjustable-rate mortgages are not inherently bad loan products, but they do shift the risk of fluctuating interest rates onto homeowners. This would be a very significant adjustment for many U.S. homeowners who are not well equipped to handle such risk.

An appealing middle way involves a hybrid of nationalized and privatized systems. Such a system could take many forms, but the most attractive would retain several roles for the federal government—insuring the system against catastrophe, standardizing the securitization process, regulating the system, and providing whatever subsidies are deemed appropriate to disadvantaged households. Private markets would provide the bulk of the capital underpinning the system and originate and own the underlying mortgages and securities.

Catastrophic insurance would be provided on mortgage securities only after major losses, much as the FDIC insures bank deposits. The FDIC ended runs by scared depositors on U.S. banks during the Great Depression. Catastrophic mortgage securities insurance would eliminate runs by scared investors on the global financial system such as those that sent the economy reeling in 2007 and 2008, precipitating the Great Recession.

Catastrophic insurance would ensure that mortgage credit remains ample in the bad times, and—assuming it is properly priced—at no cost to taxpayers. It would also reduce the odds of bad lending in good times, since the insurance would be offered only to qualifying mortgages, or to others only at a high price. Since private financial institutions would put up the system's capital, there would be significant incentive to lend prudently and, given the competition in a mostly private system, to innovate as well.

In a hybrid system that is proposed in detail later in this paper, mortgage rates would be higher than they were before the housing crisis, but only because the previous system was undercapitalized.<sup>2</sup> If the future system

is capitalized sufficiently to withstand losses on defaulting mortgages that would result if house prices declined by say 25%—consistent with the price declines experienced in the current housing crash—mortgage rates would be approximately 30 basis points higher. The pre-financial crisis mortgage finance system was capitalized to losses associated with a 10% decline in house prices.

But mortgage rates in the proposed hybrid system would be almost 90 basis points lower than under a fully privatized system. This is a significant difference. The monthly principal and interest paid by a typical borrower who has taken out a \$200,000 loan for 30 years at a 6% interest rate is \$1,199 under the hybrid system. With a 90-basis point premium in the privatized system, the monthly payment increases to \$1,317, a difference of \$118, or nearly 10%. The difference in payments under the two systems would likely be even greater for borrowers with less than stellar credit or who are seeking loans with higher loan to value ratios. The greater the risk, the greater the rate premium under the privatized system.

Homeowners would also benefit from the preservation of the popular 30-year fixed-rate mortgage, a type of loan that would quickly fade in a fully privatized system. Taxpayer bailouts would also be unlikely in the hybrid system, as homeowners and private financial institutions would be required to put substantial capital in front of the government's guarantee, and there would be a mechanism to recover costs if necessary.

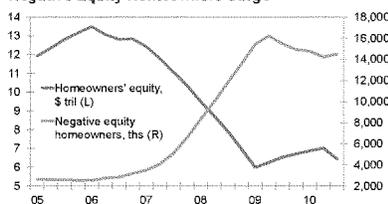
Given the fragile states of the U.S. housing market and economy, a transition from the current nationalized mortgage system to a hybrid system would take years and raise many issues, but these will be manageable. Given the expertise they have acquired over the past several decades, the downsized Fannie and Freddie could become federal catastrophic insurers. The transition would also involve establishing institutions and an infrastructure necessary to attract private capital.

Homebuyers will have to pay more for mortgage loans in the future than they did prior to the financial crisis. Given the nation's fiscal challenges, the federal government cannot afford to continue large subsidies for

<sup>1</sup>This is based on data from the Federal Housing Finance Administration available since 1985.

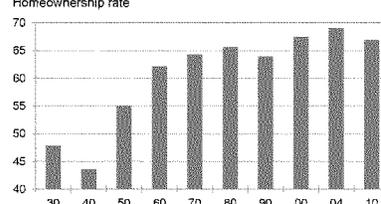
<sup>2</sup>The hybrid system proposed in this paper are similar to a number of other proposals. Most notable include a proposal by the Housing Policy Council of the Financial Services Roundtable (a group of 32 leading national mortgage finance companies) <http://www.fsround.org/hous818g208.htm>, the Mortgage Bankers Association <http://www.mbaa.org/Advocacy/IssuePapers/CEML.htm>, and the Center for American Progress <http://www.americanprogress.org/issues/2011/01/pdf/responsiblemarketforhousingfinance.pdf>

**Chart 1: Homeowners' Equity Evaporates... Negative Equity Homeowners Surge**



Sources: Federal Reserve, Moody's Analytics

**Chart 2: Homeownership Soars After the Depression**



Source: Bureau of Census

homeownership. It is unclear that these subsidies were effective in any event, given the current foreclosure crisis. Nonetheless, it is critical that the mortgage finance system be better designed, or the costs for future prospective homeowners will be prohibitive, and the costs to taxpayers in the next financial crisis will be overwhelming.

#### History lessons

Before designing a mortgage finance system for the future, it is important to understand why the previous system failed so dramatically. There is no simple explanation; the collapse resulted from an unfortunate confluence of factors. But carefully documenting and weighing the importance of each is necessary to avoid repeating the same mistakes.

The old system's failure was devastating. Since the housing crash began nearly five years ago, house prices have fallen between 15% and 30%, depending on the house price measure, wiping out \$7 trillion in housing equity and leaving more than 14 million homeowners underwater (see Chart 1).<sup>3</sup> Approximately 7 million households have lost homes through distress sales, generating \$700 billion in mortgage losses. The global financial system was brought to its knees, as major financial institutions buckled under the weight of these losses.

The resulting credit crunch ignited the Great Recession—the longest and most se-

vere economic downturn since the 1930s. An economic recovery has since taken hold, but growth has been insufficient to reduce the unemployment rate, which remains stuck near 10% despite almost \$1.5 trillion in fiscal stimulus and other financial support from the federal government.<sup>4</sup> The federal debt-to-GDP ratio is now as high as it has been since the nation had to pay for World War II, and rising.

#### Depression baby

This was not the way it was supposed to be. After the Great Depression, the federal government established a number of institutions, including the FHA, the Federal Home Loan Banks, and Fannie Mae, to forestall wild swings in the housing market and to promote homeownership. The system worked reasonably well for more than 60 years. The housing market suffered ups and downs, but its problems were modest and manageable. As a consequence, the homeownership rate rose steadily from about 45% after the Depression to 65% by the mid-1990s (see Chart 2).

The key innovation of the Depression-era institutions was the 30-year, fixed-rate, self-amortizing mortgage. Before this, short-term balloon mortgages were common; after a few years, borrowers would either pay off their outstanding balances or, more typically, refinance their loans. As long as liquidity was flowing and banks were willing to roll over loans, the system

worked well enough. But in bad times, liquidity quickly disappeared, and borrowers with expiring mortgages found themselves in foreclosure, as millions did during the Depression. The FHA introduced the 30-year fixed-rate mortgage to shelter homeowners from the business cycle and provide a fixed payment schedule in order to attract Depression-scarred households back to the housing market.

Fannie Mae and the Federal Home Loan Bank System were established to ensure mortgage lenders had adequate capital and liquidity during both good and bad times. Fannie Mae purchases mortgages from banks and other lending institutions, while the Federal Home Loan Bank System offers cheap loans to banks collateralized by the mortgages they originate. All this was important, because 30-year fixed-rate mortgages exposed lending institutions to interest rate and prepayment risks, much more than short-term balloon payment mortgages had.

The FHA, Fannie Mae and FHLBs performed their functions well during the decades that followed their creation. Underwriting standards were high and loan losses were low, because banks looking to sell loans to the government were required to attest that they had met certain standards. Under this "rep and warrant" model, any defaulting loans found not to have met these conditions had to be repurchased by lenders at cost—giving lenders a strong incentive to follow the rules.

Fannie Mae's success was reflected in its quickly expanding balance sheet, which by the 1960s had become a sizable part of the fed-

<sup>3</sup> The Federal Reserve's Flow of Funds, the Treasury Department, the FHFA, Bureau of Labor Statistics, Equifax, Fiserv Case-Shiller, and Moody's Analytics are the sources for the data cited in this and the next paragraph.

<sup>4</sup> This includes approximately \$1.3 trillion in a fiscal stimulus, \$150 billion in capital provided to Fannie Mae and Freddie Mac, and \$50 billion in other costs including TARP.

Chart 3: Private Label RMBS Soars During the Bubble

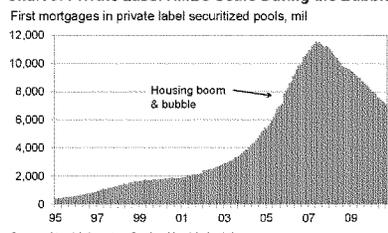
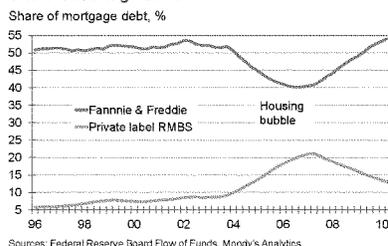


Chart 4: Trading Places



eral government's own assets and liabilities. For a government looking to finance both the Vietnam War and Great Society programs at home, Fannie's debt was a heavy burden, even if its underlying assets were solid. As a result, Fannie was spun out to private shareholders as a so-called government-sponsored enterprise at the end of the decade.<sup>5</sup>

The federal government still maintained significant control over the mortgage finance system. Fannie had presidentially appointed board members and a line of credit with the U.S. Treasury. There were no explicit guarantees, but Fannie's creditors assumed the government would come to the company's aid if necessary. A second GSE, Freddie Mac, was established to provide more support to the housing market and supply competition for Fannie.<sup>6</sup>

At the same time, policymakers also created Ginnie Mae and launched the residential mortgage-backed securities market. Ginnie Mae guarantees timely payment of principal and interest on RMBS backed by federally insured or guaranteed loans, mainly from the FHA and VA.<sup>7</sup> Ginnie does not buy or sell mortgage loans or issue mortgage-backed securities, but securitization would likely not have spread without its guarantees.

<sup>5</sup> Fannie Mae's evolution into a GSE began with the 1968 Charter Act and was completed by 1970.

<sup>6</sup> Freddie Mac was created under the Emergency Home Finance Act of 1970.

<sup>7</sup> Mortgage-backed securities are pools of mortgages used as collateral for securities sold in the secondary market. Ginnie Mae RMBS are commonly referred to as "pass-through" certificates because the principal and interest of the underlying loans is passed through to investors. The interest rate of the security is lower than the interest rate of the underlying loan, to allow for payment of servicing and guarantee fees.

The mortgage finance system worked admirably for 30 years after Fannie and Freddie became GSEs. The system was severely tested during the recessions of the early 1980s, the savings & loan crisis of the late 1980s and early 1990s, and the Asian financial crisis of the late 1990s, but it did not break. Without the government and government-backed institutions that formed its backbone, the system would not have weathered these storms nearly as well.

#### Securitization fails

The seeds of the mortgage finance system's failure were sown in the late 1990s, when private mortgage lenders and investment banks began to expand aggressively. A ballooning U.S. trade deficit generated massive global capital inflows, powering this expansion into increasingly risky mortgages that were not allowed under GSE guidelines. Ultimately, millions of loans were made that could not have been repaid under any reasonable scenario. The private-label securitization process that created them was fundamentally broken.

The private-label RMBS market surged between the late 1990s and the mid-2000s. Fewer than 1 million first mortgage loans backed such securities in early 1997, amounting to \$130 billion in outstanding mortgage debt. A decade later there were nearly 12 million such loans, equal to \$2.2 trillion in outstanding mortgage debt (see Chart 3). It is no coincidence that as the market experienced exponential growth, the housing bubble was inflating rapidly.

The loans backing securities in the private-label RMBS market grew increasingly risky. At the market's apex in early 2007, almost 40% of such loans went to subprime borrowers with low credit scores and carried elevated loan-to-value ratios. So-called alternative-A loans, made to homeowners whose credit files contained some irregularity, accounted for another 27% of the market.<sup>8</sup> Option-ARM loans, which allowed homeowners to make reduced principal and interest payments and thus increase their debt over time, accounted for 13% of the market. All these novel loan arrangements increased the lenders' risk; adding to it further was the practice of issuing "stated-income" loans, for which borrowers were not required to document their incomes with W2 statements or tax returns. At the peak in activity in 2007, almost half of all mortgages were stated-income loans.

The explosion in private mortgage lending and securities issuance significantly diminished the role of the GSEs and FHA. Their share of total mortgage debt outstanding, which was consistently above 50% during the late 1990s and early 2000s, fell to 40% during the housing bubble (see Chart 4). The FHA and GSEs lost business to private-label RMBS, whose market share rose above 20%.<sup>9</sup> In particular, FHA lending all but dried up.

<sup>8</sup> The definition of a subprime mortgage loan blurred as lending surged, but traditionally a subprime loan has a FICO score of less than 620. An alt-A loan has a score of between 620 and 660. The average FICO score across all borrowers is approximately 700.

<sup>9</sup> The private-label RMBS market accounted for an even greater 70% share of origination volume at the height of the housing bubble, with the FHA and GSEs accounting for only a 30% share.

### Global liquidity

The explosive growth of private-label RMBS was fueled by a flood of global capital. An explosion of low-cost Chinese production and a strong U.S. dollar caused the trade deficit to swell, as hundreds of billions of dollars flowed overseas each year in exchange for imported goods. Surging prices for oil and other commodities, driven in part by booming Chinese demand, added to the import bill. As a result, investors in places from China and India to Russia and Brazil collected huge pools of dollars.

For these newly flush global investors, Wall Street's innovative financial securities seemed perfect investments. Global investors were led to believe they could take precisely calibrated risks using the new instruments, within a U.S. bond market that was huge, liquid and historically safe. Overseas cash soon showered U.S. credit markets, pushing interest rates lower.

It did not take long for some of these global investors to become especially enamored of private-label RMBS. Foreigners had historically bought risk-free U.S. Treasuries; bonds issued and insured by government-tied institutions such as Fannie Mae and Freddie Mac were only a small step removed. From there it was not much of a leap to invest in mortgage securities tied to Wall Street instead of the U.S. government.

### Not responsible

But the private-label RMBS market was not up to the task of investing global investor dollars wisely. Trillions of dollars in bad mortgage loans were made because none of the system's participants were responsible for ensuring that it worked. These included the mortgage banks that originated the loans, the investment banks that packaged the loans into securities, the rating agencies that graded the creditworthiness of the securities, the global investors who purchased the securities, and the government regulators who oversaw various pieces of the system.

Securitization changed mortgage banks' long-standing "originate-to-hold" model of lending, in which they kept the loans they

made on their own balance sheets. In its place was a new "originate-to-distribute" model, in which loans were sold to investment banks. That left the mortgage banks less exposed to risk and thus less motivated to lend carefully in the first place. This change in the banking business model was tacitly endorsed by regulators, who saw

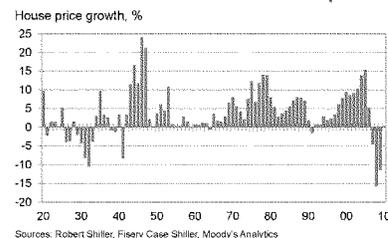
the transfer of risk as a way to diminish the chance of another savings & loan-type crisis. But of course the risk in these loans did not disappear; it simply shifted to investors and, by extension, to the broader financial system.

Investment banks themselves did not retain the risk long, as they bundled loans from various mortgage lenders into securities. As a result, the investment banks would not be on the hook if things went wrong. Yet their incentives for ensuring the securities were sound also grew fuzzy as the investment banks acquired their own mortgage banking operations and even became investors in their own securities to keep the deals and fees flowing.

Without a rating from the credit rating agencies, the investment bankers who issued the RMBS could not have sold them to investors. The agencies' opinions held particular weight when it came to pricing RMBS, as most global investors were ill equipped and often disinclined to evaluate these extraordinarily complex debt instruments on their own. But when house prices fell sharply starting in 2007, the agencies downgraded the ratings of tens of thousands of RMBS.

The rating agencies' opinions were in many cases based on bad data. Unable to scrutinize each of the thousands of mortgages and properties that served as collateral in RMBS, the agencies accepted the representations of RMBS bond issuers as complete and correct. So when the issuers provided data on such things as homebuyers' debt-to-income ratios, property prices, and so on, the agencies took it at face value. This aspect of securitization was widely understood; the

**Chart 5: Consistent Price Gains Since the Depression**



agencies did not consider it their responsibility (nor was it practical) to verify such data, so they had no basis for judging whether homebuyers were stretching the truth, or simply lying. With so many loan documents containing "stated" incomes and lax appraisals, ratings on trillions of dollars of RMBS were based on what is now understood to be faulty, if not falsified, data.

The agencies also relied too heavily on historical performance trends rather than the full range of possible economic outcomes – including a Great Depression-style scenario. The long history of house price gains since the Depression (at least in nominal terms averaged nationwide) led to the strong conclusion that prices, in aggregate, would never decline (see Chart 5). Prices in one region or two another might fall, as in Los Angeles in the early 1990s or Houston in the 1980s, but a broader downturn was unthinkable. The maxim that "all real estate is local" – a once strongly held tenet of the mortgage business – was ingrained in the assumptions of rating agencies and other securitization market participants.

