S. HRG. 110–559

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 2009

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

January 24, 2008—THE CONGRESSIONAL BUDGET OFFICE BUDGET AND ECONOMIC OUTLOOK

January 29, 2008—THE LONG-TERM BUDGET OUTLOOK

January 30, 2008—ECONOMIC STIMULUS: BUDGET POLICY FOR A STRONG ECONOMY OVER THE SHORT AND LONG TERM

January 31, 2008—THE LONG-TERM OUTLOOK AND SOURCES OF GROWTH IN HEALTH CARE SPENDING

February 05, 2008—THE PRESIDENT'S FISCAL YEAR 2009 BUDGET PROPOSAL

February 06, 2008—THE PRESIDENT'S FISCAL YEAR 2009 BUDGET AND REVENUE PROPOSALS

February 12, 2008—THE PRESIDENT'S FISCAL YEAR 2009 DEFENSE BUDGET AND WAR COSTS

February 14, 2008—HEALTH CARE AND THE BUDGET: INFORMATION TECHNOLOGY AND HEALTH CARE REFORM

Printed for the use of the Committee on the Budget

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U.S. GOVERNMENT PRINTING OFFICE

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THE CONGRESSIONAL BUDGET OFFICE BUDGET AND ECONOMIC OUTLOOK

THURSDAY, JANUARY 24, 2008

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

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

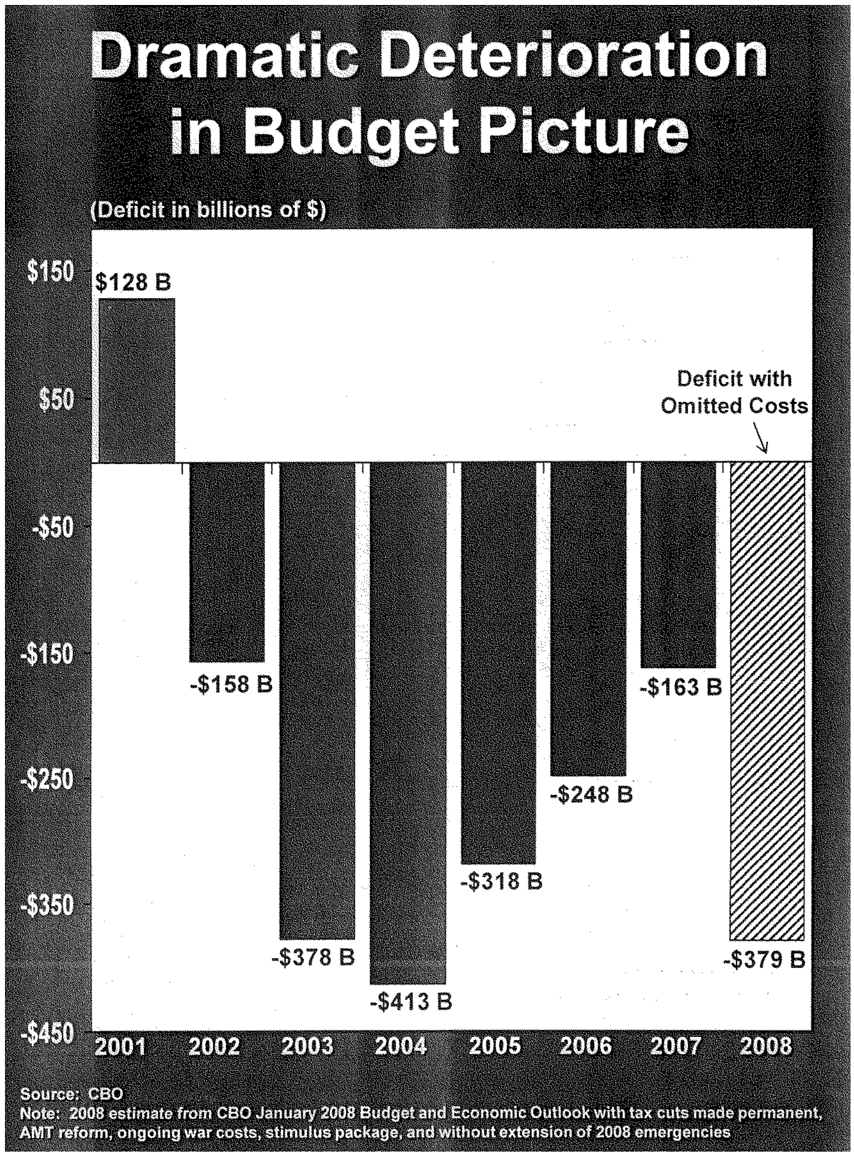
Present: Senators Conrad, Murray, Stabenow, Whitehouse, Gregg, Allard, and Crapo.

Staff present: Mary Ann Naylor, Majority Staff Director and Denzel McGuire, Minority Staff Director.

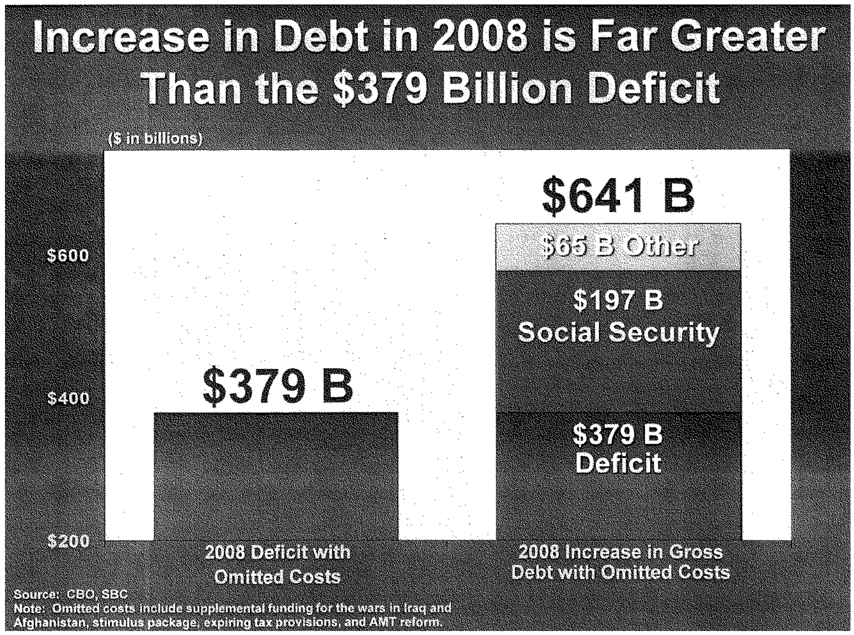
OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. We will bring the hearing to order. I want to welcome very much our distinguished witness, Dr. Orszag, to talk about the CBO outlook. We appreciate very much your being here and your service as the Director of the Congressional Budget Office. I know you have already had a chance to testify over on the House side and also in the Finance Committee on the stimulus package, so you have been very busy to start the New Year. But we welcome you to the Senate Budget Committee as well.

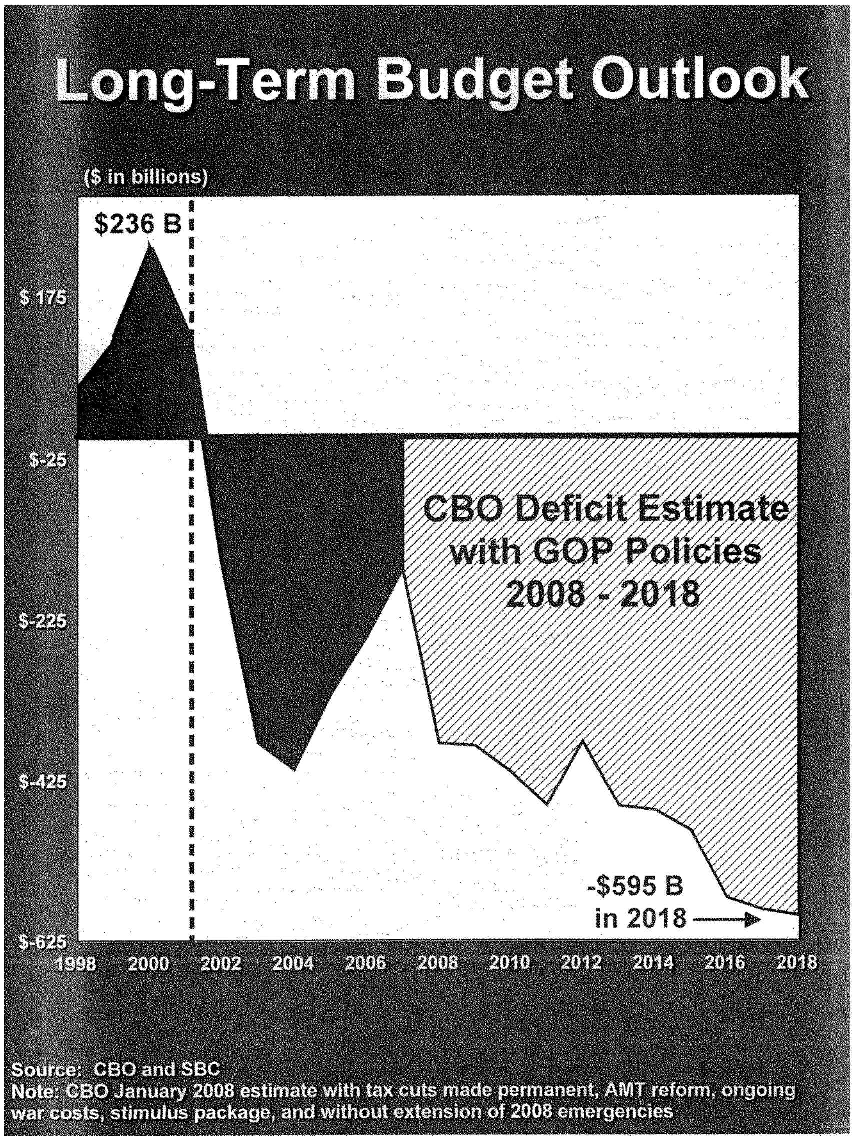
Let me just go through quickly a couple of slides to put in perspective the circumstances we find ourselves in. We have had a substantial deterioration in the budget picture. You can see last year we had a deficit of about $163 billion. This year, when we take the CBO baseline and we add back war spending that is not in the CBO baseline and the effects of the proposed stimulus package, we see a deficit this year approaching $380 billion.



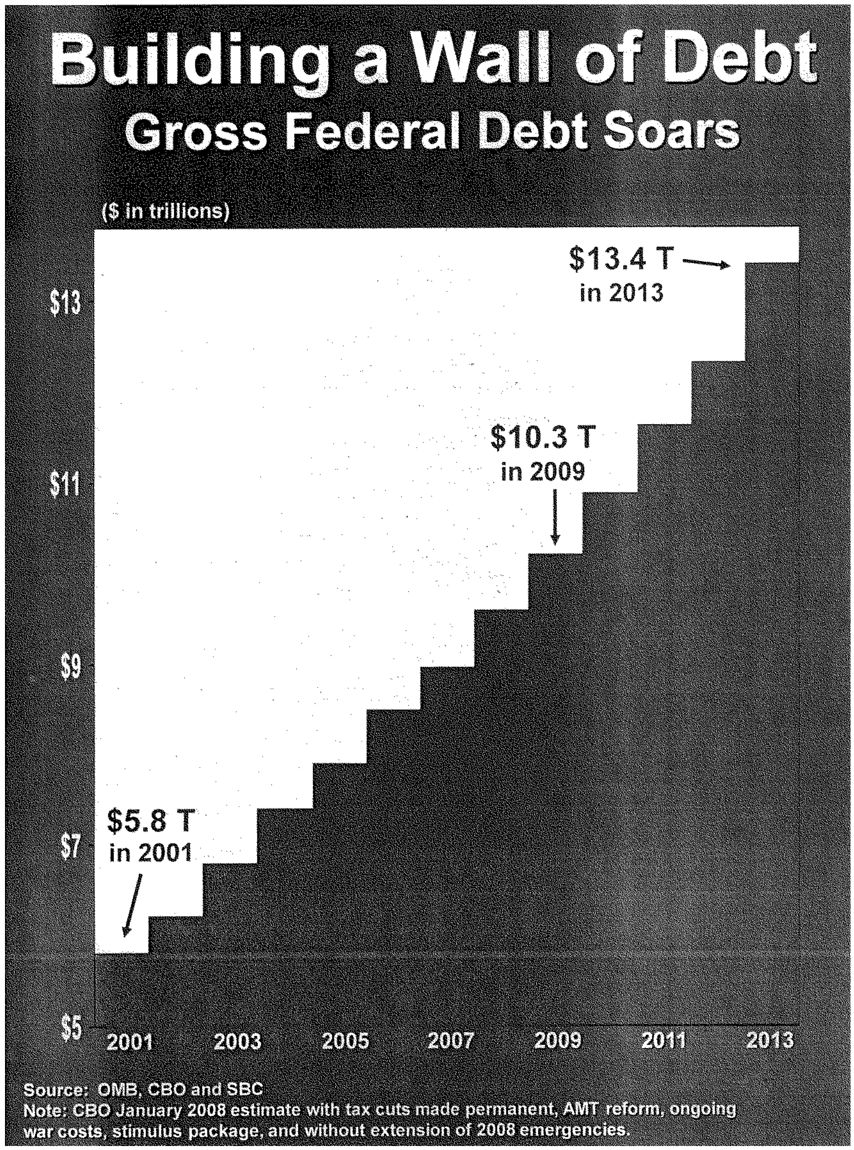
But that tells just one part of the story. We also see the debt going up substantially more than the deficit, and as I travel around, I find enormous confusion among the public about the difference between the deficit and the debt. The biggest difference between these figures, of course, is the Social Security Trust Fund money that is being used to pay regular operating expenses of the Federal Government. That is money that will have to be paid back, but it does not show in the deficit calculation. It is nearly $200 billion. But it is all added to the debt.



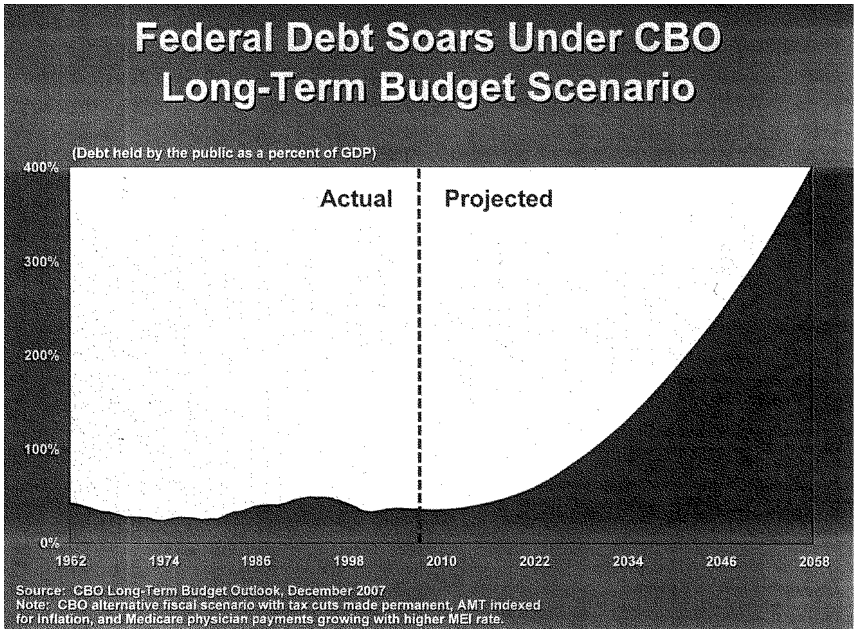
Let's go to the next slide if we can. We look at the CBO deficit estimate, and we put with that the President's policies—that is, the extension of the tax cuts and additional war costs—and we see that by 2018 we would face a deficit of nearly $600 billion.



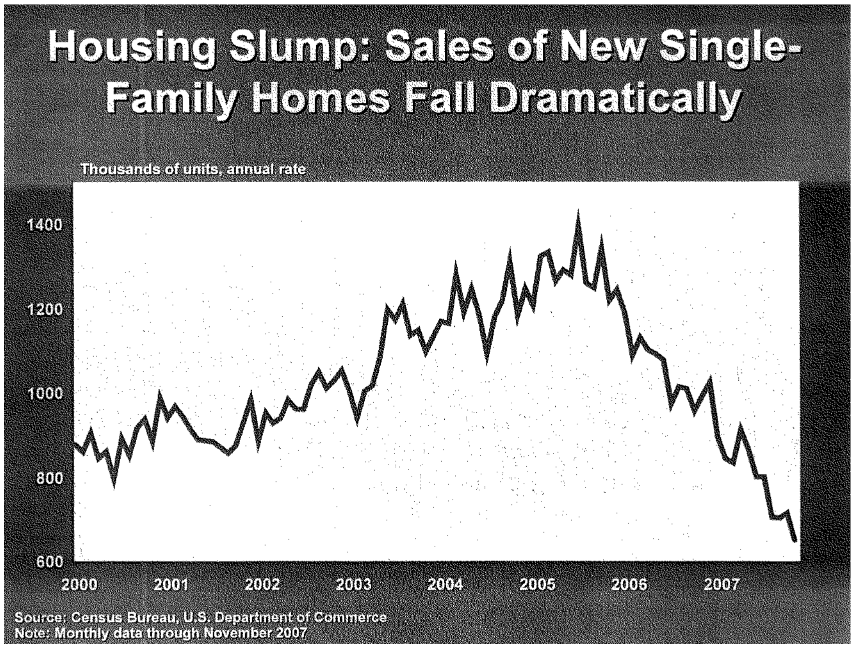
We can go to the next slide. All of this leaves us with a picture of ever escalating debt. The gross debt of the United States was $5.8 trillion at the end of 2001. At the end of 2009, which will be the last year that the President's budget will have been operational, we anticipate now the gross debt of the United States will be $10.3 trillion, and we are headed by 2013 for a gross debt of over $13 trillion.



Let's go to the next slide, if we can, and if we look at an even more extended picture, according to CBO, the Federal debt absolutely soars on the long-term budget scenario going out to 2058. This is a result largely of the retirement of the baby-boom generation and the pressure on Medicare and Social Security. And I hope that we will have a chance to have some discussion today about the absolute need to face up to these long-term imbalances, these shortfalls in the entitlements, and the disconnect between revenue and expenditure, at least proposed expenditure.



I would like also just to put in perspective economic conditions that we face, the housing slump. We see that the sales of new family homes has fallen dramatically. We continue to see fallout from the subprime crisis and the other credit markets. We have seen certainly serious effects in the financial markets.

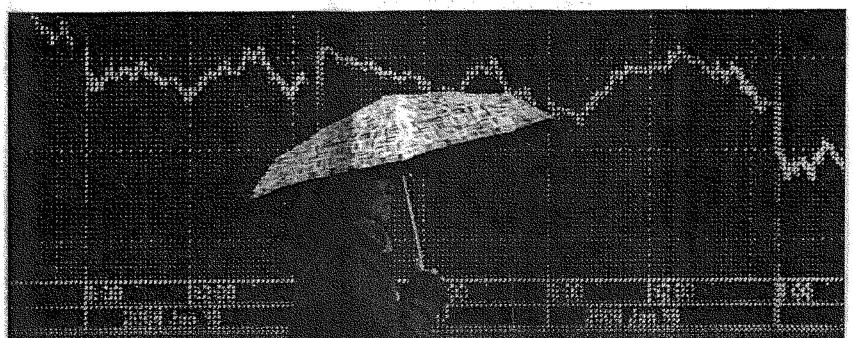


This is a headline from the Financial Times: "Fears spark global plunge." This is what happened—this is from January 22nd. These are foreign markets. Obviously, our market yesterday showed a significant increase. I think we were up almost 300 points yesterday on the Dow. But this is what has been happening in other markets, the U.K., Europe, Asia.

FINANCIAL TIMES

USA Tuesday January 22 2008

Fears spark global plunge



Take cover: a pedestrian shelters from the rain as she passes a screen in west London showing downward stock market trends Reuters

Markets suffer biggest one-day fall since 9/11

Worries of recession in US help trigger rout

By Joanna Chung and Robert Orr in London and Andrew Wood in Hong Kong

Global equities plunged yesterday as investor concerns over the economic outlook and financial market turbulence snowballed into a sweeping sell-off.

Tumbling Asian shares – which continued to fall early today – led European stock markets into their biggest one-day fall since 9/11 as the prospect of a US recession and further fall-out from credit market turmoil prompted near panic among investors, who rushed to the safety of government bonds.

About $490bn was wiped off the market value of Europe's FTSE Eurofirst 300 index and $148bn from the FTSE 100 index in London, which suffered its biggest points slide since it was formed in 1983. Germany's Xetra Dax slumped 7.2 per cent to 6,790.19 and France's CAC-40 fell 6.8 per cent to 4,744.45, its worst one-day percentage point fall since September 11 2001.

"September 11 aside, I can't remember a day like this. It was carnage," said Jimmy Yates, a dealer at CMC Markets in London. "It's been a really good four or five years but it looks like the end of the bull run."

US markets were closed for the Martin Luther King Jr Day holiday, but the futures market suggested the S&P 500 index would fall more than 4 per cent when it resumes trading today.

Traders said that the prospect of a sudden decline in US stocks could prompt the Federal Reserve to cut interest rates before its scheduled meeting on January 30. The Fed said it did not comment on speculation.

"What we are seeing now has the hallmarks of both a financial shock and the beginning of a [US] recession, or at least of growth grinding to a halt," said Credit Suisse's fixed income strategy team in a research note.

Despite the dramatic falls, many believe there may be worse to come. "We believe the trough is not reached yet," said Teun Draaisma, European equity strategist at Morgan Stanley.

Fears of fresh writedowns from financial institutions and downgrades of bond insurers – so-called monolines – are unnerving markets. The cost of insuring the debt of 125 investment-grade companies in the iTraxx Europe index leapt 10 per cent.

"The news that some monoline insurers have seen their ratings lowered, potentially with more to come, has opened up a very nasty scenario," said Andrew Milligan, head of global strategy at Standard Life Investments. "Financials may very well face another hefty round of write-offs, which would reduce their future potential to extend credit to businesses, thus causing a vicious spiral to develop."

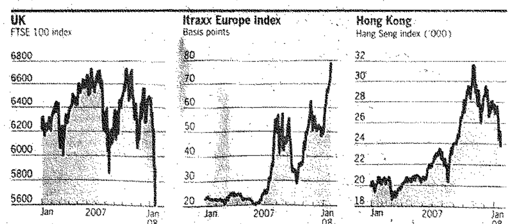
On Friday, Ambac, the second-biggest bond insurer, lost its triple-A credit rating from Fitch Ratings, a move set to undermine the company's ability to attract business and hit billions of dollars of securities it guarantees.

Michael Cox, of the Royal Bank of Scotland, said: "We now believe there are no public markets open to the monolines in their quest to raise capital . . . The only potential solution we can see that would enable triple-A ratings to be retained now is a co-ordinated bail-out by interested parties – banks and/or politicians."

In Asia, Indian shares ended 7.4 per cent lower; Hong Kong closed down 5.5 per cent; and Japan's Nikkei average slid nearly 4 per cent, falling a further 4 per cent in early trading today while South Korea's Kospi index lost a further 3.9 per cent.

"In the past few weeks, the froth had been knocked off the markets but we haven't seen real pain – until today," said Ian Harnett, managing director of Absolute Strategy Research.

Additional reporting by Krishna Guha and Saskia Scholtes in New York, Jamil Anderlini in Beijing, Geoff Dyer in Shanghai and Lindsay Whipp in Tokyo



Sources: Thomson Datastream; Reuters; Markit

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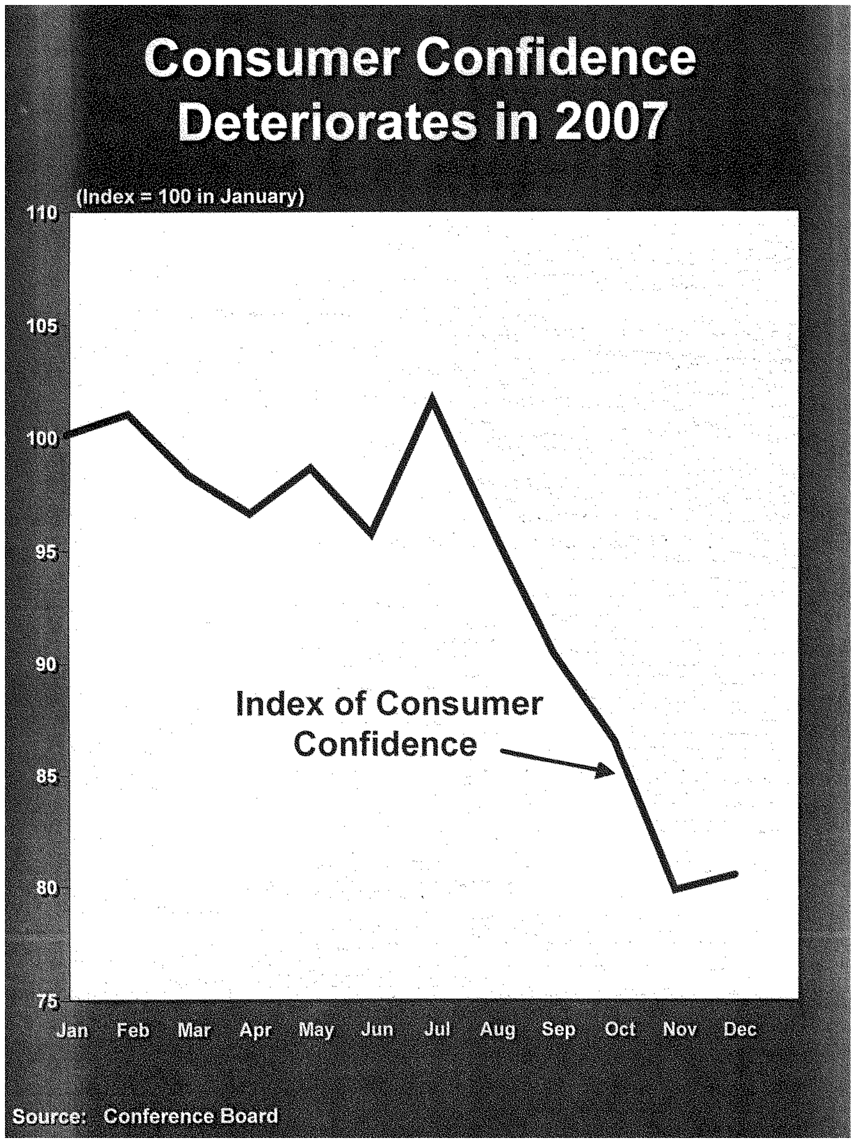
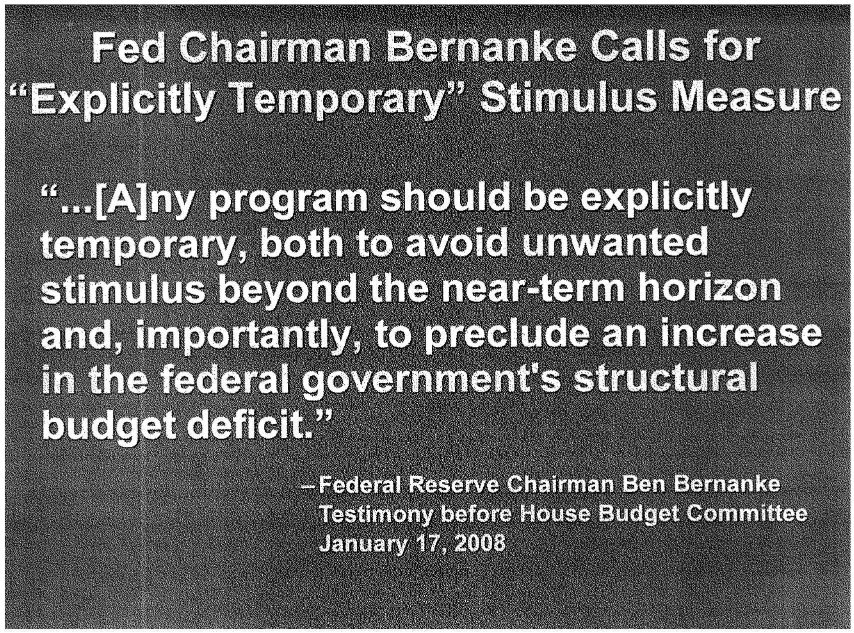
www.ft.com/ukdailyview

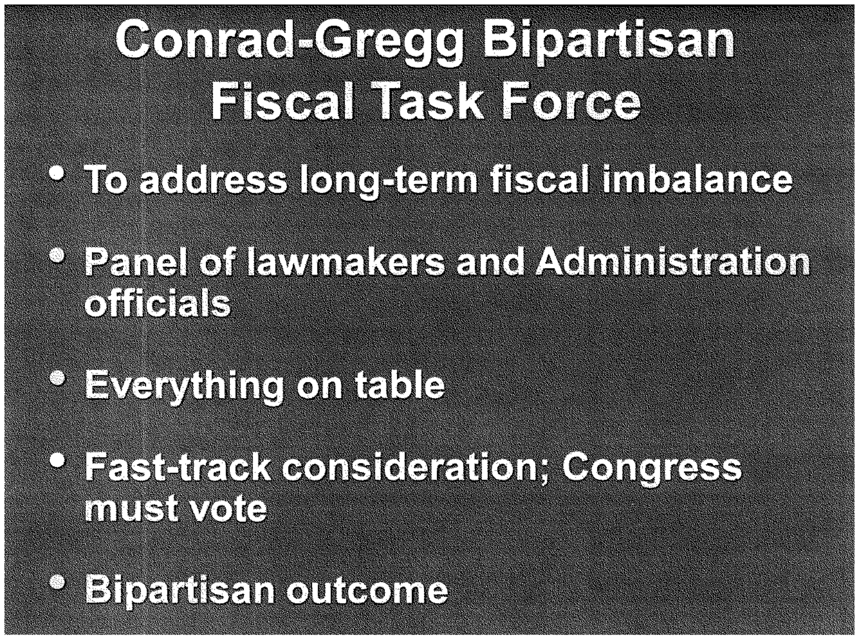
We have also seen consumer confidence deteriorate in 2007. The index of consumer confidence from the Conference Board has slumped dramatically. That is why there is the talk of a stimulus package, the need to do something and do it quickly.



I just want to reference the Chairman of the Federal Reserve, who warned us that any program should be explicitly temporary, both to avoid unwanted stimulus beyond the near-term horizon and, importantly, to preclude an increase in the Federal Government's structural budget deficit.



Finally, I would like to end on something that is bipartisan, at least on this Committee, and that is the question of a device to address these long-term imbalances, the shortfalls in Medicare and Social Security. That is the proposal that the Ranking Member Senator Gregg and I have made for a task force to address the long-term fiscal imbalance. A panel of lawmakers and administration officials with everything on the table, with fast-track consideration so it is not just another commission report that sits on a shelf somewhere but actually comes to Congress for a vote, and that is structured in a way that assures a bipartisan attention to these issues.



I just want to alert my colleagues that it is going to be my intention to advance this proposal this year. Senator Gregg and I are talking about on what vehicle it would be most appropriate, but I want to alert staff of our colleagues who are here. I have been patient. I have listened very carefully to the concerns of colleagues. We are prepared to have some change in the timing of the report. We are also prepared to consider other constructive suggestions. But I just want to alert my colleagues that I am not going to allow this year to go by without giving our colleagues an opportunity to vote on whether or not we advance this proposal.

With that, I want to turn to my very able colleague, the Ranking Member, the former Chairman of this Committee, Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Senator Conrad, and, Dr. Orszag, it is nice to have you here today. Let me pick up where Senator Conrad, the Chairman, has left off on the issue of addressing what I consider to be—after the issue of fighting Islamic fundamentalism, which is a threat to us from a physical standpoint—the issue that I consider to be the biggest issue we face as a Nation, which is the potential fiscal meltdown of our country over the fact that we have on the books obligations exceeding our net worth, $66 trillion of obligations for three entitlement programs—Medicare, Medicaid, and Social Security. Our net worth as a Nation is about $52 trillion. We simply have to address this.

The Bipartisan Fiscal Task Force proposal that Senator Conrad and I have drafted and for which there was considerable input from a lot of people as it evolved is a valid way to approach this. We have shown over time, unfortunately, that as a political culture we cannot address this issue by simply putting ideas on the table because everybody shoots at the ideas, especially people who like to make money by doing that shooting. And so the best approach, in our humble opinion, is to set up a procedure which drives policy, and that is what this proposal does.

Obviously, any procedure, to be successful in these areas, because they are so sensitive to the American people and because all Americans are affected by them, has to be seen by the American people as absolutely fair and absolutely bipartisan. And that is why this proposal is structured this way.

Interestingly enough, yesterday Republicans convened, Senate Republicans convened for a day-long session of sorting through our thoughts as we start this session, and one of the main considerations was a discussion of this proposal, the Conrad-Gregg proposal. And there was, I think, general agreement—although there was no formal vote taken, but there was general agreement within the conference, the Republican conference, that this was a legitimate and appropriate idea to proceed on and that we should be proceeding in a bipartisan way to try to address this. There are two of my colleagues here who were at that meeting who maybe can hopefully substantiate that as being the sense of the meeting. So that is good news, and I congratulate the Chairman for being willing to push this to the front of the agenda.

We are here today to discuss the recent findings of CBO relative to our economic outlook and what is happening. I am interested in discussing that. Also, I am most interested, obviously, in the topic of the day, which is the stimulus package and how that will be put together and what its real impact is.

On the issue of the actual numbers that we have seen on projecting deficits into the out-years, I just want to put out the caveat that the CBO numbers were done under a baseline which is controlled by arcane rules which do not accurately reflect reality in many ways. For example, there is in that baseline approximately $800 billion of revenue, I believe, from the AMT which is assumed. There is also an assumption that we will be doubling the tax on dividends—actually, more than doubling the tax on dividends for high-income individuals and moderate-income individuals, and that we will be doubling the tax on capital gains, and that as a result revenues will essentially be increased by trillions of dollars over the same period through tax increases. That may occur, but my view is that that is probably not an event that should be scored if you were looking at it in a realistic way versus subject to the rules of the baseline. So I do not say that in terms of in any way trying to throw disparagement on CBO. You have done your job the way you have to do it—the way we require you to do it, by the way—but what we are telling you to do is not realistic to what will actually happen on the ground over the next 10 years. So that would concern me.

The biggest issue that concerns me is how we put this stimulus package together. I readily admit—in fact, I have been talking about it for a long time—that we are facing an extraordinarily sensitive economic time and potentially a very severe economic event. The subprime collapse—which represents this year about $500 billion and next year about another $600 billion of rollovers in mortgages, which, because of the way they were structured, a large percentage of them will not be able to be repaid by the people who borrowed the money because of the jump in the interest rates and the collateral underneath them does not support them—creates just a massive economic credit crunch. And that is feeding on itself right now, and I have been through three of these in my professional lifetime, and, regrettably, at one point I was Governor during the last major real estate meltdown. And so I think I understand how they work, and, unfortunately, what happens is that when you get into one of these contractions, you not only see the bad loans get called, but the good loans do not get made because the lenders have to build up their capital positions and, therefore, it feeds on itself and the whole system starts to contract and that causes the economy to slow down. And we are, regrettably, on the cusp of that occurring in a fairly significant way, I am afraid.

However, we also have some good news out there. For example, today's unemployment numbers are very strong, extremely strong, and we appear to have other sectors of the economy which have not yet been overwhelmingly impacted by the housing slowdown. But they will be impacted, I suspect, by the credit contraction.

And so what should we as a Government do to address this is the question, and the proposal that has been put forward by both the administration and the Democratic leadership of the Congress is an attempt to try to address this, and I congratulate them for taking that initiative. But I want to make sure that we put the money where we get the action, where we get something for it. And my concern is every dollar that we are going to put into this economy in stimulus is going to have to be borrowed. That chart that the Chairman just put up is going to be aggravated by it. It is going to be a compounding event. If we put $150 billion into this economy today, we are not going to pay for it. Our children are going to pay for it, and our children's children, and it is going to be paid for at a much higher price because they are going to have to borrow it. That compounds.

So let's get something for it. Let's just not send helicopters over the country throwing cash out the door. Let's get something for it. So what I am going to want to ask you about, Doctor, is what gets us the most for those dollars. How do we get the most out of those dollars? And I know you have an opinion on that. Some people agree with it and some people do not, but I want to get it because you are one of our most professional people around here.

I thank you for coming today, and we look forward to hearing from you.

Chairman CONRAD. Again, Dr. Orszag, welcome and thank you very much for your service at the Congressional Budget Office. It has been exemplary.

Dr. ORSZAG.

STATEMENT OF PETER R. ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. ORSZAG. Thank you very much, Mr. Chairman. My testimony this morning will discuss the economic and budget outlook.

First, the economy has been buffeted by several interlinked shocks, and the risk of recession is significantly elevated relative to normal economic conditions. After a dramatic run-up in housing prices during the first half of the decade, as my first chart shows, housing prices have started to decline, and many forecasters expect further declines this year. The weakening of the housing sector directly affects the economy through reductions in residential investment and indirectly affects it by reducing consumer spending as housing wealth declines. Moreover, problems in the housing and mortgage markets have spilled over into broader turmoil in financial markets, which poses the risk of impeding the flow of credit essential to a modern economy.

Energy prices have also increased substantially. Although the effect of increases in the price of oil today on the economy are not as large as they were in the 1970's or 1980's, the rise in oil prices is still an economic drag. The combination of these forces has not yet fully manifested itself, although the unemployment rate has ticked up. Indeed, the 3-month moving average unemployment rate is now 0.4 percentage points higher than it was a year ago, and any time that has occurred in the past, it has tended to be associated with recessions, as you can see from that graph. The dark bars are recessionary periods. An increase of about 0.4 percentage points tends to be associated with a recession.

On the other hand, and as Senator Gregg noted, other labor market indicators that have typically been associated with those kinds of increases in the unemployment rate in the past during recessionary periods are not currently occurring. For example, in the past, unemployment insurance claims have tended to rise by, say, 20 percent associated with the kinds of increases in unemployment rates that I show there. That has not occurred currently, and, in fact, if anything, initial unemployment insurance claims have ticked down just a bit.

Especially with the most recent and notable action by the Federal Reserve earlier this week, many professional forecasters are projecting continued, albeit sluggish, economic growth in 2008 rather than an outright recession. And one bright spot which reinforces that view has been net exports. The dollar has depreciated gradually, which is part of the necessary adjustment to the Nation's external imbalances, and that depreciation of the dollar along with strong growth abroad has driven rapid growth in net exports, which has helped to stabilize, and even improve slightly, the Nation's current account deficit.

The bottom line is that although the risk of recession is substantially elevated, CBO expects, along with most professional forecasters, a period of unusually weak growth rather than outright recession. In particular, CBO expects growth for the year as a whole of under 2 percent and an increase in the unemployment rate to 5.1 percent on average for the year.

A reflection of the overall slowing of economic activity is seen in job growth. In 2005, jobs grew by an average of 220,000 per month. In 2007, that fell in half to an average of 110,000 a month. We project that it will fall in half again to an average of 55,000 per month in the first half of 2008.

Let me now turn to the budget outlook. A reflection of the softening economy is already seen in slowing revenue growth, especially in corporate income taxes. And, in fact, we now have projections for January in which we expect corporate income tax receipts to be below their level of a year ago for the seventh month in a row. For 2008 as a whole, we are projecting a slight decline in corporate income tax revenue relative to the previous year. That is notable because, as CBO highlighted in a letter to Senator Conrad last year, a large share of the improvement in the fiscal picture between 2003 and 2006/2007 can be attributed to a very rapid rise in corporate income tax revenue over that period.

Our baseline suggests that after 3 years of reductions in the budget deficit, the slowing economy will boost the deficit this year to $219 billion, or roughly 1.5 percent of the economy. If policymakers provide the additional funds that the administration has requested for the ongoing war in Iraq and Afghanistan, the deficit would rise to about $250 billion this year. And if additional measures are undertaken as fiscal stimulus, the deficit could rise significantly above that, although I would note that would be one of the purposes of temporary fiscal stimulus.

Thereafter, under the official baseline, the budget moves toward balance in 2012. However, as both Mr. Conrad and Mr. Gregg have noted, that baseline is not a prediction of the future but, rather, a projection of a certain set of policies that are embodied in current law.

For example, as the next chart shows, the baseline assumes no further relief from the alternative minimum tax, and as a result, the AMT rises from about—affecting 4 million taxpayers last year to 26 million this year, and then continues to rise thereafter. If instead of making that type of current law assumption one instead continued the alternative minimum tax relief, extended the 2001 and 2003 tax legislation past their scheduled expiration in 2010, adopted our higher-cost scenario for the global war on terrorism, and increased the rest of discretionary spending in line with the economy rather than just in line with inflation, the outcome is substantially different than the baseline. As the next chart shows, indeed instead of a cumulative surplus of $274 billion between 2009 and 2018, the result would be a deficit of roughly $6.5 trillion, about 3.5 percent of the economy.

Even over the next 10 years, furthermore, the Nation's long-term budget pressures begin to manifest themselves. Caseloads on both Medicare and Social Security are projected to rise rapidly as the first edge of the baby-boom generation becomes eligible for benefits. Social Security beneficiaries are projected to rise from about 50 million currently to 64 million by 2018. Projected increases in beneficiaries account for about 30 percent of the growth in mandatory spending over the next decade. A far more important factor is the ongoing rise in the cost per beneficiary, especially in our health-related programs, and you can see that the health-related programs grow more rapidly than Social Security does. Indeed, Medicare and Medicaid are projected to increase from 4.6 percent of the economy to 5.9 percent of the economy over the next decade, an increase of 1.3 percentage points, while Social Security rises from 4.3 to 4.9, or about half a percentage point of the economy. And that reflects that differential growth rate in health care costs.

Thereafter, under the long-term budget outlook that we released in December, health care costs increasingly dominate the Federal budget. You can see the light blue area in that graph, which is Medicare and Medicaid, is really the key to our fiscal future. If you combine that spending path with a revenue projection that reflects the Tax Code as it existed at the end of last year, you can come up with a summarized fiscal gap which measures the difference between projected revenue and projected spending. And over the next 75 years, that gap amounts to 7 percent of the economy. What that tells you is that if you want to avoid an explosion of Government debt over the next 75 years, you need to reduce spending by 7 percent of GDP or increase revenue by 7 percent of GDP. And given that both of those are now about 20 percent of the economy, you can see that those are very large adjustments that are necessary, and they reflect the scale of the Nation's long-term fiscal imbalance.

I would just note quickly that most of that long-term fiscal gap is not due to the pure effect of aging and demographics. As this chart shows, the dark blue area there—and also there is an interaction effect, the light blue area—reflects the pure effect of aging and demographics. Most of the long-term fiscal gap, that lighter area, is not due to that factor but, rather, reflects things like the ongoing increase in health care costs per beneficiary.

Finally, the combination of an elevated risk of recession in the short term and the Nation's very serious long-term fiscal imbalances leads me to a short discussion of fiscal stimulus. Last week, we submitted a report to this Committee and the House Budget Committee on fiscal stimulus options. Let me just briefly say that in a period of unusual economic weakness, which is unusual, the key constraint on economic growth is the demand for goods and services that firms could produce with their existing resources. By contrast, in most circumstances, and certainly over the long term, the key constraint on economic growth is the rate at which those resources or that capacity is expanding through increases in capital and labor and improvements in productivity.

When we face ourselves with the unusual situation in which aggregate demand is the key constraint on economic growth, fiscal policy and monetary policy can help by stoking demand. And the key question is—we need to remember on the fiscal policy side the automatic stabilizers built into the budget will already help to attenuate any economic downturn by cushioning the blow in terms of after-tax income. The question is whether additional fiscal action is necessary.

Our analysis suggests that a fiscal stimulus, if it were well designed, of roughly one-half to 1 percent of GDP or roughly $75 to $150 billion—and, again, I want to emphasize if it were well designed—could help to reduce the elevated risk of a recession down to more normal levels.

The stimulus need not be targeted at the source of economic weakness; that is, even though the weakness started or originated in the housing and mortgage markets, the economic stimulus need not be targeted there. Instead, the key is that it helps to bolster aggregate demand and thereby helps to jump-start a positive cycle of increased demand leading to increased production until the constraint once again becomes how much we can produce rather than how much we are willing to spend.

In the report that we provided to you, we analyzed many more specific options, and I would be happy to answer questions about them. But I did want to emphasize that it is an unusual situation in which we find ourselves because more typically the constraint on economic growth has to do with the rate at which resources are being expanded and what is appropriate to a period of economic weakness is, unfortunately, often the opposite of what is appropriate to long-term economic growth.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Orszag follows:]

CBO TESTIMONY

Statement of
Peter R. Orszag
Director

The Budget and Economic Outlook: Fiscal Years 2008 to 2018

before the
Committee on the Budget
United States Senate

January 24, 2008

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Thursday, January 24, 2008. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

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

The Budget and Economic Outlook: Fiscal Years 2008 to 2018

Chairman Conrad, Senator Gregg, and Members of the Committee, thank you for giving me the opportunity to present the Congressional Budget Office's (CBO's) outlook for the budget and the economy in fiscal years 2008 to 2018.[1]

CBO projects that after three years of declining budget deficits, a slowing economy this year will contribute to an increase in the deficit. Under an assumption that current laws and policies do not change, CBO projects that the budget deficit will rise to 1.5 percent of gross domestic product (GDP) in 2008 from 1.2 percent in 2007 (see Table 1). Enactment of legislation to provide economic stimulus or additional funding for military operations in Iraq and Afghanistan could further increase the deficit for this year.

The state of the economy is particularly uncertain at the moment. The pace of economic growth slowed in 2007, and there are strong indications that it will slacken further in 2008. In CBO's view, the ongoing problems in the housing and financial markets and the high price of oil will curb spending by households and businesses this year and trim the growth of GDP. Although recent data suggest that the probability of a recession in 2008 has increased, CBO does not expect the slowdown in economic growth to be large enough to register as a recession.[2] Economic performance worse than that suggested in CBO's forecast could significantly decrease projected revenues and increase projected spending. Furthermore, policy changes intended to mitigate the economic slowdown would, by design, tend to increase the budget deficit in the short term.[3]

CBO expects the economy to rebound after 2008, as the negative effects of the turmoil in the housing and financial markets fade. Under the assumptions that govern CBO's baseline, the budget deficit will amount to 1.5 percent of GDP or less each year from 2009 to 2011. Subsequently, the budget will show a small surplus of 0.5 percent of GDP in 2012 and remain near that level each year through 2018 (the end of the current 10-year projection period).

The relatively sanguine outlook suggested by the 10-year baseline projections should not be interpreted as implying that the nation's underlying fiscal condition is sound, both because the United States continues to face severe long-term budgetary challenges and because many observers expect policy changes that would deviate from the current-law baseline over the next decade. Ongoing increases in health care costs, along with the aging of the population, are expected to put substantial pressure on the budget in coming decades; those trends are already evident in the current projection period. Economic growth alone will be insufficient to alleviate that pressure, as Medicare and Medicaid and, to a lesser extent, Social Security require ever greater resources under current law. A substantial reduction in the growth of spending, a significant increase in tax revenues relative to the size of the economy, or some combination of the two will be necessary to maintain the nation's long-term fiscal stability.[4]

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1. For further details, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018* (January 2008).
2. The National Bureau of Economic Research, which by convention is responsible for dating the peaks and troughs of the business cycle, defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real [inflation-adjusted] GDP, real income, employment, industrial production, and wholesale-retail sales."
3. See Congressional Budget Office, *Options for Responding to Short-Term Economic Weakness* (January 2008).
4. For a detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2007).

Table 1.

CBO's Baseline Budget Outlook

	Actual 2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
							In Billions of Dollars							
Total Revenues	2,568	2,654	2,817	2,907	3,182	3,442	3,585	3,763	3,941	4,131	4,334	4,548	15,933	36,649
Total Outlays	2,731	2,873	3,015	3,148	3,299	3,355	3,524	3,666	3,824	4,037	4,183	4,325	16,341	36,376
Total Deficit (-) or Surplus	**-163**	**-219**	**-198**	**-241**	**-117**	**87**	**61**	**96**	**117**	**95**	**151**	**223**	**-408**	**274**
On-budget	-344	-414	-396	-450	-343	-151	-184	-154	-136	-160	-102	-27	-1,525	-2,104
Off-budget[a]	181	195	198	210	226	238	244	251	254	254	253	249	1,117	2,378
Debt Held by the Public at the End of the Year	5,035	5,232	5,443	5,698	5,827	5,751	5,701	5,613	5,503	5,414	5,269	5,050	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Total Revenues	18.8	18.7	19.0	18.6	19.3	19.9	19.9	20.0	20.0	20.1	20.2	20.3	19.4	19.8
Total Outlays	20.0	20.2	20.4	20.2	20.1	19.4	19.5	19.4	19.4	19.7	19.5	19.3	19.9	19.7
Total Deficit (-) or Surplus	**-1.2**	**-1.5**	**-1.3**	**-1.5**	**-0.7**	**0.5**	**0.3**	**0.5**	**0.6**	**0.5**	**0.7**	**1.0**	**-0.5**	**0.1**
Debt Held by the Public at the End of the Year	36.8	36.8	36.7	36.5	35.4	33.3	31.6	29.8	28.0	26.4	24.6	22.6	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	13,670	14,201	14,812	15,600	16,445	17,256	18,043	18,856	19,685	20,540	21,426	22,355	82,156	185,018

Source: Congressional Budget Office.

Note: n.a. = not applicable.

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

CBO's baseline budget projections for the next 10 years are not a forecast of future outcomes; rather, they are based on the assumption that current laws and policies remain the same. The projections stem from long-standing procedures that were, until recently, specified in law, and they serve as a benchmark that lawmakers and others can use to assess the potential impact of future policy decisions.[5] Following those procedures generates deficits and surpluses in the baseline that are predicated on two key projections:

- That revenues will rise from 18.7 percent of GDP this year to almost 20 percent of GDP in 2012 and then remain near that historically high level through 2018. Much of the projected increase in revenues results from the growing impact of the alternative minimum tax (AMT) and, even more significantly, the expiration at the end of 2010 of various provisions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

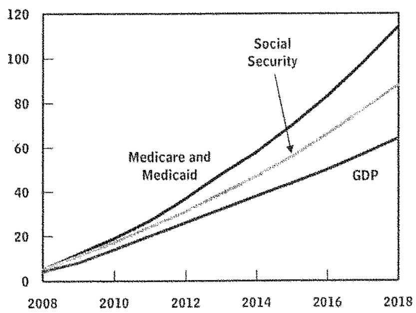
- That outlays for discretionary programs (those whose spending levels are set anew each year through appropriation acts) will decline from 7.6 percent of GDP last year to 6.1 percent by 2018—a lower percentage than any recorded in the past 40 years. Such a projection derives mainly from the assumption in the baseline that discretionary funding will grow at the rate of inflation, which is lower than the growth rate that CBO projects for nominal GDP. Implicit in the projection for discretionary spending is an assumption that no additional funding is provided for military

5. The Balanced Budget and Emergency Deficit Control Act of 1985, which established rules that have governed the calculation of CBO's baseline, expired on September 30, 2006. Nevertheless, CBO continues to prepare baselines according to the methodology prescribed in that law.

Figure 1.

Projected Growth of the U.S. Economy and Federal Spending for Major Mandatory Programs

(Cumulative nominal percentage growth from 2007 level)



Source: Congressional Budget Office.

operations in Iraq and Afghanistan in 2008 and that future appropriations for activities related to the war on terrorism remain equivalent, in real (inflation-adjusted) terms, to the $88 billion appropriated so far this year.

Policy choices that differ from the assumptions in the baseline would produce different budgetary outcomes. For example, if lawmakers continued to provide relief from the AMT (as they have done on a short-term basis for the past several years) and if the provisions of EGTRRA and JGTRRA that are scheduled to expire were instead extended, total revenues would be $3.6 trillion lower over the next 10 years than CBO now projects. Similarly, if discretionary spending (other than that for military operations in Iraq and Afghanistan and other spending labeled as emergency) grew at the rate of nominal GDP over the next 10 years, total discretionary outlays during that period would be about $1.4 trillion higher than in the baseline. Combined, those policy changes—and associated debt-service costs—would produce a deficit of $402 billion (2.3 percent of GDP) in 2012 and a cumulative deficit of $5.7 trillion (3.1 percent of GDP) over the 2009–2018 period.

The Budget Outlook

CBO estimates that if today's laws and policies did not change, federal spending would total $2.9 trillion in 2008 and revenues would total $2.7 trillion, resulting in a budget deficit of $219 billion. That deficit could increase significantly if legislation is enacted to provide economic stimulus—as is currently under consideration. Furthermore, additional funding that is likely to be needed to finance military operations in Iraq and Afghanistan could add $30 billion to outlays this year.

Baseline Projections for the 2009–2018 Period

According to CBO's projections, under current laws and policies the deficit will drop slightly in 2009, to $198 billion. That decrease results primarily from two factors. On the revenue side of the budget, receipts from the AMT are estimated to increase by about $75 billion next year, largely because of the scheduled expiration of the relief provided through tax year 2007. On the spending side of the budget, outlays for military operations in Iraq and Afghanistan are about $10 billion lower in 2009 than in 2008 under the assumptions of the baseline.

The deficit is projected to rise modestly in 2010, as outlays grow by about 4.4 percent and revenues increase by about 3.2 percent. That projected growth rate for revenues is lower than in recent years, mainly because of a projected slowdown in corporate tax receipts (to a level that is more consistent with their historical relationship to GDP).

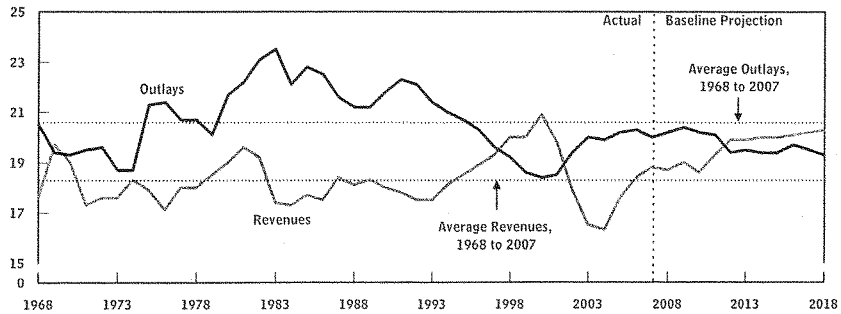
After 2010, spending related to the aging of the baby-boom generation will begin to raise the growth rate of total outlays. The baby boomers will start becoming eligible for Social Security retirement benefits in 2008, when the first members of that generation turn 62. As a result, the annual growth of Social Security spending is expected to accelerate from about 5.1 percent in 2008 to 6.4 percent by 2018.

More important, because the cost of health care is likely to continue rising rapidly, spending for Medicare and Medicaid is anticipated to grow even faster—generally in the range of 7 percent to 8 percent annually. Total outlays for those two health care programs are projected to more than double during the baseline period, increasing by 114 percent, while GDP is projected to grow somewhat more than half as fast, by 64 percent (see Figure 1). Under the assumptions underlying CBO's baseline, spending for Medicare and Medicaid will rise to

Figure 2.

Total Revenues and Outlays as a Percentage of Gross Domestic Product

(Percent)



Source: Congressional Budget Office.

5.9 percent of GDP in 2018, compared with about 4.6 percent this year, and spending for Social Security will rise to 4.9 percent of GDP from 4.3 percent this year.

Revenues are projected to increase sharply after 2010 under the assumption that various tax provisions expire as scheduled. In the baseline, total revenues grow by 9.4 percent in 2011 and by 8.2 percent in 2012, thereby bringing the budget into surplus. Beyond 2012, revenues are projected to grow at roughly the same pace as outlays (between 4 percent and 5 percent a year), keeping the budget in the black through 2018.

Outlays over the 2009–2018 period are projected to range between 19.3 percent and 20.4 percent of GDP under the assumptions of the baseline—somewhat lower than the 20.6 percent average of the past 40 years (see Figure 2). Mandatory spending (funding determined by laws other than annual appropriation acts) is projected to grow by nearly 6 percent a year over that period, which is faster than the economy as a whole. By contrast, discretionary appropriations are assumed simply to keep pace with inflation and, to a lesser extent, with the growth of wages. Thus, discretionary outlays are projected to increase by about 2.2 percent a year, on average, or less than half as fast as nominal GDP.

In CBO's projections, revenues average 18.8 percent of GDP in 2009 and 2010 (close to the 18.7 percent level expected for this year) before the sharp jump in 2011 and 2012 with the expiration of tax provisions originally enacted in EGTRRA and JGTRRA. After that, revenues continue growing faster than the overall economy for three reasons: increases in total real income combined with the progressive structure of the tax code, the increasing reach of the AMT, and taxable withdrawals of retirement savings as the population ages. Under the assumptions used for the baseline, CBO projects that revenues will equal 20.3 percent of GDP by 2018—a level reached only once since World War II.

Federal government debt that is held by the public (mainly in the form of Treasury securities sold directly in the capital markets) is expected to equal about 37 percent of GDP at the end of this year. Thereafter, the baseline's projections of short-term deficits followed by emerging surpluses diminish the government's need for additional borrowing, causing debt held by the public to shrink to 22.6 percent of GDP by 2018.

Changes in the Baseline Budget Outlook Since August

The budget outlook for 2008 has deteriorated somewhat since CBO issued its previous projections in August, but the pattern of deficits and surpluses in the outlook for the

Table 2.

CBO's Economic Projections for Calendar Years 2008 to 2018

(Percentage change)

	Estimated	Forecast		Projected Annual Average	
	2007	2008	2009	2010-2013	2014-2018
Nominal GDP					
Billions of dollars	13,828	14,330	14,997	18,243 [a]	22,593 [b]
Percentage change	4.8	3.6	4.7	5.0	4.4
Real GDP	2.2	1.7	2.8	3.1	2.5
GDP Price Index	2.5	1.9	1.8	1.9	1.9
PCE Price Index[c]	2.5	2.6	1.8	1.9	1.9
Core PCE Price Index[d]	2.1	1.9	1.9	1.9	1.9
Consumer Price Index[e]	2.8	2.9	2.3	2.2	2.2
Core Consumer Price Index[f]	2.3	2.2	2.2	2.2	2.2
Unemployment Rate (Percent)	4.6	5.1	5.4	4.9	4.8
Interest Rates (Percent)					
Three-month Treasury bills	4.4	3.2	4.2	4.6	4.7
Ten-year Treasury notes	4.6	4.2	4.9	5.2	5.2

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

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

Percentage changes are measured from one year to the next.

a. Level in 2013.

b. Level in 2018.

c. The personal consumption expenditure chained price index.

d. The personal consumption expenditure chained price index excluding prices for food and energy.

e. The consumer price index for all urban consumers.

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

following 10 years is about the same.[6] At $219 billion, the deficit projected for 2008 is $64 billion higher than what CBO estimated in August. Because the August projections already reflected some expected slowing of the economy in 2008, most of that difference stems from legislation that extended relief to individuals from the AMT for one year.

For the 2009–2017 period, the baseline's bottom line has improved slightly, compared with CBO's projections in August. In the current baseline, projected revenues are lower, mostly as a result of lower estimates of corporate profits. Projected outlays are also lower, primarily because of the use of partial-year funding for military operations in Iraq and Afghanistan; this baseline extrapolates the $88 billion appropriated thus far for 2008, whereas the August baseline extended the entire funding provided for 2007 (about $170 billion). With the effect of partial-year funding excluded, the current baseline would show an increase in the cumulative deficit for 2008 through 2017 of more than $850 billion (0.5 percent of GDP).

The Economic Outlook

Underlying CBO's baseline projections is a forecast that U.S. economic growth will slow in calendar year 2008 but pick up in 2009. Specifically, CBO anticipates that GDP will grow by 1.7 percent in real terms for 2008 as a whole, about half a percentage point less than the

6. Those projections were published in Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2007).

growth recorded last year. For 2009, CBO forecasts that GDP growth will rebound to 2.8 percent (see Table 2).

Problems in the housing and financial markets, along with high oil prices, triggered much of the recent slowdown. Between mid-2006 and the end of 2007, residential investment (which includes the construction of new housing units, improvements to existing units, and brokers' commissions) declined, but the drop was largely offset by growth in both consumer spending and business fixed investment (businesses' spending on structures, equipment, and software). Those two sectors are unlikely to provide as much support to economic growth this year. Residential investment is expected to continue to decline through much of 2008; in addition, the growth of consumer spending, sustained thus far by solid growth in people's real income as well as by their borrowing and use of savings, is likely to fall off, curtailed by a drop in housing wealth (home equity), increased costs for borrowing, the high price of oil, and slower growth of real income. The resulting weak domestic demand for goods and services in turn is expected to slow the growth of business fixed investment, which is likely to further diminish the pace of overall economic growth this year.

In contrast, the relative economic strength of the United States' major trading partners—in particular, developing countries with emerging market economies—when combined with the dollar's decline will partially offset the sluggishness in domestic demand expected in 2008 and support U.S. economic growth by stimulating exports. Emerging economies have become increasingly less dependent on demand in the United States to fuel their expansions and, as a result, have become less vulnerable to slowdowns in U.S. economic growth. Moreover, the pace of the decline begun in 2002 in the value of the dollar relative to the currencies of major trading partners—which helps make U.S. exports less expensive—has quickened. Those developments, accompanied by less domestic demand for imports, are likely to reduce the U.S. current-account deficit (broadly, the summary measure of the United States' trade with the rest of the world).

Inflation (as measured by the year-to-year change in the price index for personal consumption expenditures) is likely to be about the same this year as last year; in 2009, CBO forecasts, the rate will fall, to 1.8 percent, as inflation in energy and food prices eases. The unemployment rate, which was 4.6 percent last year, will average 5.1 percent in 2008 and reach 5.3 percent by the end of the year, CBO estimates. Interest rates on Treasury securities are expected to remain low this year and to increase in 2009 as the economy works through and emerges from its current difficulties. In CBO's forecast, the rate on 3-month Treasury bills averages 3.2 percent in 2008 and moves higher, to 4.2 percent, in 2009. Similarly, the rate on 10-year Treasury notes moves from an average of 4.2 percent in 2008 to 4.9 percent in 2009.