Global investors grew increasingly complacent in making decisions about RMBS. In other asset classes, institutional investors had well-established in-house analytical capabilities to augment the judgment of the rating agencies. But in RMBS, they accepted the agencies' opinions as fact. Times were great, the global economy was strong, and asset prices were rising quickly almost everywhere. Skeptics argued for a time that markets were becoming overpriced, and for a time they were heeded. The financial pain of the tech-stock bust

and the Asian financial crisis had not been forgotten, and most of the signals used to value investments were flashing red. However, as asset prices continued to march higher, those who argued that something was askew in global asset markets lost credibility. Eventually they either changed their minds or their views were dismissed as simplistic and impractical.

Seeking to make sense of their own investment decisions, asset managers devised their own intellectual defense of lofty global asset prices. This time it was different, the argument went. Never before had the global economy been this stable or this open. In this great moderation, business cycles would be milder and briefer than in the past. Ups and downs in employment and income, corporate profits, and landlords' rents—conditions that determined the value of mortgage-backed bonds—were less volatile. Investors were encouraged to believe a more stable global economy meant more stable returns. Feeling secure, they sought to magnify their returns through leverage, borrowing to buy even more of whatever they were investing in. Leverage can generate extraordinary returns if an investment works out but can be financially devastating if it does not.

Government regulation of the housing and mortgage markets proved ineffective during the boom. This was in part simply because of the mishmash of regulators overseeing different aspects of the market. Their sheer numbers muddled the response to the frenzy leading up to the financial crisis. Some regulators recognized that increasingly easy lending standards would soon be a problem; a few publicly warned of the risks. But with so many diverse groups involved, it was difficult to get a working quorum for decision-making. At a time when more diligent oversight was desperately needed, half the nation's lenders were regulated at the federal level and half by the states.

The 1980s and 1990s were also marked by a steady march toward deregulation. The trend climaxed in 1999 with congressional passage of the Gramm-Leach-Bliley bill, which overturned Depression-era

banking laws separating commercial banking from securities dealing and insurance. The Basel II rules on banks' capital reserve requirements were being fashioned at about the same time. These rules rely heavily on market forces; how much capital banks need, and therefore how aggressive they can be in their lending, is determined mainly by the market value of their holdings. The fashion in banking circles was to let the market—not regulators—determine what was appropriate.

As the subsequent financial crisis has made clear, the private label RMBS market did not responsibly self-regulate.

#### Homeownership goals

While securitization failed, the excesses in the housing and mortgage markets were also fueled by America's fierce, long-running devotion to the goal of homeownership for all. Since the Depression, policymakers had viewed the percentage of American families who owned their dwellings as a benchmark of economic success. Regulators were given a seemingly open-ended mandate to drive that number higher.

The policy pursuit of higher homeownership went into high gear beginning in the 1970s, as it also became a test of the nation's success in promoting civil rights. The 1977 Community Reinvestment Act had outlawed "redlining," banks' practice of withholding mortgage loans from certain disfavored neighborhoods, which typically were outlined in red on maps. Such neighborhoods were usually inhabited by the poor or by out-of-favor ethnic or racial groups. The CRA was meant not just to end but to actively reverse the effects of such discrimination by encouraging banks to lend in underserved areas. The CRA was given more teeth during the 1990s: Regulators could now require banks to explicitly target disadvantaged neighborhoods for both business and home-mortgage lending.

About this time, the Federal Reserve also unveiled new statistical methods for detecting discrimination in mortgage lending. Marrying data from mortgage loan applications and approvals (as required under the 1975 Home Mortgage Disclosure Act)

with sophisticated econometric techniques, researchers at the Fed felt they could tell whether lenders were discriminating racially. A bank tagged by the Fed's models could be denied permission to acquire or merge with another bank. This was a period of active consolidation in the banking industry, and any institution that could not be a shark quickly became a minnow. Only a handful of banks actually failed the Fed's test, but they were soon acquired, reinforcing the regulators' message to push homeownership aggressively.

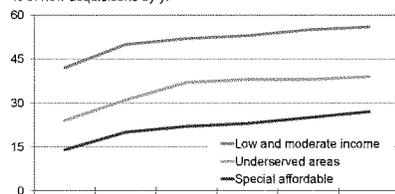
The Clinton administration was proud of the rise in homeownership during the 1990s, particularly among lower-income and minority households who gained meaningful access to mortgage credit for the first time. African-American and Hispanic households with incomes and savings, who may have been unable to obtain mortgage loans in the past, now finally could do so. While homeownership rose 7% among white households during the decade, it increased 13% among African American households and 18% among Hispanic households. This was a priority for the Clinton administration; it empowered and then pushed regulators to aggressively enforce requirements on mortgage lenders to extend more loans to previously excluded groups.

President George W. Bush readily took up the homeownership baton at the start of his administration in 2001. A home became one pillar of his "ownership society," a vision in which every American would possess a financial stake in the economy. For millions, this meant owning their home. In the summer of 2002, Bush challenged lenders to add 5.5 million new minority homeowners by the end of the decade; in 2003 he signed the American Dream Downpayment Act, a program offering money to lower-income households to help with down payments and closing costs on a first home.

To reinforce this effort, the Bush administration put substantial pressure on Fannie Mae and Freddie Mac to increase funding of mortgage loans to lower-income groups. HUD gave them aggressive "affordable"

Chart 6: Fannie and Freddie's Housing Goals

% of new acquisitions by yr



Source: HUD

housing goals (see Chart 6). Both Fannie and Freddie—whose activities had been severely circumscribed after they were found to have improperly managed their earnings through irregular accounting during the early 2000s—were willing to go along with policymakers' requests. This also fit with the GSEs' business objective to stem erosion in their market share to the private-label RMBS market. The GSEs thus lowered their underwriting standards—becoming sizable buyers of the Aaa tranches of subprime and alt-A mortgage securities—at the very worst time, just prior to the start of the financial crisis in 2007.<sup>10</sup>

The federal government's aggressive pursuit of homeownership was a significant contributing cause of the financial crisis. It was up to policymakers and regulators to strike the appropriate balance between promoting homeownership and ensuring prudent mortgage lending. They failed to strike that balance.

#### Government backstop

The housing market peaked in the spring of 2006, and cracks in the mortgage finance system were developing by the spring of 2007.<sup>11</sup> By the spring of 2008, house prices were falling quickly and mortgage delinquencies and foreclosure were rising rapidly. Bear Stearns failed under

<sup>10</sup> The affordable housing goals also created a perverse outcome: Private lenders knew the GSEs would be desperate to purchase loans to meet their goals and extracted higher prices or other concessions such as the purchase of lower-quality loans.

<sup>11</sup> The Case-Shiller national house price index hit an all-time high in first quarter of 2006. Two high-profile Bear Stearns hedge funds with investments in subprime and other mortgage-related securities failed dramatically in May 2007.

the weight of its exposure to the housing and mortgage markets, and it was evident that Fannie and Freddie's gambit to regain market share from the private-label RMBS market had been a serious mistake. Federal regulators put the GSEs into conservatorship in early September 2008, effectively wiping out shareholders.<sup>12</sup>

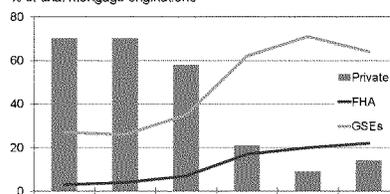
The missteps and failure of the GSEs did not cause the housing market and mortgage finance system to collapse, but they set off a chain of events resulting in the most severe financial crisis and economic downturn since the Great Depression. Fannie and Freddie's takeover persuaded global investors that none of their investments were safe, and just as occurred during the Great Depression, a panic ensued. Lehman Brothers, the next weakest link in the financial system, filed for bankruptcy a week after the government takeover of the GSEs, and a series of blue-chip financial institution failed soon thereafter.

The GSEs had come full circle, once again becoming part of the federal government. Along with the FHA, they quickly filled the void left by the vanishing private-label RMBS market. The GSEs' share of mortgage originations surged to almost 95% in 2010, and their share of mortgage debt outstanding is quickly closing in on

<sup>12</sup> The enactment of the Housing and Economic Recovery Act of 2008 established the Federal Housing Finance Agency and gave it the authority to place Fannie Mae and Freddie Mac in conservatorship—a step it took in September 2008. The Treasury was granted authority to provide the GSEs with unlimited capital (by purchasing their stock) to maintain their solvency through 2012. Those actions gave the government control over the two institutions and effectively made its backing of their debt securities and MBS guarantees explicit.

Chart 7: Government Lending Filled the Void

% of total mortgage originations



Sources: FHA, GSEs, Moody's Analytics

55%, a record (see Chart 7). There currently is no private-label RMBS-related origination activity to speak of, and the private share of mortgage debt outstanding is falling rapidly toward 12%.

The federal government's ability to quickly intervene in the nation's mortgage finance system saved the housing market and economy from an even more catastrophic fate.<sup>13</sup> While a severe credit crunch took hold across nearly all lending and credit markets, residential mortgage credit continued to flow. Credit was not nearly as ample as it had been—which, given the egregious underwriting of the housing boom, was a desirable outcome—but the availability and cost of mortgage credit was not a major impediment to homebuying. This government backstop is one of the most important reasons why the economy suffered a Great Recession, and not another Great Depression.

#### Remaking the mortgage finance system

Aggressive government intervention succeeded in backstopping the housing market during the financial crisis, but the costs were high. Taxpayers will ultimately spend nearly \$200 billion to shore up Fannie and Freddie, fund mortgage modification and refinancing efforts, finance three rounds of homebuyers' tax credits, and cover the Federal Reserve's

<sup>13</sup> The federal government took a large number of other steps to directly support the housing and mortgage markets, most notable being the Federal Reserve's purchases of Fannie and Freddie debt and mortgage-backed securities, an increase in conforming loan limits, various efforts to facilitate mortgage loan modifications including HAMP and HARP, and three rounds of tax credits to incent homebuying.

Table 1:  
Federal Government Response to the Housing and Mortgage Market Crisis

	Originally Committed	Ultimate Cost
Total	1,494	202
Federal Reserve		
Purchase of GSE debt and MBS	1,425	15
Treasury		
Homeowner Affordability and Stability Plan	52	28
Fannie Mae and Freddie Mac	Unlimited	142
Congress		
Homebuyer Tax Credits	17	17

Sources: Federal Reserve, Treasury, Moody's Analytics

likely losses on the mortgage securities it purchased during its period of credit easing (see Table 1).<sup>14</sup>

Meanwhile, the financial crisis has left the mortgage finance system in tatters. Fannie and Freddie are operating in conservatism, an unsustainable form of financial and regulatory limbo. The FHA makes almost half of all home-purchase mortgage loans and is thus taking on more credit risk than policymakers ever envisaged. The Federal Reserve has close to \$1.2 trillion in Fannie and Freddie debt and mortgage securities on its balance sheet, which it will eventually sell or allow to mature. Very little private lending is taking place, save for large jumbo mortgage loans to borrowers with high credit scores and ample home equity. Private lenders will likely remain reluctant to provide more credit until the government's future role in the mortgage market is clear.

This is untenable; thus, planning for a new mortgage finance system is under way. Given the fragility of the housing and mortgage markets and the complexity of the system, any change will take years, if not decades, to be fully implemented.

<sup>14</sup> The bulk of the costs are related to the capital provided to Fannie and Freddie, which amounts to nearly \$140 billion to date. For historical context, the cleanup of the savings & loan crisis in the late 1980s and early 1990s cost U.S. taxpayers an estimated \$275 billion in today's dollars.

The new mortgage finance system should satisfy several criteria. Most importantly, it must provide a source of dependable and affordable mortgage loans for homeowners through both good and bad economic times. The new system must also be able to effectively and explicitly provide whatever government subsidies policymakers deem appropriate, particularly to minority, lower-income and other disadvantaged groups.<sup>15</sup> The new system should also be evaluated for its effectiveness at controlling risk-taking and addressing the too-big-to-fail or systemic risk that emerged over the past decade.

Three broad approaches to reform have been proposed, including:<sup>16</sup>

- » Nationalize Fannie and Freddie, under a federal agency that would purchase and guarantee qualifying mortgages.
- » Privatize Fannie and Freddie and encourage a secondary market with no

<sup>15</sup> Since housing is a necessity and not a luxury, there is a justification for the provision of housing subsidies. Minority groups should also have the same access to mortgage funding as other groups. There is a reasonable debate regarding the current magnitude of those subsidies and whether they strike the appropriate balance between single-family and rental housing. But all housing subsidies should be explicit.

<sup>16</sup> A wide range of proposals to reform the mortgage finance system have already been put forth, and the Obama administration is expected to come forward with its suggestions later this month. The Congressional Budget Office has provided a comprehensive evaluation of these proposals in a study released late in 2010, "Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market," <http://www.cbo.gov/doc.cfm?index=12932>

federal guarantees, possibly drawing on one or more of the systems in use overseas as models.

- » Create a hybrid public/private system with explicit federal government guarantees of some privately issued mortgage securities. Fannie's and Freddie's operations would be wound down, with some of their activities subsumed within the government and other activities spun out to the market.

#### Nationalized system

In a nationalized mortgage finance system, the federal government would provide the buyers of mortgage securities explicit protection in the case of default by homeowners. The cost of this insurance would be paid through guarantee fees charged by the government and ultimately passed on to homeowners through higher mortgage rates. If the guarantee fees do not fully cover the cost of the government's default risk, then this subsidy would be counted as part of the federal budget. In a nationalized system, Fannie and Freddie's current activities could be largely subsumed into a new or existing federal agency such as FHA/Ginnie Mae.

The principal advantage of a nationalized system would be a sure, steady flow of cheap mortgage credit to homeowners both in normal times and in times of stress. The

economic benefit of keeping credit available during stressful periods can be seen in the severe credit crunch that occurred during the recent financial crisis and Great Recession. Mortgage credit was not disrupted nearly as much as were other forms of credit, but only because of the federal government's intervention.

Mortgage rates would also be lower in a nationalized system. The guarantee fee necessary to compensate the government for credit losses associated with a 10% drop in house prices is estimated at 13 basis points (see Chart 8).<sup>17</sup> Fannie and Freddie were charging guarantee fees closer to 20 basis points before the housing market crash, using the same 10% decline scenario as required by their regulator, then known as OFHEO.

Given that the GSEs are now operating in conservatorship, however, those guarantee fees were clearly inadequate to compensate for the risks they took on. It would thus be prudent to consider what fees the government would need to charge under a more severe house price decline scenario. For example, assuming a 25% decline, the government would have to increase its guarantee fees to 41 basis points to be fully compensated for the risk, more than double the amount Fannie and Freddie were charging. A 25% house price decline is comparable to the ultimate peak-to-trough decline expected in the current housing market. Under this assumption, mortgage rates would be higher than they were prior to the crash, even under a nationalized system.<sup>18</sup>

A nationalized mortgage system would also make it easier for the government to direct subsidies to specific groups whom

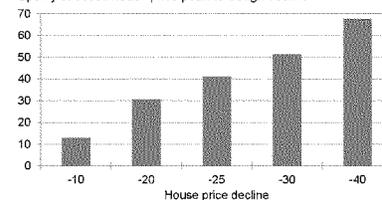
policymakers wish to help with their housing costs. The government could also provide consumer protections, requiring greater transparency in mortgage loan documents for example or encouraging mortgage loan products considered safer for households.

The key disadvantage of a nationalized mortgage finance system is that taxpayers would be on the hook for all the system's credit risk. The government could charge fees to compensate for this risk, but if history is any guide, it would very tempting for policymakers to subsidize homebuyers by setting fees too low.

This could have very significant macroeconomic implications, as the residential mortgage market accounts for almost a third of all domestic nonfinancial private debt outstanding.<sup>19</sup> Underpricing risk in such a large part of the credit market could significantly misallocate capital toward housing and away from arguably more productive investments in technology, education or infrastructure. Perhaps this risk could be mitigated at least in part by adopting budget accounting rules that ensure these subsidies are fully accounted for, but the accounting could also be used to mask the subsidies' cost.<sup>20</sup>

A nationalized mortgage finance system also risks opening a door to increased moral hazard. Since taxpayers in this system bear the cost of credit problems, mortgage originators may not scrutinize loans rigorously. More stringent government requirements regarding the quality of the loans might address this problem, but the mortgage industry's recent problems highlight the difficulty of making this process work efficiently.

**Chart 8: Gfee for Baseline Loan in Nationalized System**  
Bps by stressed house price peak-to-trough decline



Source: Moody's Analytics

There is also a risk that a nationalized system would discourage innovation of new mortgage loan products and limit productivity gains that could lower mortgage transaction costs. Government bureaucracies have fewer incentives than do private financial institutions in the competitive marketplace to change the way they do business.

#### Privatized system

In a fully privatized mortgage finance system, the government would provide no backstop—implicit or explicit—to financial institutions or to the mortgage securities market. Most privatization proposals retain a role for government, but a much diminished one.<sup>21</sup> FHA/Ginnie Mae would still operate, but with a much smaller market share, and regulators would still set safety and soundness standards for the system. Successfully winding down Fannie and Freddie would be particularly important to erecting a private system; private capital would not return to the mortgage system until it is clear how the GSEs plan to exit.

The principal advantage of a privatized mortgage system lies in its stronger incentives for prudent mortgage lending. Mortgage originators, issuers, rating agencies and investors understand that if things go badly and defaults rise, they will suffer the financial consequences. Of course these incentives depend on how strongly investors

<sup>17</sup> The guarantee fee calculator used to determine this is described in Appendix A. All of the guarantee fee calculations presented in this paper are based on a typical homebuyer with a 30-year fixed-rate mortgage with an 80% loan-to-value ratio and 750 FICO score. It is assumed that the government requires a risk free return of 4% on the capital it is providing to the mortgage finance system.