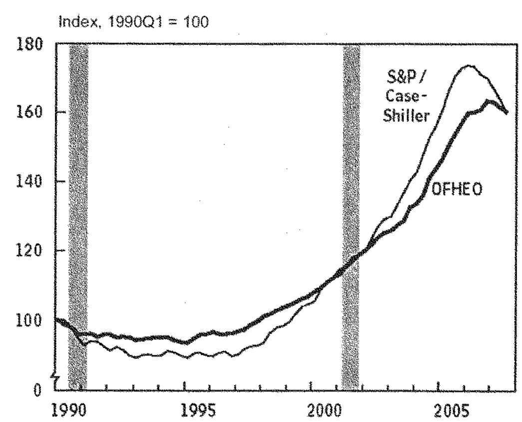
For 2010 to 2018, CBO projects that real growth will average 2.7 percent and the personal consumption expenditure price index, 1.9 percent. CBO also projects that in the latter years of the projection period, the unemployment rate will average 4.8 percent and that the interest rates on 3-month Treasury bills and 10-year Treasury notes will average 4.7 percent and 5.2 percent, respectively.

Congressional Budget Office

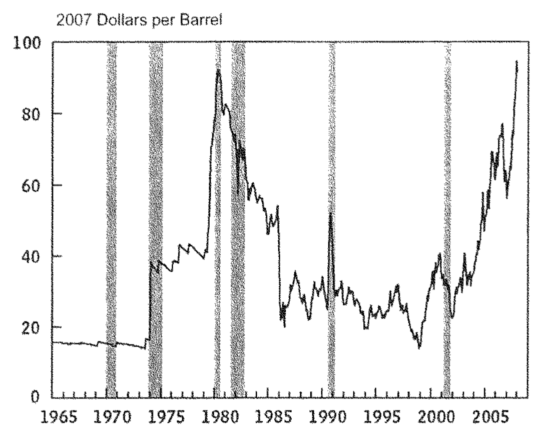
The Budget and Economic Outlook: Fiscal Years 2008 to 2018

January 23, 2008

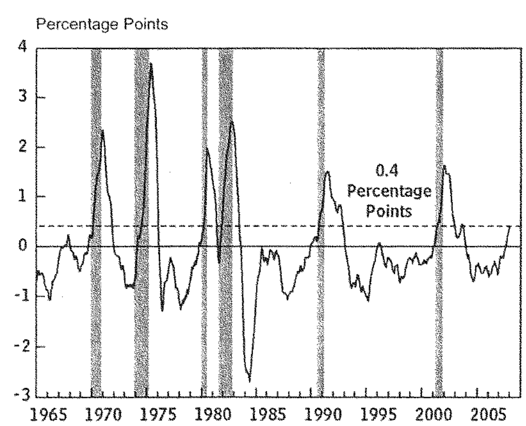
Inflation-Adjusted Prices of Houses



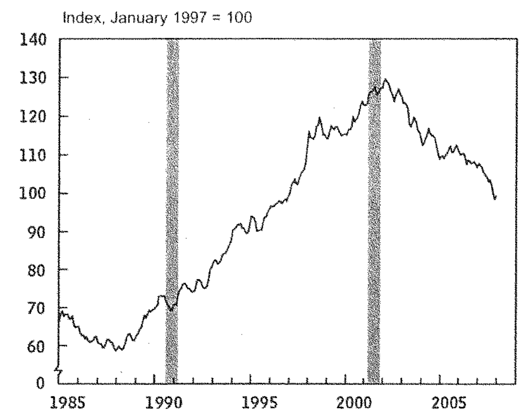
Inflation-Adjusted Price of Crude Oil



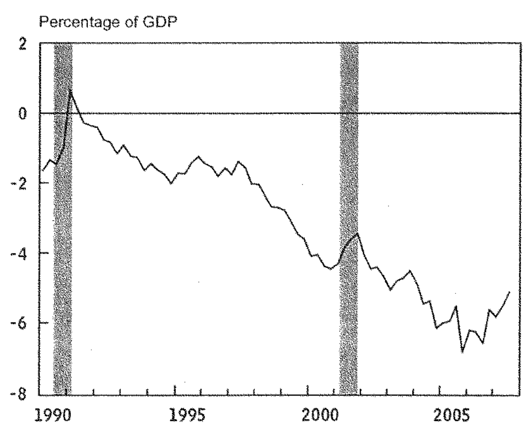
Changes in the Unemployment Rate



Nominal Trade-Weighted Value of the Dollar



The Current-Account Balance



CBO's Economic Projections for Calendar Years 2008 to 2018

Percentage Change

	Estimated	Forecast		Projected Annual Average	
	2007	2008	2009	2010–2013	2014–2018
Nominal GDP					
Billions of dollars	13,828	14,330	14,997	18,243	22,593
Percentage change	4.8	3.6	4.7	5.0	4.4
Real GDP	2.2	1.7	2.8	3.1	2.5
PCE Price Index	2.5	2.6	1.8	1.9	1.9
Unemployment Rate (Percent)	4.6	5.1	5.4	4.9	4.8

Average Annual Growth Rates of Revenues Since 1997 and in 2008 in CBO's Baseline

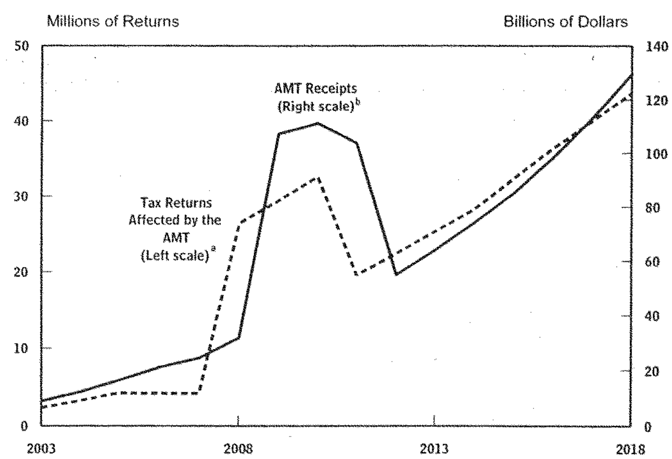
Percent

	Actual		Estimated
	1997–2006	2007	2008
Individual Income Taxes	4.7	11.5	4.1
Corporate Income Taxes	7.5	4.6	-1.7
Social Insurance Taxes	5.1	3.8	4.6
Other	4.0	-4.2	3.1
Total Revenues	5.2	6.7	3.4
Memorandum:			
Consumer Price Index	2.6	2.3	3.2
Nominal GDP	5.4	4.6	3.9

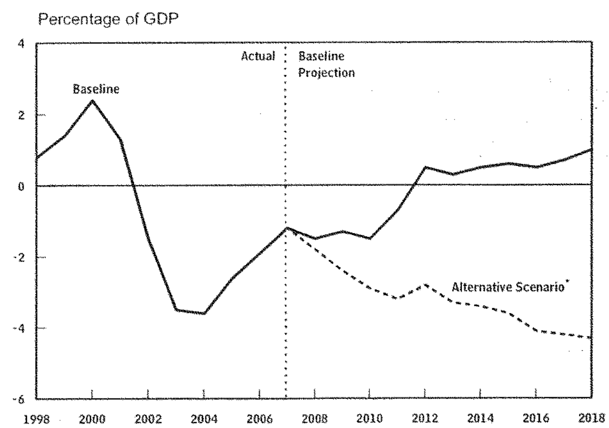
Total Deficit or Surplus Under CBO's Baseline

	Actual 2007	2008	2009	2010	2011	2012	2013	Total, 2009-2018
Percentage of GDP	-1.2	-1.5	-1.3	-1.5	-0.7	0.5	0.3	0.1
Billions of Dollars	-163	-219	-198	-241	-117	87	61	274

Effects of the Individual Alternative Minimum Tax in CBO's Baseline

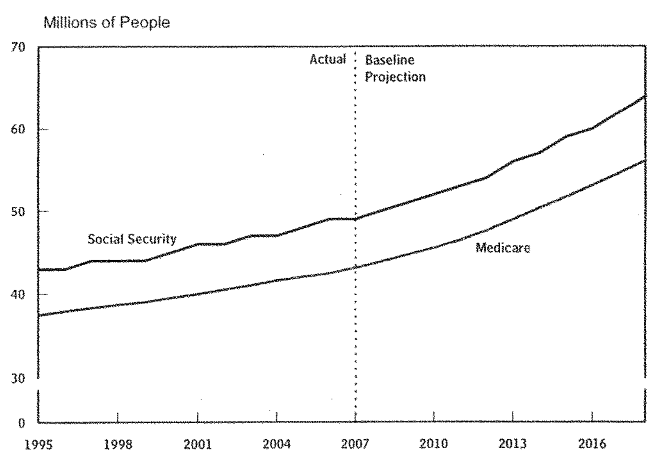


Total Deficit or Surplus Under CBO's Baseline and an Alternative Scenario

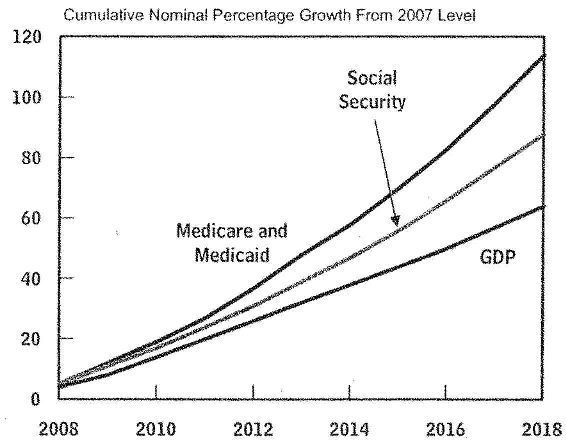


* Extends all expiring tax provisions, reforms the AMT, assumes the number of military personnel in the war on terrorism falls to 75,000 by 2013, and assumes regular appropriations grow at the rate of nominal GDP

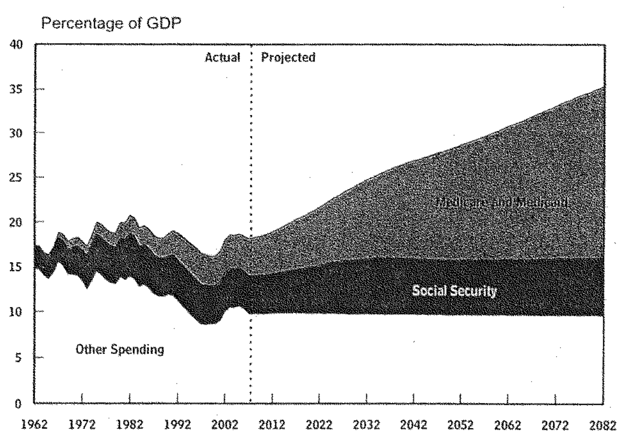
Caseload Growth in Social Security and Medicare



Projected Growth of the U.S. Economy and Federal Spending for Major Mandatory Programs



Projected Federal Spending Over the Long Term

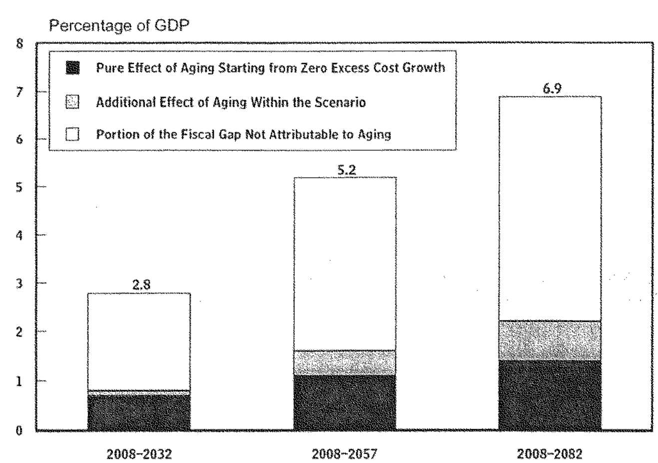


Federal Fiscal Imbalance Under CBO's Long-Term Budget Scenarios

Percentage of GDP

Projection Period	Revenues	Outlays	Fiscal Gap
		Extended-Baseline Scenario	
25 Years (2008–2032)	20.2	19.5	-0.7
50 Years (2008–2057)	21.3	21.9	0.6
75 Years (2008–2082)	22.1	23.8	1.7
		Alternative Fiscal Scenario	
25 Years (2008–2032)	18.6	21.4	2.8
50 Years (2008–2057)	18.8	24.1	5.2
75 Years (2008–2082)	19.2	26.1	6.9

Contribution of Aging to the Fiscal Gap Under CBO's Alternative Fiscal Scenario



Chairman CONRAD. Thank you for that very excellent description.

Let's go right to the question of stimulus and what you see as the need for it. You can see already people questioning stimulus, the requirement for stimulus. I was doing a series of interviews yesterday, some of them on talk radio, and it was very interesting the kinds of questions people raised about stimulus.

First of all, the first question I got was: Gee, do we really need stimulus? We saw a market rebound yesterday, some 300 points, before any stimulus package has been put in place but after the Federal Reserve has taken action.

Some have said to me, you know, $140 billion of stimulus, which is roughly what the President is talking about, is 1 percent of gross domestic product. One of the questions I was asked, what is the effect in a comparable way, of what the Federal Reserve has already done? Do you have any rule of thumb that could tell us? For example, when they reduced rates by three-quarters of 1 percent in an emergency meeting, is there any rule of thumb about what that means in terms of share of gross domestic product?

Mr. ORSZAG. Yes. The typical rule of thumb—and there is an important caveat—is that a reduction of, say, 100 basis points could have an effect on economic activity of about 1/2 percent of GDP. There is a big "but." The "but" is that the lag involved is typically lengthy, that is, somewhere between four and eight quarters. So when you reduce interest rates today, you are disproportionately affecting economic activity in early 2009.

Or it may be a slightly different situation currently. To the extent that part of what the monetary policy interventions are trying to do has to do with calming financial market turmoil, we have seen, in response to both interest rate changes and the new term auction facility that the Federal Reserve introduced, a very significant reduction in the spreads—that is, in basically the interest rates that banks charge each other for short-term borrowing.

Chairman CONRAD. Which had become quite large.

Mr. ORSZAG. Which had become quite elevated, yes, and they are now back to somewhat more normal levels.

Chairman CONRAD. So let me see if I can translate this. Fifty basis points would translate into about 1 percent of GDP, but that is with a lag of four to——

Mr. ORSZAG. Eight.

Chairman CONRAD. Eight quarters.

Mr. ORSZAG. Yes.

Chairman CONRAD. So we are talking a year to 2 years.

Mr. ORSZAG. And so the real question is: Is there an air pocket, especially in early 2008? And what, if anything, can be done in the intervening period?

Chairman CONRAD. "Air pocket" meaning economic weakness that might be somewhat offset by our providing fiscal stimulus in addition to the monetary stimulus provided by the Fed?

Mr. ORSZAG. "Air pocket" meaning that most forecasters project very weak growth, if any growth, in early 2008. And I think the key question then becomes whether there is any additional fiscal stimulus that can be delivered in a timely enough fashion to affect economic activity in early 2008. And I think that is a very significant question.

Chairman CONRAD. Well, that is exactly the next question I wanted to go to. Yesterday, I was, as I indicated, doing a series of interviews. A talk-radio host asked me, "Senator, what are the odds that this stimulus turns out to be ill-timed, turns out to come too late and actually becomes counterproductive?" What would you say in answer to that question?

Mr. ORSZAG. The longer you wait and the longer the implementation lag involved, the more risk there is of that.

Chairman CONRAD. And can you give us some rule of thumb in terms of time? For example, if the fiscal stimulus that we put in place, Congress working with the President put in place, was not felt for 6 or 8 months, is that within the timeframe that is relevant? Or is that on the brink of being too late?

Mr. ORSZAG. That would be pushing it. And as you move into early to mid-2009, I think the risks that you are—especially given the impulse from the monetary policy changes that have already occurred, the risks that you are then being counterproductive go significantly up.

Chairman CONRAD. All right. Senator Gregg?

Senator GREGG. When you say counterproductive, do you mean you are creating an inflation event?

Mr. ORSZAG. Yes. You do not want to add demand to an already rapidly growing economy because all you do at that point is increase inflationary pressures.

Senator GREGG. Which is a really severe event.

Mr. ORSZAG. Which would be an unfortunate circumstance, yes.

Senator GREGG. Second, as I understand it, you testified yesterday, I think, that the IRS could not get out rebate checks before June. That is your understanding.

Mr. ORSZAG. Yes. Our information suggests that—and let me just explain briefly because I think the experience from 2001 may be being misapplied. When the rebates were issued in 2001, the IRS had already completed, basically, the tax filing season. The computers and people and infrastructure that are used for the tax filing season unfortunately are exactly the same ones that have to be used in the process of issuing rebates. So until the IRS has completed the peak filing season for 2007—which traditionally would be the end of May but perhaps could be accelerated to mid-May—it cannot really turn to processing the rebates. So you are looking at the first checks being available mid- to late May, maybe early June, and then it takes 6 to 8 weeks to actually mail the checks out. And I would also note the evidence suggests that the 2001 rebates were relatively effective, but their maximum kick came after two quarters. So if people are receiving checks in June or July and then the maximal response is two quarters thereafter, you are affecting Christmas spending in 2008, not economic activity in the first half.

Senator GREGG. Which would be well outside the window you just testified about.

Mr. ORSZAG. That is correct. At least somewhat outside the window, yes.

Senator GREGG. Now, you made an eloquent argument that the counterintuitive position makes sense right now, that you can stimulate the economy through consumption and that that is what you should do in the short run, as versus stimulating the economy through making it more productive, which is what you would want to do, I think, if you want to make the economy stronger.

Let me make the opposite case, which is more traditional—not necessarily more traditional because it is not accepted by economists, I guess, of your expertise, which is extraordinarily high and well admired by myself. But if we know the problem was the credit contraction caused by the housing bubble, where we know that the problem was that too many loans were made to people who did not have the wherewithal to pay the loans back under the terms of the loans because of the acceleration in the interest rate as a result of the ARMs, and that the collateral underneath the loans did not support the loans, and then those loans were taken, sold, resold, synthesized, and syndicated in a way that you basically had an inverted pyramid so that you had a lot of people creating a bubble out of the housing market, wouldn't it make some sense to say to the economy and to the consumer we have a housing problem, we are going to give you an incentive to go out and buy a new house, and get right to the essence of the issue through a tax credit on the purchase of a new house in some form so that basically you are picking up the cost of the interest and you are creating an incentive for people to go out and buy a house and get that inventory out of the market and get that part of the economy going again?

Mr. ORSZAG. I guess I would say two things.

First, many of the proposals aimed specifically at the housing market probably would not have that large of an effect even on the housing market. It depends exactly what you did, and it depends, for example, on your tax credit idea of what the parameters were and what have you. But I think more broadly, the point at this stage is that the concern has expanded well beyond just the housing market. It is like—I do not know. If you had a wound and your body became infected, you need to treat the general infection and not just the——

Senator GREGG. But isn't the general infection the contraction in credit?

Mr. ORSZAG. It is not just the contraction——

Senator GREGG. And the lack of liquidity in the market.

Mr. ORSZAG. That is perhaps the most salient and prominent concern, but it also includes consumer confidence; it includes the elevated energy prices, which have some drag on the economy. It is the confluence of those events and the combined impact on aggregate demand at this point.

Senator GREGG. Well, I appreciate that, but I guess my point is if you simply give everybody in America who paid taxes an $800 or a $600 check for a one-time consumption event, which may occur outside the window of the severity of the problem. You are basically adding to the debt, so it is going to have to be paid through debt financing, so you are going to create an out-year problem of debt. You may be creating an inflationary event. And you are probably not doing a lot to get to the underlying productivity of the economy.

Do you solve the confidence issue by doing that? The confidence issue seems to me to be resolved when the markets feel that the underlying problem has been made transparent so that they can evaluate what it really costs and then they have adjusted to it. That is happening now, hopefully, and the Fed is reacting. But I am not sure that a stimulus package that simply puts money into the economy through consumption which may occur after the framework of the problem will do anything other than say that the Government reacted. It will not solve the problem. I do not think that does a lot for confidence.

Mr. ORSZAG. Let me try to answer that in two different ways.

First, on the housing market, we have to realize that part of the issue here is that through a confluence of events, including very low interest rates, including perhaps lax regulatory standards and expectations of ongoing price increases, a series of developments occurred that are difficult to now clean up after the fact. So even a tax credit is not going to—or even trying to bolster demand for housing temporarily or even over an extended period of time is not going to jump-start immediately a housing market that has some adjustment that has to happen. And, in fact, you could argue that trying to prevent that from happening will just prolong the pain that is necessary to work off imbalances that occurred.

I would also just come back to one should not expect a temporary fiscal stimulus to be a panacea. Even with an effective stimulus package, it is possible, perhaps even likely, that economic activity will be sluggish for some period of time.

Senator GREGG. But under the structure that is being talked about here, where most of this stimulus goes to consumption that is most likely going to occur outside the window of the slowdown issue, isn't the real exercise of the stimulus package to show that the Government reacted and create confidence?

Mr. ORSZAG. Well, what I wanted to get to is whether there are—I still think there are options that could act more quickly. They may not be the ones that are featured in the discussion, but a real question——

Senator GREGG. Well, give us your top three. I would be interested in your top three.

Mr. ORSZAG. Fastest spendout would include—from my understanding, unemployment insurance benefits and food stamp benefits would spend out—would start spending out within 2 months.

Senator GREGG. Unemployment insurance benefits in a time of full employment, is that really a good idea?

Mr. ORSZAG. It depends what your objective is. Again, if the objective is to spur spending, unemployment insurance benefits will spur spending because the people who receive them tend to spend the vast majority of them. So unemployment insurance benefits being extended or expanded are a way of getting money out the door fast and having it spent rapidly. But I think they also underscore this tension between this unusual short-term weakness and what might be appropriate there and long-term economic performance.

The evidence does suggest that especially during periods of economic strength, extending unemployment benefits or raising their level has some adverse effect in terms of lengthening the spell of unemployment.

Senator GREGG. It reduces productivity.

Mr. ORSZAG. It increases unemployment levels, at least. That effect, by the way, it is not clear it actually occurs to the same degree during these unusual periods of economic weakness. So the question is: Are you trying to, again, do this quick jump-start, or are you thinking about longer-term structural——

Senator GREGG. I know we have Senator Allard here and he has some questions, but I want to come back to that point. I have always thought any unemployment expansion should be tied to a trigger. But——

Chairman CONRAD. If I can just interrupt, Senator Allard, if you would not mind, we have just had breaking news here that would go to this question. We have just been told the AP is reporting now there is an agreement on a stimulus package, and the elements of the stimulus package do not include food stamps or unemployment benefits. Those have been left out, according to this AP report, that it is a rebate from $300 up to $1,200 for a family of four, would apply to people who paid payroll taxes but not income taxes, as well as those who pay income taxes, would be limited to individuals earning $75,000 or less and couples with incomes of $150,000 or less. People would have had to have earned at least $3,000 in 2007 to receive the rebates.

The business package is much larger than previously discussed, some $70 billion. The business tax portion would give businesses incentives to invest in plant and equipment, give small businesses more generous expensing rules, and allow businesses suffering losses now to reclaim taxes previously paid.

So that is the outline, according to the Associated Press, of the agreement——

Senator GREGG. Can I ask you a question? Did you say it was coming out of payroll taxes?

Chairman CONRAD. No. It was——

Senator GREGG. Is there a payroll tax holiday here?

Chairman CONRAD. It is to provide a rebate to people who have not only income tax liability but payroll tax liability. That is, again, according to the AP's report.

Senator Allard? And thank you for your courtesy, Senator Allard.

Senator ALLARD. You bet. Thank you.

In 2003 when we actually increased the expensing for small business, I talked to Alan Greenspan, at that time Chairman of the Fed, and I made the comment to him, that, I think one of the greatest drivers to get our economy going is the increased expensing for small business, because that is where you get your innovation, that is where you get new job creation. And I think I am pleased to hear that this proposal has increased or sustained those expensing provisions. And he happened to agree, by the way. He said nobody has been talking about how increasing the expensing provisions has driven the economy in a positive direction. But he felt like it had a 'pro' kind of impact.

I would appreciate your comments and feeling on that because that is part of what has just been announced by the media. So go ahead and comment on that, if you would.

Mr. ORSZAG. Sure. Let me comment both on the Section 179 small business expensing and also the bonus depreciation provisions that were included in legislation in 2002 and 2003.

The theory here, especially for temporary changes in those kinds of provisions, is very strong in the sense that you create an incentive for firms to do more investment today, maybe some that they were planning on doing in 4 or 5 years, do it today instead to capture a more substantial tax incentive.

At least with regard to the bonus depreciation provisions that were appropriate for many larger businesses, too, the results from 2002 and 2003 were not as auspicious as we had hoped. So we have a really good theory. The most recent experience was not as promising as one would have hoped for, and that led us in our report to conclude that this would have a kind of medium effectiveness, in part because the most recent experiment or experience was not as strong as we would have hoped.

Senator ALLARD. Well, of the things that we did, what did you think did the most to stimulate the economy?

Mr. ORSZAG. Per dollar, it looks like the rebate that was advanced in 2001 turned out to be the most effective. Per dollar?

Senator ALLARD. Long term?

Mr. ORSZAG. No, no. I should back up. This entire discussion—or from my end, this entire discussion is in terms of short term.

Senator ALLARD. Short term.

Mr. ORSZAG. Aggregate demand, and those are much different considerations than long-term growth.

Senator ALLARD. Were your comments on expensing and the other provision, was that long-term or short-term discussion?

Mr. ORSZAG. It was short term, although the same considerations there would apply to long term. The question is how much kick you are getting.

Just briefly, there is some ambiguity, but studies that looked at the bonus depreciation provisions before, during, and after, you would expect the largest response for long-lived assets because if you were under previous law allowed to depreciate something over 20 years and all of a sudden you are allowed to expense or depreciate a lot more of it up front, that is a much larger change than for a 3- or 5- or 10-year property. And there is some ambiguity about whether we even got the response in terms of investment classes, that is, whether the longer-lived assets disproportionately responded. In any case, even the studies that found that that did occur suggested that the aggregate impact was small.

Senator ALLARD. The fact that we sunsetted that in 10 years, you know, if it is a long-term benefit, you whack off your long-term benefit when you do that. Is that correct?

Mr. ORSZAG. Again, it depends what your objective is. If you want to spur short-term investment——

Senator ALLARD. No, I am talking about long term.

Mr. ORSZAG. Long term.

Senator ALLARD. Yes.

Mr. ORSZAG. Long-term investment, you can argue that more permanency is beneficial. But if you are trying to accelerate things into the short term, actually having it be temporary is beneficial because firms then say, oh, something I was going to do in 5 years might as well do today to capture this benefit.

Senator ALLARD. Well, you know, I am of the view with many people that there has to be an adjustment in the markets. I mean, obviously, there was a lot of willingness to move into buying a home with the assumption that the growth in value was always going to be there year after year. And, realistically, that does not happen where you have a capital market.

Is there anything other than perhaps a tax credit for buying new homes, which would tend to cut down your inventory on homes that would be coming on, is there anything that you see where we could target the problem where it originated, which is out of the housing market and the subprime loan area?

Mr. ORSZAG. The final section of our report to the Committee on stimulus options had to do with options in the housing and mortgage market area. I would just note a lot of them—there is no clean, you know, perfect solution here. Again, imbalances built up, and trying to come in after the fact and kind of clean up is very difficult. So they all have both pros and cons. There is nothing that sort of stands out as an elixir.

Senator ALLARD. It seems to me that we can be thankful that we have allowed for the securitization of these loans, which has spread risk. If we had not done that, I think we would be in a worse problem today than we are. But with the securitization, we spread the risk. In fact, we spread it beyond the borders of the United States. But I guess the downside is you do have not only an impact on our economy here, but you have a worldwide impact, and other countries do not have the flexibility to adjust, I think, that our economy does.

Go ahead. I know you are anxious to comment.

Mr. ORSZAG. Oh, no. I was just going to say I agree. Securitization is very beneficial in spreading risk, and that is a wonderful innovation and very important to our financial markets.

On the other hand, the securitization process may have played some role in the situation that we currently find ourselves, both because originators may not have had adequate incentive to take care in originating loans, and also because securitization complicates the renegotiation of mortgages. The traditional model where you sat down with your banker and said here is what happened and you sort of work out a deal to renegotiate the mortgage is difficult when there are thousands and thousands and thousands of people or investors owning bits of your mortgage.

Senator ALLARD. Yes. What about the regulatory environment? You know, it seems to me that we are getting pretty heavy on the regulatory side and making it much more difficult for companies to produce and create jobs because of the regulatory environment. Do you think the regulatory environment now is at a point where it is having a noticeable effect on the economy?

Mr. ORSZAG. Well, I mean, in general, relative to, say, the 1960's and 1970's, the regulatory environment has moved toward a more flexible and more market-oriented structure. And certainly relative to other, especially continental European countries, we have a more market-oriented system of regulations. But it really depends on what you——

Senator ALLARD. In the United States.

Mr. ORSZAG. It really depends on what you are comparing it to, and I think we are learning to apply the insights from market incentives to a broader array of regulatory matters so that you can accomplish your public policy purposes as efficiently as possible.

Senator ALLARD. Well, one of the things I am looking at, when you presented your chart there on the accelerated costs of health for Medicare and Medicaid, you said a certain portion was demographics. The other portion was the cost of Medicare. The big impact of that is regulation. You know, you use a lot of hazardous materials in medicine, and so we have applied a lot of regulations and rules on the way we manage our hazardous materials for laboratory tests, in products that we use for medicine. They end up in machinery and the stuff that you use in medicine such as X-ray machines and all the other machines that we have now. And so I do not think a lot of people in implementing those stop to think of what the end impact may be on some industry that provides a vital service that Americans have considered No. 1 in priority, and that is health care.

And so that is what brings up that question, and you may not want to comment on it, but I think it is worth some discussion.

Mr. ORSZAG. Well, Senator, I understand. I think I may be appearing before this Committee next week to talk about rising health care costs, so we can have an extended discussion next week on those topics.

Senator ALLARD. Yes, because there are built-in things that we— well, energy is another area, and it is a fundamental area. When you have cost growth, it affects everything. And you get an area like medicine, you use a lot of energy, too. In the hospitals the lights are on 24 hours a day, equipment is on 24 hours for monitoring and everything like that.

Mr. ORSZAG. I look forward to that.

Chairman CONRAD. Let me just say I was just in the hospital several nights with my daughter who had an appendectomy and spent all night in the hospital, and they do keep the lights on through the night.

[Laughter.]

Chairman CONRAD. I found that out.

Senator Murray.

Senator ALLARD. By necessity.

Senator MURRAY. Well, Mr. Chairman, thank you. Thank you very much, and I apologize for being late. I had three hearings at the same time this morning. This is obviously a very important one. I had a number of questions about the short-term economic stimulus. I understand you just announced that there is some kind of deal, and many of those questions have been covered so I will not dwell on that too much.

I did want to ask you one question regarding short-term economic stimulus. It is an issue that I have been looking at very closely, and that is the issue of what is called the Summer Jobs for Youth program that helps bring some money into the economy quickly, clearly helps businesses with getting some workers, solid workers, but has an additional impact of giving skills to young people when we have a rising number of young people that cannot get into the work force. And the unemployment rate for African Americans 16 to 19 years old has increased last month just by 5 percent, and the unemployment rate for all teens rose to 17 percent, up from 13 percent a year ago.

So I just wanted to ask you that one small question, do you agree that putting some money into a summer youth employment jobs program would help bring some stimulus to the economy?

Mr. ORSZAG. Well, I think two things. First, let me just underscore that there are significant problems and challenges associated with unemployment rates and lack of labor force attachment among teenagers and the serious long-term consequences that can flow from that. But we might want to think about programs like that in the camp of sort of long-term economic performance, and the question becomes whether you can effectively and efficiently dial that program up in a short period of time to deliver stimulus in the near term, and I think that is a little less clear.

Senator MURRAY. Right. And we do already have a WIA, Workforce Investment Act, program that gets those dollars out to the communities. It is already there. Beefing it up will, I think, make a tremendous impact. I know it is not short term. It is like next summer. But even the rebate checks that we are talking about will take several months to enforce and get out into the economy.

Let me go back. You know, one of the reasons we are considering this economic stimulus package, the crisis everyone is talking about, is the issue of the rising foreclosures, particularly in the subprime market, and major writedowns on the subprime-backed securities in the financial sector that have sort of led to this crunch in the credit market.

Some people are talking about raising the conforming loan limit that is set at $417,000 as sort of a means of providing liquidity into the market. Do you believe a temporary increase in that conforming loan limit would be helpful?

Mr. ORSZAG. It depends what else was done, and it depends in what part of the market. We have experienced some difficulty in the so-called jumbo market, above those conforming loan limits, as a spillover from other problems in the mortgage markets. Raising the conforming loan limit would tend to help bring down rates, especially on jumbo, that is, mortgages that are above the conforming loan limit. But it also depends on whether you are changing the overall limits on the portfolios that the GSEs—Fannie Mae and Freddie Mac—are allowed to hold. If you just raise the conforming loan limit and do not change the aggregate amount of mortgages that they are allowed to either securitize or hold on their own books, you are then just merely shifting things around from one part of the market to another. If you temporarily raise the limits, the issue then becomes whether you are concerned about increased risks associated with those entities.

Senator MURRAY. So do you think it is a good idea or not?

Mr. ORSZAG. Oh, I am not allowed to say things like that anymore.

[Laughter.]

Senator MURRAY. OK. Well, what other actions do you think we should consider to help provide liquidity into the markets and bring some stability to the housing market?

Mr. ORSZAG. We go through a whole variety of options in the back end of the stimulus report that we provided to the Committee. And as I indicated earlier, the problem at this point is there is no perfect solution. A set of imbalances arose for a variety of reasons, and it is a mess now. And cleaning up a mess is difficult, so——

Chairman CONRAD. Messy.

Mr. ORSZAG. It is messy. And I cannot give you, you know, one option that just clearly stands out as having benefits that far surpass potential costs because everything, unfortunately, has both costs and benefits in that area. I do not have an elixir here.

Senator MURRAY. OK. Well, we are talking about a short-term boost to the economy. What actions do you think we should be looking at for a longer-term stability and boost to the economy?

Mr. ORSZAG. Longer term, the key issues facing the economy involve things like our significant fiscal imbalance, and especially bending the curve on health care costs so that we are not only avoiding a very rapid increase in expenditures, but also getting more for our health care dollars. There is a lot more value and efficiency that we can get out of the money that we are putting into health care.

Relatedly, raising our Nation's national saving rate is essential over the long term because we cannot continue saving just 1 or 2 percent of our income. That is something, again, I want to emphasize long term. We do not want to be doing that right now because it would exacerbate the economic downturn. Part of that has to do with increasing household saving, and I think there are things that have now been shown to really work in terms of boosting both retirement and other saving for households, mostly by making saving more automatic and easier for households to do.

Beyond that, we can keep going down the list, but we have——

Senator MURRAY. What about investment in infrastructure?

Mr. ORSZAG. Investment in infrastructure is part of the physical capital that helps to improve productivity, and I think there are questions both about the amount of infrastructure investment that we are undertaking over the long term, and also how we are allocating and pricing the infrastructure that we currently have. So a question not only about how much, but also where and how well we are using what exists.

Senator MURRAY. OK. Well, thank you very much, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Murray.

Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Mr. Orszag, welcome back. I understand that we will be having a health care-specific budget hearing shortly, so although that is my favorite and constant subject, let me ask you, since we are in the arena now of stimulus packages, you point out in your written testimony that the enactment of a stimulus could further increase the projected deficit for 2008. The hope of a stimulus package would be that it would be helpful to boost consumption and GDP. Do you believe that the revenue generated by a carefully crafted stimulus could cancel out that cost over the 10-year horizon?

Mr. ORSZAG. The revenue generated by effective stimulus, because the stimulus would then boost economic activity, could offset part but not all of the cost. A rough rule of thumb—and I want to again say we are now entering a round that in official scoring CBO does not undertake, but a rough rule of thumb is that each additional dollar of economic activity generates roughly 20 cents in revenue. We have said that an effective stimulus could generate roughly an extra dollar of economic activity for each dollar of budgetary costs. So if one wanted to go down that path of figuring out what the net impact is, you could shave something like 20 percent off the budget cost, if it were well designed and you wanted to incorporate that revenue feedback effect. But, again, I want to emphasize in official scoring that is not done.

Senator WHITEHOUSE. And in terms of the quality of design, in terms of the effectiveness that you have described, how would you rank income tax rebates, unemployment compensation extensions, and food stamp provisions along that, by those two benchmarks?

Mr. ORSZAG. All of them rank high in terms of their cost-effectiveness; that is, the extra consumption or demand that you get per dollar of budgetary cost, especially on the rebate, if it were tilted toward liquidity-constrained and lower-income households.

There is, however, a difference in terms of timing. We indicated in our——

Senator WHITEHOUSE. Could I interrupt you and ask you to define a liquidity-constrained——

Mr. ORSZAG. Sorry. A household that has difficulty borrowing. So the evidence, for example, from the 2001 tax rebate suggested that households with lower credit limits were those who had exhausted a larger share of their credit limit.

Senator WHITEHOUSE. Would that correlate to family income?

Mr. ORSZAG. It does not always, but disproportionately lower-income households tended to spend more of their rebate ultimately than households that did not face those kinds of borrowing constraints.

Senator WHITEHOUSE. OK. Sorry to interrupt.

Mr. ORSZAG. But that is the logic for why tilting a rebate toward lower- and moderate-income households tends to get you more kick in terms of immediate spending.

There is, however, a difference between the—the unemployment insurance benefits and food stamps benefits similarly will rank high because any money that you pump out the door will likely get spent, to a large degree, and result in additional consumption. There is, however, a difference in terms of timing. The length of lag from the enactment to the actual stimulus we said for a tax rebate is medium, and I can define medium more precisely in a second; whereas, for unemployment insurance benefits and food stamp benefits, it is short. So there is a difference in timing. We expect that after enactment, food stamp benefits and unemployment insurance benefits could start to affect spending within, say, 2 months; whereas, under a rebate, because of where the IRS is currently—where it currently is in the tax filing season and because the response to a rebate seems to lag by a quarter to two quarters, you are going to be disproportionately affecting spending basically at the end of 2008. And that may well be outside of the window of economic weakness that you want to be targeting.

Senator WHITEHOUSE. In addition to the question of effectiveness and in addition to the question of timing, is there also a question of multiplier effect depending on what goods are likely purchased with the stimulus funds? For instance, since food is fairly likely, particularly if the income level is affected by food stamps, to be American produced, is there a multiplier effect from that versus somebody with a higher income buying a made-in-China television that has bounced once in a low-margin, big-box American company before it moves into the hands of the consumer?

Mr. ORSZAG. There could be differences. I would say in general the type of spending that is induced probably is less important than the aggregate amount that you do. But you are right that to the extent the response is disproportionately consumption of imported goods, you do not get as much impact on domestic production as if it were domestically produced goods.

Just in general, those ratios do not tend to vary so much across broad categories of spending that it is a first—of sort of primary importance. But you are right that there could be differences.

Senator WHITEHOUSE. I think my yellow light is on so I will not trespass on the red light, and I will yield back my time. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Whitehouse.

I would like to go back to this question of timing because it is very, very important, I think, to an analysis of how effective this stimulus package might be. What I heard you say was that the IRS, given its position in the filing cycle, will not be able to send out checks until the May timeframe. Is that correct?

Mr. ORSZAG. Well, more precisely, and again, I do not—this is the information that we are being provided with, and I am under the impression that even extraordinary efforts would not change the basic facts. The IRS would be able to process the rebate amounts by mid-May at the earliest, maybe beginning of June. Technically, the checks are then sent out by FMS, the Financial Management Service, and that process takes 8 to 10 weeks. So——

Chairman CONRAD. Eight to 10 weeks. So now we are talking mid-July.

Mr. ORSZAG. Until all of the checks are out, yes.

Chairman CONRAD. So we are talking about June-July, the checks actually go out. Somewhere in this mid-June timeframe, mid-July. Correct?

Mr. ORSZAG. I think that would be the most reasonable estimate.

Chairman CONRAD. Then, as I heard you say, the analysis of what happened in 2001 indicated that the economic effects of that were not felt—or the biggest part of it—for one to two quarters. Is that correct?

Mr. ORSZAG. Yes. And, in fact, just coming back to the discussion before about households with credit card debt, it looks like what happened initially was people disproportionately brought down——

Chairman CONRAD. Paid down debt.

Mr. ORSZAG. They paid down their credit card debt during the first quarter, and then it is like they realized, “Oh, my credit card debt is down, I can go out and spend.” And they brought their credit card debt back up, which means they ultimately did spend most of the money. But it took some time. They initially responded by buying down some of their credit card debt.

Chairman CONRAD. So we are really talking about the effects of these rebates that have been discussed in the Associated Press story about the potential agreement, that the economic effect of those not being felt until December, January—December of this year, January of next year.

Mr. ORSZAG. If you were worried about Christmas spending this year, this would be a particularly effective approach to adopt.

Chairman CONRAD. Well, that strikes me as kind of missing the ball game myself.

Now, let me ask you this: The 2001 rebates were different than these rebates.

Mr. ORSZAG. Yes.

Chairman CONRAD. The 2001 rebates only went to those who paid income taxes. These rebates are more targeted. They are going to people who paid payroll taxes as well as income taxes, and they are, as I understand it from the press reports, going to couples earning less than $150,000 a year.

Do we have any picture from 2001 on lower-income people using that money more quickly than higher-income people?

Mr. ORSZAG. Well, what we have is only among those recipients of the 2001 rebate, which, again, did not——

Chairman CONRAD. But we would have—but those are only income taxpayers.

Mr. ORSZAG. Right.

Chairman CONRAD. I understand.

Mr. ORSZAG. But as you go down the——

Chairman CONRAD. This is income taxpayers and payroll taxpayers, but among income taxpayers, did those of lower income spend this money more rapidly?

Mr. ORSZAG. I do not think we can say that, and indeed, again, among those who had higher credit card debts, the response tended to be to initially buy down credit card—I brought all the studies with me. I can check that in a moment. But, in general, I do not think you should necessarily expect a much different response in terms of timing, just because you are including those who have payroll tax liabilities but not income tax liability.

Chairman CONRAD. Let me say that would be counterintuitive to me. I would think somebody that is more hard pressed gets a check that they are more likely to do something or that——

Senator GREGG. He is saying they are going to pay down their credit card.

Chairman CONRAD. Yes, I understand they are going to pay down their credit card initially, but then they are going to spend it in the second quarter.

Mr. ORSZAG. Right, and they tend to spend—let me be clear. They tend to spend more of it ultimately, but your question was do they—whatever they ultimately do, does more of it happen rapidly? And I do not think we have evidence of that, but I will check.

Chairman CONRAD. Right.

Senator Stabenow?

Senator STABENOW. Mr. Chairman, I apologize for being late. I was in the Finance Committee. But it was a very interesting testimony from two economists: Dr. Martin Feldstein, who was President Reagan's Chairman of the Council of Economic Advisers, and Dr. Jason Furman from President Clinton's administration. And what was interesting—and it leads into this discussion right now—is how much they were saying the same thing. And it was the same thing we have heard from CBO. Both of these economists agreed that we should be stimulating the economy by increasing food stamps, and they disagreed on unemployment insurance, but on food stamps they agreed that the quickest way was to put money in the hands of those who will immediately go to the grocery store and buy food for their families.

There was also a very interesting debate among colleagues on the other side of the aisle who were arguing for more supply side tax cuts, and Dr. Feldstein, again, coming from the Reagan Council of Economic Advisers, indicated he felt this was a demand issue, not a supply issue. And there was amazing agreement that we ought to be focusing on demand, which is, in fact, putting money in the pockets of people who have been unemployed or losing their income or find themselves—who basically we know to be the people squeezed, middle-class people squeezed economically right now.

So I share that because I think having heard last week from Dr. Orszag and then this week from two other economists, it was an amazingly uniform message, even though some of the pieces were different. And I am very disappointed in what I am reading so far of what the agreement is in the House because it does not address what—if I remember correctly—and I apologize for not coming in, again, for your presentation, Dr. Orszag. But having heard it in Finance, if I remember correctly, food stamps and extending unemployment compensation were the top two ways in which you suggested we could get the most immediate bang for the buck, as it were, in terms of the least risk and the most impact. Is that correct, in terms of economic stimulus?

Mr. ORSZAG. Yes. The impact is similar to a rebate in terms of dollars spent, but the effect tends to be quicker because you can get money to recipients faster.

Senator STABENOW. Mr. Chairman, I would just raise one other issue that I hope we will have on the table in the Senate as well. There is no question there will be pieces focused on business, and we can debate, you know, issues of bonus depreciation or what is the quickest way to stimulate the economy. But we do know that when we look at something like bonus depreciation, the States lose revenue as a result of that—in Michigan, it is about $150 million lost in tax revenue—at the same time that cash-strapped States are finding more people going on Medicaid and needing more social services.

I would hope that we would do what was done in 2003, which is include a temporary increase in match for Medicaid. There was a $20 billion economic stimulus piece for States in the 2003 package, and I know, Dr. Orszag, you had recommended that just general support for States was not particularly effective as a stimulus. But to the extent that we could target it, that would be more effective. Is that correct?

Mr. ORSZAG. The States are in much different fiscal conditions, and the impact from providing relief to the States depends on what they do with the money. If it just winds up in a rainy day fund because the States have a decent fiscal position, you are not doing much in terms of stimulus.

Senator STABENOW. Right. But if we can focus it on those—because right now we have a number of States that have announced they are going to be cutting Medicaid, so we have people who will be losing their insurance. So if we can stop that, that, in fact, would assist in what we are trying to do.

Mr. ORSZAG. Yes. If you can target fiscal relief on the States and local governments that are having difficulty and that would otherwise be cutting spending or raising taxes and then by providing them relief they do not, that is effective stimulus. The Government Accountability Office, I think last year or the year before, came out with an analysis of ways of trying to do that through changes in local and State unemployment rates. And there are other ways of trying to target it more efficiently also.

Senator STABENOW. Thank you. Well, I would hope as the Senate works its will that we will add to the package that appears to be coming from the House and focus on the issues that there is broad support for in terms of truly stimulating the economy, which is unemployment compensation, food stamps, and hopefully adding support for States directly as it relates to Medicaid as a part of the balanced approach that we come up with.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Stabenow. I would just say that we have some additional details coming in at the moment that indicates there is a housing piece to this, increasing the loan limits for FHA and for Fannie Mae and Freddie Mac—for FHA from $362,000 to $725,000, and for Fannie Mae and Freddie Mac from $417,000 to $625,000. So these are additional details that were not included in the previous story.

Senator Gregg.

Senator GREGG. Thank you, Mr. Chairman. Obviously, we do not have the specifics of this proposal, but as you look at the proposal as it has been outlined by the Chairman, what is your reaction relative to its ability to infuse consumption dollars into the economy—because you believe that is what we need—into the economy in the next two quarters, which is the period where you said there is a window of softness?

Mr. ORSZAG. Again, I do not have the details, but the general structure of the proposal seems like it would rank relatively well from a perspective of bang for the buck. But the question is when the bang occurs, and I think there are issues surrounding the timing involved, especially on the rebate side, which sounds like it may be, you know, the biggest single component of the proposal.

Senator GREGG. I think that was my question. I appreciate that your answer was not as precise as I might like, but let me try to get a more precise answer. In the next two quarters, including this quarter as the first quarter, and the next quarter being the quarter that ends in the beginning of the summer, would this proposal give you the bang for the buck?

Mr. ORSZAG. It sounds like you would not—most of the stimulus would not be delivered during that period of time.

Senator GREGG. Actually, if you—OK.

Mr. ORSZAG. Could I quickly add on the response—because I think this is an important question—on the response of low-income households, that I was able now to look these up. It depends on whether we are looking at households that are credit-constrained or low-income households. The credit-constrained households do not seem to—the time pattern does not seem to be that different. It is just kind of scaled up. The evidence on low-income households does seem to suggest that more of the response is up front than medium or typical households.

Chairman CONRAD. I should have been an economist.

Mr. ORSZAG. There you go.

[Laughter.]

Senator GREGG. This idea that you get more for the food stamp dollar, I want to get to the point that Senator Whitehouse was making. Where does the dollar of consumption go? And you seem to feel that it did not matter. If you give somebody $800 or $600, or whatever this works out to, and they go out and consume and they buy a product which is not made in the United States, what is the value that is added to the American economy that causes you to say that that energizes economic stimulus here?

Mr. ORSZAG. To the extent that the additional consumption comes in the form of imports, it does not add directly to the demand for domestic production. My point was just that the share of imports in general, if you are thinking about providing food stamp benefits—well, food stamp benefits——

Senator GREGG. Well, I do not want to take food stamps. They are an agricultural product, and it just becomes another farm bill. But——

Mr. ORSZAG. I guess my point was just that——

Senator GREGG. Six hundred dollars——

[Laughter.]

Senator STABENOW. And what is wrong with that?

[Laughter.]

Senator GREGG. I am talking about a $600, $800 rebate check that is not tied to any specific spending program. The person gets the check, they pay down their credit card, or they go out and they buy a product; and if the product is manufactured outside the United States, what is the economic stimulus?

Mr. ORSZAG. There is none there, and my only point was that across broad categories of goods, the variation in the share of imports, while it is there, it is not large enough to think that we should be targeting specific categories of spending. It is just—food stamps may be a particularly viable—or may work better from that perspective than other things. But if the question is should we worry about where people spend the money, in general I am not sure that that is a productive undertaking, because in general, the share of imports in consumption is small enough that most of the bang will spill over into domestic production. It does not hold universally across all categories of goods.

Senator GREGG. That is a statement which I hope is correct, but I am not sure that I intuitively think it is, because if you are buying a product or an item that is in that price range, which is not going to be a house or something that is fairly large—you are buying basically a durable good. You are buying a television, a dishwasher, or something in that range. What percentage of those types of items are imported versus domestically produced? Do we have any numbers on that?

Mr. ORSZAG. Yes. But I am not sure that we should accept the premise, which is the response to the 2001 rebate suggested it was not just that kind of thing, but also increased consumption of, you know, going out to restaurants, apparel—I mean, there are a whole variety——

Senator GREGG. What percentage of apparel is American manufactured?

Mr. ORSZAG. I do not have an exact percentage, but——

Senator GREGG. Low.

Mr. ORSZAG. Low. "Low" would be a good characterization.

Senator STABENOW. If I might just interject for my friend there, I would be happy if we would target that to American-made automobiles.

Senator GREGG. I know.

[Laughter.]

Senator GREGG. I have no problem with that. That means we would be buying more automobiles made in Tennessee or South Carolina.

Mr. ORSZAG. Well, let us pause on apparel for a second because it did seem like the response to the 2001 rebates came—I mean, you have to be careful because the data are a little slippery here—came disproportionately in that category. We do need to remember that, you know, part of the price of apparel here is not just the cost of the good itself but, rather, also the value-added and the retail——

Senator GREGG. Right. I understand that——

Chairman CONRAD. Can I just say that the Chairman deems that the time of the Senator from New Hampshire has expired.

Senator GREGG. I am just getting into the agriculture.

Chairman CONRAD. Even though let me just say it cost him 1 minute of his time to make this crack about the farm bill.

[Laughter.]

Senator GREGG. I do want to go back, though, to this question of whether under this stimulus package as presented we are going to get it into the two quarters that we presume are going to be the most problematic or is it going to be outside those quarters and toward the end of what we can see is the problematic period. Shouldn't the stimulus package therefore take on more of a personality of being a long-term structural improvement of the competitiveness so that the underlying economy is made stronger as versus stimulated?

Mr. ORSZAG. Well, I suppose you could ask whether if the short-term impact is so delayed, what exactly one's—what one is doing.

Senator GREGG. Confidence. This is all about confidence that the Government can act. That is what this appears to be about. But if the Government is going to act but act in a way that does not stimulate the two quarters that we are most concerned about, shouldn't the practical implications of this package be that it improve the underlying structure of the economy by going toward productivity and more efficiency in the economy?

Mr. ORSZAG. The longer out you go, the more the entire premise of undertaking this kind of activity would need to be questioned. I mean, there still might be concerns about economic activity in the latter half of this year, but as you go out beyond that, certainly, again the whole sort of theory behind it changes.

Senator GREGG. Thank you.

Chairman CONRAD. Yes, I think this is really not what I was hoping for from a package. I would just say that. I was hoping that in terms of doing a package, we are going to do one that had a more rapid effect. I do not know. Do we have any measure of psychological effect? That is, if people anticipate that they are going to get a check, and they are going to get it in June or July, do we have anything, any evidence that would suggest that affects their consumption now?

Mr. ORSZAG. There is theory behind that. In practice, especially if you are trying to target the households that have difficulty borrowing, it is often difficult to spend it in advance of when you actually receive the money.

Chairman CONRAD. Those are people that you described as credit-constrained.

Mr. ORSZAG. They are living paycheck to paycheck.

Chairman CONRAD. Yes. I do not know, though. People always have an ability—it is amazing how innovative, creative people are in terms of they want something they need, or at least think they need.

Mr. ORSZAG. I mean, so, for example, one can imagine also there have been issues surrounding the terms of various transactions, but in traditional income tax refunds, there are loans that are advanced by private sector entities to advance the money to individuals, often at what some people believe are very high interest rates. But there are ways of——

Chairman CONRAD. Payday loans.

Mr. ORSZAG. There are ways of, you know, even in advance of when the checks arrive, having some of the liquidity provided to households that may spend it.

I think it is also worth pausing on the bonus depreciation or business investment incentives component because there may well be some response to businesses as soon as that is announced, but firms usually take some time to adjust their investments decisions. And you also tend to get the peak response toward the end of whatever the period is when you are providing an incentive, because you might as well capture it right then.

Chairman CONRAD. People wait.

Mr. ORSZAG. So, again, the impact over the next couple months presumably will be relatively limited in terms of its direct impact, and the confidence effects, coming back to Senator Gregg's comments, will depend again on how people perceive it in psychology. That is difficult for me to evaluate immediately.

Chairman CONRAD. Well, we are finding out a little more about this package now, at least press reports. They are saying that specifically the plan would modify the 10-percent bracket, a change worth up to $600 for a single taxpayer, $1,200 for a married couple. Tax filers earning too little to pay income taxes could still benefit under the plan from a refundable $300 child tax credit.

So, you know, I do not know—there is no indication in this story whether it is limited to people, couples below $150,000. But assuming the previous report was correct on that, this does appear to be targeted to middle-income people, lower-middle-income people. And I guess one has to hope that there is some expectation effect, that people see that they are going to be getting this money, and then move to increase their spending in order to stimulate the economy.

In terms of the business side of it, they are saying that businesses would be able to write off 50 percent of the cost of capital purchases and allow small businesses to write off all of the costs of some additional purchases. So that is increased expensing.

You know, I have been a big supporter of that in the past, but I must say the—as a stimulus, I supported that very strongly in 2001. Isn't the evidence from 2001 that increased expensing, bonus depreciation got us pretty weak bang for the buck?

Mr. ORSZAG. One study suggested that you, again, did not even get the response across different types of investments that you would have expected. Another study suggested you did get that but the aggregate impact was something like 0.1 or 0.2 percentage points of GDP, which is obviously quite modest.

Chairman CONRAD. Very weak, much weaker than I would have anticipated.

Mr. ORSZAG. We had built into our baseline at the time an expectation of much more rapid growth in investment as a result of bonus depreciation that then did not occur.

Senator GREGG. May I ask a question on that point?

Chairman CONRAD. Sure.

Senator GREGG. Doesn't that depend, though, on where you are in the business cycle?

Mr. ORSZAG. It may, yes.

Senator GREGG. Because if you basically are pretty much at full plant utilization, then an investment tax credit is going to generate an immediate reaction. But if you have assets that are not being used, people are not going to go out and buy more assets.

Mr. ORSZAG. It is possible that the reaction now will be different. At that time we had built up basically a capital overhang, and there was a very steep reduction in investment that occurred post, say, 2000 and it may well be that the——

Senator GREGG. And where are we now in that cycle?

Mr. ORSZAG. We are not at the same point. In other words, it is possible that the response now will be better than it was then. But I think some caution——

Chairman CONRAD. Actually, following Senator Gregg's logic, that would tell you it would be weaker. It would be weaker now.

Mr. ORSZAG. No, no. The point being that at that time I think the perception among firms was that they had overinvested especially in particular kinds of physical capital.

Chairman CONRAD. Y2K effect.

Mr. ORSZAG. And telecommunications capacity and other things, and so were more reluctant to undertake new investment. That overhang is not present currently.

Chairman CONRAD. But if you have a weakening economy—Senator Gregg's point as I heard it was if you have a weakening economy, if you are in that part of the business cycle, people are not going to go out and make more capital investments when they do not need it to produce for the demand that they are facing.

Mr. ORSZAG. Right. I am sorry. I was keeping sort of expectations of economic activity constant. It is absolutely—I think one of the reasons why the effect may not have been as large as expected is the investment decision is being driven much more by expectations about what future prospects are like for firms than from any tax savings, which can often be quite modest. And I would also point out one other factor that may have affected the impact in 2002 and 2003, which is that many States decoupled from the Federal tax change, and as a result, I think some corporations just said I do not even want to undertake the complexity of——

Chairman CONRAD. Sorting that all out.

Mr. ORSZAG. Sorting that all out.

Chairman CONRAD. Senator Whitehouse?

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Two quick questions. Back to the issue of the timing of the stimulus effect—and I do not know if you are the person to even answer the first one. But with respect to the IRS and its ability to put the rebate through the tax system, is there any chance that this could be connected to the 2007 refund process, which would presumably be quicker than——

Mr. ORSZAG. Yes, my understanding is that there is special programming that would be required for processing a rebate like this and that it could not be done in conjunction with the current tax filing season.

Senator WHITEHOUSE. OK. The other question is that we have sort of overlooked our senior citizens in this whole stimulus equation in the event that we were to choose a stimulus mechanism that involved seniors, and specifically a Social Security mechanism, how quickly would money flow through Social Security to seniors?

Mr. ORSZAG. I am told that after enactment it would involve something like perhaps a 3-month lag or so before it would actually show up in benefit payments.

Senator WHITEHOUSE. So quicker than tax rebates, less rapid than unemployment insurance extensions and food stamps.

Mr. ORSZAG. That is probably fair.

Senator WHITEHOUSE. Thanks, Mr. Chairman.

Chairman CONRAD. Any others, Senator Gregg?

Senator GREGG. No. I want to thank the doctor for his excellent presentation. He is always so competent, and we very much appreciate it.

Mr. ORSZAG. If I could take the opportunity to thank my excellent staff for both the stimulus report and the economic and budget outlook, both of which were produced under tight time constraints.

Chairman CONRAD. We appreciate that very much as well. We appreciate the professionalism of you, Dr. Orszag, and your staff. They are really excellent to deal with, and we appreciate it very, very much.

With that, we will adjourn the hearing.

[Whereupon, at 11:32 a.m., the Committee was adjourned.]

THE LONG-TERM BUDGET OUTLOOK

TUESDAY, JANUARY 29, 2008

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

The Committee met, pursuant to notice, at 10:01 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Murray, Wyden, Stabenow, Menendez, Whitehouse, Gregg, Domenici, Allard, and Bunning.