<sup>18</sup> Peak to trough, house prices are expected to reach 15% based on the FHFA house price index and almost 35% based on the Fiserv Case-Shiller national index. Under the assumption that qualified mortgages will exclude many of the subprime and alt-A mortgages that underlie homes in the Case-Shiller index, a peak-to-trough decline of 25% is a reasonable assumption for stress losses.

<sup>19</sup> According to the Federal Reserve's Flow of Funds, there is more than \$9 trillion in residential first mortgage debt, \$2.5 trillion in other household debt, and \$18.5 trillion in nonfinancial domestic business debt outstanding.

<sup>20</sup> Fair-value accounting would include the cost of market risk. In which loans and guarantees are valued based on comparable market prices.

<sup>21</sup> A good example of a fully privatized system is presented in "Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market," Wallison, Pollock and Pinto, AEI Public Policy Research Paper, January 20, 2011. <http://www.aei.org/paper/100189>

Table 2:  
Guarantee Fees in a Privatized System

Basis points	Privatized	Nationalized	Difference
Stressed Peak-to-Trough House Price Decline			
-10	57	13	44
-20	108	31	78
-25	137	41	96
-30	166	51	115
-40	208	68	141

**Key Assumptions:** Private capital requires a 25% ROE; 10-basis point liquidity risk premium in a privatized system; 25-basis point financial market risk premium in a privatized system

Source: Moody's Analytics

truly believe there will be no government intervention, even in bad times. Moreover, sturdy regulatory oversight would still be necessary; the recent collapse of the private-label securities market demonstrates that imprudent risk-taking can occur in a private market, even where enormous losses are possible.

A privatized system would also protect taxpayers by restricting the government's ability to provide subsidies to the mortgage and housing markets. The FHA would still be a potential source of subsidy, but policymakers would not be able to use institutions such as Fannie and Freddie for this purpose. There is thus less risk that the economy's capital would be misallocated toward housing and away from more productive activities.

Without institutions such as Fannie and Freddie, moreover, the systemic risks borne by taxpayers should also be reduced. In a competitive private market, the GSEs' role would presumably be filled by smaller institutions that would not threaten the broad financial system if they were to fail. However, given scale economies in mortgage lending and servicing and historical precedent, it is very possible that the market would become more concentrated with greater too-big-to-fail risks. Private capital is also not limitless, and there are plausible catastrophic scenarios that would completely wipe it out.

At that point, the government would have little choice but to intervene, or the system would collapse.

Indeed, full privatization is much more plausible in theory than it would be in practice. Regardless of what policymakers say, global investors will almost surely continue to believe the U.S. government would backstop a badly foundering mortgage finance system. This is particularly true since, in the wake of the financial panic, the U.S. government came to the GSEs' rescue despite saying it would not for years. After the TARP and the bank bailout, investors believe that if push comes to shove, the U.S. will inevitably act to rescue the broader financial system.<sup>22</sup>

A disadvantage of a privatized mortgage finance system would be much higher mortgage rates and a much less stable source of mortgage funding. The 30-year fixed-rate mortgage, the bedrock of mortgage lending since the Great Depression, would likely decline as well.

In a fully privatized system, mortgage rates would be 40 to 140 basis points higher than in a nationalized system, depending on the privatized system's capitalization requirements. Assuming the system requires enough capital to withstand

mortgage default losses consistent with a 25% decline in house prices, privatized mortgage rates would be nearly 100 basis points greater than in a nationalized system (see Table 2).

This assessment depends on three important assumptions. First, it assumes that financial institutions providing capital to a privatized mortgage system will require a 30% return on equity. This is greater than the 15% ROE that the private mortgage insurance industry (PMI) has typically obtained during times of normal market conditions with a government backstop, but less than the 30%-plus return that unsecured credit card issuers have traditionally sought. Investors providing capital to a fully privatized system will need a higher return to compensate for greater risks when the government does not have their proverbial backs. To gauge the sensitivity of the results to this assumption, consider that if the ROE required by financial institutions in a privatized system was 15%—same as the PMI industry in normal times—then privatized mortgage rates would be 75 basis points higher than in a nationalized system.

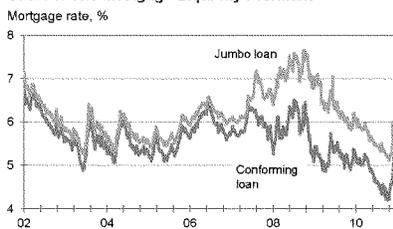
A second assumption is that investors in a privatized market would assess a liquidity risk premium of 10 basis points. A private system will likely feature a greater variety of securities than would a nationalized system, resulting in a smaller, shallower market. The benefit of a deeper market is evident in the interest-rate spread between jumbo and agency-backed mortgage securities, which has ranged from 10 to 30 basis points in normal periods.<sup>23</sup> In times of stress, the spread has been much greater (see Chart 9). If a private securities market were able to gain traction and displace the current agency market with standardized securities, this liquidity premium would presumably decline, but even under the best of circumstances, it would not disappear.

A third assumption is that investors in a privatized market would require a financial

<sup>22</sup> The \$700 billion Troubled Asset Relief Program, established during the height of the financial panic in late 2008, committed as much as \$250 billion to provide capital to troubled banking institutions.

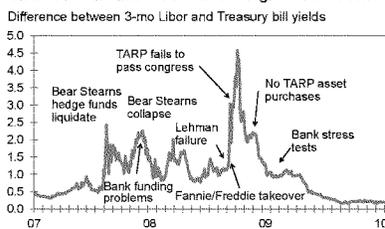
<sup>23</sup> See "TBA Trading and Liquidity in the Agency Market," Vickery and Wright, Federal Reserve Bank of New York Staff Report 468, August 2010. [http://www.ny.frb.org/research/staff\\_reports/sr468.pdf](http://www.ny.frb.org/research/staff_reports/sr468.pdf)

Chart 9: The Mortgage Liquidity Premium



Sources: Bankrate.com, Moody's Analytics

Chart 10: Fan and Fred Takeover Ignited the Panic



Sources: Federal Reserve Board, Moody's Analytics

market risk premium of 25 basis points. Investors will want some compensation for the additional risks of investing without a government backstop. Just how much compensation is difficult to determine, but it is instructive that the TED spread—the difference between three-month Libor and Treasury bill yields—surged from 25 basis points just prior to the financial crisis to a peak of almost 400 basis points at the height of the financial panic, when investors were seriously questioning whether the government would support the financial system (see Chart 10).<sup>24</sup> After the TARP and other government interventions, the TED spread came full circle, reflecting the widespread belief that the government will not allow major financial institutions to fail.

To further test this assumption, a vector autoregressive model of the 30-year fixed mortgage rate was constructed.<sup>25</sup> The mortgage rate is explained in the model by the 10-year Treasury bond yield, house price growth, and the TED spread. The model was simulated under the assumption that the TED spread narrows by 100 basis points, which is not quite the average TED spread over the model's estimation period back to the mid-1970s. The exercise effectively simu-

<sup>24</sup> Libor is the interest rate large money-center banks charge for borrowing and lending to each other. The TED spread is a very good proxy for anxiety in the global banking system. The 25-basis point TED spread that prevailed just prior to the crisis was a record low, as the period was characterized by substantial euphoria and even complacency regarding global financial conditions.

<sup>25</sup> Appendix B provides a detailed description of this VAR model for mortgage rates.

lates the impact on mortgage rates of the counterfactual in which the entire financial system is nationalized. Since money-center banks are part of the government in this scenario, they are willing to lend to each other at the risk-free Treasury interest rate. The 30-year fixed mortgage rate narrows by an average of nearly 50 basis points in this simulation. The assumption that investors will require only a 25-basis point financial market risk premium in a fully privatized system seems conservative.

This assessment is also conservative as it does not account for the institutional constraints impacting investor demand in global fixed income markets. Some global institutional investors, mutual funds and pension funds are not able to invest in assets with credit risk due to their charters or even by law. These investors, who are willing buyers of government-backed mortgage securities, would be unable to purchase mortgage securities issued in a fully privatized system. These barriers may or may not come down in the future. To the degree they don't, mortgage rates would be necessarily higher in a privatized system. Given the difficulty in quantifying and categorizing the variety of MBS investors, we recognize the impact these restrictions could have but are unable to measure them at this time.

Looking overseas for guidance to determine the impact on mortgage rates of a privatized mortgage finance system is not very helpful. While few advanced economies provide direct government support to their

mortgage finance systems, many provide substantial indirect support through their banking systems. Mortgage lending is dominated by the banking system, which is generally very concentrated, and as can be seen in Europe, much too big to fail. Also common overseas is the widespread use of prepayment penalties and recourse mortgages with lenders routinely pursuing deficiencies against defaulting borrowers. This keeps mortgage rates much lower compared with rates in the U.S. where such practices are much less common.

A fully privatized mortgage finance system also may not provide stable mortgage funding during difficult financial times. Mortgage securities markets are prone to investor runs, much like the bank runs that occurred before FDIC deposit insurance.<sup>26</sup> In an all too familiar refrain, investors are very willing buyers of securities and providers of capital in good times, but will tend to run for the door in bad times. Risk premiums and interest rates spike in times of financial crisis. The only remaining source of credit is lenders making the highest quality loans for their own portfolio. The resulting credit crunch further undermines housing demand, prices and the broader economy, and a vicious cycle is unleashed. Requiring the private market to hold more capital would certainly mitigate

<sup>26</sup> See "An Analysis of Government Guarantees and the Functioning of Asset-Backed Securities Markets," Hancock and Passmore, Federal Reserve Board Finance & Economics Discussion Series, 2010-46, August 2010. <http://www.federalreserve.gov/pub/feds/2010/46/201046abs.html>

this risk, but there may not be any economically viable amount of private capital that will sufficiently reduce it.<sup>27</sup>

The 30-year fixed-rate mortgage would likely become much less prevalent in a fully privatized mortgage finance system. Financial institutions have historically found it very difficult to manage the interest rate risk in such mortgages: as the cost of funds changes, the rate received from homeowners remains fixed. The savings & loan industry collapsed largely because of the mismanagement of this interest rate risk during the 1980s, and even Fannie and Freddie got into trouble using inappropriate interest-rate hedging techniques to manage their earnings in the early 2000s.

It thus is not surprising that 30-year fixed-rate mortgages are very uncommon overseas, where the interest rate risk resides with lenders and not in securities markets. Indeed, FRMs are prevalent only in the U.S., Denmark and France.<sup>28</sup> FRMs persist in the U.S. because of the government's support of the mortgage finance system; in Denmark, because of that nation's very unique "principal of balance" framework that equates individual mortgages and bonds; and in France, because of restrictions of prepayment (that is, prepayment penalties of 3% of outstanding balances or 3 months interest are typical).<sup>29</sup>

It seems likely that a privatized U.S. market would come to resemble overseas markets, primarily offering adjustable-rate mortgages. Based on the experience overseas, the FRM share in the U.S. would decline to an average of between 10% and 20% of the mortgage market compared

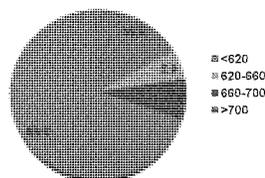
with a historical average of closer to 75%.<sup>30</sup> Reinforcing this likelihood are the limits placed on the use of prepayment penalties in the recently passed Dodd-Frank financial regulatory reform legislation. ARMs are not inherently bad loan products, but they do shift the interest rate risk to homeowners.

This would be a very significant adjustment for many U.S. homeowners who are not well equipped to handle such risk.<sup>31</sup>

It would also be much more difficult in a privatized system for non-prime households to get mortgage credit or at least get credit at an affordable interest rate. Borrowers with any kind of unusual financial circumstance or blemish could be effectively locked out of getting a mortgage loan. Given the economic turmoil of the Great Recession, this is a sizable share of the population with well over one-fifth of borrowers nationwide currently with credit scores below 660; the traditional demarcation between subprime, alt-A borrowers and prime borrowers (see Chart 11). In some economically-distressed states, such as Arizona and Florida, the current share is closer to one-third. While this may not be an undesirable outcome, it is also important to recognize.

The broader transitional issues of moving from the current government-dominated mortgage finance system to a fully privatized system would also be extraordinarily challenging. It would probably take the better part of a decade from start to finish for private capital to sufficiently fill the void left by government and to give homebuyers time to adjust to higher mortgage rates and chang-

**Chart 11: Distribution of Household Credit Scores**  
% of consumers with credit scores as of Dec 2010



Sources: Equifax, Moody's Analytics

ing loan products. This would probably be best accomplished through a slow, but clearly articulated, reduction in conforming loan limits.<sup>32</sup> Private capital is more likely to step into the mortgage market if the government clearly spells out its plans to step out.

The transition would also proceed more quickly if Fannie's and Freddie's assets were sold, liquidated or subsumed within the rest of the government. The GSEs have already begun reducing their sizable portfolios of mortgage loans and securities, but this process would likely have to be accelerated. The government may also want to maintain a small part of the portfolio to provide it the technical infrastructure necessary to quickly re-enter financial markets if conditions demanded it. Of course, this might dilute the benefits of privatization if investors felt it signaled that some government backing continued in the system.

Fannie and Freddie's underwriting and securitization capabilities and relationships with lenders, servicers and insurers are also very valuable and could be spun out to private investors.<sup>33</sup> This would have to be done carefully to ensure that the resulting private market was not overly concentrated, creating a different set of too-big-to-fail risks.

<sup>27</sup> This concern is well articulated in "The Future of Mortgage Finance in the United States," a speech given by Bernanke at the University of California Symposium "The Mortgage Meltdown, the Economy, and Public Policy," Berkeley California, October 31, 2008. <http://www.federalreserve.gov/newsevents/speech/bernanke20081031a.htm>

<sup>28</sup> A very good survey of mortgage lending internationally is provided by "International Comparison of Mortgage Product Offerings," Lea et. al., Research Institute for Housing America, September 2010.

<sup>29</sup> The Danish system allows borrowers to pre-pay their loans when rates fall, as in the United States, and allows them to buy back their bond when rates rise. This feature allows the borrower to adjust to interest rate increases and decreases and facilitates deleveraging when rates rise, reducing the incidence of negative equity.

<sup>30</sup> This is based on data from the Federal Housing Finance Administration available since 1985.

<sup>31</sup> The implications of this lack of experience are evident in the extraordinarily high default rate on subprime mortgages, most of which were two-year ARMs. According to Equifax credit file data, nearly one-fourth of subprime loans originated in 2005 defaulted when they hit their first payment resets two years later. These defaults ignited the financial crisis and Great Recession.

<sup>32</sup> This approach is described in "The Dead Shall Be Raised: The Future of Fannie and Freddie," Wallison, AEI for Public Policy Research, January-February 2010. The conforming loan limit was raised during the financial crisis to allow Fannie, Freddie and the FHA to provide mortgage credit to parts of the mortgage market hurt by the collapse of the private-label mortgage securities market.

<sup>33</sup> It is plausible to envisage that the sale of these assets could ultimately recoup much, if not all, of the current costs to taxpayers of capitalizing Fannie and Freddie.

### Hybrid system

In a hybrid mortgage finance system, private financial institutions and the federal government share the risks of providing mortgage credit. In most hybrid proposals, private capital takes on most of the risk, with the federal government providing insurance that pays out only when mortgage losses are extraordinarily severe.

Fannie Mae and Freddie Mac would no longer exist in a hybrid system. Some of their operations would be spun out to the private market, while others would be transferred to the government.<sup>34</sup> The market-distorting, implicit government guarantees provided to the GSEs would be replaced by government insurance with an explicit price. The hidden cost of Fannie and Freddie's subsidies to homeowners would also be made visible, with the government's books showing any subsidies provided in the hybrid system.

The economic logic underpinning a hybrid system starts with the assumption that under most conditions, well-capitalized private financial institutions should be able to manage the risks involved in mortgage lending. Most of the time, as the economy grows, house prices rise modestly and most homeowners are able to pay their mortgages on time. Mortgage defaults are generally due to individual events such as unemployment, a medical problem, or a divorce. The number of mortgage defaults is thus generally stable and relatively easy to predict.

As recent events have shown, however, there are times when mortgage losses become severe. In a hybrid system, private institutions would be required to hold sufficient capital to withstand losses in all but those extraordinary times, when the government insurance would be needed (see Chart 12).

Even though such times are rare, it would be difficult to attract sufficient private capital into the mortgage finance system without a government backstop,

particularly given recent events. But with the government agreeing to cap their losses, private institutions can quantify their maximum risk exposure while keeping an incentive to underwrite loans prudently and minimize their credit losses.

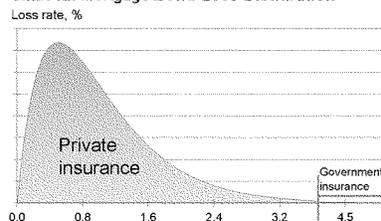
Without a cap, private institutions' risk would be uncertain; they either would not participate in the market—as is the case now—or they would demand an exorbitant risk premium, resulting in high mortgage rates to homebuyers.

This is illustrated by the performance during the housing crash of the private mortgage insurance industry, which insures losses on mortgages with loan-to-value ratios above 80%. Although it has seen large losses, the mortgage insurance industry has survived largely because its potential loss exposure was clearly visible in the contracts it wrote. Knowing this exposure, shareholders and regulators were able to determine an appropriate amount of capital for the industry to hold.

In a hybrid mortgage finance system, private institutions would pay the government a risk-based guarantee fee in exchange for catastrophic insurance. This fee would act much like the insurance premiums paid by depository institutions to the FDIC. Since the FDIC began during the Depression, there have been no bank runs by depositors fearful of losing their money. Providing government catastrophic insurance for the mortgage market would similarly remove the chance of a run by providers of private capital. This would significantly reduce the odds of a credit crunch that would undermine the housing market and a further spiral of mortgage defaults and losses.

A hybrid system would preserve the benefits of both privatized and nationalized systems. Private financial institutions would remain on the hook for the bulk of mortgage losses, keeping incentives in place for prudent mortgage lending and risk pricing. The tax-

Chart 12: Mortgage Bond Loss Distribution



Source: Moody's Analytics

payers' burden would also be lower than in a nationalized system. A hybrid system seeks to attract as much private capital as possible into the mortgage finance system while explicitly acknowledging the need for government participation and appropriate oversight.

By providing a role for government, a hybrid system also ensures measurably lower mortgage rates, standardizes the securitization process, and thus reduces transaction costs, providing greater liquidity and a steadier flow of mortgage credit, especially during tough times.

Mortgage rates in a hybrid system would be approximately 10 basis points higher than in a nationalized system but 87 basis points lower than in a privatized system. This assumes that private financial institutions in the hybrid system require a 15% ROE, are required to hold capital consistent with a 25% decline in house prices, and that the government picks up any mortgage losses after all private capital is exhausted (see Table 3).<sup>35</sup> At this level of capitalization, mortgage rates would be just over 30 basis points higher than they were prior to the financial crisis, when the mortgage finance system was capitalized to withstand only a 10% decline in house prices.

Mortgage rates are not especially sensitive to the assumption regarding the required ROE of private financial institutions in a hybrid system. For example, if private capital in the hybrid system required a lower

<sup>34</sup> The GSEs' accumulated information and infrastructure make them good candidates to provide the federally backed insurance, providing a rationale for restructuring the GSEs toward a purely public purpose.

<sup>35</sup> More precisely, this assumes that private capital is maintained to support a loss limit of 3%, with government capital bearing any additional losses. Government capital is assumed to have a cost of 4% per annum.

Table 3:  
Guarantee Fees in a Hybrid System

Basis points

Stressed Peak-to-Trough House Price Decline	Hybrid			Privatized	Nationalized	Difference Between	
	Private	Government	Total			Hybrid-Nationalized	Hybrid-Privatized
-10	19	0	19	57	13	6	-38
-20	37	7	44	108	31	13	-64
-25	36	15	51	137	41	10	-87
-30	35	22	58	166	51	6	-109
-40	35	34	69	208	68	2	-139

**Key Assumptions:** Private capital requires a 25% ROE; Government requires a 4% ROE; Private stop loss rate of 3%; 10-basis point liquidity risk premium in a privatized system; 25-basis point financial market risk premium in a privatized system

Source: Moody's Analytics

Table 4:  
Guarantee Fees in a Hybrid System Under Different Private Capital ROE Assumptions

Basis Points

Private Capital ROE	Hybrid			Privatized	Difference Between Hybrid-Privatized
	Private	Government	Total		
10%	31	15	46	137	-92
15%	36	15	51	137	-87
20%	42	15	57	137	-80
30%	44	15	59	137	-78

**Key Assumptions:** Hybrid and Privatized systems are capitalized to a 25% decline in house prices. In the Hybrid system, government receives a 4% return, in the Privatized system, government receives a 4% return, and there is a 10-basis point liquidity risk premium and a 25-basis point financial market risk premium

Source: Moody's Analytics

ROE of say 10% rather than the 15% assumed, then mortgage rates would be an additional 5 basis points lower and thus a total of 92 basis points lower in a hybrid compared to a privatized system. If instead private institutions required a 25% ROE, then mortgage rates would be an additional 7 basis points higher and thus a total of 80 basis points lower in a hybrid compared to a privatized system (see Table 4).

Under almost any assumptions, the difference between mortgage rates in a hybrid versus privatized system is large enough to have meaningful impacts on the housing market and homeownership. For example, using

the most likely case in which a hybrid system results in mortgage rates that are 90 basis points lower than in a privatized system, there would ultimately be 375,000 more new and existing home sales each year, median existing house prices would increase by almost 8%, and the homeownership rate would be almost one percentage point higher.<sup>36</sup>

Most versions of a hybrid system maintain some government role in the securitiza-

tion process to encourage standardization and transparency. This keeps transaction costs down and promotes participation by smaller lenders. In a fully privatized system, the securitization process would likely be more fractured, raising transaction costs and thus reducing mortgage lending by smaller financial institutions.

Hybrid systems are also more likely to preserve the important "To Be Announced" market.<sup>37</sup> The TBA market allows lenders to cheaply lock in mortgage rates for borrowers

<sup>36</sup> These results are based on simulations of the Moody's Analytic's model of the U.S. macroeconomy under the assumption that the mortgage finance system is reformed and thus the impact on mortgage rates occurs gradually over the next decade ending in 2021.

<sup>37</sup> The TBA market is a forward market in which lenders promise to deliver loans in the future with preset interest rates that qualify for an agency guarantee.

obtaining GSE or FHA loans as far as three months in advance. This provides an important source of stability to the mortgage and housing markets, particularly in periods of high interest rate volatility. Under current law, the TBA market exists because Fannie and Freddie are exempt from SEC regulations and disclosure requirements. Under SEC Regulation AB, investors in asset-backed securities must have all relevant information about the assets underlying the security at the time of their purchase. This is not possible in the TBA market, since loan pools have yet to be assembled and the underlying loans may not even have been originated. Hybrid systems can be designed in a way that preserves the TBA market; it is difficult to see how this market could survive in a fully privatized system.

A hybrid system with government backing would likely benefit from other regulatory advantages held by Fannie, Freddie and FHA-guaranteed securities. The Federal Reserve would presumably still be able to purchase securities backed by government insurance, as it purchases agency securities. This is an important monetary policy tool and a vital source of liquidity for the mortgage and housing markets. Depository institutions are also able to hold unlimited amounts of agency securities. This benefit may not continue completely in a hybrid system, but depositories should still be able to maintain greater holdings of mortgage securities than they would in a fully privatized system, adding to the hybrid system's liquidity and stability.

Considerable time and cost would be required to move to a hybrid system, but not as much as moving to a fully privatized one. While the 30-year fixed-rate mortgage would likely fade away in a privatized system, it would remain the predominant loan product in most hybrid systems. Some form of government backing is essential to the survival of this popular loan product. A hybrid system also allows the government to more directly and efficiently protect consumers, promote safety and soundness, and provide home purchase subsidies to lower-income and minority households, if policymakers deem that appropriate.

A key transitional question is the structure of the mortgage securities market. Important

issues include the number and types of private financial institutions that should be allowed to participate.

At one end of the spectrum is a public utility model, in which a small number of highly regulated private institutions would be permitted to issue securities with government insurance.<sup>38</sup>

Such a model would ensure broad access to the mortgage securities market to all lenders, big and small. It would also foster a more homogeneous and liquid market. Limiting these institutions to only a few activities would make them more transparent and easier to regulate. However, this model most resembles the previous GSE-dominated system and would have some of the same risks such as regulatory capture<sup>39</sup> and creating institutions that are too big to fail. Narrowing the scope of these institutions' activities also raises the odds that they will have trouble in a housing downturn.

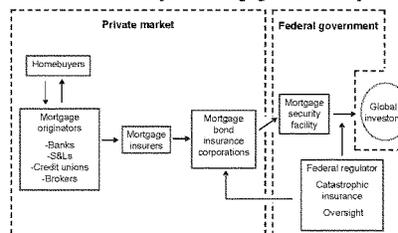
At the other end of the spectrum, any private institution could be allowed to issue securities with government insurance as long as they satisfy certain regulatory requirements.<sup>40</sup> In this model, mortgage securities pricing would be determined by competition, ensuring that the benefits of government support go to borrowers rather than to the shareholders and employees of these institutions. Systemic risks would also be much lower given a larger number of institutions in the market. Yet the greater the number of institutions issuing securities, the more likely the market will become fractured and less liquid, raising costs for borrowers. It is also possible that smaller lenders could be locked out of the market

<sup>38</sup> A detailed description of these different models, their advantage and disadvantages is provided in "Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market," CBO study, December 2010.

<sup>39</sup> Regulatory capture occurs when regulators become more responsive to the goals of the regulated entities than to the interests of the general public.

<sup>40</sup> For example, these requirements could include capital standards and restrictions on certain activities.

Chart 13: Future Hybrid Mortgage Finance System



if larger institutions are unwilling to buy mortgages from them.

Striking the appropriate balance between the public utility and competitive models will be vital to determining the success of a hybrid mortgage finance system.

#### The Future Mortgage Finance System

A hybrid mortgage finance system holds out the most promise for delivering consistent, affordable access to prudent mortgage loans to homeowners, while minimizing costs to taxpayers. In this system, private institutions would provide the bulk of the capital underpinning the system, and would also originate and own the underlying mortgages and securities. The federal government would insure the system against catastrophe, standardize the securitization process, regulate the system and provide whatever subsidies policymakers deem appropriate to disadvantaged households.

The proposed mortgage finance system would include five types of institutions (see Chart 13):

- » Mortgage originators: Private institutions creating mortgages for homeowners.
- » Mortgage insurers: Private institutions insuring against mortgage loan defaults.
- » Mortgage bond insurance corporations (MBICs): Private institutions buying and securitizing mortgages, and insuring those mortgage securities.
- » A mortgage securitization facility: A federal institution providing administrative services to mortgage securities created by MBICs.

- » Federal regulator: An agency to oversee MBICs and maintain a reserve fund to provide catastrophic insurance on mortgage securities issued by MBICs.

#### Mortgage Bond Insurance Corporations

A key to this proposal is the creation of Mortgage Bond Insurance Corporations, privately capitalized, federally chartered institutions that would:

- » Purchase conventional mortgages from mortgage originators.
- » Package these mortgages into mortgage securities.
- » Guarantee the payment of interest and principal on these securities.
- » Charge mortgage originators a fee (a so-called "gfee") for this guarantee.

MBICs would be private and thus not backed, either explicitly or implicitly, by the federal government. They would be federally chartered and supervised much like national banks and savings and loans. The federal regulator overseeing MBICs would set their capital and liquidity requirements and any other prudential standards, and determine underwriting standards and loan limits for the mortgages they would be permitted to include in securities they issue and insure.

The federal government would provide catastrophic insurance on the MBICs' securities, with the MBICs paying a guarantee fee to the government for this. Such "gfees" would be held in a reserve, similar to the FDIC deposit insurance reserve. The federal government could make the gfees actuarially fair—setting them so that the net present value of all expected future gfee income covers the outlays to lenders of the cost of any mortgage defaults. Thus, they would have no impact on the federal government's budget.<sup>41</sup>

MBICs would not be permitted to hold portfolios of mortgages or mortgage securities for investment. Small portfolios should be permitted for specific purposes such as warehousing loans before securitization, purchasing loans from smaller banks, developing new products, supporting certain loans for

which there are limited markets such as multifamily mortgages and for loss mitigation and REO disposition.<sup>42</sup>

The organization and governance of the MBICs would be determined by the private investors that establish them.<sup>43</sup> Somewhere between five and ten MBICs would be appropriate. Too few MBICs would leave the system without enough competition and vulnerable to too-big-to-fail risks. It is difficult to know how many MBICs would be necessary to sufficiently mitigate the too big to fail risks, but it seems likely that if there were five well-capitalized MBICs operating without government support (resulting in stronger market surveillance) and without lending goals, the odds are much higher (but still not a certainty) that some would have survived and policy makers would have had more options to let the others fail. Too many MBICs could lead to prohibitively high transaction costs especially for smaller lenders. Given the complexity of the contracts, data exchange, accounting, and underwriting systems that would make up a relationship between lenders and MBICs, more than ten MBICs is probably more than lenders would be able to support.

A return on equity between 10% and 20% should attract sufficient private capital to establish an appropriate number of MBICs. The private mortgage insurance industry has historically required a 15% ROE and survived the housing market crash largely intact. MBIC equity investors could require less of a return given the liquidity support provided by the government's catastrophic guarantee. These entities might be better able to recapitalize through continuing operations in situations where other entities might fail. Investors should be willing to pay some premium for this reduced volatility versus the returns required from a traditional bond insurer. However, some investors might feel they are taking a certain

amount of government risk and could demand a higher return.

#### Mortgage securitization facility

Another important element of the proposal is the creation of a single mortgage securitization facility by the federal government. The MSF would provide administrative services related to mortgage securities issued by the MBICs, including processing payments to investors and administering the federal catastrophic guarantee on the MBIC securities. The services provided by the MSF to the MBICs would be like those Ginnie Mae provides to the FHA—indeed, the MSF could very well be created within Ginnie Mae.

The MSF would standardize the securitization process; all MBICs would be required to adopt the same form of mortgage security with the same legal structure, terms and conditions regarding repayment and other conditions. A standard for mortgage securities would increase the liquidity of the market; the performance and value of Fannie and Freddie securities differ because of varying underwriting standards and the treatment of delinquent loans in their pools. Standardization would certainly have supported policy efforts to address the current mortgage crisis by facilitating mortgage modification and refinancing. A standard mortgage security structure would neither inhibit the type of mortgages originated nor limit the loans included in a mortgage security to a single lender.

With the MSF controlled by the federal government, MBIC-issued mortgage securities should be exempt from SEC registration requirements, thus preserving the all-important TBA market. As previously discussed, the TBA market allows mortgage borrowers to lock in an interest rate before a loan closes, and permits mortgage lenders to hedge their corresponding interest-rate risk.

#### Federal regulator

For the proposed hybrid mortgage finance system proposed to succeed, it requires a strong and independent federal government regulator. The regulator would:

<sup>42</sup> There have been times such as during the 1990s Asian financial crisis or after 9/11, when liquidity temporarily dried up and the GSEs' portfolios helped restart markets. However, it is clear from recent events that the Fed can use its own balance sheet to backstop the financial system so that large additional sources of liquidity are unnecessary.

<sup>43</sup> The MBIC regulator would evaluate the structure of the MBIC and its investors when determining whether to grant the MBIC a federal charter.

<sup>41</sup> This is the same budgetary treatment given to the FHA and Ginnie Mae; fees paid for their federal guarantees generally cover the claims on those guarantees and other operational expenses.

- » Charter MBICs.
- » Establish prudential standards, capital and liquidity requirements.
- » Determine underwriting standards and loan limits for mortgages included in MBIC securities.
- » Determine the appropriate size and purposes for MBIC portfolios.
- » Audit and monitor MBICs and resolve those that get into financial trouble.
- » Administer the federal catastrophic insurance fund, levying fees on MBICs and making payments in case of catastrophic losses.

The recently formed Federal Housing Finance Agency already performs many of these functions for the GSEs and would be a good candidate to assume the role of federal regulator in the future mortgage finance system. Fannie and Freddie's extensive experience setting fees on their insurance could be used by the FHFA.

#### Benefits to homeowners, taxpayers, and the financial system

In this future hybrid mortgage finance system, homeowners would benefit from stable, affordable mortgage credit. The federal government's catastrophic backstop should ensure that credit flows through good times and bad. Mortgage rates would be only modestly higher in this system than they were before the housing crisis, and that is only because the previous system was undercapitalized. Capital was sufficient to withstand peak-to-trough house price declines of only 10%. If the future system is capitalized to withstand a 25% decline in house prices, which seems more realistic, mortgage rates will be approximately 30 basis points higher.<sup>44</sup>

Compared with a fully privatized system, mortgage rates in this future system would be almost 90 basis points lower. The monthly principal and interest payment for a typical borrower taking out a \$200,000 loan for 30 years at a 6% interest rate is \$1,199 under the hybrid system. With a 90-basis point premium, the monthly pay-

ment increases to \$1,317, a difference of \$118 or nearly 10%. The difference in payments under the two systems would likely be even greater for borrowers with less than stellar credit or who are seeking loans with higher loan to value ratios. The greater the risk, the greater the rate premium under the privatized system.

Homeowners would also benefit from the preservation of the 30-year fixed-rate mortgage. Catastrophic government backing and the continuation of the TBA market are important to the survival of the 30-year fixed-rate mortgage, which at least partially insulates households from interest rate risk—something many are ill-equipped to manage on their own. The 30-year fixed-rate mortgage would likely quickly fade in a fully privatized system.

This future hybrid mortgage finance system would make future taxpayer bailouts unlikely and would create a mechanism to recover costs if one should prove necessary. Homeowners and private financial institutions would be required to put substantial capital in front of the government's guarantee, including:

- » Homeowners' mortgage down payments.
- » Private mortgage insurance or other credit enhancements on mortgage loans.
- » MBICs' shareholder's equity.
- » A reserve, funded by the MBICs in return for the government's catastrophic guarantee.

Much as in the FDIC system, MBICs could also be charged special assessments to compensate taxpayers if all these private resources were exhausted and the federal government were required to make good on its catastrophic guarantee.