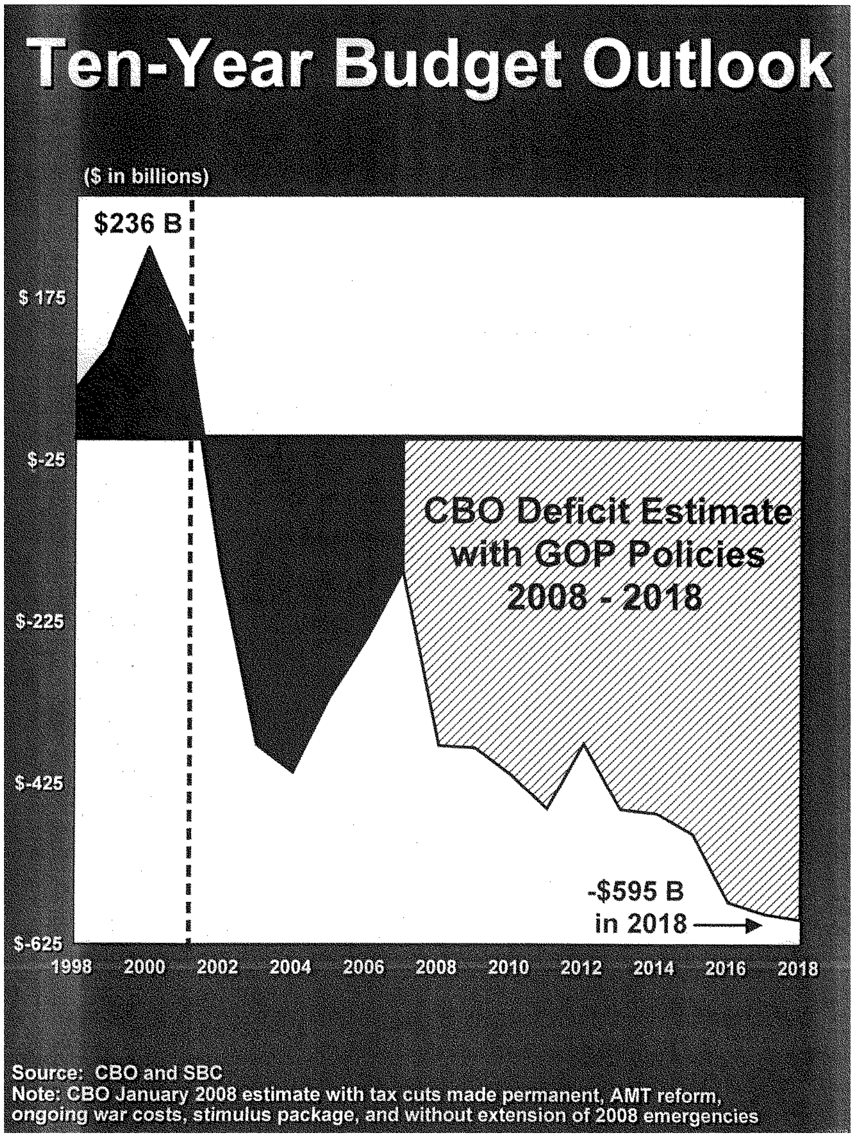
Staff present: Mary Ann Naylor, Majority Staff Director; and Denzel McGuire, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

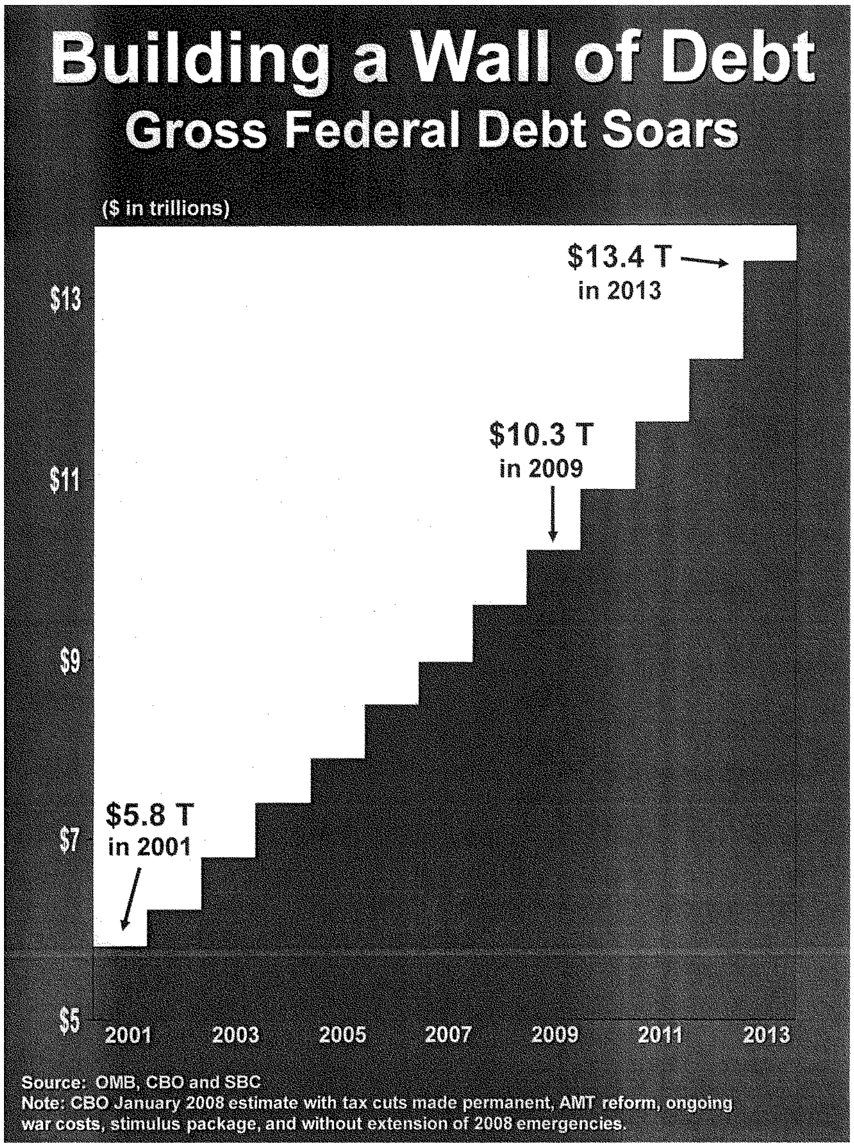
Chairman CONRAD. The hearing will come to order. I want to welcome our witness, the Comptroller General of the United States, David Walker. We want to extend a special welcome to his wife, Mary, who is with him this morning. I think we now know why General Walker has been so well received in Congress. It is really not him. It is all about Mary. But, Mary, we especially thank you for what has to have been a challenging time in the Walker household, with General Walker going around the country with the Fiscal Wake-Up Tour, and we thank you very much for your contribution to having that happen.

I know how challenging it can be for spouses who have to put up with our schedules, and I just want to say how much we appreciate the contribution that has been made by the Walker household to alerting the American people about the real serious challenges facing this country, and your husband has really been a leader and somebody that those of us on this Committee admire greatly.

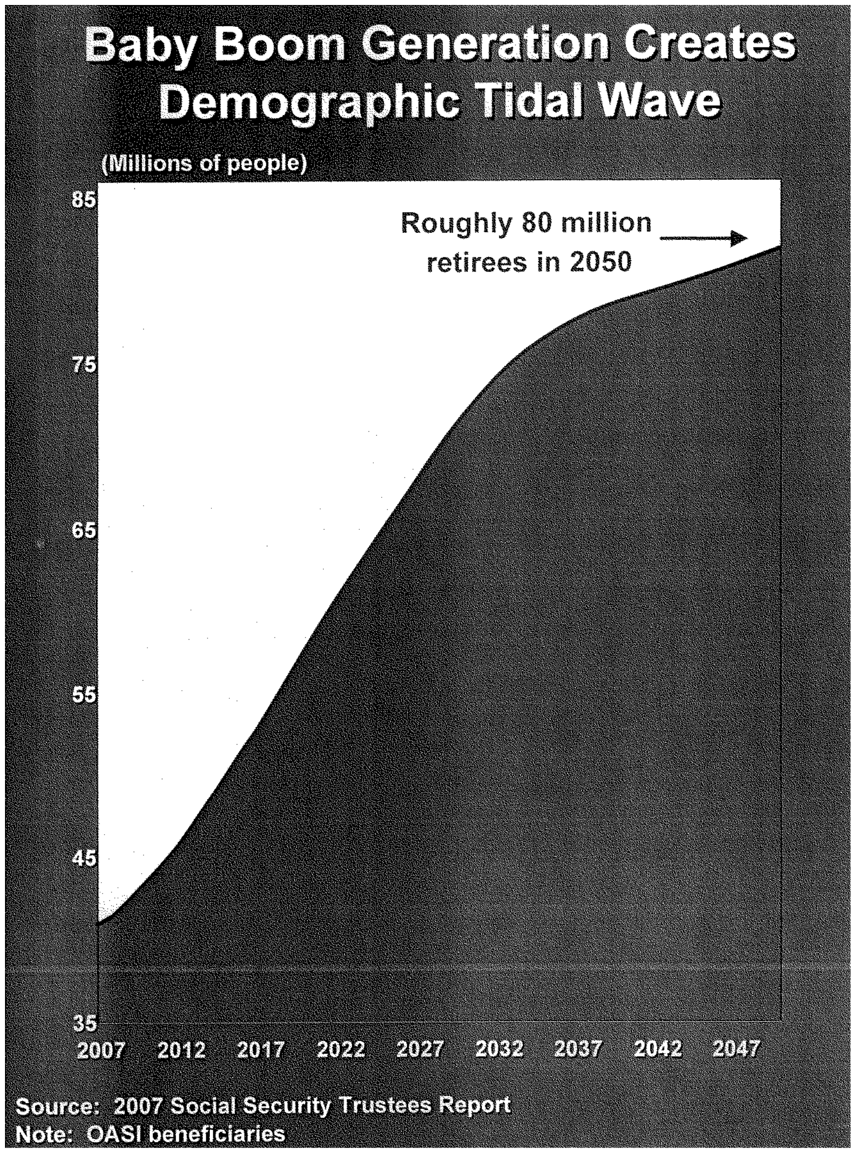
Let me just kind of give my own review of where we are. When we look at the 10-year budget outlook, and when we put back the proposals the President has made on both making the tax cuts permanent and war costs, we see that the 10-year deficit situation continues to deteriorate.



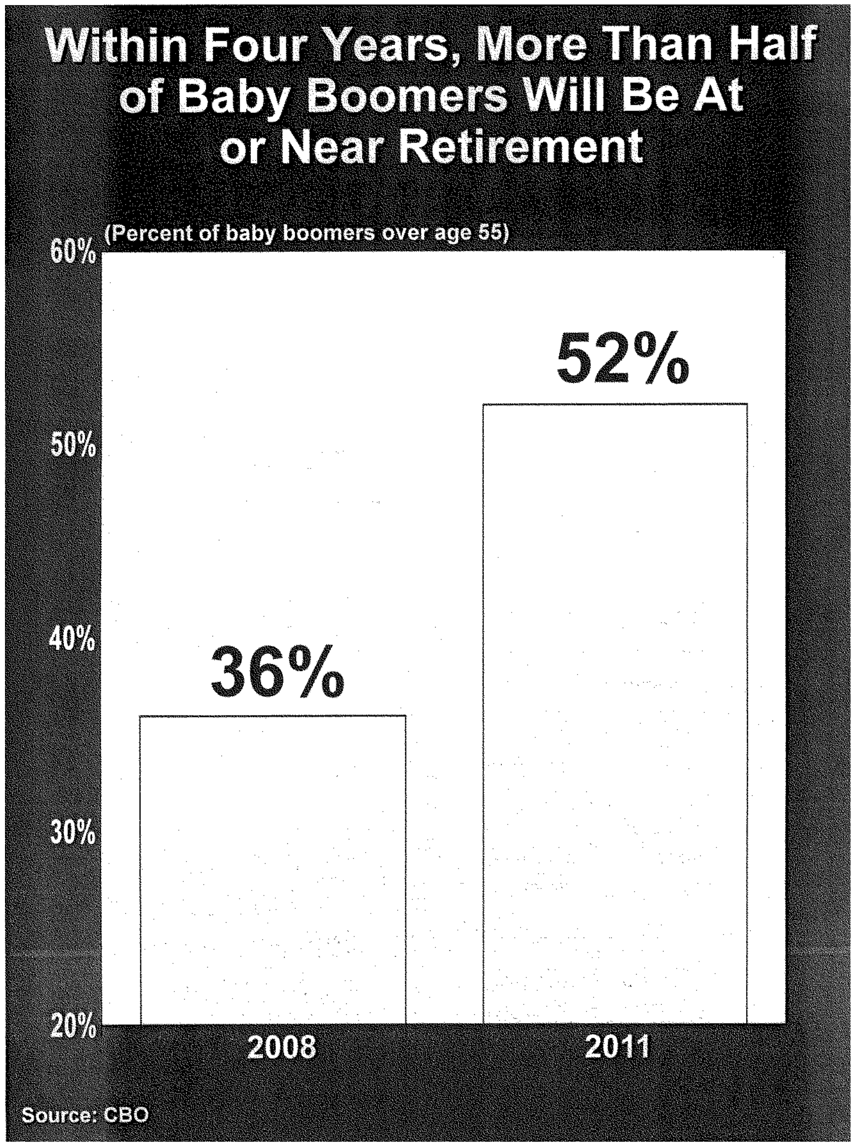
When we look at the debt, that also deteriorated even further. It was $5.8 trillion at the end of the President's first year. At the end of his 8 years of responsibility, we now see the debt, the gross debt of the United States, will be over $10 trillion, and we are headed to more than $13 trillion of debt by 2013.



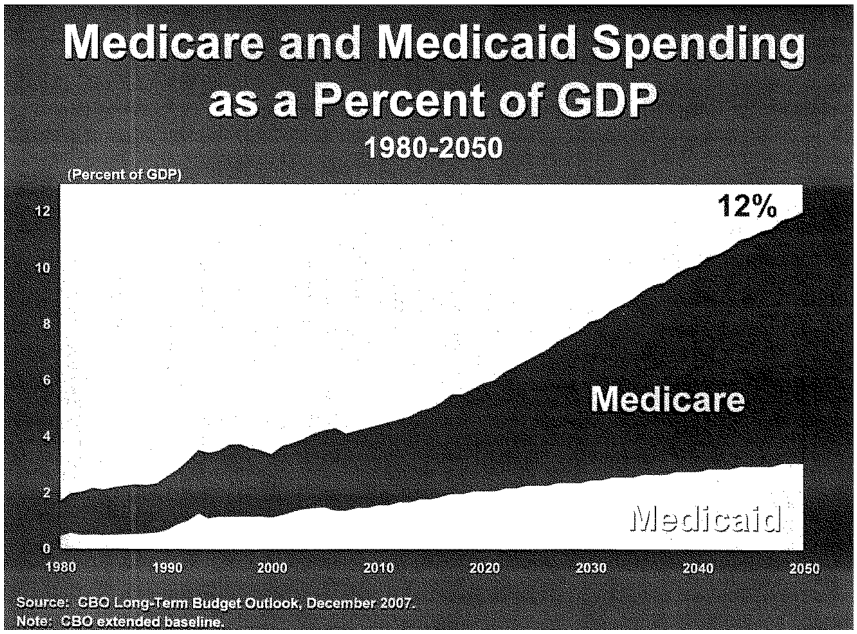
Part of the reason, of course, is the demographic tidal wave that is coming at us—roughly 80 million retirees by 2050.



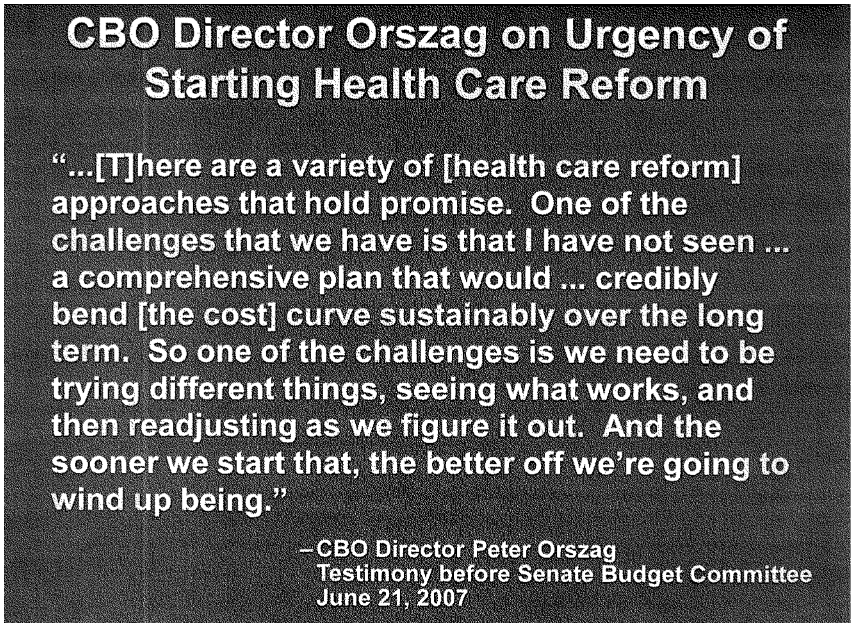
And let's go to the next slide. Within 4 years—and I think this is a very sobering slide. Within 4 years, more than half of the baby boomers will be at or near retirement; that is, they will be 55 years of age or over. And while many do not retire at 55, increasingly people are retiring at 55. And what this tells me is the urgency of addressing these long-term problems. We are preparing a chart that will show at age 62 what percentage of the population; I hope to have that for our next meeting.



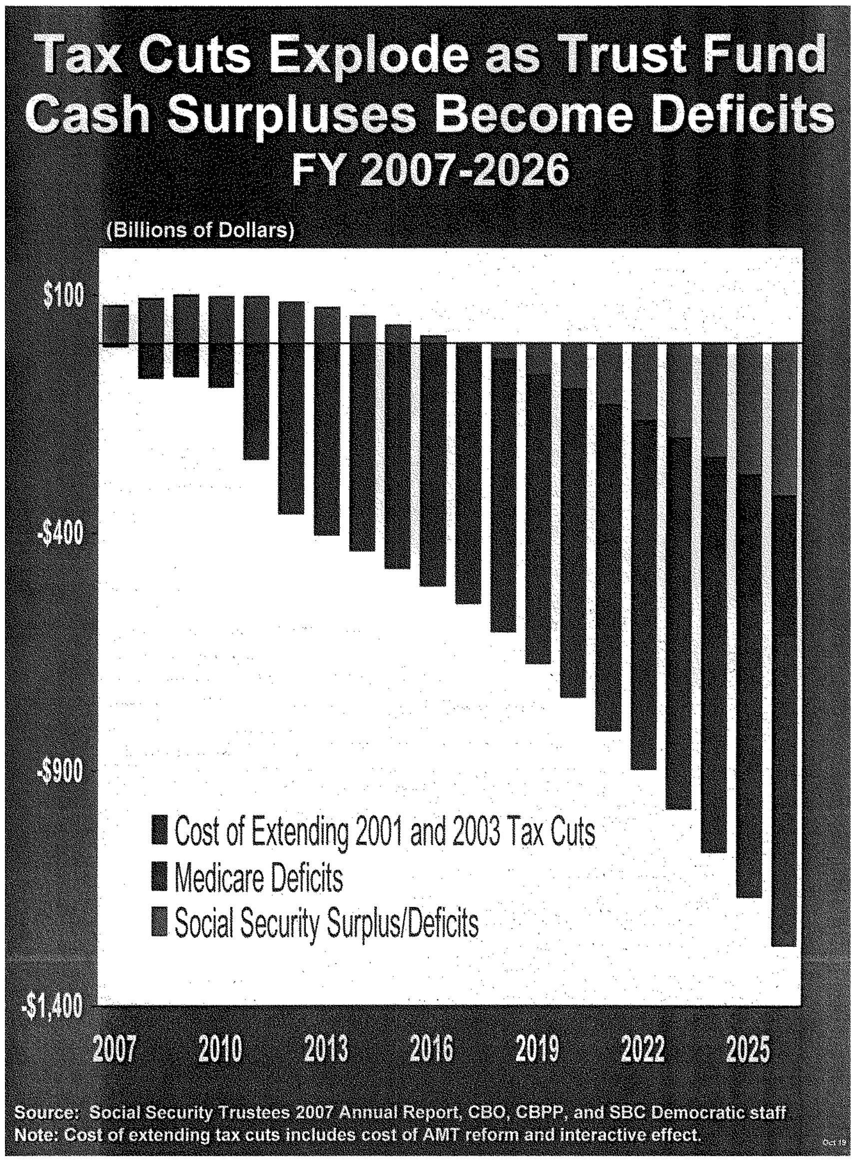
Let's go to the next slide, if we can. Looking at CBO's long-term budget outlook, we now see by 2050 that 12 percent of all Federal spending will go just to Medicare and Medicaid—by 2050, according to CBO's latest estimates. This is actually somewhat better than their previous estimates, but, nonetheless, Federal Government spending is about 20 percent of GDP now. To have just two items—just two—take up 12 percent of GDP, and this does not include Social Security, nothing for defense, nothing for parks, nothing for law enforcement, nothing for debt service, nothing for any of the other—look, we are on a course that is utterly unsustainable.



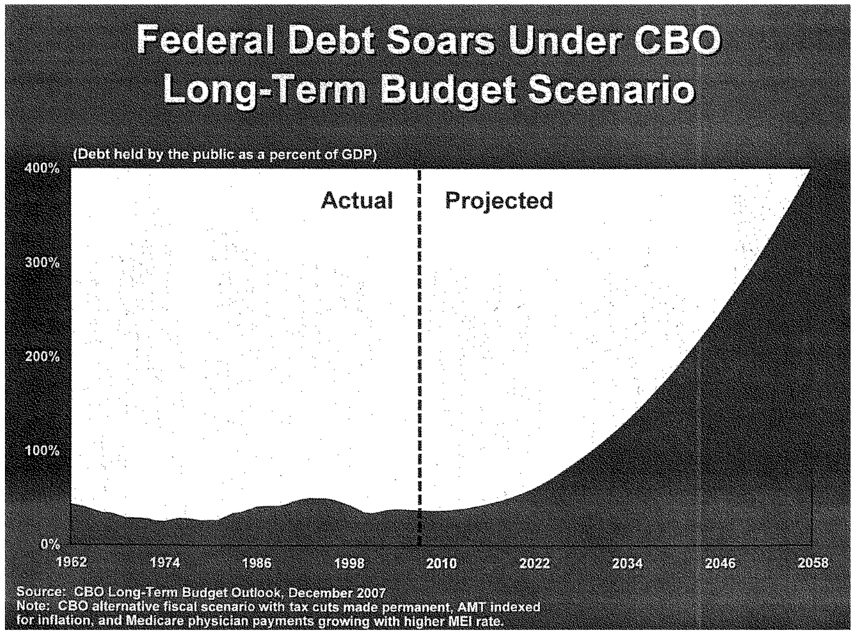
Let's go to the next slide, if we can. This is Director Orszag's testimony before this Committee last June, and he said, "There are a variety of health care reform approaches that hold promise. One of the challenges we have is that I have not seen a comprehensive plan that would credibly bend the cost curve sustainably over the long term. So one of the challenges, we need to be trying different things, seeing what works and then readjusting as we figure it out. And the sooner we start that, the better off we are going to wind up being."



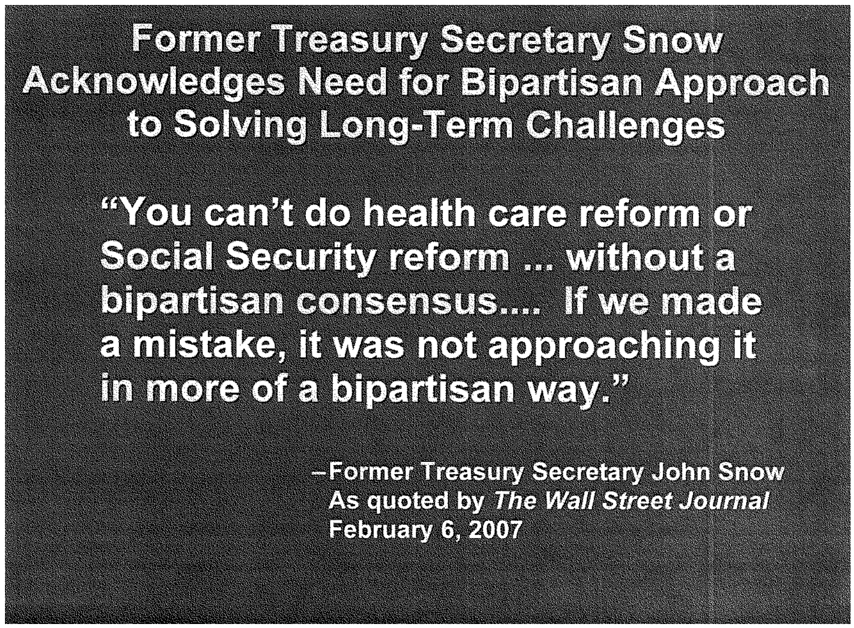
Let's go to the next slide, if we can. This is on the question of tax cuts. The President called last night for making the tax cuts permanent but not paying for them. If we do that, the cost of the tax cuts explodes at the very time the trust fund cash surpluses turn to deficit. This is looking at the period 2007 to 2026, and we can see we just go right over the cliff. So this is not going to work.



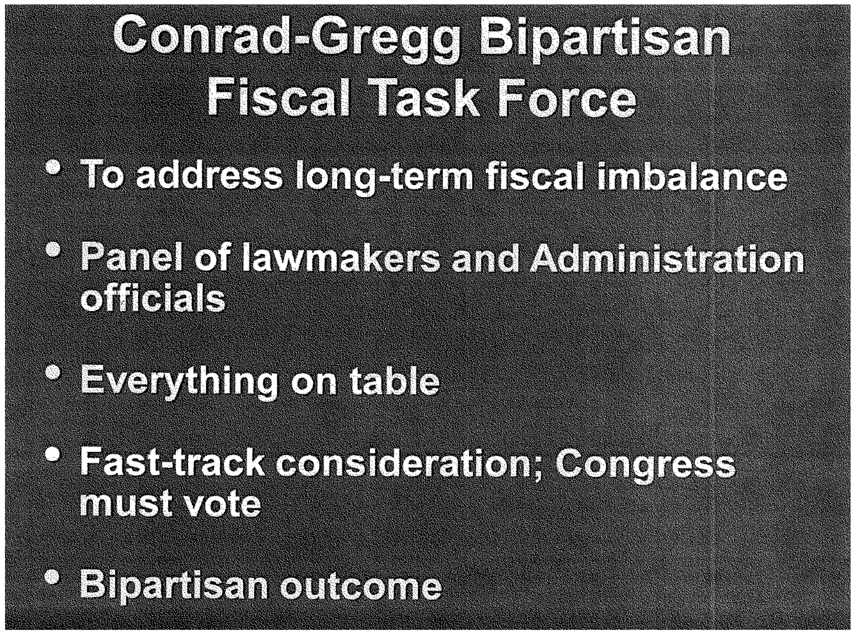
When we look at the Federal debt, under CBO's long-term budget scenario we see where we are now, but we see where we are headed. The debt absolutely explodes.



The former Treasury Secretary told us this. Former Treasury Secretary Snow acknowledged the need for a bipartisan approach to solving our long-term challenges. He said, "You cannot do health care reform or Social Security reform without a bipartisan consensus. If we made a mistake, it was not approaching it in a more bipartisan way."



That brings me to the proposal that the Ranking Member Senator Gregg and I have made on a fiscal task force to address the long-term fiscal imbalance: 16 members—8 Democrats, 8 Republicans; everything on the table; and an assurance that if 12 of the 16 could agree, it would come to a vote in the U.S. Congress. That would assure a bipartisan outcome because we would require a super majority of the committee, 12 of the 16, to report a plan and a bipartisan vote in both the House and the Senate.



I announced at our last meeting that it will be my intention to bring this to a markup this year in this Committee, and I know there is controversy surrounding that. We know that we are going to have to change the timing of what was in our proposal last year because that was really geared to this year. We know that a number of the Presidential candidates have now affirmatively endorsed this approach. Governor Romney and Senator Obama have both affirmatively endorsed this approach. Senator Clinton has endorsed a commission approach. We welcome that. We would urge the other Presidential candidates to come forward and indicate support for this kind of approach as well because there is really no alternative.

Let's face it. We have to do something, and in the early period of the next administration, that is the time to act. This will bedevil the next administration, whoever it is, unless they face up to it. Can you imagine the squeeze that the next administration will face on every domestic priority with—as more and more of the baby boomers retire and we get closer and closer to the point of insolvency, this will be the opportunity. And we cannot let it pass.

With that, I want to call on Senator Gregg, the very able Ranking Member of this Committee. Senator Gregg?

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Senator Conrad, and let me associate myself with especially your final comments relative to the need to do something now and the use of this approach of the task force as a procedure to force policy in a bipartisan and fair way, which are the two operative words here that will allow us to make progress.

I also want to associate myself with your comments relative to the Comptroller General and his great assistance in this effort, really being on the point, and I thank his wife, as Senator Conrad did, for her forbearance and tolerance in allowing her husband to do public service and such important public service. It is very much appreciated.

I want to join in the concern expressed by Senator Conrad that the numbers are not sustainable. Most of the numbers have come from Mr. Walker, General Walker, and they simply speak for themselves. And I know you are going to go through these numbers again for us, which is important, because although we understand them, the idea is to communicate them. And so even though it may seem a bit repetitious to some in this room, it is not repetitious to a lot of people. We are hearing it for the first time.

We as a generation, the baby-boom generation, have no right to pass on to our children less of a Nation than we received. But that is exactly what we are going to do if w do not address this issue. We will give them a Nation in fiscal meltdown, where their capacity to list as high a quality life as our generation has will simply be limited by the fact that they will have to support our generation at such levels with taxes or the burden of support that they will no longer be able to afford their first home, afford their college tuitions for their children, afford their opportunity to live the quality of life that we have lived. And that is not right for one generation to do to another generation, so it is our responsibility as the generation that is going to be causing the problem, the baby-boom generation that retires, to step forward with a solution.

That is why Senator Conrad and I have come up with this idea of allowing a process to set policy, to drive policy. We have come to the conclusion that everybody who puts policy on the table first ends up getting shot at by the different interest groups who want to make progress around here, on fundraising usually, but who have some axe to grind, and that putting policy on the table first simply does not work in our institution. But the only way to do this is to create a procedure which is viewed as absolutely fair, absolutely bipartisan; where nobody can game anybody; and where the decision of that process, the task force, is viewed by the public as fair, open and bipartisan; and that that decision by that task force, which will be a decision being made by people who understand the issues and who have skin in the game, so to say, will then be voted up and down by the Congress, and without amendment, the reason being that if you have amendments, everybody can go and hide behind an amendment. And we hopefully will, as a result of that, make very significant progress on these big issues and everything is on the table. All the entitlements are on the table, all the tax policy is on the table, with the idea that we would move significantly down the road toward reducing the burden on the next generation, on our children and our children's children. This is all about that—making sure that we pass on to them a viable Nation that they can afford.

And so I congratulate the Chairman of the Committee for being so aggressive in promoting this idea. We may disagree on some things, like tax policy, but we do not disagree on the need to have a procedure to reach an agreement here. And it has to be done sooner rather than later.

So we look forward to hearing from you, General, again, on your thoughts. We know that it is as a result of your efforts and the information that you have been putting out with your tour that the public is getting educated, and this is another opportunity to do that. Thank you for being here today.

Chairman CONRAD. I thank the Ranking Member for his statement, and, again, General Walker, we thank you for your contribution. You know, you would not have to do this, you would not have to stick your neck out, you would not have to go traveling around the country trying to alert the country about the risk of what is out there for our Nation. But you have taken on the responsibility, and we greatly admire you for it. General Walker?

STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. WALKER. Thank you, Chairman Conrad, Senator Gregg, other Senators. It is a pleasure to be back before you here today, and it is a privilege to be the sole witness before this important hearing. Thank you for your kind comments also about myself and my wife.

I want to thank Chairman Conrad, Senator Gregg, and others for their leadership in connection with this issue. As you know, it takes patience, persistence, perseverance, and ultimately pain before you prevail in a really important change effort. And this issue is no exception, but it is important that we prevail.

What I would like to do is submit my entire statement for the record and then use a quick PowerPoint presentation to make some key points and then make myself available for questions. But let me, before I begin the PowerPoint presentation, make a few comments.