This future financial system will also benefit taxpayers by remaining budget-neutral for the federal government, assuming the fees for federal catastrophic insurance are actuarially fair. There would be a budget impact if policymakers decided to subsidize homeowners by lowering the fee, but this subsidy would be explicit and transparent, unlike those in the current system.

A hybrid mortgage system would make the broader financial system more stable as

well. The too-big-to-fail risks posed by Fannie and Freddie would be eliminated as the GSEs are replaced by better capitalized and regulated MBICs. Standardizing the securitization process will ensure that securitization markets are more liquid and open to smaller institutions, reducing the market power of larger institutions and thus mitigating too-big-to-fail risks throughout the financial system. Establishing a clear resolution process if MBICs stumble would also reduce the odds that the mortgage system will be the source of another global financial panic.

#### Affordable housing

The mortgage finance system should continue to be sensitive to policymakers' efforts to promote homeownership and support affordable housing. Historically, subsidies were provided to lower-income households and minority groups through Fannie and Freddie. While these efforts were a well-intentioned attempt to channel some of the profits earned by the GSEs because of their implicit government guarantee, they often created perverse incentives and unintended consequences.

To minimize future conflicts of interest, MBICs should not be subject to specific affordable housing goals. These institutions should focus exclusively on providing liquidity to the mortgage finance system and properly measuring and pricing credit risk. The FHA is best situated to provide any housing subsidies policymakers deem appropriate in a clear and transparent manner.

That said, policymakers may require MBICs to pay an explicit fee to help fund specific housing goals. For example, the GSEs set aside approximately 0.04% of the mortgages they acquire to support programs that produce and rehabilitate housing for low-income households.<sup>45</sup> This may be a good guide for fees on the MBICs.

The FHA may also benefit from the establishment of MBICs. Rather than issuing Ginnie Mae securities that keep 100% of the FHA's risk exposure on the government's books, the FHA could require MBICs to provide bond in-

<sup>44</sup>The basis for and assumptions underlying this estimate of the impact on mortgage rates were previously described in this paper on page 9.

<sup>45</sup>This was stipulated as part of the 2008 Housing and Economic Recovery Act.

insurance. Under this structure, the FHA would subsidize part of the mortgage market by lowering the cost of its insurance, but would benefit by transferring some of its risk exposure to private financial institutions.

#### Transition costs

The current mortgage finance system is effectively nationalized, dominated by the GSEs and FHA. Moving to the proposed future hybrid system, with MBICs and a much smaller FHA, will be less arduous than moving to full privatization but will still involve major transitional issues and costs.

The principal goal of the transition process should be to ensure a steady flow of reasonably priced mortgage credit. This is critically important until the housing market is healthy again, which, given the still very high number of mortgage loans in the foreclosure process, will take a number of years.<sup>46</sup>

The transition will involve simultaneously winding down and distributing Fannie's and Freddie's operations and assets, raising the costs of utilizing the FHA, and ramping up the MBICs, their regulator and the new mortgage securitization facility. The following steps will be required:

- » Steadily reduce the GSE's retained portfolios.<sup>47</sup> This process is already under way, as under conservatorship the GSEs must reduce their mortgage assets 10% annually until each portfolio is no greater than \$250 billion. At their current size, the GSEs should reach this target by 2020.
- » Steadily reduce the conforming loan limits for the GSEs and FHA. The current loan limits, set during the financial crisis, will expire this fall. This is probably premature given the state of the

housing market; policymakers should extend the higher limits through 2012. After that, they should be consistently scaled back, so that by 2020 they will have returned to their precrisis limits adjusted for house price growth.

- » Phase in the definition of a qualified residential mortgage loan (QRM) with the implementation of the hybrid mortgage finance system. Under the Dodd-Frank financial regulatory reform legislation, issuers of mortgage securities backed by mortgage loans that do not meet the QRM standard must retain a 5% financial stake in the security.<sup>48</sup> A too narrowly defined QRM standard would likely incent more mortgage borrowers into FHA loans that by Dodd-Frank satisfy QRM, increasing the already very outsized FHA share of originations. This problem could be addressed by tightening FHA underwriting standards and increasing its insurance premiums, but this would require additional legislation, which may be difficult to pass in a timely way. Too broad a QRM standard would make it ineffective as mechanism to better align the incentives of mortgage originators, securitizers, and investors in mortgage securities.
- » Transfer the GSEs' credit enhancement functions to the MBICs' new regulator (the reconstituted FHFA). Assign that agency the job of determining appropriate fees for the federal catastrophic insurance. The GSEs' extensive data, models, and information systems are well suited to this.
- » Place the GSEs' securitization functions within the new mortgage securitization facility (the reconstituted Ginnie Mae). Give that agency the task of establishing a single securitization process for MBIC securities. The MSF will ensure that all MBICs adopt the

same mortgage security format, with the same legal structure, repayment terms and other features. The MSF will also allow for continuity within the TBA market.

- » Charter the MBICs. The FHFA would evaluate the organizational structure, management, and capital positions of private investors applying for an MBIC charter. The process would resemble chartering a commercial bank or savings and loan. Banks would be likely sources of capital for MBICs, given their reliance on the securities market. MBICs could be formed by individual banks or consortiums of banks. Mortgage and bond insurers are other possible sources of capital.
- » Move the GSEs' affordable housing goals to the FHA. A fee levied on MBICs could be used to fund any subsidies that the FHA provides to lower-income or minority groups requiring help with their housing needs.

#### Conclusions

Even after the housing crash, the financial panic, and Great Recession, the residential mortgage finance system is working. Mortgage credit remains reasonably ample and at generally affordable rates because the federal government stepped into the breach left by the collapse of the private residential mortgage securities market. The FHA has dramatically expanded its lending and Fannie Mae and Freddie Mac, even in conservatorship, continue to provide mortgage credit.

The mortgage finance system has been mostly nationalized. There is little private lending save for large jumbo mortgage loans to borrowers with high credit scores and substantial equity. The return on capital demanded by private investors translates into mortgage rates well above those offered by either the FHA or the GSEs. This is even before considering the new requirements placed on issuers of mortgage securities under the Dodd-Frank financial regulatory reform law.

The current mortgage finance system is not sustainable. Fannie and Freddie cannot remain in conservatorship forever, and no one is comfortable with the FHA's outsize

<sup>46</sup> There are approximately 4 million first mortgage loans 120 days and over delinquent or somewhere in the foreclosure process, according to Equifax credit file data. There are some 50 million first mortgage loans outstanding.

<sup>47</sup> Before they were put into conservatorship, GSEs benefited from an implicit government guarantee whenever they issued corporate debt at favorable rates and used the proceeds to buy both agency and nonagency mortgage-backed securities with higher coupons. (Portfolio managers at the institutions may have been interested in other investments, but their federal charters limited them to U.S. residential real estate.) For many years, the earned interest rate spread provided the lion's share of their income, with the credit guarantee business helping facilitate creation of additional securities for investment.

<sup>50</sup> Under Section 941 of Dodd-Frank, the Treasury and regulators have until April 2011 to propose a QRM definition, which must begin to take effect in spring 2012. Treasury recently released a study of the risk retention rule. "Macroeconomic Effects of Risk Retention Requirements," January 2011. [http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20\(FINAL\).pdf](http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20(FINAL).pdf).

share of mortgage lending. Since there is no appetite for a return to the pre-crisis, GSE-based system, several broad approaches to reform have been proposed.

Arguably the most straightforward approach, involving the lowest transition costs, would be complete nationalization. Fannie and Freddie would be placed into permanent receivership and the bulk of their assets would be assumed by the federal government. The chief benefit would be a steady flow of credit in good and bad economic times at a relatively low interest rate.

On the downside, nationalization would saddle the federal government with significant new risks, as well as with Fannie's and Freddie's debts, which would be added to an already mountainous federal debt load. There are also legitimate concerns that in the long run, such a system would stifle innovation and productivity. Policymakers could be tempted to increase subsidies to the mortgage and housing markets, misallocating the nation's limited savings. It would be disquieting to have the government control such a large part of the nation's credit markets.

A second approach to reforming the mortgage finance system would be to fully privatize it. The government would provide no backstop, either implicit or explicit, to financial institutions or to the mortgage securities market. Most privatization proposals retain a role for government, but a much diminished one, and Fannie's and Freddie's operations would be wound down and spun out to the private market.

A privatized system would provide stronger incentives for prudent mortgage lending. Mortgage originators, issuers, rating agencies and investors would understand that if defaults rose, they would suffer the consequences. A privatized system would also protect taxpayers, by restricting government's ability to provide subsidies to the mortgage and housing markets, and reducing the risk that the economy's resources would be misallocated toward housing and away from more productive activities. Without institutions such as Fannie and Freddie, the too-big-to-fail risks borne by taxpayers would also be lower.

Full privatization is more plausible in theory than in practice, however. Regardless of what policymakers say, global investors would continue to assume that the U.S. government would backstop a foundering housing market. More importantly, a privatized mortgage finance system would feature significantly higher costs for borrowers, and would be a much less reliable source of credit. The 30-year fixed-rate mortgage, the bedrock of mortgage lending since the Great Depression, would likely fade away.

A hybrid mortgage finance system, with private institutions and the federal government sharing the risks, holds out the most promise for delivering consistent, affordable credit on prudent terms to borrowers, with minimal costs to taxpayers. In this system, private institutions would provide the bulk of the system's capital and would also originate and own the securities and their underlying mortgages. The federal government would

insure the system against catastrophe, standardize the securitization process, regulate the system, and provide whatever subsidies policymakers deem appropriate.

Some of Fannie's and Freddie's operations would be turned over to the private market, while others would be transferred to the government. The market-distorting, implicit government guarantees provided to the GSEs would be replaced by government insurance with an explicit price. The hidden cost of Fannie and Freddie's subsidies to homeowners would also be made visible on the government's books.

This hybrid system would preserve the key benefits of both a nationalized and a fully privatized system. Private investors would remain on the hook for most mortgage losses, keeping incentives in place for prudent lending and risk pricing. The government's involvement, however, means that mortgage rates will be lower, the securitization process will be standardized—lowering transaction costs and raising liquidity—and mortgage credit will flow more freely, especially during difficult times.

Policy decisions about the future of the mortgage finance system in the coming months will affect U.S. homeowners and the broader 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.

Appendix A.

Description of Guarantee Fee Model<sup>51</sup>

Guarantee fees are determined through a net-present-value computation of cash flows, in order to meet conditions for both solvency and return on equity.

Under the solvency condition, the capital held by the insurer plus the guarantee fee (or premium) income paid by the insured entity must be greater than or equal to a specified level of stress losses:

$$\sum_{t=1}^T \beta^t UPB_t^E \times \frac{\phi}{1200} + K = \sum_{t=1}^T \beta^t SL_t$$

- Where
- $\beta^t = \left(\frac{1}{1+r_t}\right)^t$
  - t = age of loan in months
  - T = term of loan in months (for example, 360)
  - $r_t$  = discount rate at time t (for example, Libor)
  - $UPB_t^S$  = unpaid principal balance at time t (in stress loss case)
  - $UPB_t^E$  = unpaid principal balance at time t (in expected loss case)
  - K = initial capital
  - $\phi$  = annualized guarantee fee
  - $EL_t$  = expected loss at time t
  - $SL_t$  = stress loss at time t (selected loss capitalization level)
  - ROE = pre-tax return on equity demanded by insurer (providers of capital)
  - tax = marginal tax rate of insurer

Investors in the insurance company provide capital to guard against stress losses, demanding a certain return on equity to compensate them for their risk. The guarantee fee must cover expected losses as well as this cost of capital:

$$\phi = K \times \frac{ROE}{(1 - tax)} + \frac{\sum_{t=1}^T \beta^t EL_t}{\sum_{t=1}^T \beta^t UPB_t^E}$$

Models for expected and stress losses can be estimated based on the historical default performance of previous mortgages. Expected losses may be derived based on the historical distribution of losses or, alternatively, may be simulated based on the distribution of economic drivers in the loss models (for example, house prices, interest rates, unemployment, etc.). A level of

stress losses must be chosen, against which the insurer must capitalize. This selection may be guided by historical experience or through simulation exercises, but neither of these processes ensures that they represent the true underlying distribution of losses. If the realized economic draw exceeds the stress loss assumption, the insurer will have capital reserves insufficient to cover losses and become insolvent.

Given parameterization of  $r_t$ , ROE and tax along with expected and stress loss estimates, the guarantee fee is derived by iterating on a solution that meets both criteria.

The structure may be generalized to the case where there are two insurers, as in the proposed hybrid model, where an MSIC covers a first-loss position and the government covers losses beyond a pre-specified stress level. In this case, the overall solvency condition is written as:

$$\sum_{t=1}^T \beta^t UPB_t^E \times \left(\frac{\phi_p}{1200} + \frac{\phi_g}{1200}\right) + K_p + K_g = \sum_{t=1}^T \beta^t SL_t$$

The conditions for the private and government insurers are, respectively:

$$\sum_{t=1}^T \beta^t UPB_t^E \times \left(\frac{\phi_p}{1200}\right) + K_p = \sum_{t=1}^T \beta^t SL_t \times D_t^{SP}$$

$$\sum_{t=1}^T \beta^t UPB_t^E \times \left(\frac{\phi_g}{1200}\right) + K_g = \sum_{t=1}^T \beta^t SL_t \times (1 - D_t^{SP})$$

- Where
- $\alpha$  = prespecified stop loss level ("attachment point") covered by private insurance
  - $K_p$  = initial capital held by private insurer to cover losses up to  $\alpha$
  - $\phi_p$  = annualized guarantee fee for private insurance
  - $K_g$  = initial capital held by the government to cover losses up to SL level
  - $\phi_g$  = annualized guarantee fee for government
  - $D_t^{SP} = 1$  if  $\sum_{i=1}^t \beta^i SL_i \leq \alpha$
  - $D_t^{SP} = 0$  otherwise

The return conditions can similarly be expanded for the private and government insurers as:

$$\phi_p = K_p \times \frac{ROE_p}{(1 - tax_p)} + \frac{\sum_{t=1}^T \beta^t EL_t \times D_t^{SP}}{\sum_{t=1}^T \beta^t UPB_t^E \times D_t^{SP}}$$

$$\phi_g = K_g \times ROE_g + \frac{\sum_{t=1}^T \beta^t EL_t \times (1 - D_t^{SP})}{\sum_{t=1}^T \beta^t UPB_t^E \times (1 - D_t^{SP})}$$

Where:

- ROE<sub>p</sub> = pre-tax return on equity demanded by private insurer
- tax<sub>p</sub> = marginal tax rate of private insurer
- ROE<sub>g</sub> = pre-tax return on equity demanded by the government
- $D_t^{SP} = 1$  if  $\sum_{i=1}^t \beta^i SL_i \leq \alpha$
- $D_t^{SP} = 0$  otherwise

Given analogous parameterization of the discount rates and returns on equity, the guarantee fee for the private and government insurers may be derived by iterating on a solution that meets the criteria.

We note that the discounted cash flow approach taken in this analysis is highly simplified and stylized. A more complete analysis would consider a wide variety of mortgage products in a portfolio subjected to multiple economic stress environments. That said, the approach is similar to that taken by the FHFA in regulating the GSEs and can provide meaningful comparisons of the relative magnitude and impact of the proposed models of housing finance. In the spirit of full disclosure and transparency, we enumerate the assumption of the model below:

- » The approach considers the pricing of a new, single loan (or pool of homogenous loans) rather than considering a portfolio of loans of varying quality and age.
- » The approach considers an instantaneous shock in house prices without consideration for house price movement before the shock. A relatively benign interest rate environment is assumed across scenarios with attention focused on house price shocks.
- » The approach does not consider shocks to other economic factors such as unemployment, assuming these to be correlated and perfectly captured by house price movements.
- » The approach assumes that the vector of outstanding balances is equivalent under both stress and expected economic scenarios. That is, a similar stream of guarantee fee income is assumed under both scenarios, al-

<sup>51</sup> The gfee model used in this analysis is a modified version of a model constructed by Deutsche Bank's RMBS Global Markets Group.

- though incurred losses are allowed to vary substantially.
- » The model assumes that the MSIC would continue to receive guarantee fee income once the stop loss level has been reached. As catastrophic insurance is applied exclusively to securities, under certain scenarios, the MSIC may continue to be solvent and functioning even though it may no longer be covering losses on a given bond. Alternatively, one could assume that any paid premiums received after the stop loss is reached would be forwarded to the catastrophic insurer.
- » The model computes the amount of capital required initially to insure solvency of the MSIC and the government insurance fund up to the prespecified stress levels. A more complex version of the model may consider solvency conditions at varying points in time and provide for the release of capital as collected guarantee fee income exceeds the amount of capital needed to insure solvency.
- » The model is based on the assumption that the level of stress losses is known and predetermined. Should the economy deteriorate beyond the specified catastrophic level, collected premiums will be insufficient to cover incurred losses.

## Appendix B.

### Description of VAR model of fixed mortgage rates

A vector autoregressive model of the Freddie Mac 30-year fixed mortgage rate was constructed to quantify the impact on mortgage rates of eliminating the federal backstop for the financial system. The model was estimated on monthly data from 1977 to 2010 and includes the 10-year Treasury yield, TED spread (the difference between three-month Libor and three-month Treasury bill yields), the difference between current 10-year Treasury yields and a five-year moving average of 10-year Treasury yields to capture the impact of prepayment risk, and house price growth (see Table 5).

Table 5:  
**Vector AutoRegressive Model of Fixed Mortgage Rates**

Dependent variable is the Freddie Mac 30-year fixed-rate mortgage  
Model is estimated on monthly data from 1977 to 2010

Explanatory Variable	Coefficient	t-statistic
Constant	2.320	2.27
10-year Treasury yield	1.034	9.74
TED spread	0.231	6.87
Difference between 10-year Treasury yield and 5-year MA of 10-year Treasury yield	-0.440	3.99
House price growth	-1.315	-1.88
AR(1)	0.972	77.93
MA(2)	-0.204	-1428.97

Source: Moody's Analytics

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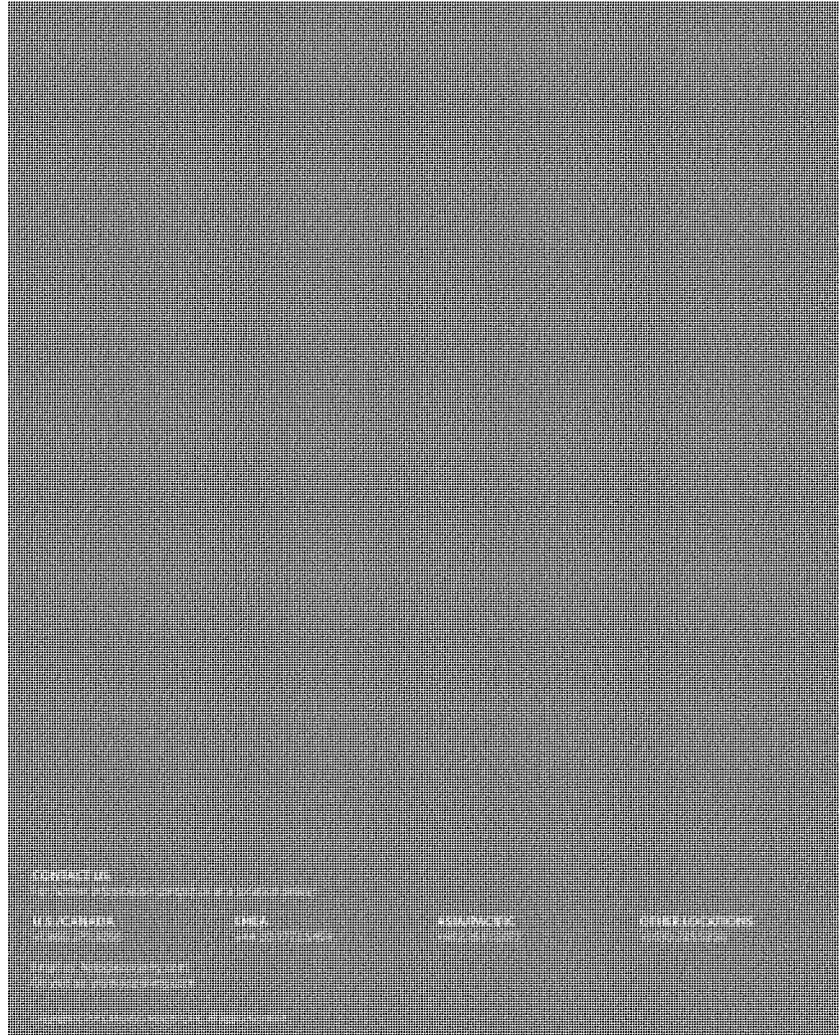
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Senator JOHNSON. Okay. Let me just ask, do any of you disagree with basically the Chairman of the Joint Chiefs of Staff Admiral Mullen's comment about the debt being the number one security threat? And then Secretary Clinton also said it is the most significant threat—or the most significant threat to our national security is our debt? Does anybody disagree with that?

General BARNO. Senator, I think it is one of the top couple of threats. I am not sure I would make it the most important threat to our national security, looking at the dangerous world we are living in, but it is certainly in the top two or top three.

Senator JOHNSON. So it is right up there. Does anybody disagree with the fact that our long-term budget deficits and debt is really being driven by Social Security and Medicare, those entitlement programs?

Mr. O'Hanlon. I would add the Tax Code, which I think is in poor shape, but I agree with you otherwise.

Senator JOHNSON. Okay. Then let me go right to the \$64 question. I am trying to look at the big picture here, and this is the fourth year that President Obama has put forward a budget. I am highly disappointed that in 4 years, four cracks at the apple here, this President has failed to lead by putting any proposal on the table whatsoever to reform Social Security and Medicare. Do you agree with that? Is that something that you would expect out of the President of the United States after 4 years to put forward a proposal to address the long-term debt and deficits? Dr. O'Hanlon?

Mr. O'Hanlon. If you do not mind, I will take a step back from the political answer, but simply say I believe—I only support additional defense cuts if they are accompanied by broad deficit reduction, including reform of entitlements, including cuts to entitlements, because I think that for me as a foreign policy strategist, the case for defense cuts is not that they are good in and of themselves. It is that they are a necessary part of comprehensive sacrifice across the country so our economy becomes stronger over time, so we can stay a great power. That will not happen unless entitlements are reformed as well.

Senator JOHNSON. Again, the practical matter of actually doing entitlement reform, doesn't it require Presidential leadership? You know, I have been watching this a long time. Have you ever seen anything that large, that significant reformed without Presidential leadership?

Mr. O'Hanlon. I will just say I agree and pass it over to Jay.

Senator JOHNSON. Dr. Carafano?

Mr. CARAFANO. This to me raises a concern, that in many ways we are repeating the mistakes of the 1990s when there was a tremendous emphasis on balancing the budget in the 1990s. Essentially what we did is we took deep cuts in the defense budget. We did nothing on entitlement reform, and we did very marginal things to slow the growth of other discretionary spending. It was kind of like a heroin fix. It felt good at the time, but it is ephemeral. Essentially, if you look at what has been done in terms of debt reduction in the 5-year plan, it is very deep cuts in defense, marginal things in other discretionary spending, and nothing to do with the big bear in the room.

Senator JOHNSON. I asked Secretary of Defense Panetta why is it that—it seems like—he disagreed with this, but I think it is true—that President Obama and his friends on the other side of the aisle always go to defense first. Would you kind of agree that is basically their outlook, when you start cutting budgets, you are going to first go to defense?

Mr. CARAFANO. Well, it is the largest part still of discretionary spending, and particularly it has been very confusing for Americans to really understand what defense dollars are being spent on because we relied on OCO, overseas contingency funding, so long, and the line between what is in the OCO and what is war cost, what is the base cost, has been so confusing. We have kind of created this impression that somehow there is a huge war savings to be had, when in many cases OCO funding was funding baseline operations. And in other cases, you were not funding core things; you were deferring funding on core things. So the notion that somehow there is a huge war savings to be gained that could be invested elsewhere in Federal spending is really kind of a Ponzi scheme.

Senator JOHNSON. Let me just quick—this is a broad question, and I would like to have all of you quick answer it. What is the number one impediment to intelligent, efficient military spending?

General BARNO. I think my answer to that actually would be bureaucracy. You know, we have not talked too much about headquarters and the headquarters overhead today, but the Defense Department, as it looks at its budget, is constrained by all manner of bureaucratic obstacles, some legislative obstacles, policies, and process that have it, really fenced in in terms of how it can spend those dollars.

I think there would be significant savings found if we were able to reform a good bit of that, and part of that—perhaps we can talk about it later—is in headquarters.

Mr. CARAFANO. I would say Congress. Look, the National Defense Authorization Act has gotten longer and longer every year, and now it is as thick as a Bible. And there is a direct correlation. The longer the act gets, the more inefficient DOD gets. And I think there is something to this. We have tried to micromanage in a sense rather than doing good business practices of giving people clear guidance and holding them accountable. And I think that would be a much more successful approach for the Congress to take.

Mr. O'Hanlon. Senator, I would simply say that while I do not disagree with my colleagues, I also think we need to remember we are not doing too bad of a job with our national defense. I think the military establishment has been remarkable. It learned in two wars how to improve tactics that were initially not working. And the broader point for me here—and I say this to my fellow Democrats as well as Republicans all the time—is that, yes, there is still fat in the Department of Defense, but it is not easy to identify and excise. It is marbled into the muscle. It is part of the way we do business, and it is, therefore, hard to reform it out. So you are not going to be able to say let us just adopt these three things and we can cut the defense budget by \$200 billion over 10 years. If you cut by those kind of numbers, you are going to have to cut capability, too.

Senator JOHNSON. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Johnson.

Senator SESSIONS.

Senator SESSIONS. Thank you.

General Barno, there has been talk about the theory that we could reduce our personnel and then surge that. I believe "reversibility" is the phrase that is being used. You have served and led me in combat. So I guess my question to you is: What are the pros and cons of that theory? And what concerns would you have? And repeat again your view about any reductions, if any, in the current personnel strength.

General BARNO. Senator, on the current strength, my take is that if we drop the Army and the Marine Corps below about the levels at 9/11/2001, which were about 482,000 in the Army and about 175,000 in the Marines, if we drop below that, I think we are starting to move into the area of high risk in terms of our ground forces.

The reversibility argument, which actually demonstrated in real terms here in the last 3 or 4 years, is that we can grow the force in the midst of a conflict. The Army and the Marines starting in about 2005, built significant numbers of additional forces by upping their recruiting numbers, reforming additional battalions, creating units that did not exist before. The Army added an additional brigade of about 3,500 soldiers onto every one of their divisional-sized elements out there. And they also reorganized to get more shooters, more fire power out of the force they had at hand.

The model that is being proposed now is that we can take the force down to a certain level because we can grow it back based on that experience here in the last 5 years. It also implicitly suggests—and I agree with this—that the Reserve component is a much more capable, much more responsive, much more experienced force today than it was 10 years ago, and we can really on the Reserve component to move into operational missions with higher confidence than we might have had 10 years ago.

My analogy would be if this was August 2001 and now we are rating the forces, as an active-duty soldier, I would have said I think the active Army is at about 0.7, but I think the Guard and the Reserve are maybe at only about 0.3 or 0.4. Today I think the active military is about 0.9, and I think the Guard and Reserve are up at about 0.7. They are remarkable. They have been out in this fight. They have tremendous experience over the last 10 years. So they are a very different organization than they were 10 years ago, and I think the active force collectively has a much higher degree, rightfully, of confidence now in the Guard and Reserves. The idea of reversibility is you can get smaller in your active component, invest some of those capabilities in the Reserve, and be prepared to bring that on board on active duty in the case of a conflict more rapidly, and then grow the force out of additional enlistments as well. There is some validity in that outlook in my view.

Senator SESSIONS. And the numbers you gave—was it 482,000 for the military?—that is part of your Army, that is part of your evaluation of reversibility and how low you could go?

General BARNO. Yes, I think that in the number—

Senator SESSIONS. Are you saying you could use that doctrine of reversibility and go even lower?

General BARNO. I would be skeptical. I think that deserves a lot more analysis. We are using the example of the last few years to say we can do that. But I do feel comfortable with the risk levels if we went down a bit lower with the Army and a bit lower with the Marines to about where we were at the 9/11 levels because of the capabilities of our Reserve component, frankly because the active component is also much more capable today than they were back then, and also because we have demonstrated we can grow this force during a conflict. Those are things we did not know 10 years ago.

Senator SESSIONS. I believe in one of the hearings General Schoomaker said—well, we were having a broken Army because of deployments in Iraq and Afghanistan, and his response was, “We do not have a broken Army, Senator. I have been in a broken Army. This is a battle-hardened Army.”

I would say, would you not, that this is the most capable, trained, equipped military that knows how to use the equipment that it has, officers and NCOs who know how to lead men in dangerous circumstances, and women, that that is an achievement maybe never surpassed in history?

General BARNO. No, I came into that broken Army right after Vietnam, and I know what that looks like, and the force today looks nothing like that. And the fact that the Army and the Marine Corps and the other services are as capable and as resilient and as healthy as they are today, despite problems, despite stresses, I think it is the most capable military I have seen in my lifetime. Certainly I cannot speak to before that.

Senator SESSIONS. And reenlistments remain high, which says something about the sense of fulfillment that men and women get in the military. So I think even though we have stressed them, the reenlistments have held up very well. So I am just proud of that group, and I worry a little bit that if we draw down these troops and too many of our soldiers are in fear that they may be RIF'd, they may be reduced and lose their job and their friends and colleagues losing theirs as part of a substantial reduction, and then they are talking about benefits being reduced, the quality of that spirit and morale might be damaged. Do you agree, Dr. Carafano?

Mr. CARAFANO. Yes, sir. I was commissioned in the broken Army, and then I watched the Army almost go broke in the 1990s. And I also watched it rebuild in the 1980s. So I have seen them all.

There is a question about how you do this mix going forward, and it is going to significantly impact on recruiting and retention, and reversibility is key. Reversibility is a key tenet of the administration's strategic guidance.

There are two kinds of forces in the military. There is the generating force and the operating force. The operating force are the guys that go out and kick in doors. The generating force are the people that put them out there. Reversibility comes from the generating force, and that is not insignificant. It goes from a high of about 50 percent in the Navy to a low of about 29 percent in the Army. So if you are going to have a zero-sum game budget, if you

want to add reversibility, that means that you are going to have to further cut into the operating force to sustain that.

I will give you an example. The reason why we were stretched for soldiers and we could not quickly reverse after 9/11 was because we had just finished at the end of the 1990s cutting the recruiting workforce in the Army to meet the steady state military that we were going to need forever. And then after 9/11, when the demand increased, there was about a 2-year lag where we ran out and recruited all the recruiters to be able to do that.

So we did reverse, but in the meantime, of course, things got very bad in Iraq and Afghanistan because we did not have enough forces, and we could not surge until we got the pipeline back up again.

So if you want to reverse quicker, for example, in this military, you are going to have to have a much larger recruiting force than you need to recruit with, and that is going to have to come from somewhere. So some of the cuts that Mike talked about where we are probably even going to go lower than this, and not only that, but, that could mean you are going to have two less brigades if you want this reversibility.

So reversibility is kind of sold as a cost mitigation measure. We will get the force if we need it. But it actually could be interpreted as a cost-imposing measure because the more reversibility you buy, the less capability you are going to have. And so when problems flare up, you are not going to have as many firemen to go fight the fire. The fire is going to have to roar while you go back and rebuild the fire department.

Senator SESSIONS. Thank you. My time is up. Dr. O'Hanlon, I appreciate your insights, and maybe I will have a chance to ask you a question or two.

Chairman CONRAD. Senator Ayotte.

Senator AYOTTE. Thank you, Mr. Chairman. I want to thank Michael Johnson for his service to our country as well as Dr. Carafano and General Barno, and I thank you all for being here today.

I just wanted to ask a straightforward question. Has the world become less dangerous, in your view? You are all national security experts. Are there less dangers out there, less risks for our country?

Mr. O'Hanlon. I will start, Senator, and they can correct my interpretation. I think certainly compared to the Cold War, things are better. The world we are living in today I think is better than having a major nuclear-armed, ambitious, aggressive, expansionist super power rival in the Soviet Union, certainly through the 1960s.

Senator AYOTTE. But what about the 1990s?

Mr. O'Hanlon. I think relative to the 1990s, I would say things are a little tougher today.

Senator AYOTTE. More dangerous than the 1990s?

Mr. O'Hanlon. Yes.

General BARNO. I would agree, Senator. More dangerous than the 1990s, very unstable and volatile, and we are not sure what is going to happen next.

Senator AYOTTE. Dr. Carafano?

Mr. CARAFANO. Again, as I stated before, I think it is certainly no less dangerous than it was in the 1990s, and that is why I am concerned that a force, which was inadequate then, would certainly be inadequate now.

Senator AYOTTE. All three of you, how good have we been at predicting our next conflict, historically?

Mr. O'Hanlon. People tend to say we are horrible at it. We have certainly made some big mistakes, which is reason enough to assume we will get it wrong again. We haven't done it right sometimes. We planned for a second war against Iraq for 15 years, and we had one. We have planned not to have a second war against North Korea by making sure we stayed ready for it, and we have successfully deterred—

Senator AYOTTE. Well, for example, did we predict the Korean War?

Mr. O'Hanlon. Not the first time. The first time we almost—

Senator AYOTTE. Or even World War I or World War II, some of the major conflicts we have been involved in, we have not been particularly prescient.

Mr. O'Hanlon. Yes, I would say less than a 50-percent track record.

Senator AYOTTE. Yes. What do the other two—what do you—

General BARNO. Absolutely, that is one of the most difficult parts of military planning, and inevitably we get surprised, and the key is how quickly can you adapt once you are surprised.

Senator AYOTTE. And so, given that we have at best 50 percent, I am not sure we have not been very good at predicting the next conflict. Can you all comment to me? We seem to be shifting our overall viewpoint that in the past has been a bipartisan viewpoint of being ready for two conflicts versus a one-plus conflict situation. And in my view, given our not too great track record of predicting where we are going to be involved, is that wise?

And the other thing that I think is encompassed in that decision is one of the things that has troubled me about where we are right now is before the—I serve on the Armed Services Committee as well, and Chairman Dempsey testified before that Committee, and Secretary Panetta, about the 2013 budget and the \$487 billion in reductions. And he has required the Chairman to submit a risk assessment to Congress, and both of them told us you cannot cut half a billion dollars from the Department of Defense and not take on risk. Yet we have yet to receive the risk assessment, and I am supposed to make decisions to make sure that we responsibly protect our country.