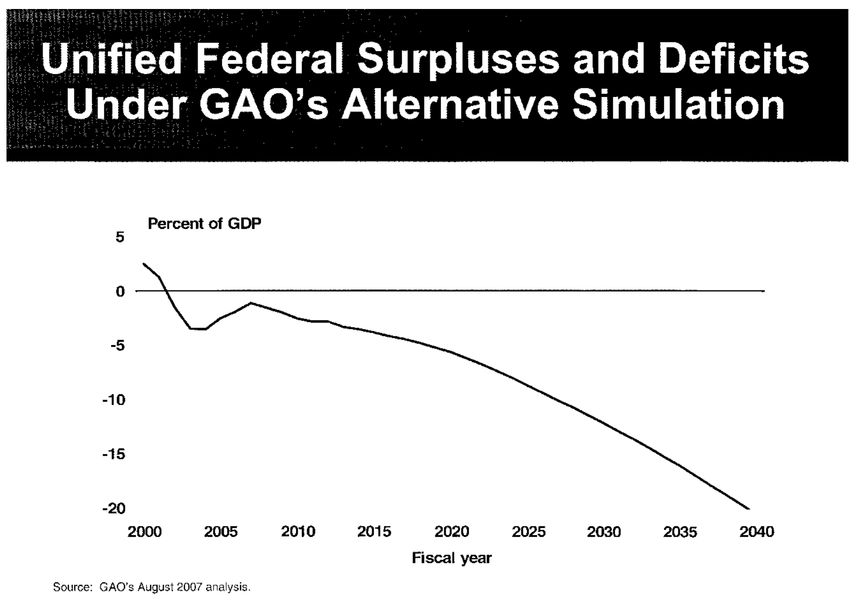
First, I was at the State of the Union last night, as I imagine most if not all of you were, and it is understandable that the Congress and the President are concerned about the current economic slowing of growth, and recent disruptions in the housing market and the capital markets. I believe that it is possible to do something with regard to a short-term stimulus while still being fiscally responsible. At the same time, I think it is critically important that such action be timely, targeted, and temporary. If something is done that meets those three criteria, then I think it would be understandable if Congress acted. But we must not be deluded to think that our problem is the short term because, quite frankly, we will have much, much, much bigger economic challenges in the future if we do not deal with our real problem, and that is our large and growing fiscal imbalance, which you will see, only grows with the passage of time.

Third, it is important that we figure out what is a proper way forward. I am going to mention two things out of many:

First, I think it is critically important that a capable, credible, and bipartisan task force or commission be formed as soon as possible in order to make recommendations to the next Congress and the next President for an up or down vote on this issue. This is critically important.

Second, I also think it is very important that this Congress enact legislation to improve transparency and accountability with regard to financial and budget matters. We are working with OMB, Treasury, and CBO to present a joint proposal within the next 2 to 3 months that I hope this Committee and others in Congress will favorably consider. I think it is very important because transparency is a powerful force.

Now, if I can, let me take you through these slides; my understanding is that all of you have a copy. At least I have asked for that to happen.

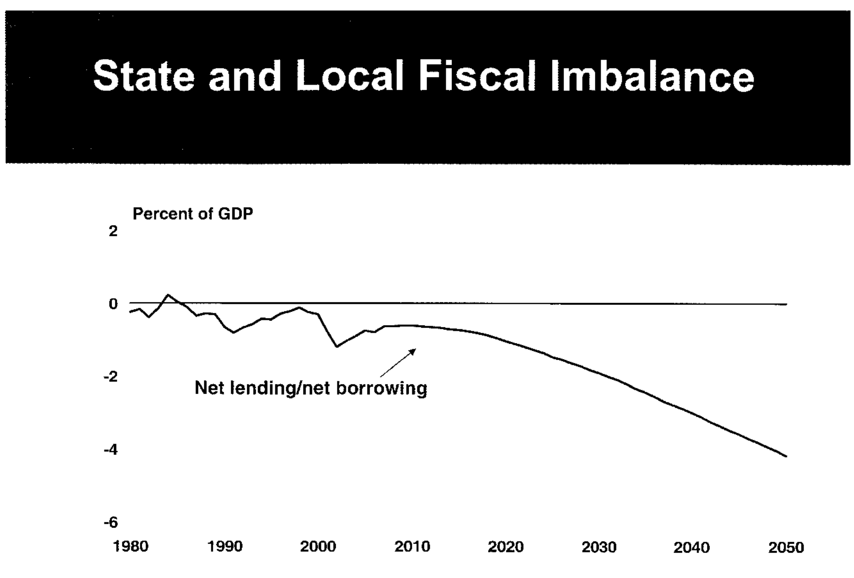


This is what the longer range looks like as it relates to the deficit as a percentage of our economy based upon reasonable assumptions. And, obviously, one can run different scenarios. The assumptions here are that we tax at historical rates of about 18.6 percent of the economy, which is roughly what we are taxing at now, and that is what we have taxed at on average over the last 40 years; that we do not reform Social Security and Medicare, which we need to, but we have not made any progress on that other than progress that digs the hole deeper, which was passage of Medicare Part D; and, third, that the rest of the budget, the so-called discretionary spending, grows by the rate of the economy. This is what you get. Not a pretty picture. And it is getting worse with the passage of time.

By the way, Mr. Chairman, let me just note for your benefit and the benefit of all the members that if you look at the composition of the Federal budget, about 38 percent of it is discretionary spending. And that is what is getting squeezed.

Now, what is interesting, when you read the Constitution of the United States—which I have one on my desk and I carry one with me in my briefcase everywhere I go. If you read the Constitution of the United States, you will find that every express and enumerated responsibility envisioned by the Founding Fathers for the Federal Government is in discretionary spending: national defense, homeland security, Federal judicial system, foreign policy, treasury function, Congress of the United States, Executive Office of the President. Those are the express and enumerated responsibilities envisioned by the Founding Fathers, and yet that is in the 38 percent portion of the budget. Stated differently, 62 percent is different things that are on autopilot, of which some is interest on the debt, which is mounting rapidly.

Next, if we look at the next chart, we will see, that although the Federal Government has a challenge, it is not the only challenge we face as a Nation. GAO for the first time 6 months ago did a long-range simulation for State and local governments in the aggregate. Now, some States are better off than others. We all know that. Some States have real balanced budget requirements; some have illusionary balanced budget requirements. For example, California, requires the Governor to submit a balanced budget but not for the State to actually have a balanced budget. They balance it the old-fashioned way, just like the Federal Government: they borrow to make up the gap. And so they have a serious problem going out. Other States have more honest balanced budget requirements.



Source: Historical data from National Income and Product Accounts; GAO analysis.

But what this shows is that within the next 10 years, just as with the Federal Government, State and local governments in the aggregate will face large and growing structural deficits, primarily for four reasons:

No. 1, Medicaid costs. And if there is one thing that could bankrupt America, it is health care costs. We are the only industrialized nation on Earth that essentially writes a blank check for health care. The only industrialized nation on Earth. We write a blank check for Medicare and Medicaid. It is imprudent, it is irresponsible, and it must change.

States also have a challenge with regard to unfunded retiree health care, underfunded pension plans, and deferred maintenance and other critical infrastructure needs. So for those reasons and others, our national challenge is actually greater than our Federal challenge.

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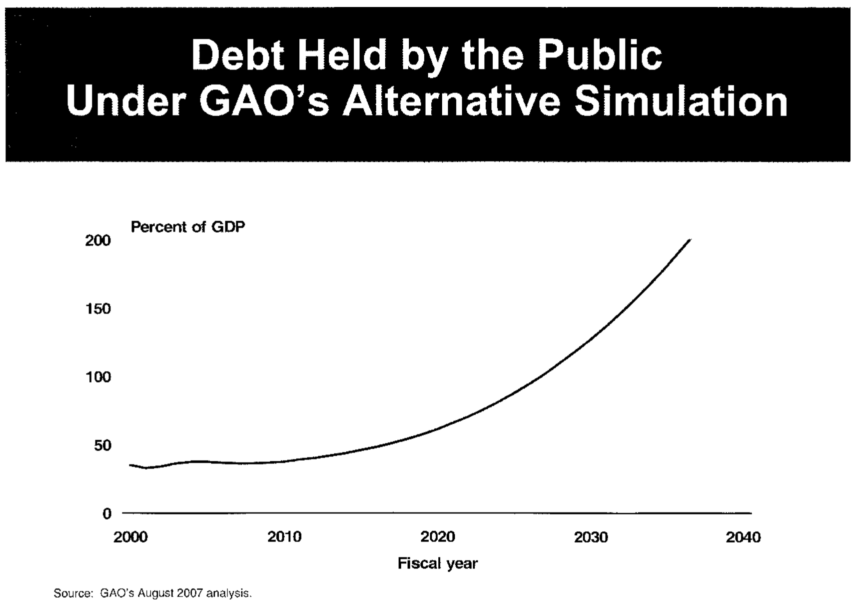
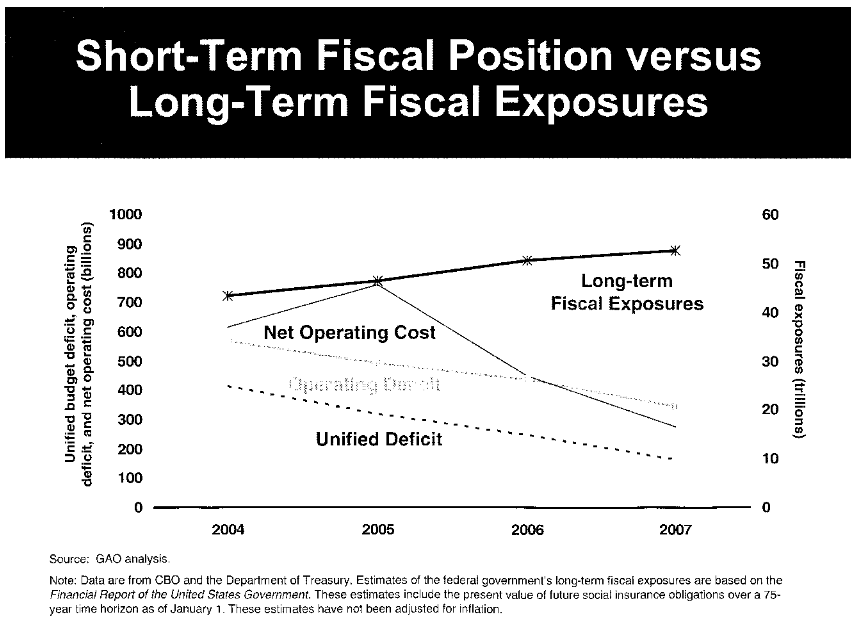


This shows you what is expected to happen on autopilot if we do not engage in fundamental reforms. This represents debt as a percentage of our economy. The all-time high in the history of the United States was about 109 percent of GDP in the aftermath of World War II. And, quite frankly, with World War II we were betting the ranch. We were betting the future of the free world in World War II, and so, therefore, we did whatever we had to do in order to make sure that we prevailed.

In today's situation, it is basically our addiction to debt. We run deficits in good times and bad. We are charging the national credit card, building up compound interest and expecting our kids and grandkids to pay it off—and many of them do not even have the right to vote because they are too young. So if you want to talk about taxation and representation, that is another way to talk about taxation without representation. These are unacceptable and unsustainable burdens and, quite frankly, the short-term burdens are really worse than advertised. You know why? Because we do not want to count debt held by the trust funds. The real debt-to-GDP ratio is about double what we advertise because some want to ignore the debt that is held in the trust funds. But guess what? That debt is real debt, too. And that debt will be honored by this Government. I mean, I have no doubt because, otherwise, that would represent a default as well—not only a default on our debt, but a default on the promise with regard to the excess revenues we have already received from Social Security beneficiaries that the government used to pay for other things.



Now, here is a challenge, a new graphic that I would like you to see, which is really important. You know, we have three ways of calculating the deficit. I would not say we have three sets of books, but we have three ways of calculating the deficit. We have the unified budget deficit, which is cash-based and last year was $163 billion. We have an operating deficit, which means that we ignore the Social Security surplus because we spend all of that on other government operating expenses. So the operating deficit last year was $344 billion. And then we have the accrual-based net operating cost. And you can see that no matter which measure you use, over the last 3 years they have come down, and that is good. Lower deficits are better than higher deficits.

But please look at the red line. The red line is on a march to the northeast corner of the graphic. That is our large and growing long-term fiscal exposures, our fiscal gap, the total liabilities and unfunded commitments of the United States, the difference between what we have promised for Social Security and Medicare and how much in payroll taxes, trust fund assets, and premiums that we are expected to receive for these programs. Namely how much money you would have to have today to deliver on those promises. And Medicare is short $34 trillion, while Social Security is short about $7 trillion.

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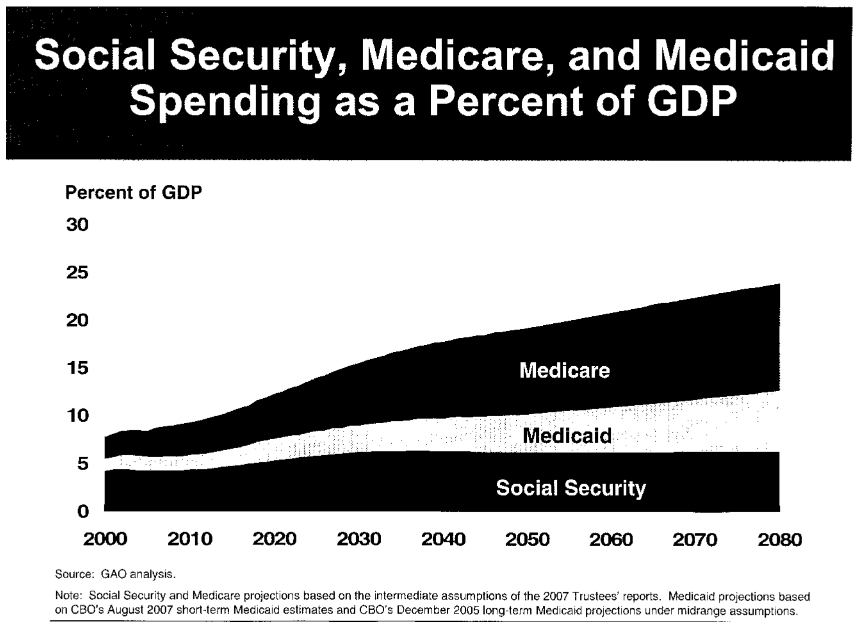

This is similar to the one that the Chairman showed, which shows Social Security, Medicare, and Medicaid are on a path to take up all of the Federal revenues based upon historical averages. This does not count interest on the Federal debt. This does not count national defense, homeland security, all those things that the Founding Fathers thought the Federal Government was going to do, and does do, but are increasingly getting squeezed.

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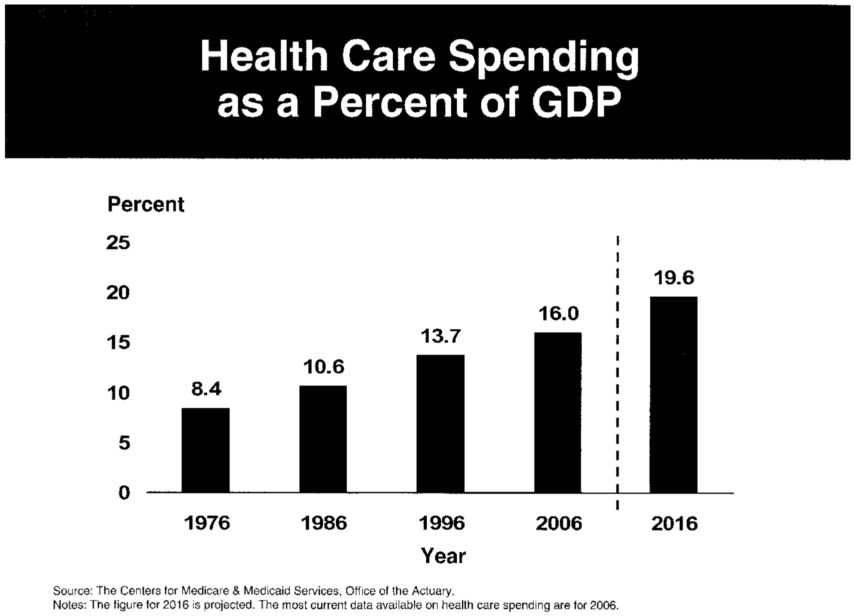
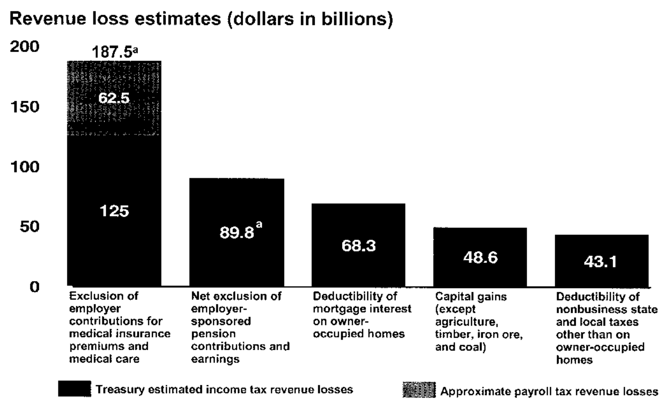


The real problem is health care. It is not demographics. I mean, demographics are a challenge. There is no question about that. But it is really health care. And if there is one thing that could bankrupt America, it is health care. It is the No. 1 challenge for the Federal Government. It is the No. 1 challenge for State governments. It is the No. 1 competitiveness challenge for American business. We spend a lot of money on health care, but we get below-average results for an industrialized nation—below-average results and yet we spend a lot more money.

This is how much of our economy we are dedicating to health care, and as I said, we spend a lot of money, but we get below-average results. I would say that is not very good value for money.

Health Care Was the Nation's Top Tax Expenditure in Fiscal Year 2006



Source: GAO analysis of OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2008.*

And, last, before I summarize, these are tax preferences. You know, there is a lot of time and effort spent discussing how much money we spend on direct spending, which is close to $3 trillion a year. But there is not enough time spent on the $800 to $900 billion in lost revenues that we incur every year because of tax preferences—deductions, exemptions, exclusions, credits. The No. 1 tax preference in the Internal Revenue Code is the fact that a vast majority of Americans do not pay income tax or payroll tax on the value of employer-provided and paid health care. It is almost $200 billion a year, the fastest-growing tax preference. And it disconnects people from the cost of health care, from the rising cost of health care.

Therefore, one of the things that we need to do is to put tax preferences on the radar screen that need to be part of any budget controls, that need to be periodically reviewed and potentially reauthorized, as we do on spending programs, because we cannot afford to keep $800 to $900 billion on autopilot either, just like we cannot afford to put $3 trillion worth of spending on autopilot.

So, in summary, in the short term deficits are coming down. Our problem is not the short-term deficit or even the current debt. It is where we are headed. We are headed for unprecedented rough seas that could swamp the ship of state if we do not get serious soon.

It is understandable that Congress and the administration want to do something with regard to fiscal stimulus in the short term to complement the Fed's monetary stimulus. But it needs to be temporary, targeted, and it needs to be timely. And, second, we cannot lose sight of the ball. I know you are a big baseball fan, Mr. Chairman. We need to keep our eye on the ball so we do not strike out.

The real problem is our large and growing structural imbalance that grows with the passage of time. If we balance the budget tomorrow, we still have a $53 trillion hole that grows by $2 to $3 trillion a year on autopilot.

And then, last, we need a task force or a commission. We need more transparency and accountability on the financial reporting and budgeting side. We at GAO look forward to working with you and your colleagues to try to make that a reality this year.

Thank you.

[The prepared statement of Mr. Walker follows:]

United States Government Accountability Office

GAO

Testimony
Before the Committee on the Budget, U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EST
Tuesday, January 29, 2008

LONG-TERM FISCAL OUTLOOK

Action Is Needed to Avoid the Possibility of a Serious Economic Disruption in the Future

Statement of David M. Walker
Comptroller General of the United States

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GAO-08-411T

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Highlights

Highlights of GAO-08-411T, a testimony before the Committee on the Budget, U.S. Senate

Why GAO Did This Study

GAO has for many years warned that our nation is on an imprudent and unsustainable fiscal path.

During the past 3 years, the Comptroller General has traveled to 25 states as part of the Fiscal Wake-Up Tour. Members of this diverse group of policy experts agree that finding solutions to the nation's long-term fiscal challenge will require bipartisan cooperation, a willingness to discuss all options, and the courage to make tough choices.

At the request of Chairman Conrad and Senator Gregg, the Comptroller General discussed the long-term fiscal outlook, our nation's huge health care challenge, and the shrinking window of opportunity for action.

To view the full product, including the scope and methodology, click on GAO-08-411T. For more information, contact Susan J. Irving at (202) 512-9142 or irvings@gao.gov.

January 29, 2008

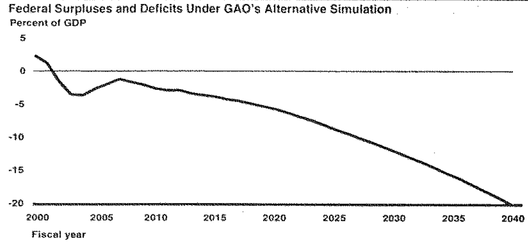
LONG-TERM FISCAL OUTLOOK

Action Is Needed to Avoid the Possibility of a Serious Economic Disruption in the Future

What GAO Found

As we enter 2008, what we call the long-term fiscal challenge is not in the distant future. Already the first members of the baby boom generation have filed for early Social Security retirement benefits—and will be eligible for Medicare in only 3 years. Simulations by GAO, the Congressional Budget Office (CBO), and others all show that despite a 3-year decline in the budget deficit, we still face large and growing structural deficits driven primarily by rising health care costs and known demographic trends. Under any plausible scenario, the federal budget is on an imprudent and unsustainable path.

Federal Surpluses and Deficits Under GAO's Alternative Simulation



Source: GAO's August 2007 analysis.

Rapidly rising health care costs are not simply a federal budget problem; they are our nation's number one fiscal challenge. Growth in health-related spending is the primary driver of the fiscal challenges facing the state and local governments. Unsustainable growth in health care spending is a systemwide challenge that also threatens to erode the ability of employers to provide coverage to their workers and undercut our ability to compete in a global marketplace. Addressing the unsustainability of health care costs is a societal challenge that calls for us as a nation to fundamentally rethink how we define, deliver, and finance health care in both the public and the private sectors.

The passage of time has only worsened the situation: the size of the challenge has grown and the time to address it has shrunk. The longer we wait the more painful and difficult the choices will become, and the greater the risk of a very serious economic disruption.

It is understandable that the Congress and the administration are focused on the need for a short-term fiscal stimulus. However, our long-term challenge increases the importance of careful design of any stimulus package—it should be timely, targeted, and temporary. At the same time, creating a capable and credible commission to make recommendations to the next Congress and the next president for action on our longer-range and looming fiscal imbalance is called for.

Chairman Conrad, Senator Gregg, and Members of the Committee:

I appreciate this invitation to talk with you about our nation's long-term fiscal outlook as we enter 2008—and the challenge it continues to present for the future of America and Americans. Your decision to dedicate a hearing to this important issue again demonstrates the seriousness with which you and this Committee view our nation's large and growing fiscal challenge. Senators Conrad and Gregg, thank you for your leadership.

I wish I could say the long-term outlook is different than when I last appeared before you on Halloween—but as all of you know, it is not. Under any plausible scenario, the federal budget is on an imprudent and unsustainable path. Long-term fiscal simulations by GAO, the Congressional Budget Office (CBO), and others all show that despite a 3-year decline in the federal government's unified budget deficit, we still face large and growing structural deficits driven primarily by rising health care costs and known demographic trends. The passage of time only serves to worsen this situation: the size of the challenge has grown and the time to address it has shrunk. Already the first members of the baby boom generation have filed for early Social Security retirement benefits—and will be eligible for Medicare in only 3 years. Although Social Security is important because of its size, the real driver of the long-term fiscal outlook is health care spending. Medicare and Medicaid are both large and projected to continue growing rapidly in the future.

Everyone on this Committee is well aware of the nature and importance of the challenge we face. Today, therefore, I will emphasize a few key points:

- Although recent declines in the annual budget deficit are good news, our longer-term fiscal outlook is worse—and absent meaningful action we will face spiraling levels of debt.
- Our long-term fiscal challenge is primarily a health-care challenge.
- We face an increasing need and yet a shrinking window of opportunity for action.

My remarks are based on GAO's previous work, including various reports and testimonies on our nation's long-term fiscal challenges, health care, and the need for budget process reform. These efforts were conducted in accordance with generally accepted government auditing standards.

Despite Several Years of Declining Annual Budget Deficits, the Long-Term Outlook Has Worsened

Between fiscal years 2003 and 2007 the unified budget deficit declined. Certainly declining deficits are better than rising deficits. But this decline in the unified deficit is not an indicator that our challenge has eased. First, even this short-term deficit is understated: It masks the fact that the federal government has been using the Social Security surplus to offset spending in the rest of government for many years. If we exclude that Social Security surplus, the on-budget deficit—what I call the operating deficit—in fiscal year 2007 was more than double the size of the unified deficit. For example, the Department of the Treasury (Treasury) reported a unified deficit of $163 billion and an on-budget deficit of $344 billion in fiscal year 2007. The accrual-based net operating deficit reported in the *Financial Report of the United States Government* was also significantly higher than the unified deficit—$276 billion for fiscal year 2007. This measure provides more information on the longer-term implications of today's policy decisions and operations than does either cash-based figure, but it too offers an incomplete picture of the long-term fiscal challenge.[1]

As we recently reported,[2] several countries have begun preparing fiscal sustainability reports to help assess the implications of their public pension and health care programs and other challenges in the context of overall sustainability of government finances. European Union members also annually report on longer-term fiscal sustainability. The goal of these reports is to increase public awareness and understanding of the long-term fiscal outlook in light of escalating health care cost growth and population aging, to stimulate public and policy debates, and to help policymakers make more informed decisions. These countries used a variety of measures, including projections of future revenue and spending and summary measures of fiscal imbalance and fiscal gaps, to assess fiscal sustainability. Last year, we recommended that the United States should

[1]For a discussion of how the accrual and cash deficits relate to each other, see GAO, *Understanding Similarities and Differences between Accrual and Cash Deficits*, GAO-07-117SP (Washington, D.C.: December 2006) and forthcoming update.

[2]GAO, *Budget Issues: Accrual Budgeting Useful in Certain Areas but Does Not Provide Sufficient Information for Reporting on Our Nation's Longer-Term Fiscal Challenge*, GAO-08-206 (Washington, D.C.: Dec. 20, 2007).

prepare and publish a long-range fiscal sustainability report every 2 to 4 years.[3]

Despite these improvements in short-term deficits, the long-term outlook continued to move in the wrong direction. Even in 2001—in a time of annual surpluses—GAO's long-term simulations showed a long-term challenge, but at that time it was more than 40 years out. Although an economic slowdown, decisions driven by the attacks of 9/11, and the need to respond to natural disasters have contributed to the change in outlook, they do not account for the dramatic worsening in the long-term outlook since 2001. Subsequent tax cuts and the passage of the Medicare prescription drug benefit in 2003 were also major factors, but they are not the only actions that challenge fiscal discipline. For example, one might also question the current farm bill in the face of reported record farm income.

As the Committee knows, CBO's latest projections show the deficit rising in response to a weakening economy. Neither this increase nor the recent declines tell us much about our long-term path. Rather, our long-term path must inform how we deal with the near-term weakness.

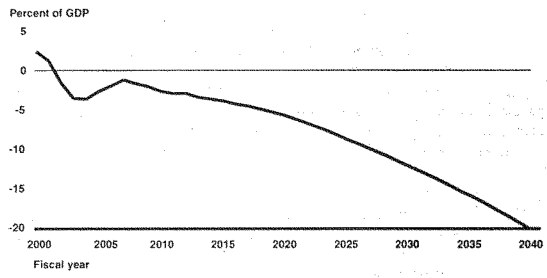
Our real challenge then is not this year's deficit or even next year's; it is how to change our current path so that growing deficits and debt levels do not swamp our ship of state. Health care costs are still growing much faster than the economy and our population is still aging. The retirement of the baby boom generation and the rising health care costs will soon place unprecedented and long-lasting stress on the federal budget, raising debt held by the public to unsustainable levels.

Figure 1 shows GAO's simulation of the deficit path based on recent trends and policy preferences. In this we assume that the expiring tax cuts are extended through 2017—and then revenues are brought to their historical level as a share of gross domestic product (GDP)—that discretionary

[3]GAO, *Long-Term Fiscal Challenge: Additional Transparency and Controls Are Needed,* GAO-07-1144T (Washington, D.C.: July 25, 2007), and *Long-Term Budget Outlook: Deficits Matter—Saving Our Future Requires Tough Choices Today,* GAO-07-389T (Washington, D.C.: Jan. 23, 2007).

spending grows with the economy and no structural changes are made to Social Security, Medicare, or Medicaid.[4]

Figure 1: Unified Federal Surpluses and Deficits Under GAO's Alternative Simulation



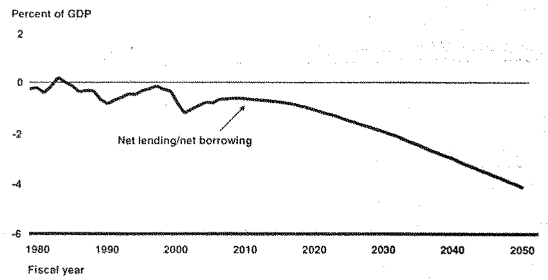
Source: GAO's August 2007 analysis.

Rapidly rising health care costs are not simply a federal budget problem; they are our nation's number one fiscal challenge. As shown in figure 2, GAO's fiscal model demonstrates that state and local governments—absent policy changes—will also face large and growing fiscal challenges beginning within the next few years.[5] As is true for the federal budget, growth in health-related spending—Medicaid and health insurance for state and local employees and retirees—is the primary driver of the fiscal challenges facing the state and local governments.

[4]Social Security and Medicare spending are based on the 2007 Trustees' intermediate projections. Medicare spending is adjusted using the Centers for Medicare and Medicaid Services' estimates assuming that physician payments are not reduced as required under current law. Medicaid spending is based on CBO's December 2005 long-term projections under midrange assumptions. Additional information about GAO's simulation model, assumptions, data, and results can be found at http://www.gao.gov/special.pubs/longterm/.

[5]See GAO, *State and Local Governments: Growing Fiscal Challenges Will Emerge During the Next 10 Years*, GAO-08-317 (Washington D.C.: Jan. 22, 2008), and *State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge within the Next Decade*, GAO-07-1080SP (Washington, D.C.: July 18, 2007).

Figure 2: State and Local Fiscal Imbalance

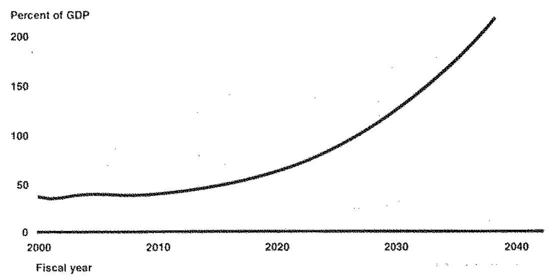


Source: Historical data from National Income and Product Accounts; GAO analysis.

Note: The state and local net lending/net borrowing measure is similar to the federal unified budget surplus/deficit in that it includes all governmental receipts and all expenditures.

For the federal government increased spending and rising deficits will drive a rising debt burden. At the end of fiscal year 2007, debt held by the public exceeded $5.0 trillion. Figure 3 shows that this growth in our debt cannot continue unabated without causing serious harm to our economy. But this is only part of the story. The federal government has been spending the surpluses in the Social Security and other trust funds for years; if we include debt held by those funds, our total debt is much higher—$9.0 trillion. On September 29, 2007, the statutory debt limit had to be raised for the third time in 4 years; between the end of fiscal year 2003 and the end of fiscal year 2007 the debt limit had to be increased by one-third. Although borrowing by one part of the federal government from another may not have the same economic and financial implications as borrowing from the public, it represents a claim on future resources and hence a burden on future taxpayers and the future economy.