So in your view, should we not have the risk assessment, what risks are we taking on with the initial \$487 billion? And I think it relates to my first question of is it wise really to be in a position where we are changing what has been our readiness posture for this country.

Mr. CARAFANO. I think that the two-war construct is often misconstrued. It is often looked at as a strategy when it was never really intended to be that. It was just a force mechanism; it was a measure of capacity. And so, again, I can only speak from experience. We are going to go back to a force that is about relative capacity of what we had in the 1990s, and that was an inadequate

force structure for the end of the 1990s. When Kosovo happened, I remember very senior officers sitting around saying, "How are we going to do this? We cannot do this." And that was a 17,000-man ground commitment, and nothing like what we did in Iraq and Afghanistan.

So if the 1990s are any measure whatsoever, that force structure is inadequate for day-to-day business and has nothing to do with—forget about fighting two wars. We will not be able to do day-to-day business.

Senator AYOTTE. General, or—

Mr. O'Hanlon. Oh, I am sorry. I will be brief.

Senator AYOTTE. Whichever. Doctor?

[Laughter.]

Mr. O'Hanlon. I think you are asking excellent questions that get right to the heart of it, and there is no definitive answer because we do not know exactly how many were the right answer in the old answer in the old days, we do not know how many today. The way I would put some perspective on it is to say that the portfolio of likely risks has shifted I think a little more towards the maritime and irregular domain. So in the 1990s, we had to worry about an overland threat, again, by Saddam to Kuwait, for example, as well as a North Korean threat to South Korea. Iraq is still obviously in turbulence, so is the whole region, but the more likely set of scenarios there now I think is more maritime or irregular counterterrorist.

North Korea remains a huge menace, and I am not among those Americans who say that we can sort of reduce our potential role in a future Korean conflict dramatically just because North Korea has atrophied, because they have now eight nuclear weapons, perhaps. But the South Koreans have really picked up their role in the alliance as well, so on balance, I think that peninsula is roughly comparably demanding to what it had been before.

So I think the portfolio risk has shifted more towards maritime and irregular domains where we still have to have simultaneous crisis responsibility for more than one potential problem at a time.

General BARNO. I would just add to that, number one, I think you are right to ask for the assessment because I think that is critical to make the judgments that you are going to be required to do here on Capitol Hill.

I think in terms of the new strategy, it does make some choices and it does rebalance our global portfolio a bit, obviously with a focus on Asia for the rest of this century, but also recognizing that the Middle East is going to continue to be a very volatile, dangerous part of the world. We are going to have military forces prominent in both of those theaters.

What it also does, though, is it says the remaining elements of the world, our European commitments, should come down, some of our commitments perhaps in South America should not be as great. So we are beginning to shift away from some of our Cold War models of how we have forces deployed and what our costs are to focusing on what we now think are the highest priorities for the years coming up.

Senator AYOTTE. I appreciate all of you, and I think it is really important we receive a risk assessment so that we can understand

and explain what risks we are taking on with the initial portion of reductions.

I know my time is coming up, but this is a very important issue, and that is sequestration. We passed the Budget Control Act in our infinite wisdom here, and I can say I voted against it. And I will tell you this: We left approximately 60 percent of the spending on the table, and so whether your issues are domestic or military, those portions are going to take a disproportionate cut.

Sequestration—Secretary Panetta has said it will hollow out our force, that we will have the smallest Navy since 1915, smallest Air Force and smallest ground forces since 1940. Do you think it is responsible for us as bipartisan Members of Congress to allow sequestration to go forward?

Mr. CARAFANO. You know, I would just say 75 percent of the cuts in this budget are capabilities, so that means if you add sequestration on top of that, it is hard to see how it is not all just capability you are cutting.

General BARNO. The answer is absolutely no, it is irresponsible.

Senator AYOTTE. Thank you.

Mr. O'Hanlon. And I agree, especially because of the implications in 2013. I am against the magnitude of the savings anticipated regardless, but what would happen to the force in 2013 is particularly unacceptable. And I actually do not like the fact we are going to spend 2012 thinking about how we would cope with sequestration. It is a waste of time. We have more important things to worry about.

Senator AYOTTE. Well, I agree. I think it is like we are asking our Department of Defense to plan their own demise, and that does not make sense in terms of our national security. So I appreciate all three of you testifying, and I will actually have some follow-up questions for you because I have a whole host of additional questions. But I appreciate your expertise in this area.

Chairman CONRAD. I thank the Senator.

Senator SESSIONS, any last observations?

Senator SESSIONS. Just briefly. I thank all of you for your comments.

Dr. O'Hanlon, as I understood your list, very valuable list of things that might could be reduced, you net that out about \$100 billion over 10 years if those cuts were all made?

Mr. O'Hanlon. Senator, yes, thank you for asking because I want to be clear. I think if you actually did those six things in their entirety, you would get a little bit more than \$100 billion in savings over 10 years. But I am assuming some of those would be needed simply to satisfy the \$487 billion 10-year requirement, because I do not think the existing program cuts are deep enough to accomplish that goal.

Senator SESSIONS. Well, that is a very serious comment you have made because I think most of us that believe in a strong Defense Department also—I mean, we support the first cuts, so we want to do that and pay for that adequately, and we would like to know exactly how much pain that is going to incur.

With regard to sea swaps, when I first got here, I ended up chairing the Sea Power Subcommittee, and we talked about that. The Kitty Hawk, that carrier in Japan, stayed there permanently.

It was maintained by the Japanese, and they provided free harboring for it, and the crews moved back and forth. I believe submarines today, some of them are being crew-swapped instead of bringing the ship back.

To what extent do you think we have achieved that? And are there still—obviously, you think there is more work to be done.

Mr. O'Hanlon. Thank you, Senator, also for what you did in spurring on some of those debates earlier. General Barno I think made the point I should have made earlier clarifying this concept. I think it is for the cruisers and destroyers and also Littoral Combat Ships that we could see the next round of innovation. We are doing this already with submarines, with mine sweepers, but I think it is the \$1.5 billion ships, the sort of bread and butter of the surface combatant Navy where we can turn next.

Senator SESSIONS. Well, I will just mention the LCS since some of that might have an interest in my home town where it is constructed. It is a fabulously modern ship. It uses far less fuel. It operates at higher speeds. It has a crew of 40 instead of a cruiser and destroyer at 200. And it is the kind of modernization that we told the Navy we wanted them to do back when I was on Sea Power and had no idea that some of it might be built in my State.

So you may not be counting in the savings on the LCS, not building them, the fact that you could de-commission other ships that are far more expensive to operate. So all of these have balanced. And the F-35, I think we will just have to look at that, and maybe the size of the tanker fleet, we will have to look at that. But I am willing to look at that. That is an insightful thing. I really believe the F-35 is critical to our defense. We should go forward with it. But I think it probably is an open question how many we have to have, what the minimum number is we have to have.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Sessions. Thanks to all of our witnesses. We appreciate very much your contribution to the work of this Committee, and with that, the Committee will stand adjourned.

[Whereupon, at 11:38 a.m., the Committee was adjourned.]

**Dr. Carafano's Responses to Questions for the Record**

**Senator Ayotte**

- 1.) **As area denial and anti-access threats are increasing, the need for Virginia class submarines, which are ideal for these environments, grows. The President has talked about an increased emphasis on the Asia-Pacific—an area of operations that is overwhelmingly maritime in character. We are also told that by 2030, according to the FY11 program of record, that we will be confronting a 30% reduction in the size of our attack submarine fleet and a 60% reduction in the undersea strike volume. Yet, the President's fiscal year 2013 budget delays the procurement of one Virginia class submarine.**

**Is it accurate to say that the Virginia class submarine provides a critical platform for our special operators, especially in the anti-access and area-denial environments?**

The growth in anti-access/area denial (A2/AD) capabilities, reflected above all in increasingly capable surveillance and reconnaissance systems, both air-breathing and space-based, places air and naval assets increasingly at risk. Anti-ship ballistic missiles, anti-ship cruise missiles, diesel-electric and air-independent propulsion submarines equipped with anti-ship cruise missiles or long-range torpedoes, as well as strike aircraft, present an array of threats against US surface ships (including aircraft carriers) and land-based tactical air forces.

In this context, the American submarine fleet is increasingly shouldering the burden of being the most survivable, as well as capable, strike platform, at least in the initial stages of a conflict before an opponent's A2/AD systems can be rolled back or otherwise neutralized. They are an essential means of attacking an opponent's land facilities (with cruise missiles) and naval assets (with cruise missiles and torpedoes). They are also an essential means of transporting special operators to close with the enemy, given the need for concealment and stealth which is increasingly difficult for traditional air and surface transports.

**Would it be accurate to describe the Persian Gulf and the seas adjacent to Iran as an increasingly anti-access and area denial environment?**

It would be accurate to describe the Persian Gulf and other areas near Iran to be described as an "anti-access and area-denial environment." Iran has built up its capacity to close (at least temporarily) the Straits of Hormuz, threaten seaborne oil exports and deny U.S. and allied navies access to the Persian Gulf. It can launch anti-shipping attacks by aircraft, missiles, mines, submarines and naval special warfare forces. Tehran has expanded its anti-ship missile capabilities, which can be deployed on its naval vessels, warplanes and land-based mobile launchers. It has acquired advanced C-801K and C-802 sea-skimming anti-ship missiles from China, in addition to older HY-1 Seersucker and HY-2 Silkworm anti-ship missiles, as well as its own versions of anti-ship missiles. In addition, Iran could target ships in the narrow Straits of Hormuz with land-based artillery or rockets.

Although its conventional naval forces are relatively weak, it has developed a sea denial strategy based on using “swarming tactics” by several hundred small fast-attack craft. It has three Russian-made Kilo subs that can threaten ships with torpedoes or mines. Iran’s Revolutionary Guards have developed special warfare capabilities that include mini-submarines, underwater demolition teams, commando-style attacks from civilian vessels and the military use of jet skis. Iran also could deploy suicide bombs in disguised fishing vessels, kamikaze-style air attacks and chemical weapons (maybe even biological weapons) against ships.

Iran also has a potent mine warfare capability that can be deployed from warships, civilian vessels, submarines and helicopters. In addition to free-floating and moored mines, it can deploy advanced non-metallic and remote-controlled mines that would be difficult to detect and disarm.

**Looking well into the future, are you concerned about the projected 60% reduction in undersea strike volume?**

Taking into consideration the President’s decision for FY-13 to push the Ohio-class replacement program beyond the FYDP, reliance on the Virginia class will only increase in the future. Unfortunately, another budgetary move discussed has been to drop the two-per-year build rate for Virginias, which has promoted efficiencies and significant cost reductions. Considering the growth in in anti-access/area denial (A2/AD) capabilities and China’s submarine buildup, the requirements placed on U.S. subs will only increase.<sup>1</sup>

The U.S. force of attack submarines fell from 102 boats in 1987 to 53 in 2009. The decline has followed repeated revisions of the Navy’s force structure plans since the Reagan-era 600-ship Navy called for 100 SSNs. The declining nuclear-powered attack submarines (SSNs) force poses a challenge not only to the Navy’s ability to maintain effective underwater deterrence, but also to the Navy’s ASW efforts, which are already suffering from declining numbers of other ASW platforms. Furthermore, more countries are deploying advanced submarines that could threaten U.S. aircraft carriers, raising the stakes of U.S. military intervention.<sup>2</sup>

In this context, reductions in the size of the attack submarine fleet and undersea strike volume directly translates to inability to hold enemy assets at risk, and to increased wear on both equipment and crews for the remaining forces.

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<sup>1</sup> Mackenzie Eaglen and Jon Rodeback, “Submarine Arms Race in the Pacific: The Chinese Challenge to U.S. Undersea Supremacy,” Heritage *Backgrounder* No. 2367, February 2, 2010, at <http://www.heritage.org/research/reports/2010/02/submarine-arms-race-in-the-pacific-the-chinese-challenge-to-us-undersea-supremacy>

<sup>2</sup> Mackenzie Eaglen and Jon Rodeback, “Submarine Arms Race in the Pacific: The Chinese Challenge to U.S. Undersea Supremacy,” Heritage *Backgrounder* No. 2367, February 2, 2010, at <http://www.heritage.org/research/reports/2010/02/submarine-arms-race-in-the-pacific-the-chinese-challenge-to-us-undersea-supremacy>

**How important will the Virginia payload module be in addressing at least a portion of this looming gap in undersea strike capabilities?**

The US Naval Institute argues that “stretching 20 of the *Virginia*-class SSNs already in the Navy shipbuilding plan to support the addition of four large vertical-payload tubes will provide the force with near-equivalent undersea payload volume currently provided by our four dual-crewed SSGNs...If all 20 of the Virginia SSNs... (beginning construction in 2019) were stretched to include this VPM, the gap in undersea strike volume would be reduced by more than three-quarters...Adding a payload module is a significant investment, adding about 20 percent to the cost of each ship. However, it is possible to stretch ten Virginia SSNs for the cost of a single new Ohio-like SSGN.”<sup>3</sup>

Given these facts and figures, the Virginia payload module is a critical element to bridging the gap in undersea strike capability. Not only will it fill a void in capability, it will also take advantage of cost savings realized by the Virginia program and save money in the process.

**2.) The President’s request for DoD reflects the slipping or restructuring of procurement of many systems and capabilities outside of the FYDP Some of these include:**

- **Slipping 1 new Virginia class submarine outside of the FYDP;**
- **Reducing Littoral Combat Ships by 2 in the FYDP**
- **Slipping a large deck amphibious ship (LHA) by 1 year;**
- **Deferral of 24 MV-22 Osprey outside of the FYDP;**
- **Reduce Joint Strike Fighter procurement by 179 aircraft in the FYDP.**

**What impact does acquisition slipping and deferral have on the unit costs of these programs? Are these actions in the President’s budget short-sighted in not taking into account future unit cost increases?**

Acquisition slipping and deferral almost always result in cost increases on programs. The Virginia-class submarine, as an example to the contrary, realized its lauded cost-savings by increasing to a two-build per year schedule (According to CRS, achieving the build of two submarines in FY-12 saves \$400 million per sub in FY-05 dollars).<sup>4</sup> Delaying this build rate, even for just one fiscal year, would negate some of the savings.

The President’s actions are shortsighted because his delays not only affect U.S. force capability in the near term, they cause uncertainty for the industrial base. For long-term build projects such as shipbuilding, suppliers often purchase long-lead materials to hedge against cost increases in

<sup>3</sup> Rear Admiral Michael J. Connor, “Investing in the Undersea Future,” *Proceeding’s Magazine* Vol. 137/6/1,300, June 2011, at <http://www.usni.org/magazines/proceedings/2011-06/investing-undersea-future>

<sup>4</sup> Ronald O’Rourke, “Navy Virginia (SSN-774) Class Attack Submarine Procurement: Background and Issues for Congress,” Congressional Research Service *Report for Congress*, updated April 2, 2012, <http://www.fas.org/spp/crs/weapons/RL32418.pdf>

the future. Pushing projects unnecessarily beyond the FYDP, for example, lowers the incentive for defense manufacturers to make such decisions.

Question #3:

There have been reports that the Obama Administration is weighing options to cut the U.S. nuclear force by up to 80%. No final decision has been made, but the administration is considering at least three options for lower total numbers of deployed strategic nuclear weapons

cutting to around 1,000 to 1,100, 700 to 800, or 300 to 400, according to a former government official and a congressional staffer.

What is the minimum number of nuclear weapons you would consider necessary to maintain a credible nuclear deterrent?

If these cuts to our nuclear arsenal take place at the same time we are cutting nearly \$500 billion in our defense budget, what happens to the U.S. ability to project power and deter aggression?

Recent news articles indicate that the Obama Administration will soon release an update to a previous study of U.S. nuclear weapons policy that will recommend that the number of strategic nuclear warheads in the U.S. arsenal be reduced to between 1,000 and 1,100. If the reporting is accurate, this proposal will reduce the number of strategic nuclear warheads in the U.S. arsenal by about 50 percent.

What is key to understand about the pending study by the Obama Administration is how everything appears to be focused on the numbers of warheads. In all likelihood, the reporting accurately reflects the views of the Obama Administration, because it is evident that its highest policy priority is to get the numbers on a downward trajectory to bolster its policy for achieving U.S. nuclear disarmament. In short, the numbers are derived, first and foremost, from disarmament considerations.<sup>5</sup>

The Administration's misplaced priorities are exceedingly dangerous, because the most important consideration in the pending study should not be U.S. nuclear disarmament, but how to maximize the deterrent value of the U.S. nuclear arsenal. Arms control should be the means to this end, not an end in itself.

The Obama administration is going about its determination of how many nuclear weapons the U.S. should have in the wrong way. In order to properly determine the minimum number of nuclear weapons necessary to maintain a credible deterrent, the target set needs to be determined first. After determining the target set, only then it is possible to ascertain what number of nuclear warheads and delivery systems are necessary.

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<sup>5</sup> Baker Spring, "Disarmament Should Not Be the Driver of U.S. Nuclear Policy," Heritage Foundation, June 19, 2012, at <http://blog.heritage.org/2012/06/19/disarmament-should-not-be-the-driver-of-u-s-nuclear-policy/>.

The United States faces an increasingly proliferated international environment with more adversaries or potential adversaries than ever before; it also provides nuclear security guarantees to more than 30 countries. As a result, the targeting list is evolving more rapidly than at any point in history.