Figure 3: Debt Held by the Public Under GAO's Alternative Simulation



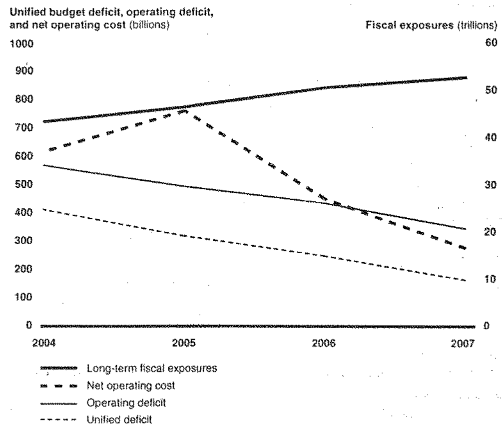
Source: GAO's August 2007 analysis.

As alarming as the size of our current debt is, it excludes many items, including the gap between future promised and funded Social Security and Medicare benefits, veterans' health care, and a range of other commitments and contingencies that the federal government has pledged to support. If these items are factored in, the total burden in present value dollars is estimated to be about $53 trillion.[6] I know it is hard to make sense of what "trillions" means. One way to think about it is this: Imagine we decided to put aside and invest today enough to cover these promises tomorrow. It would take approximately $455,000 per American household—or $175,000 for every man, woman, and child in the United States.

Clearly, despite some progress in addressing our short-term deficits, we have not made progress on our long-term fiscal challenge. In fact, we have lost and continue to lose ground absent meaningful action (see fig. 4).

[6] The total burden is estimated based on the federal government's liabilities, commitments, and contingencies, including the present value of future Social Security and Medicare benefits as reported in the fiscal year 2007 *Financial Report of the United States Government*.

Figure 4: Short-Term Fiscal Position versus Long-Term Fiscal Exposures



Source: GAO analysis.

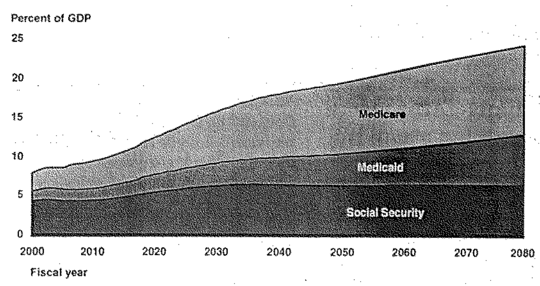
Notes: Data are from CBO and Treasury. Estimates of the federal government's long-term fiscal exposures are based on the *Financial Report of the United States Government*. These estimates include the present value of future social insurance obligations over a 75-year time horizon as of January 1. These estimates have not been adjusted for inflation.

Our Long-Term Fiscal Outlook Is Driven by Health Care

Although Social Security is a major part of the fiscal challenge, it is far from our biggest challenge. Spending on Medicare and Medicaid represents a much larger, faster growing, and more immediate problem. In fact, the federal government's obligations for Medicare Part D alone exceed the unfunded obligations for Social Security. Health care spending systemwide continues to grow at an unsustainable pace, eroding the ability of employers to provide coverage to their workers and undercutting their ability to compete internationally. Finally, despite spending far more of our economy on health care than other nations, the United States has above average infant mortality, below average life expectancy, and the largest percentage of uninsured individuals. In short, our health care system is badly broken.

Medicare and Medicaid spending threaten to consume an untenable share of the budget and economy in the coming decades. The federal government has essentially written a "blank check" for these programs. In contrast, other industrialized nations have put their health care programs on a budget, even ones with national health care plans. We should consider imposing limits on federal spending for health care sooner rather than later. Figure 5 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Although Social Security in its current form will grow from 4.2 percent of GDP today to 6.3 percent in 2080, Medicare and Medicaid's burden on the economy will almost quadruple—from 4.7 percent to 17.7 percent of the economy. Unlike Social Security, which grows larger as a share of the economy and then levels off, Medicare and Medicaid continue to grow during this projection period. Furthermore, these projections assume growth in Medicare and Medicaid spending of GDP per capita plus about 1 percent on average—a rate that is significantly below recent historical experience of about 2.5 percent above GDP per capita. But even with this "optimistic" assumption, the outlook is daunting. It is clear that health care is the main driver of our long-term challenge. In fact, if there is one thing that could bankrupt America, it's runaway health care costs. We must not allow that to happen.

Figure 5: Social Security, Medicare, and Medicaid Spending as a Percent of GDP



Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

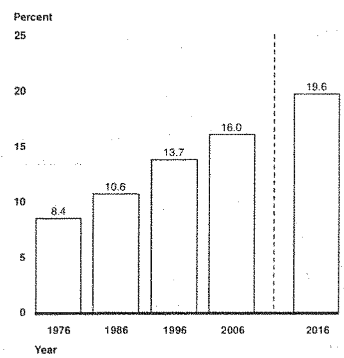
Notes: Social Security and Medicare projections are based on the intermediate assumptions of the 2007 Trustees' reports. Medicaid projections are based on CBO's August 2007 short-term Medicaid estimates and CBO's December 2005 long-term Medicaid projections under midrange assumptions.

Changing the path of health care spending is much more complicated than dealing with Social Security. Unlike Social Security, Medicare spending growth rates reflect not only a burgeoning beneficiary population, but also the escalation of health care costs at rates well exceeding general rates of inflation. The growth of medical technology has contributed to increases in the volume and complexity of health care services, and information on the cost and quality of health care is not readily available.

Systemwide Growth in Health Care Spending Driven by Certain Factors

Public and private health care spending continues to rise because of increased medical prices and increased utilization due to growth in the number, or volume, of services per capita, and use of more intense, or complex, services. Moreover, the actual costs of health care consumption are not transparent. Consumers are largely insulated by third-party payers from the cost of health care decisions. As shown in figure 6, total health care spending is absorbing an increasing share of our nation's GDP. From 1976 through 2006, total public and private spending on health care grew from about 8 percent to 16 percent of GDP. Total health care spending is projected to grow to about 20 percent of GDP by 2016.

Figure 6: Health Care Spending as a Percent of GDP



Source: Centers for Medicare and Medicaid Services, Office of the Actuary.

Notes: The figure for 2016 is projected. The most current data available on health care spending are for 2006.

Addressing the unsustainability of health care costs is a major competitiveness and societal challenge that calls for us as a nation to fundamentally rethink how we define, deliver, and finance health care in both the public and the private sectors. A major difficulty is that our current system does little to encourage informed discussions and decisions about the costs and value of various health care services. These decisions are very important when it comes to cutting-edge drugs and medical technologies, which can be very expensive but offer no advantage over their alternatives.

Medical technology is a major contributor to growth in health care spending. For example, one study found that the average amount spent per heart attack case increased nearly $10,000 per case after controlling for inflation, or 4.2 percent real growth per year between 1984 and 1998.[7] Nearly half of the cost increases resulted from people getting more intensive technologies—such as cardiac catheterization—over time. In some cases, new technology can lead to overdiagnosis and the excessive use of resources. One study cites the use of spinal magnetic resonance imaging (MRI) as one example.[8] Researchers find that diagnostic spinal MRI sometimes reveals abnormalities having no clinical relevance. According to the study, some physicians act on this information and perform unnecessary surgery that can lead to complications.

Obesity, smoking, and other population risk factors can lead to expensive chronic conditions; the increased prevalence of such conditions—for example, diabetes and heart disease—drives growth in the utilization of health care resources and therefore in spending. Obesity has been the subject of several recent studies focusing on associated health care cost increases. For example, one study attributes 27 percent of the growth in inflation-adjusted per capita spending between 1987 and 2001 to the rising prevalence of obesity and higher relative per capita spending among obese individuals.[9]

[7]David M. Cutler and Mark McClellan, "Is Technological Change in Medicine Worth It?" *Health Affairs*, vol. 20, no. 5 (September/October 2001).

[8]See Richard A. Deyo, "Cascade Effects of Medical Technology," *Annual Review of Public Health*, vol. 23 (May 2002).

[9]Kenneth E. Thorpe et al., "The Impact of Obesity on Rising Medical Spending," *Health Affairs Web Exclusive*, http://content.healthaffairs.org/cgi/content/abstract/hlthaff.w4.480 (Oct. 20, 2004).

Fundamental Challenges in Containing Health Care Spending Growth

Both public and private payers face fundamental challenges in the struggle to contain health care spending growth. One of the challenges involves the unbridled use of technology and society's unmanaged expectations. Experts note that the nation's general tendency is to treat patients with available technology when there is the slightest chance of benefit to the patient, even though the costs may far outweigh the benefit to society as a whole. They note that the discipline of technology assessment has not kept pace with technology advancements.[10]

Today's employers, which finance a substantial share of the health care of the privately insured population, are seeking more information on health care technology costs and benefits. Although the Food and Drug Administration (FDA), for example, evaluates new medical products based on safety and efficacy data submitted by manufacturers, it does not evaluate whether the new products are cost-effective compared with existing products used for the same treatment indications. In turn, Medicare, which generally relies on FDA approval decisions, does not evaluate whether new technologies are superior, either clinically or economically, compared with technologies already covered and paid for by the program. Further exacerbating the situation, consumers, spurred by advertising and the Internet, demand access to new medical technology without knowledge of its value, safety, or efficacy.

Another cost containment challenge for all payers relates to the market dynamics of health care compared with other economic sectors. In an ideal market, informed consumers prod competitors to offer the best value. However, without reliable comparative information on medical outcomes, quality of care, and cost, consumers are less able to determine the best value. Insurance masks the actual costs of goods and services, providing little incentive for consumers to be cost-conscious. Similarly, clinicians must often make decisions in the absence of universal medical standards of practice. Under these circumstances, medical practices vary across the nation, as evidenced by wide geographic variation in per capita spending and outcomes, even after controlling for patient differences in health status.

[10]GAO, *Health Care: Unsustainable Trends Necessitate Comprehensive and Fundamental Reforms to Control Spending and Improve Value*, GAO-04-793SP (Washington, D.C.: May 2004).

Solutions to Health Care Cost Growth Are Likely to Be Incremental

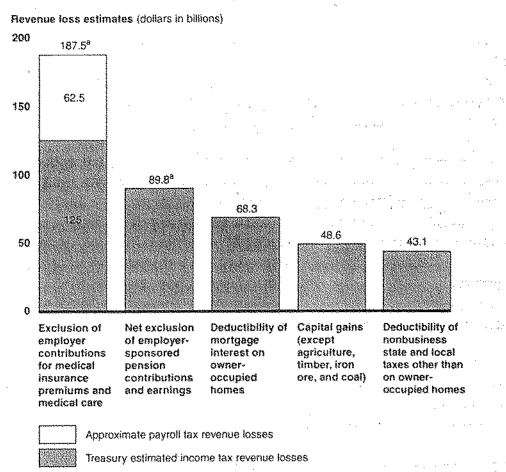
In recent years, policy analysts have discussed a number of incremental reforms aimed at moderating health care spending, in part by unmasking health care's true costs. Some call for devising new insurance strategies to make health care costs more transparent to patients. Currently, many insured individuals pay relatively little out of pocket for care at the point of delivery because of comprehensive health care coverage—precluding the opportunity to sensitize these patients to the cost of their care.

Other steps include reforming the policies that give tax preferences to insured individuals and their employers. These policies permit the value of employees' health insurance premiums to be excluded from the calculation of their taxable earnings and exclude the value of the premium from the employers' calculation of payroll taxes for both themselves and employees. Tax preferences also exist for health savings accounts and other consumer-directed plans. These tax exclusions represent a significant source of forgone federal revenue and work at cross-purposes to the goal of moderating health care spending.

Proposals have been made to better target tax preferences to low-income individuals and to change the tax treatment to allow consumers the same tax advantages whether they receive their health insurance through their employers or purchase it on their own.

As figure 7 shows, in 2006 the tax expenditure responsible for the greatest revenue loss was that for the exclusion of employer contributions for employees' insurance premiums and medical care.

Figure 7: Health Care Was the Nation's Top Tax Expenditure in Fiscal Year 2006



Source: GAO analysis of OMB, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2008.

[a]The value of employer-provided health insurance is excluded from Medicare and Social Security payroll taxes. Some researchers have estimated that payroll tax revenue losses amounted to more than half of the income tax revenue losses in 2004, and we use this estimate for 2006. The research we are aware of dealt only with health care, therefore the 50 percent figure may not apply to other items that are excluded from otherwise applicable income and payroll taxes.

Another area conducive to incremental change involves provider payment reforms. These reforms are intended to induce physicians, hospitals, and other health care providers to improve on quality and efficiency. For example, studies of Medicare patients in different geographic areas have found that despite receiving a greater volume of care, patients in higher use areas did not have better health outcomes or experience greater satisfaction with care than those living in lower use areas. Public and private payers are experimenting with payment reforms designed to foster the delivery of care that is proven to be both better clinically and more cost-effective. Ideally, identifying and rewarding efficient providers and encouraging inefficient providers to emulate best practices will result in better value for the dollars spent on care. The development of uniform standards of practice could lead to more cost-effective treatments designed to achieve the same outcomes.

The problem of escalating health care costs is complex because addressing federal programs such as Medicare and the federal-state Medicaid program will need to involve change in the health care system of which they are a part—not just within federal programs. This will be a major societal challenge that will affect all age groups. Because our health care system is complex, with multiple interrelated pieces, solutions to health care cost growth are likely to be incremental and require a number of extensive efforts over many years. In my view, taking steps to address the health care cost dilemma systemwide puts us on the right path for correcting the long-term fiscal problems posed by the nation's health care entitlements. I have suggested in the past that we consider four elements as pillars of any major health care reform effort:

- Provide universal access to basic and essential health care.
- Impose limits on federal spending for health care.
- Implement national, evidence-based medical practice standards to improve quality, control costs, and reduce litigation risks.
- Take steps to ensure that all Americans assume more personal responsibility and accountability for their own health and wellness.

As a nation, we need to weigh unlimited individual wants against broader societal needs and decide how responsibility for financing health care should be divided among employers, individuals, and government in an affordable and sustainable manner. Ultimately, we may need to define a set of basic and essential health care services to which every American is ensured access. Individuals wanting additional services, and insurance coverage to pay for them, would have that choice but would be required to allocate their own resources. Clearly, such a dramatic change would require a long transition period—all the more reason to act sooner rather than later.

The Window of Opportunity Is Narrowing

As we enter 2008, what we call the long-term fiscal challenge is not in the distant future. In fact, the first baby boomers already have filed for early retirement benefits and will be eligible for Medicare benefits in less than 3 years. The budget and economic implications of the baby boom generation's retirement have already become a factor in CBO's 10-year baseline projections and that impact will only intensify as the baby boomers age. As the share of the population over 65 climbs, demographics will interact with rising health care costs. The longer we wait, the more painful and difficult the choices will become. Simply put, our nation is on an imprudent and unsustainable long-term fiscal path that is getting worse with the passage of time.

The financial markets are noticing. Approximately 3 years ago, Standard and Poor's issued a publication stating that absent policy changes, the U.S. government's debt-to-GDP ratio was on track to mirror ratios associated with speculative-grade sovereigns. Within the last month, Moody's Investors Service issued its annual report on the United States. In that report, they noted their concern that absent Medicare and Social Security reforms, the long-term fiscal health of the United States and our current Aaa bond rating were at risk. These not too veiled comments serve to note the significant longer-term interest rate risk that we face absent meaningful action to address our longer-range challenge as well. Higher longer-term interest costs would only serve to complicate our fiscal, economic, and other challenges in future years.

As you are aware, during the past 3 years, I have traveled to 25 states as part of the Fiscal Wake-Up Tour. During the tour, it has become clear that the American people are starved for two things from their elected officials—truth and leadership.

Last fall, I was pleased to join you when you announced your proposal to create a Bipartisan Task Force for Responsible Fiscal Action.[11] As I said at the time, I believe it offers one potential means to achieve an objective we all should share: taking steps to make the tough choices necessary to keep America great and to help make sure that our country's, children's, and grandchildren's future is better than our past. By introducing your proposal to create a Bipartisan Task Force for Responsible Fiscal Action, you have shown the kind of leadership that is essential for us to successfully address the long-term fiscal challenge that lies before us. And I want to note you are not alone. Several other members on both sides of

[11]The Bipartisan Task Force for Responsible Fiscal Action Act of 2007 (S. 2063, Sept. 18, 2007) would establish a task force to address, and report to the President and Congress on, the nation's long-term fiscal imbalances, including those attributable to the Medicare and Social Security programs and the gap between their projected revenues and expenditures. Representatives Cooper and Wolf have also introduced a companion bill to the Conrad-Gregg proposal (H.R. 3655, Sept. 25, 2007).

the political aisle and on both sides of Capitol Hill have also introduced legislation seeking to accomplish similar objectives.[12]

But we do need to act. The passage of time is shrinking the window for action. Albert Einstein said the most powerful force in the universe is compound interest and today the miracle of compounding is working against us. After 2009 the Social Security cash surplus—which has cushioned and masked the impact of our imprudent fiscal policy—will begin to shrink, putting pressure on the rest of the budget. The Medicare Hospital Insurance trust fund is already in a negative cash flow situation. I hope we do not wait to act until the Social Security trust fund turns to negative cash flow in 2017. Demographics narrow the window for other reasons as well. People need time to prepare for and adjust to changes in benefits. There has been general agreement that there should be no change in Social Security benefits for those currently in or near retirement. If we wait until the baby boom generation has retired, that becomes much harder and much more expensive.

Mr. Chairman, Senator Gregg, Members of the Committee, meeting this long-term fiscal challenge overarches everything. It is our nation's largest sustainability challenge, but it is not our only one. If we want to position the United States to meet the challenges of this century both abroad and at home, we must also tackle other challenges, including reexamining what government does and how it does business. Last month, we published a new report that lays out a possible path for change. The report is entitled *A Call for Stewardship: Enhancing the Federal Government's Ability to Address Key Fiscal and Other 21st Century Challenges.*[13] It provides 13 potential tools for Congress and the administration to use to begin to confront our long-term fiscal and other challenges. I hope you find this report useful in facilitating discussions and decisions about various challenges facing our great nation in the 21st century.

Today it is understandable that many Americans and their elected representatives are concerned about recent market declines and a slowing

[12]Senator Voinovich introduced The Securing America's Future Economy Commission Act (S. 304, Jan. 16, 2007), or SAFE Commission Act that would establish a commission, among other things, to develop legislation to address the imbalance between long-term federal spending commitments and projected revenues. Representatives Cooper and Wolf have also introduced a companion bill to the Voinovich proposal (H.R. 3654, Sept. 25, 2007).

[13]GAO-08-93SP (Washington, D.C.: Dec. 17, 2007).

economy. We have an obligation, however, to look at both the short term and the long term. Whatever Congress and the President decide to do in response to our current economic weakness, it is important to be mindful of the danger posed by our long-term fiscal path. This long-term challenge increases the importance of careful design of any stimulus package—it should be timely, targeted, and temporary.

Budgets, deficits, and long-term fiscal and economic outlooks are not just about numbers, they are also about values. It is time for all Americans, especially baby boomers to recognize our collective stewardship obligation for the future. In doing so, we need to act soon because time is working against us. We must make choices that may be difficult and unpleasant today to avoid passing an even greater burden on to future generations. Let us not be the generation that sent the bill for its conspicuous consumption to its children and grandchildren.

Thank you Mr. Chairman, Mr. Gregg, and Members of the Committee for having me today. We at GAO, of course, stand ready to assist you and your colleagues as you tackle these important challenges.

Contacts and Acknowledgments

For further information on this testimony, please contact Susan J. Irving at (202) 512-9142 or irvings@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. Individuals making key contributions to this testimony include Jay McTigue, Assistant Director, and Melissa Wolf.

Chairman CONRAD. Thank you, General Walker, for once again laying out, I think in a clear and concise way, the challenge that we confront.

Let me ask you this: I have had people say to me: "You guys are a bunch of Chicken Littles down there. 'The sky is falling, the sky is falling.' Nothing ever happens. Your deficit is only 1.2 percent of gross domestic product. That is well within historical norms. Aren't you guys just overstating the problem facing the country?"

What would you say in answer to people who have that view?

Mr. WALKER. First what I would say is it is absolutely true that our current deficit and debt levels are not a major problem. It is absolutely true that we have run larger deficits and have had higher debt levels as a percentage of our economy in the past than we do now. But it is also true that when you are trying to help make sure that we discharge our fiduciary and stewardship responsibilities to this great Nation, you should not just look in the rearview mirror; you should actually look ahead and find out where we are headed. And when you look ahead and find out where we are headed, based upon reasonable and realistic assumptions, we have never seen anything like what we are heading into. And there is absolutely no question that it is imprudent and unsustainable. There is absolutely no question we cannot grow our way out of the problem. And there is absolutely no question that it is going to take budget controls, entitlement reforms, spending reprioritization and constraint, and tax reform, and ultimately more revenues than 18.5 percent of GDP.

But, you know, we are going to have to do it, and the sooner we do it, the better, because in the end the default is probably higher taxes. And that is not good for economic growth, that is not good for disposable income, and that is not good for our competitive advantage.

Chairman CONRAD. Well, and really isn't the default position not only dramatically higher taxes, but very dramatic cuts in benefits? Because, I mean, if we fail to act, if we just wait—which some are suggesting. I hear this, you know, from some of my colleagues. Let's just kick this can down the road. You know, everybody is concerned about the next election, the next election, the next election. Let's just wait.

What is the risk of just continuing to kick the can down the road?

Mr. WALKER. First, Mr. Chairman, I would say it is fiscally irresponsible to do that, and it is politically less feasible to do that as time goes on—I am not an elected official. You are. But let me analyze it from my perspective.

The longer you wait, the bigger the gap is going to be, the more change you have to make, the less transition time you have, the more disruptive it is likely to be, and the greater the risk that we are going to have a serious economic disruption, not the kind of challenge we are seeing right now. Therefore, I think it is prudent to act sooner.

Second, I believe we have a 5- to 10-year window of opportunity to demonstrate to our foreign lenders that we are going to get serious about this—5 to 10 years, and it is closing. And I think it is closer to 5 than to 10.

The longer you wait, the more people are enfranchised in the status quo. And the people that are enfranchised in the status quo tend to be more politically active—namely, seniors. The people who are going to pay the price and bear the burden, younger people, tend to not be as informed and involved. Therefore, I think for fiscal reasons, for political reasons, for economic security reasons and otherwise, it is prudent to move sooner rather than later.

Keep in mind, we are the largest debtor nation in the history of mankind, and it is getting worse, not better.

Chairman CONRAD. What is the threat to the economy? You know, we talk about a need to act. You have just talked about a 5- to 10-year window to convince these international markets that the United States is going to be fiscally responsible. What is the threat to this economy of a failure to act?

Mr. WALKER. I think one of the most likely threats would be a reduction in the willingness of foreign lenders to continue to buy our debt at attractive rates that we have been able to finance our debt recently. If interest rates go up, that will have a compounding effect on the budget, a compounding effect on the economy, a compounding effect on American families. And, by the way, the scenarios that I just showed you do not assume a significant rise in interest rates. If there is a significant rise in interest rates, then we accelerate and compound our challenge.

Chairman CONRAD. Well, let me ask you this: So what if foreign lenders become less willing to extend credit to this country? Couldn't we just finance this internally? Couldn't we just borrow from ourselves?

Mr. WALKER. No. We are a great country, and Americans are a great people, and we are particularly great at spending. But, unfortunately, we are poor at saving. America has the lowest savings rate of any major industrialized nation. In the last 2 years, Americans spent almost everything that they made. We had close to a 0 personal savings rate in the last 2 years.

Now, why would you be concerned about that? Because with savings comes investment. With investment comes research and development. With that comes innovation and productivity increases. And with that comes an additional economic growth and additional competitive advantage. With that comes improvement in our standard of living. We are eating our seed corn. And there are a lot of American families that are following the bad example of their Federal Government. They are spending more money than they make. They are charging their credit cards, taking out home equity loans, building up debt and compound interest. You can do that for a little while. You cannot do that over the long run.

Chairman CONRAD. Well, the Government can do it because we can print money. What is the adverse effect of doing that?

Mr. WALKER. First, we are no longer the single reserve currency in the world. We have competitors, and they are likely to grow over time.

Second, some people say, well, don't worry about it, we will just print money and inflate our way out of the problem. As we all know, inflation is probably the cruelest tax of all. It affects people that are lower- and lower-middle-income worse than it does people that are middle- and upper-income.

Furthermore, we cannot inflate our way out of the problem, and here is why. Of the $53 trillion hole, only $9 trillion relates to current debt. You can inflate and decrease the burden associated with that $9 trillion, but the remaining $44 trillion is growing faster than inflation. Health care costs have grown about 2.6 faster than the economy, which grows faster than inflation. Social Security costs are indexed. They are indexed for inflation once you draw the benefit, and they are wage-indexed in determining your primary initial benefit.

You cannot grow your way out of this problem, and that is an illusion. So people who think that you can do not understand the programs and have not run the numbers.

Chairman CONRAD. The final point I would make, and I will then turn to Senator Gregg: These people that talk about 1.2 percent of GDP as the deficit, that was last year. This year the deficit is going to be 2.5 percent of GDP. But of greater concern, the increase in the debt this year will be well over $600 billion, which is well over 4 percent of GDP. And this is the sweet spot in the fiscal cycle. This is the sweet spot. This is before the baby boomers start to retire. This is before we have the additional continuing explosion of health care costs.

Senator Gregg?

Senator GREGG. Well, I think you have certainly summarized the problem, and I think Senator Conrad's questions, which were intentionally structured so, led through the different options and why many of them are not viable, such as inflating your way out of this issue and losing investment from abroad as a result of lack of confidence or raising the interest rates as a result of having to attract more investment.

Let me get more into the weeds, if I can. Because this problem is so significant, I think there has to be an admission that there are going to have to be some tough decisions made.

For example, we are going to get a budget this year. Shouldn't that budget include reconciliation instructions which address the issue of entitlement spending if we are going to start moving on this problem?

Mr. WALKER. I think there needs to be something on that. We need to move. I talked before about budget controls, bringing back budget controls, and I think part of those budget controls have to include something to do with mandatory spending, both direct as well as entitlement programs, as well as tax preferences. But on the instructions, yes, I think——

Senator GREGG. Last year, for example, the President proposed—and I thought it was a fairly reasonable proposal—that we should require high-income individuals to pay a percentage of the Part D premium. Today they are not required to do so. You know, if you are Warren Buffett and you get the Part D premium, you do not have to pay anything for that. Isn't that a reasonable movement in the direction of trying to get some relationship between the burden and the expense?

Mr. WALKER. In my view, the Congress should seriously consider better targeting beneficiary subsidies by the taxpayers—both with regard to Medicare as well as with regard to tax preferences for employer-provided and -paid health care.

In other words, it is one thing to say that you are eligible for coverage at group rates under these programs. It is another thing to say that irrespective of your wealth and your means, you are going to get the same taxpayer subsidy. That is a logical place to start, but ultimately, I think we are going to have to reform the entire health care system in installments.

Senator GREGG. But in a world where incremental action is more likely than global action, isn't it reasonable to do reconciliation instructions which actually accomplish incremental action? Wouldn't that be helpful?

Mr. WALKER. I think it is essential that you act on health care incrementally because there is no way that you are going to be able to achieve comprehensive health care reform in one proposal.

Senator GREGG. Now, one of the proposals that has been floated—and it actually, interestingly enough, was again floated by the White House because it would be perceived as impacting high-income taxpayers, just like the Part D premium was, basically a requirement that high-income individuals pay more for their premium. Is this idea that your $187 billion of tax preference which is tied to the deductibility of insurance plans being—of insurance plans being deductible, that that tax preference should be cutoff at some point—I think it was $11,000 per employee—so that high-income employees or more expensive plans would not be covered, and that we should take that money that is saved so that high-income employees or more expensive plans would not be covered, and that we should take that money that is saved—and this was the White House proposal—take that money that is basically generated from revenue and use it to fund insurance plans, private insurance plans, for people who are not covered today, that 41 million people who potentially—who do not have health insurance.

First off, do you think it is a good idea to cap the deductibility? Which I suspect you do. And, second, though, getting into the more substantive—the more geopolitical or geo-economic issue, does that really in the long term address the health care question because basically money is fungible, and whether it is—I mean, it is going to be spent on health care if it is taken as a deduction, or it is going to be spent on health care if it is given as a payment to allow a person to buy an insurance policy. Other than getting more people covered, which is a social policy, does it really impact the bigger issue of the fiscal policy?

Mr. WALKER. First, I do not believe that you ought to limit the deduction. The deduction is what the employer gets. And I think if you tried to seriously limit or eliminate the deduction, it would be counterproductive because employers are looking for an excuse to get out of this business.

Senator GREGG. Not eliminate.

Mr. WALKER. Right.

Senator GREGG. Cap.

Mr. WALKER. Exclusion. I think what you meant, Senator, which I agree with, is the income exclusion. The $187.5 billion is the fact that none of us have to pay income tax on what is paid for by our employer; by the Federal Government in our case since it is our employer. Same thing for payroll taxes.

I do think that just as it is appropriate to better target direct taxpayer subsidies through spending, as we talked about before, it is also appropriate to target taxpayer subsidies through tax preferences; and that, intellectually, you should determine at what level of health care coverage you might provide a tax incentive, and anything beyond that should be included as taxable income.

Think about the way the system works now——

Senator GREGG. But my question is: If you take that revenue that you get from there and move it over to funding coverage of uninsured, which is, of course, a legitimate public policy decision and social decision, have you really addressed your bigger issue of the cost drivers in health care?

Mr. WALKER. No. I think you—well, yes and no. First, I think to the extent that you make individuals more aware of and sensitive to the increasing costs of health care, that will have a behavioral effect over time that will help to deal with excess utilization. However, if you end up taking the money that you save and spend it on something else, then immediately you have really done only 2 things increased sensitivity to cost and improved coverage. I do think the four things you need to try to do in health care are: deal with universal access to basic and essential health care; impose a cap on what the Federal Government will spend on health care every year; implement universal national practice standards for the practice of medicine and also use of prescription drugs; and provide more personal responsibility and accountability for one's health and wellness.

And so I think targeting is a logical first step both for tax preferences as well as for taxpayer subsidies through Medicare.

Senator GREGG. Doesn't your second idea of capping the amount of Federal payments, which may very well be required here, lead to some significant adjustments in the delivery of health care?

Mr. WALKER. Yes, it would. Some people say, Would it result in the rationing of health care? The answer is let's be honest with people. We ration health care now. We just do not ration it rationally. We cannot afford to write a blank check for health care. That is why I think you have to look at all four things. Just putting a cap on how much the Federal Government will spend by no means solves the problem. You need to look at universal access to basic and essential health care, which I am happy to answer questions on that if you want. You need to have national evidence-based practice standards that will improve consistency, enhance quality, reduce costs, and dramatically reduce litigation risk because it would be a safe harbor for the practice of medicine. And you need to increase personal responsibility and accountability for one's own health and wellness.

So one piece by itself will not get the job done. They work in an interactive fashion—and, by the way, I might say that on this issue and Social Security reform and some other things that I have been working on at GAO, along with others, we have run up this in 26 States, in town hall meetings in 26 States, and it gets a pretty favorable reaction.