Every U.S. President faces a difficult decision regarding what to target in the case that the U.S. homeland or allies are attacked. The President can choose to strike counter-force and counter-value targets. Counter-force targets are the enemy forces and supporting infrastructure—including weapons capabilities like missile sites, production capabilities, and command and control centers. Counter-value targets are the enemy cities and population. Lowering the number of weapons could reduce the President's options when deciding what would be an appropriate response in the case of an enemy strike.

Moreover, with lower numbers of nuclear weapons, the United States would be *forced* to threaten the population centers in other countries. A country that values freedom—for itself and others—above anything else should not divest itself of weapons that allow it to destroy enemy forces and forces them to target civilian populations. Purposeful attacks on undefended populations are alien to the values of the American people.

While the Administration has apparently instructed the Pentagon to see “just how low it can go,” it is worth recalling the testimony of General Kevin Chilton, then-Commander of the United States Strategic Command, before the Senate Committee on Foreign Relations in 2010. In describing the appropriate size of the nuclear arsenal, he stated that “I think the arsenal that we have is exactly what is needed today to provide the deterrent. It is sized to be able to allow us to hedge both against technical failures in the current deployed arsenal and any geopolitical concerns that might cause us to need more weapons.”<sup>6</sup>

What conditions in the world have changed since 2 years ago? How could a number like 700 or 300 even be conceivable? The Obama Administration appears to want to pick a number whether it makes any military sense or not. After implementing the flawed review's recommendations, the U.S. nuclear forces left in place will likely be too small, outdated, and inappropriately postured to meet U.S. and allied security requirements in a proliferating world.

The further reduction of nuclear forces could create an incentive for nuclear proliferation—as the U.S. reduces its nuclear arsenal it increases the value not only of its remaining weapons but also of nuclear weapons for U.S. adversaries. The perceptions of parity with the U.S. would be a powerful enabler for aspiring regional powers and potential strategic adversaries. This danger was captured by Dr. Keith Payne in March 2001 testimony to the House Strategic Forces Committee: “Any new guidance that adopts minimum deterrence could easily increase the nuclear danger by undermining credible US deterrence and by pushing friends and allies toward nuclear proliferation.”<sup>7</sup> Moreover, there is simply no evidence U.S. disarmament leads to less

<sup>6</sup> General Kevin Chilton, Statement before the Senate Committee on Foreign Relations, June 16, 2010 at <http://www.foreign.senate.gov/imo/media/doc/Chilton,%20Gen.%20Kevin%20P.pdf>.

<sup>7</sup> Dr. Keith Payne, Statement before the House Strategic Forces Subcommittee, March 2, 2011, at [http://armedservices.house.gov/index.cfm/files/serve?File\\_id=e0f547b4-64f6-4ea2-ab91-c64197738cb6](http://armedservices.house.gov/index.cfm/files/serve?File_id=e0f547b4-64f6-4ea2-ab91-c64197738cb6).

proliferation. Since 1991, the U.S. has eliminated roughly 73 percent of its nuclear stockpile, yet the number of nuclear weapon states has grown.

The Heritage Foundation believes that in this complex and increasingly proliferated environment, the U.S. must accept a concept for deterrence that leads to a targeting policy that is consistent with a “protect and defend” strategy for the U.S. The Heritage Foundation spelled out this concept for deterrence in a 2008 Backgrounder.<sup>8</sup> As will be explained in a forthcoming Backgrounder, U.S. strategic planners, at the outset, must start with a basic concept for deterrence that overarches the chosen targeting policy. This concept must at the same time recommend a deterrence posture for the U.S. that is convincing to both the allies and current and potential enemies of the U.S., as well as remain in keeping with the values of the American people and the federal government’s solemn commitment to protect and defend them to the best of its ability.

Will the U.S. ability to project power and deter aggression be seriously hampered if further cuts to our nuclear arsenal take place along-side of further defense cuts by the defense sequester? Yes, there is no question.

First, cutting nuclear capabilities while drawing down conventional forces makes no sense. In the 1950s, Eisenhower cut conventional and ground forces but expanded the U.S. nuclear arsenal to compensate for smaller forces and to hedge against foreign aggression. Additionally, the defense sequester will also further cut U.S. missile defenses. This will be on top of the Obama Administration’s inadequate budget for missile defense.<sup>9</sup>

Senator Kyl captured the overall picture and trajectory of the U.S. defenses when he said, “some people have said you might be able to reduce the number of warheads, but only if we have a robust missile defense system and we build up our conventional capabilities. And in the budget, both of those items are dramatically reduced, and this Administration has no commitment, serious commitment, to either one.”<sup>10</sup> Taken together, this combination of events is a dangerous mix and sends the wrong signals to our friends and our enemies.

History has taught us all too well that the best way to prevent aggression is through strength. If we slip as a nation into complacency and fail to uphold a credible conventional and nuclear deterrent, current or potential enemies may be tempted toward aggression or miscalculate.

### Senator Whitehouse

#### **1.) The new defense strategy places significant emphasis on the concept of reversibility, which aims to enable our military to reconstitute forces and regenerate capabilities to**

<sup>8</sup> Baker Spring, “Congressional Commission Should Recommend ‘Damage Limitation’ Strategy,” *Heritage Backgrounder* No. 2172, August 14, 2008, at <http://www.heritage.org/research/reports/2008/08/congressional-commission-should-recommend-damage-limitation-strategy?query=Congressional+Commission+Should+Recommend+%2522Damage+Limitation%2522+Strategy> (June 22, 2012).

<sup>9</sup> Baker Spring, “President Obama’s Missile Defense Program Falls Behind the Threat,” *Heritage Backgrounder* No. 2686, May 3, 2012, at <http://www.heritage.org/research/reports/2012/05/president-obamas-missile-defense-program-falls-behind-the-threat> (June 27, 2012).

<sup>10</sup> “Defending Defense: Choosing Decline: The Meaning of Obama’s Defense Guidance and Budget,” February 16, 2012 at <http://www.foreignpolicy.org/content/choosing-decline-meaning-obamas-defense-guidance-and-budget>.

**respond to unforeseen threats. According to the strategic guidance, a strong Reserve Component is a vital component of reversibility. Given the operational experience and expertise that the National Guard and Reserves have developed in the last decade, how does the budget reflect long-term programming for the Reserve Component and new force mix combinations to preserve these capabilities and reduce costs? In particular, comment on the cuts reflected in the Air Guard component of the Air Force's budget.**

**The Reversibility Problem.** The strategic guidance also called for adding —reversibility to the force. Reversibility was described as the capacity to reconstitute military capabilities to respond to unforeseen military requirements. Reversibility is provided by the —generating force. The services already have substantial investments in the generating force, from a high of about half of the Navy to a low of a little less than 30 percent of the Army. Since the military is being further reduced under the President's plan, additional increases in —reversibility can only be achieved by further reducing the —operating force. This will leave even less forces available for current missions that the Administration currently projects in its budget proposal. Reversibility under the President's budget plan will drive risk up, not down because the military will be even less ready and capable to respond to near-term challenges or dissuade or deter adversaries for pursuing aggressive designs in the future.

2. Scientists predict that extreme weather patterns will become more frequent as a result of climate change. We have seen a multitude of catastrophic storms and weather events in recent years and scientists predict that they will become more frequent as a result of climate change. How does the budget for the National Guard take into consideration increased requirements and demands for homeland missions in response to these types of disasters?

Over the last several years, the forecasters at the National Oceanic and Atmospheric Administration and at Colorado State University have predicted above average hurricane activity. According to the Federal Emergency Management Agency, however, from 2009 to 2011, only three hurricanes--two of which didn't directly strike the United States--had any impact on the United States: Hurricane Alex produced minor wind and rain in Texas in August 2010 (Category 1); Hurricane Earl produced moderate wind and rain in September 2010 (Category 4); and Hurricane Irene produced significant wind, rain, and flooding in August 2011 (Category 3). In that same period of time, only two 5.0 or higher earthquakes occurred in the United States.

Even though there was little to no major natural disaster activity in the United States, from 2009 to today, FEMA issued 474 declarations. The vast majority of these declarations covered events that had no national impact. Prior to 1993 and the increasing federalization of natural disasters, the clear majority of the events for which FEMA issued declarations would have been entirely handled by state and local governments without any federal assistance. Hence, the issue is not about the National Guard's budget; rather, the issue is about the continued federalization of natural disasters.

For example, in 2011, the Obama Administration shattered—an understatement if there ever was one—the records for:

- The total number of FEMA declarations: 242 versus 158 set in the 1996 election year;
- The number of Major Disaster Declarations (MDDs): 99 versus 75 set in 1996 and 2008.
- The number of Fire Management Assistance Declarations (FMADs): 114 versus 86 set in 2006.

It also posted the third-highest number of Emergency Declarations (EDs) in FEMA history—29 versus 68 set in 2005, the year of Hurricane Katrina. These records fell despite the absence of any successful terrorist attacks, any Category 2 or higher hurricanes (Irene was downgraded to a Category 1 by the time it struck the United States), or any earthquakes greater than 6.0 on the Richter Scale. Congress should amend the Stafford Act to decrease the number of events that are eligible for FEMA declarations.

It is state and local governments, not the National Guard that should be increasing their budgets to deal with the routine natural disasters that occur and have occurred throughout American history, within their jurisdictions.

**Lieutenant General Barno's Responses to Questions for the Record****From Senator Ayotte**Question #1

The Virginia class submarine offers a critically important capability for overcoming anti-access/area denial (A2/AD) strategies and weapons, which China and Iran are increasingly employing. A2/AD capabilities range from high- to low-tech, and include precision-guided cruise missiles, anti-satellite weapons, cyber weapons, advanced fighter aircraft, diesel-electric submarines and underwater mines. These capabilities, whether used for combat or deterrence, could prevent the U.S. military from operating in – and preserving unfettered access to – the global commons of the Western Pacific and Persian Gulf.

Though Virginia class submarines will not serve as a primary way to transport special operators to and from their missions, their ability to do so – particularly in A2/AD environments – will give U.S. military planners an additional option and thereby complicate the planning of potential adversaries.

The referenced 60 percent reduction in undersea strike volume is a concern, but it should be viewed in a broader context. The reduction is mostly attributable to the impending retirement of four SSGNs, although a smaller SSN fleet is also a contributing factor. The Navy converted these SSGNs from SSBN configuration because the cessation of Cold War hostilities enabled reductions in U.S. nuclear force structure. In effect, the Navy received an unplanned “bonus” increase to its undersea strike volume. Given these unique circumstances, it is not clear that the strike capacity added by SSGNs represents the appropriate baseline against which to measure future investments and capabilities.

That being said, the Navy should make investments to reduce the risk presented by the reduction in undersea strike volume. If each Virginia class submarine is better outfitted, the Navy will be able to meet its operational requirements even though it possesses fewer overall ships. The addition of the Virginia payload module offers the most promising way to outfit each submarine with larger or asymmetrical payloads that will complicate the strategic calculus for potential adversaries.

Question #2

Depending on the situation, delaying the procurement of weapons systems can either increase or decrease unit costs. On the one hand, delays can increase unit costs if they postpone the contractor's ability to move along the learning curve and achieve the efficiencies that accompany full-rate production. On the other hand, delays can decrease unit costs if they prevent a weapons system from entering accelerated production before the design is fully ready, a situation that often leads to cost growth and forces the contractor to make expensive changes to early-production units.

The Budget Control Act (BCA) imposes a short-sighted vision of affordability on U.S. defense plans. The BCA mandates a decade-long window, from FY 2012 to FY 2021, to achieve deficit reduction. From a

national security perspective, this timeline is completely artificial and does not correlate to any event taking place in the real world. Because the BCA only concentrates on deficit reduction over the next 10 years, it forces the Pentagon to change its plans in ways that generate near-term savings – *even if these changes result in higher costs over the long-term*. In other words, the BCA encourages the Pentagon to prioritize near-term savings over long-term affordability.

It was reasonable for Congress to include a forcing mechanism in the BCA to get DOD to reduce its near-term costs; if one wasn't included, it would be too easy for DOD to simply pledge future savings that may never materialize. Nonetheless, Congress should enact changes to the BCA that give DOD more flexibility to balance near-term savings with long-term affordability. This will be especially important if Congress doesn't repeal sequestration, a process that grants the Pentagon virtually no flexibility to make internal budgetary tradeoffs based on strategic calculations or affordability considerations.

#### Question #3

Determining the minimum number of nuclear weapons required to maintain a credible U.S. nuclear deterrent is a process fraught with considerable guesswork. Though government and non-government experts often present their recommended nuclear force levels with scientific certitude, the reality is that these recommendations are based on assumptions that can and should be questioned. This is precisely what the Obama administration is doing right now, and I applaud them for it.

Based on military and political calculations that are at the heart of effective deterrence, I believe that mutual U.S.-Russian reductions down to 1,000-1,100 deployed strategic nuclear weapons per side represent a responsible next step for America's arms control agenda. While cuts below that level might be achievable purely in terms of maintaining credible deterrence, I am concerned that pursuing larger cuts might have a disruptive and negative effect on America's alliance relationships and international standing at a time when there is already uncertainty about whether the United States will continue to play the leading role in global affairs. In sum, "slow and steady" is the most responsible course for future U.S. nuclear reductions.

#### **From Senator Whitehouse**

#### Question #1

The National Guard and Reserves have proven their mettle over the last ten years of war. Reserve component forces not only are highly capable, but also are less expensive to maintain than active forces; their costs only rise to the level of active forces when activated for full-time duties. These facts strongly argue for moving more expensive military capabilities that are not immediately needed in crises into the reserve component. The concept of reversibility enshrined in DOD's new strategic guidance relies heavily on the reserve component, and rightfully so. This reliance means that reserve component readiness must be well resourced and measured objectively. For the foreseeable future, the reserve

component will remain a cost-effective choice for the U.S. military's efforts to build partner capacity with allies worldwide. The National Guard's State Partnership Program is the flagship initiative in this area.

Today, the Air Force is struggling to find the best mix between its active and reserve components. In its FY 2013 budget request, the Air Force proposed larger reductions to its reserve component than to its active component. Its rationale was that over the past decade, it has reduced its active component forces more than its reserve component forces. It is concerned that further reductions to the active component "would limit our ability to respond quickly to multiple crises or sustain long duration commitments" without asking the total force "to deploy at rates that cannot be sustained."

I endorse the reductions to the reserve component proposed by the Air Force in the FY 2013 budget. I believe the service has reasonable concerns about how further shrinking the active component below the level proposed in the FY 2013 request could harm the aggregate capacity of the total force. However, the Air Force has erred by not providing a comprehensive long range plan for the total force which is comprehensive and widely understood. Such a plan is urgently needed to help the Air Force manage the transition to a new era in which it will still operate actively around the globe but will not necessarily do so in direct support of wartime operations in Iraq, Afghanistan, Libya, and elsewhere. Producing this long range plan will help the Air Force maintain sustainable dwell ratios and preserve the reserve component's operational expertise and strategic depth, the two attributes that make it the rightful, if often unacknowledged, centerpiece of the principle of reversibility articulated in the new strategic guidance.

#### Question #2

The National Guard's FY 2013 budget continues to prioritize the critical dual use (CDU) equipment that is essential to performing operations at home and abroad. National Guard units must be able to respond to a broad range of crises at home and abroad, and must be trained and equipped to do so. However, as the U.S. military transitions gradually out of Afghanistan, DOD must explain and justify how it plans to allocate equipment returning from theater and how it intends to fill CDU equipment capability gaps. The transition to a more CONUS-based U.S. military presents opportunities to rethink the personnel and equipment mix between the active and reserve components.

## Dr. Michael O'Hanlon's Responses to Questions for the Record

For Senator Ayotte's questions:

- 1) I agree with much of the thrust of this question. It is why I would not look to the attack submarine fleet for budget savings, generally speaking, and why I would convert 6 more Trident SSBNS to a nonnuclear configuration and mission in the near future
- 2) I am sympathetic to some program slippages and delays but also worry about unit costs going up as a result. I prefer changes to acquisition programs that cancel some programs or scale them back in size. It is for that reason that I focus on savings in the size and scale of the F35, LCS, and V22 programs among others, in my testimony and my recent book, *The Wounded Giant*.
- 3) As for nuclear force reductions, while I favor a less expensive nuclear force, I believe it important to maintain parity with Russia and substantial superiority vis-à-vis China for the foreseeable future. A realistic arms control treaty goal with Moscow might thus be 1,000 to 1,200 strategic warheads and a comparable number of tactical or surplus warheads, for the next round of arms control. Even getting to such numbers will be quite challenging and probably take years.

## RESPONSES FOR SENATOR WHITEHOUSE

- 1) On balance I believe the Reserve Component can be asked to shoulder a somewhat higher percentage of the total military mission, including in the Air Force, than the Obama strategy and budget would have it do. One must avoid going too far; we need responsive forces that can accept high operational tempo on a routine basis, and that set of considerations steers one to a substantial reliance on active-duty forces. But on balance my assessment is that we could in fact shift perhaps 5 to 10 percent more of the overall ground force and Air Force burden onto the reserve component.
- 2) This is an excellent question. I have favored configuring one Guard brigade primarily for homeland response for this and other reasons (which could require additional funds for a time), and continue to believe that is a worthy idea—while keeping other parts of the Guard “on call” for such missions as well.

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