Senator GREGG. Thank you.

Chairman CONRAD. Senator Murray?

Senator MURRAY. Thank you very much, Mr. Chairman. And thank you for the tremendous amount of work you have done on this and your passion on an issue that is very difficult to deal with, but one we clearly have to. In your testimony, you are talking about as the long-term challenge increases, it is really important how we design any stimulus package. And as you know, the House and White House came to an agreement on an economic stimulus package. I believe they are passing it out today, with tax rebates.

Do you think that package in its current form meets your criteria of timely, targeted, and temporary?

Mr. WALKER. Senator Murray, I have not studied it in detail. I have read press accounts with regard to that package. On the surface, it appears to be timely, targeted, and temporary. Reasonable people can and will differ as to whether or not it is the right package.

Senator MURRAY. Have you looked at how it might affect our long-term fiscal challenge at all?

Mr. WALKER. I think by definition you are going to increase deficits in the short term. All the more reason why it is important that it be temporary. If you want to have the impact on economic growth, it needs to be timely and targeted to people who are likely to use that money and spend that money because 70 percent of our GDP is based upon consumer spending.

Senator MURRAY. So if the caps were lift on the rebate, for example, that would not be very effective?

Mr. WALKER. On which rebate?

If your income is less than, I think it is, $150,000, if that $150,000 was eliminated and it was for anybody, I assume that that would be——

Mr. WALKER. One would want to target it to those that are most in need and those that are more likely to spend the money, I think from an intellectual standpoint.

Senator MURRAY. OK. You talked a lot about health care, Social Security, those kinds of issues. One issue you did not talk about was the war in Iraq and the impact on our deficit. We have continued to see supplemental requests for funding this war, and we are now almost into the sixth year of this war. I think we have spent about $450 billion on the war already in a supplemental. Can you tell us what the annual interest is we are now paying on that debt?

Mr. WALKER. Our effective interest rate now is, about 5 percent. One of the fortunate things that we have right now, Senator Murray, is that we have very low interest rates right now, but we will not have low interest rates over the longer run if we do not get our fiscal house in order.

Senator MURRAY. I would like to see that and what your projections are for the future on that, too. I would assume that your recommendation would be that we include that—or the President include that within his budget request and not a supplemental because of its impact?

Mr. WALKER. Well, GAO has already recommended that, to the extent that we expect to have recurring costs in the Defense Department budget, that those ought to be put in the regular budget request. And it is only the temporary or non-recurring costs that are more difficult to estimate that ought to be in a supplemental. We have said that for a long time.

And, by the way, I think it is pretty clear that there are things coming through the supplemental that do not relate solely to the global war on terrorism. There are ways to try to help make the Pentagon whole with regard to some of the effects of the global war on terrorism.

Senator MURRAY. Within the budget?

Mr. WALKER. Yes.

Senator MURRAY. OK. You stated in your testimony that CBO's latest estimates project the deficit rising in response to a weakening economy, and you talked a little bit about the trust fund issue. Can you tell us, as we draw down that remaining surplus in Social Security, how that affects our deficit projections in the future?

Mr. WALKER. Yes. First, the trust funds are not really trust funds. I was a trustee of Social Security and Medicare from 1990 to 1995. And, you know, Washington uses some words that do not mean the same thing as Webster's Dictionary. I used to be a fiduciary in the private sector for real trust funds. Trust funds are separate and distinct legal entities. They come with fiduciary responsibility and liability. And in most cases, when you are dealing with other people's money, they come with very strict prohibitions on what you can and cannot do with regard to investments.

In the case of the trust funds for Social Security and Medicare, they are sub-accounts of the general ledger. They do not have fiduciary responsibility and liability. We are investing in our own debt. If the private sector did with its pensions the same thing that we do with Social Security and Medicare, the fiduciaries would go to jail, because employers cannot invest all their pension assets in their own debt.

The other thing that is outrageous is that we do not show the bonds in the trust fund as a liability on the financial statements of the U.S. Government. We also do not consider it in our debt-to-GDP ratio.

So, we are playing fast and loose here with regard to how we are treating this. So, you know, I apologize. You hit a chord here. If you noticed.

Senator MURRAY. I noticed.

Mr. WALKER. And I apologize. Please let me know when I have not answered the——

Senator MURRAY. I just wanted to know if you could specifically tell us how it affects the debt projections in the future.

Mr. WALKER. Sure. Thank you very much.

In 2009, the Social Security surplus will start declining rather than increasing, as it has been. That means Congress will start going through withdrawal, and the executive branch, because they have been used to spending and having the ability to spend, increasing surpluses. It will flip in 2009. And then in 2017, based upon the current projections, the cash-flow will be negative. So rather than helping the unified budget deficit, it will hurt the unified budget deficit.

Guess what? I think somebody will probably have an epiphany in 2017 to say, Gee, maybe we ought to take this off budget, because then it starts hurting you rather than helping you.

Senator MURRAY. OK. One other question for you. If we extend the 2001 and 2003 tax cuts, can you tell us what happens to the deficit projections?

Mr. WALKER. I think Chairman Conrad showed some graphics on that. I would be happy to provide you something for the record. Obviously it hurts. I think you have to keep in mind it adds about 1 to 2 percent of GDP. Clearly it does not help. At the same point in time, the gap that we face over the longer term is multiple times that.

And let me say—and I have said this before—I do not think we can solve our long-range problem with Federal revenues at 18.5 percent of GDP. At the same point in time, I think it is important to try to keep taxes as low as possible for several reasons. No. 1, on the corporate side, because we compete in a global economy—and believe me, corporations do not have duty of loyalty to countries. They have duty of loyalty to their shareholders. They will move someplace else. They will move operations offshore if we are not competitive on corporate taxes.

On individual taxes, if we want to maximize economic growth, maximize disposable income, and maximize individual choice, you want to try to keep it as low as possible. On the other hand, you have to have enough revenues to pay your current bills and deliver on the promises that you intend to keep.

Senator MURRAY. And you also need to invest in order to grow your economy as well.

Mr. WALKER. You have to invest selectively, although one has to be careful about how you define investment, because one of the things I have found over the years is one person's investment is another person's waste, and one has to deal with that.

But you are right, and that comes back to the savings issue I talked about before. We are eating our seed corn. We are not investing, which means that we are not doing what it takes to maintain and to improve our competitive advantage, and as a result it is diminishing with the passage of time.

Senator MURRAY. Thank you very much.

Mr. WALKER. Thank you.

Chairman CONRAD. Senator Allard?

Senator ALLARD. Thank you, Mr. Chairman.

You made a comment in regard to the health care here in the United States. You said that we are below average. When you said we are below average, you were referring to, I assume, the life expectancy and percentage of uninsured, were you not?

Mr. WALKER. Several things, Senator Allard. First, for an industrialized nation—and these are based upon OECD statistics, the Organization of Economic Cooperation and Development, of which the U.S. is one of 30 members. It is based in Paris. We are below average on life expectancy. We are below average on preventable death rates. We have higher than average infant mortality rates. Now, these are not good things. And we are way above average on the percentage of our population that is uninsured. We are number one on spending though.

Now, in some areas we do well, but with regard to generally accepted outcomes that deal with broad segments of society, we are not getting value for money.

Senator ALLARD. I think it maybe depends on how you measure outcomes. You know, when you talk about infant mortality, some countries—and I do not know what percentage of these would be considered industrial—really do a poor job of reporting infant mortality. Infant mortality will occur outside a hospital. And so how valid would that sort of comparison be? Or if you look at the uninsured percentage, for example, this has been a flat line. If you look at the percentage of uninsured in the country, as well as my State of Colorado—we have done a lot of things to try to deal with the uninsured—the flat line is right at 15, 16 percent uninsured, no matter what we do.

And so there are things in our medical system, I think, that are good. People come to this country for medical care. You know, you imply somehow or other that there is not quality here. I think there are things that we can do to improve physician care, but I do think that we have to be careful on a study like this because I can see other countries do not do as good a job of gathering their statistics as we do in this country. Would you say there is some validity to that?

Mr. WALKER. Thank you, Senator Allard. First, I am not saying that we are below average in everything. We are not. And you are correct in saying that with regard to high-end medical procedures, many people come to this country because of our proven track record of success with regard to high-end medical procedures.

The OECD countries are major industrialized countries that do a pretty good job with their statistics. We are talking about Germany, United Kingdom, France, Italy, the Netherlands. We are talking about Japan. We are talking about Australia, Canada, New Zealand. So we are not talking about Third World countries when we cite the OECD. But you are correct in saying that the statistics are only as good as the reliability of the data that underlie them. But I think OECD generally is viewed as being a pretty reliable source.

Senator ALLARD. So assuming that they are correct then, what could we do to make that better in this country as far as our health care so that these look better for us?

Mr. WALKER. Senator, I think we need to focus as a country on something that we have really not done before. In my opinion, we have not had a national discussion and debate to differentiate between broad-based societal needs in health care that are affordable and sustainable over time versus unlimited individual wants in health care which are not affordable and sustainable.

And so what happens, like so many government programs, whether it be on the spending side or the tax side, you end up enacting something into law. You add things to it. You add things to it. Things get layered on. Before you know it, you have an amalgamation and combination of things that may not make any sense. And I think that is exactly where we are at.

I think we need to step back and say what is basic and essential in terms of health care coverage and services that everybody needs and that it is in our broad-based societal interest to do that. And you know with your background, things like wellness and preventative care; inoculations against infectious diseases; things like protection against financial ruin due to unexpected catastrophic illness; things like guaranteed insurability at group rates but have choice as to whether or not you want more, but you are going to have to pay for it if you want more than that. So focusing on the basic and essential needs of everybody rather than what we have today: broad-based, much more generous coverage to some segments of the population and nothing for other segments of the population.

Second, a budget, not a blank check.

Third, national evidence-based practice standards that would be determined by physicians and other qualified parties that could help serve as a safe harbor for malpractice, among other things.

And we need to make sure that individuals have incentives and accountability for taking care of their own health and wellness. Right now, take Medicare as an example. The subsidy is the same. The subsidy is the same not only with regard to your income in most cases, but also with regard to whether or not you take care of yourself or not. That creates very perverse incentives over time.

And so, I think, you know, in the short term we need to target better; in the long term we need to restructure the whole system, including the division of responsibilities between employers, Government, and individuals. And I am not talking about socialized medicine, Senator, let me make that very clear. But even countries that have "socialized" medical systems, they ration and they have budgets. And, by the way, they also have private sector systems where employers end up buying supplemental policies for many of their employees, because they may not want their employees to wait or may want them to have access to certain procedures they otherwise would not get access to through the government system.

We have done some work on this, as you know, at GAO, Senator Allard.

Senator ALLARD. Mr. Chairman, thank you.

Chairman CONRAD. I turn to Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman, as usual for a very important hearing, and thank you, Mr. Walker, for your service and for being here.

Just to continue on health care for a moment, I appreciate your numbers because it is clear. As I understand it, we spend about twice as much of our gross national product on health care as any other country, and yet we have almost 50 million people with no health insurance so that picture does not seem to jibe. And I am wondering if you might speak a little bit more about the notion of universal access because, as you have indicated, the Federal Government really is not unique. Every family, every business, every State and local government is facing the same kinds of things that we are in terms of the costs going up and the fact that we use emergency rooms inappropriately. I mean, we have a universal system. It is just extremely expensive because you walk into the emergency room, you receive care, you may be sicker than you otherwise would be. The hospital treats you and then shifts the costs to those employers that have insurance. So we are paying for a system right now that it is pretty crazy to me on how we are paying for the overall system for folks.

But I wonder if you might talk about in a little more detail the need to do something more systemwide in order to capture savings and to be able to address the broader issues that you talked about.

Mr. WALKER. Thank you, Senator Stabenow. First, I think we spend about 2.5 times more per capita than the median OECD country, almost 50 percent more of our economy than the median for all OECD nations and we have about 47 million uninsured, roughly those numbers which you touched on.

I think we have to recognize that there is a lot of cost shifting going on right now, and I think people have to keep in mind when you look at the data, you will find that in the last 40 years, health care costs have grown about 2.6 percentage points faster than the economy every year. And the point of compounding that over time means that is why we are spending so much more of our economy on health care than we used to.

But during that same 40-year period, you will find that a disproportionate amount of the increase in the health care costs has been borne by two parties: No. 1, employers; and, No. 2, governments. And while individuals have paid more as a percentage of their income on health care than they did 40 years ago, the relative burden share has been more for government and for employers. But governments face fiscal challenges, and employers face competitiveness challenges.

And so starting within the last several years, we have seen governments and employers start to shift costs to individuals. So individuals really for the first time within the last several years are starting to feel the effect of increased health care costs, and they do not like it.

Something has to give; I think we need to take a systemic approach. We need to focus on all four of those elements, but with regard to access, I think we have to be honest with ourselves to say let's focus on what our broad-based societal needs in the form of health care are, basic and essential health care services that everybody should have. Let's focus on trying to deliver that, and when we are doing that, we need to make sure that it is affordable and sustainable over time. Because right now we have a situation that the Federal Government has made a lot of promises it is not going to be able to keep, and it ought to be honest with the American people and tell them that. It is not going to be able to keep them without doubling tax levels, which this country has never supported in the past. Now, maybe they will, but I would not bet on it.

Senator STABENOW. Well, just to followup on your comments, when you say individuals do not like having to pay more, they cannot pay more I mean, many——

Mr. WALKER. Some can.

Senator STABENOW. Far more people are finding themselves less wages or unemployed, and so obviously the cost shift is increasingly putting pressure on middle-class families, and it certainly is a competitiveness issue. I can look in Michigan right across the river that literally you can swim across, and the difference between Canada and the U.S.—and we could debate the systems, but the reality is wages are the same for manufacturing, environmental standards are the same. The only difference is health care, and we see plants being built there. So it is an issue that is costing us jobs, there is no question.

I wonder, before my time runs out, if I might ask you one other issue related to this, and that is talking about comparative effectiveness, which is so important. And because of these issues being so important for us from a competitive issue in Michigan, we have developed in the medical society something called the Keystone Project, which has focused on quality initiatives very, very effectively. I do not know if you have looked at that. But we have also been very aggressive on information technology and have in southeastern Michigan very aggressively focused on e-prescribing, which has made a big difference in quality and dealing with costs and so on.

I wondered if you might speak to what you view as an effective comparative effectiveness program and also how technology, information technology and those kinds of things fit into that.

Mr. WALKER. Sure. First, I do think there is an opportunity to leverage technology to improve outcomes and to reduce cost. But it has to be leveraged with more information and evidence-based practice standards. Right now what is happening is a lot of the technology is being used because it is available, and it is actually driving health care costs. I am talking about MRIs and a variety of other procedures, where everybody wants one and as long as somebody else is willing to pay for it, why not?

Second, there is a very real competitiveness issue here on health care. You are right that some families are already feeling the squeeze, and it is only going to get worse with the passage of time. You are right in knowing that Michigan, in particular, is affected by this because you have a number of major employees that have huge legacy costs for health care. You are also, in a situation where a lot of people do not realize the impact of health care costs being out of control. One of the reasons that we have not been able to get pension coverage up higher than 50 percent of the full-time work force for 40 years is because health care costs are out of control, and, therefore, employers cannot afford to do more because of out-of-control health care costs.

So it is really the big challenge from a variety of perspectives.

Senator STABENOW. Mr. Chairman, I know my time is up. I would be remiss if I did not also indicate I am pleased to join with Senator Wyden. I am sure he is going to talk about his health care proposal, but we do have, I think, an important proposal on universal coverage that I know we are going to be discussing more. Thank you.

Chairman CONRAD. I thank the Senator.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

Mr. Walker, I am interested in your statement to the effect that our total debt, including the gap between funded and unfunded future benefits, is approximately $53 trillion. Is that correct?

Mr. WALKER. That is correct, Senator.

Senator BUNNING. OK. More than 4 times the current size of our economy.

Mr. WALKER. That is correct.

Senator BUNNING. Because of this, the major credit rating agencies recently have questioned our Nation's ability to maintain our AAA-rated debt if we do not make changes. I understand that other major industrial nations are coming to terms with their own pension and health care liabilities in light of their own aging populations. How does our current situation compare to theirs at the present time?

Mr. WALKER. Thank you, Senator Bunning. First, just to clarify, the $9 trillion, roughly—a little bit more than that—is current debt. The balance represents the unfunded commitments that will be future debt if we do not engage in reforms. But it is a current commitment.

We issued a report on January 18, 2008, at the request of this Committee to look at what other countries have done to try to deal with their fiscal challenges and to also look at whether and to what extent they use task forces or commissions as a way to try to help facilitate more expedited action. That has been made available to this Committee.

Some countries are ahead of us. A number of countries, frankly, are ahead of us. Australia is ahead of us. New Zealand is ahead of us. Canada is ahead of us. The U.K. is ahead of us. Sweden is ahead of us.

Senator CONRAD. Norway.

Mr. WALKER. Norway is ahead of us. Well, they actually have real money in their trust funds. That is a different issue.

So, you know, we are a great Nation. We are not the only nation that faces this challenge. The problem is we are slow off the start. We are late to the effort to start dealing with this, and it is important that we start sooner rather than later.

Senator BUNNING. We talked about the fiscal stimulus package. What changes, if any, would you make in the fiscal stimulus package that the House is voting on today? Should we be concerned about the long-term consequences of this package if the stimulus is poorly timed or ineffective in 2008?

Mr. WALKER. Senator, unlike you and other members here, I have not been elected, so I do not think it is appropriate that I critique it in detail.

I will tell you this. I will come back to what I said to begin with. I think action needs to be timely. I think the Congress needs to act by no later than February on something. Second, I think it needs to be targeted so that the money is likely to be spent and otherwise help our economy. And, third, I think it needs to be temporary so that it does not end up increasing our longer-range structural imbalance. And I will leave it to your judgment and your colleagues to figure out how best to do that.

Senator BUNNING. Well, but that is a cop out.

Mr. WALKER. I am not elected, Senator.

Senator BUNNING. It is not a question of being elected. You study these things constantly.

Mr. WALKER. Yes, sir.

Senator BUNNING. What happens if we fail to hit the mark and in 2008 the approximately $155 billion is pushed into calendar year 2009 when the interest rates are low and the jobs are not forthcoming? You know what happens when we do that. We have something that was created in 1980 or so called "stagflation." We have inflation going up this way and we have jobs going the other way, and that leads to bad things for our economy.

Mr. WALKER. Paul Volcker is a friend of mine, and he is very familiar with stagflation, and it is not something that we want to try to have to go through again, quite frankly, in the history of this country.

I think it is very important that you, again, try to make sure that you target this so that it does good quickly and that it be a temporary initiative. If it does not work, then I think you and I both know that Congress is going to try to figure out what else it might need to do. And I think one of the things that I introduced a number of years ago—remember when we had surpluses. Remember when we thought—I know you do, Senator Domenici. Remember when we thought we actually were going to pay off all the national debt and people were worried about it? Well, we do not need to worry about it anymore.

One of the concepts we need to think about is triggers. How can we identify triggers——

Senator BUNNING. That is something that has been discussed in this Committee.

Mr. WALKER. Right. How can we talk about triggers that say when something comes off and when something goes on? You know, that is really important.

I also think we have to think about incentives, how can we create incentives, you know, so that it would provide discipline on spending and other types of actions through proper design.

Senator BUNNING. I have one last kicker.

Mr. WALKER. Yes, sir.

Senator BUNNING. You talked about entitlements and the uncontrolled escalation in entitlements. And my numbers may be off a year or two, but by the year 2030, if we do not cap or change our entitlements, take them off automatic pilot, we will spend our entire budget on entitlements and, therefore, the 12 agencies that we enact appropriations bills for will have no money.

Mr. WALKER. In theory. If you tax at historical levels and you allow—and you say I am not going to reform entitlement programs, they are going to be a first claim on tax revenues, then you squeeze out everything else.

By the way, the numbers do not include interest on the Federal debt, so when you include interest on the Federal debt, it is actually worse than that. And, in addition——

Senator BUNNING. It comes earlier.

Mr. WALKER. Correct. And, in addition, they do not assume a significant increase in interest rates, and I can assure you there will be before then based upon our——

Senator BUNNING. Well, depending on who is running the Federal Reserve. Thank you.

Chairman CONRAD. Thank you, Senator Bunning.

Senator Menendez?

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Walker, thanks for your testimony, for being a little bit of a Paul Revere about our long-term fiscal challenges. I appreciate your service in that respect. I have a series of areas I want to pursue, so if you would work with me in trying to be tight in the answers but nonetheless responsive, I would appreciate it.

First, on page 14 of your testimony, you talk about this whole health care issue being the overriding issue—they are all important, but the overriding issue in terms of the long-term fiscal challenge, and in that respect, the four points that you have there as pillars, I just want to—you say provide universal access to basic and essential health care. Access is not necessarily coverage, though, right?

Mr. WALKER. No, I think I intended it to be coverage.

Senator MENENDEZ. You intended it to be coverage.

Mr. WALKER. I intended it to be coverage, which either could be provided through a Federal program, through a State program, through an employer, through a union, but basically one way you could do it—one way—would be a universal mandate and provide alternative ways that it could be delivered, Government being one of the ways it could be delivered. But it means coverage, not just the option but you will be covered.

Senator MENENDEZ. All right. Good, because I have heard "access" be used in the past not as covered.

Mr. WALKER. I understand.

Senator MENENDEZ. Second, you talk about imposing limits on Federal spending for health care. Does that imply necessarily paying more for those who have the health care coverage by virtue of the Federal Government, Medicare and Medicaid?

Mr. WALKER. It means that we——

Senator MENENDEZ. The individuals I am talking about.

Mr. WALKER. It means that we cannot afford to write a blank check, and if we end up having a budget, it will force tough choices, and it will force tough choices on behalf of the Government to restructure its programs.

Senator MENENDEZ. There is one of three possibilities: either you cut back on services to providers, payments to providers; you cut back on the universal services or how those services are delivered; or, third, the person who is covered contributes to it or it is a combination of all of those.

Mr. WALKER. I think that is clearly what the three options would be absent fundamental reform. But if you engage in fundamental reforms, I think you have other options. We need to recognize that the system we have right now is badly broken, and we cannot just tinker around the edges because we are betting the ranch. Wand esse are betting the future of our economy on health care costs.

Senator MENENDEZ. Third, you talk about evidence-based practice standards to improve quality, control costs, reduce litigation. Is prevention a big part of that? You know, we work on a disease-based system, largely.

Mr. WALKER. I think it is a function of three different elements: I think that is a function of defining what "basic and essential" is; I think that is a function of evidence-based standards; and I think it is also a function of increased personal responsibility and accountability for one's own health and wellness. So I think prevention comes into all three of those elements, those pillars.

Senator MENENDEZ. Many of us have been saying for quite some time, though, that it seems that in a system that is based on disease versus on preventing that disease, which is a lot less costly, that it should be a significant part of the equation.

Mr. WALKER. I agree.

Senator MENENDEZ. And, last, when you talk about steps for Americans to assume more personal responsibility and accountability, do you see incentives in that to move Americans in that direction?

Mr. WALKER. I do, but it does not necessarily mean tax incentives. For example, to the extent that one does more to try to take care of one's own health and wellness, maybe there would be a difference as to what your cost sharing would be. Rather than giving you an incentive to do something, maybe you would have to bear more burden if you do not take care of yourself. So incentives, broadly defined.

Senator MENENDEZ. Let me turn to an answer you gave Senator Murray when she was talking about what would happen if we made the President's long-term tax cuts permanent, and you did acknowledge that they would increase the deficit over time. Then you got onto a discussion of—and correct me if I am wrong—that we cannot solve our long-term fiscal challenges by taxing at 18.5 percent of GDP. And then you went on to say how it is also important to keep taxes as low as possible. It sounds like having it everybody wants it the same way.

Did I understand that answer to mean that you believe that you are going to have to increase taxes as a percent of the gross domestic product, but while increasing them, try to increase them at the lowest possible level?

Mr. WALKER. Right. Let me clarify what I mean. Historically, the highest that Americans have allowed themselves to be taxed as a percentage of the economy is roughly 20.5 percent of GDP, and that is roughly where we were when we had the surpluses, at about 20.5 percent of GDP. And, by the way, Congress periodically has to do tax cuts in order to keep tax burdens from going higher. Why? Because with inflation, economic growth and other factors, if you do not end up taking steps over time, by definition you will end up having a higher percentage of GDP in the form of taxes because of inflation and economic growth and other factors.

So, historically, Americans have only gone to 20.9. Are they willing to go higher than that for things like security and safety and a variety of other issues? Maybe. But they are not, I do not think, likely to be willing to go to 30.

So the answer is as follows: We are taxing at about 18.5. You are going to have to get the most money, in my opinion, out of entitlement reform. You are going to have to get a considerable amount of money out of reprioritizing and constraining spending. But even after you do all of that, the gap is so great, you are going to need more than 18.5 percent of revenues.

I will say this: I have been to 25 States for town hall meetings. I am going to my 26th one tomorrow. The American people are hesitant about sending more money to Washington absent tough budget controls that will make sure that that money will not be wasted.

Senator MENENDEZ. And I appreciate that view. Finally, let me get to a provincial question but one that has ramifications. I read your response to a New Jersey delegation letter about comments made by individuals who were suggesting that the GAO and the BRAC process was on their side and that they needed the right figures to make it work. And I saw the press accounts of your review with this individual. You know, my problem is we have seen BRAC go from an allegation that it was going to save X number of billions of dollars, $36 billion, to now being reduced to about $15 billion. That is 58 percent less. In my home State of New Jersey, Fort Monmouth was supposed to be $780 million. Now it is at almost $1.5 billion. And I do not think we are finished yet.

I have a real problem looking at this process which is supposed to save us an enormous amount of money, then gets reduced dramatically, does not even take into effect the economic consequences of what happens in those communities at the end of the day, which ultimately contributes to the tax process. And then I get really concerned when I read comments, e-mails that say that the GAO, which I really have faith in, generally speaking, is on the side of the BRAC process. And I do not understand—I read the comments about what the person supposedly meant that we have supported—the GAO supported overall the concept of BRAC. You do not have to say I am on your side to say you support the BRAC process. That seems to me I am on your side in making the numbers work for something that does not work.

Mr. WALKER. Sure. Well, Senator, first, I have not written that letter yet. I told——

Senator MENENDEZ. I just read the public comment——

Mr. WALKER. I told the press that I intended to. I have met with Dr. College, who was the person who sent that e-mail. I think if Dr. College had thought about it, he probably would have sent a different e-mail rather than that one, because there has been a lot of speculation about what he meant.

I know GAO's procedures. I know the people who worked on this engagement. I stand behind our work. Here is the key point——

Senator MENENDEZ. How could we be so far off?

Mr. WALKER. Well, you make a good point, Senator Menendez, and let me be clear. We were asked, GAO was asked—in fact, it was statutorily required—to look at the overall process, methodology, the reasonableness of the overall assumptions. We were not asked, nor do I think it is appropriate for us to be asked, about a decision with regard to an individual base. I testified myself on behalf of GAO and expressed serious concerns with regard to the over-optimism by the Department as to how much money they were going to save with regard to this BRAC round, both as it relates to military construction costs as well as personnel savings.

And, furthermore, with regard to Fort Monmouth, I testified myself that we also had concerns that they were being overly optimistic with regard to what percentage of skilled employees were going to be willing to move from Fort Monmouth to Aberdeen or elsewhere. That is on the record. We stand by that. And I would be happy to talk to you separately if you want.

Senator MENENDEZ. I would look forward to that conversation.

Mr. WALKER. I would be happy to.

Senator MENENDEZ. Thank you, Mr. Chairman, for your courtesy.

Chairman CONRAD. Senator Domenici?

Senator DOMENICI. Thank you very much.

Mr. Walker, I do not come to every meeting, but I spent plenty of time in the past at meetings of this Committee, so I like to let other people come now, like the distinguished Chairman, he and this distinguished Republican. They are doing well, and I come when I am needed. But there are so many questions to ask of you that I am going to tick through a few and just see what you say. OK?

Mr. WALKER. Yes, sir.

Senator DOMENICI. Is the stimulus package proposed by the House and the President, as you look at things, more or less the right size and the right kind of stimulus, if we need one now?

Mr. WALKER. Senator, I will just go back to what I said. Timely, targeted, and temporary, it appears to meet those three criteria. I have not studied it in detail.

Senator DOMENICI. All right. But dollar-wise, you know how many billion it is.

Mr. WALKER. It is about $145 to $150 billion.

Senator DOMENICI. Right. So I guess I am going to just put this up there from my standpoint, see if you agree. It is barely of sufficient size for an economy of our size to do the job.

Mr. WALKER. We have about a $13 trillion economy.

Senator DOMENICI. And so this is a pretty small kick, but if it is done quickly and we do not fool around with it forever, coupled with the Chairman of the Federal Reserve and his use of their power on interest rates, it would seem like we are sending a strong signal that we are going to do something and do it now. Is that correct?

Mr. WALKER. That is correct, Senator. You know, the Fed is looking at monetary policy. You are looking at fiscal policy. You and I both know that there are limits as to how quickly the IRS can act in the middle of the tax season. So all the more reason why you need to move very quickly because the money may not flow for several months.

Senator DOMENICI. That is right. Now, my next question, just do it as quickly as you can, but it certainly is something we have never had in all the years I was Chairman up here, and it is there now, and that is what has happened to the American dollar. Would you just answer for me, is that a serious problem now, as you see it? And if it is, is there anything that can be done in any event by the United States or others?

Mr. WALKER. I think it is a serious problem. We are no longer the world's only reserve currency, the euro being one that people are looking to with increasing frequency.

I think one of the other reasons, Senator Domenici, that it is a problem is a lot of people do not realize that crude oil is priced in dollars.

Senator DOMENICI. Right.

Mr. WALKER. And that one of the reasons that crude oil prices go up is not just because of supply and demand, but if those producing countries want to maintain purchasing power, they have to charge more dollars because the dollar is in the tank.

Senator DOMENICI. You are right. Now, there is no question that that is a correct statement. There is no question that all the debt we have, the world has bought it up, whether it is China that bought it up or European countries or India or Indonesia or whomever. And it is precarious when they thought they were buying up the best currency in the world, and it turns out that they may not. That causes some consternation on the part of those who had bought our money, right?

Mr. WALKER. Correct. When third parties hold more of your national mortgage, it means that they have more influence on you and you have less influence on them. It is that simple.

Senator DOMENICI. And people that would say they do not have anything, they hold nothing over us, I think they are mistaken when, as a matter of fact, somebody like China owns so much of our debt, it is not, as some say, "Well, that is good." It is not perfect, right? It might be less than good, right?

Mr. WALKER. In the short term it is good because we are lucky that they are willing to lend us their savings. But in the longer term, it increases our risk.

Senator Domenici, you probably recall what happened in 1956 with regard to the Suez crisis.

Senator DOMENICI. No. I am old but not that old.

Mr. WALKER. Well, the bottom line is France and U.K. and Israel wanted to challenge President Nasser's taking over the Suez Canal, and at that point in time, the U.S. held a lot of U.K.'s debt and a lot of pounds and suggested that they may want to rethink their actions if they wanted us to continue to support their currency and their debt. That was an ally.

Senator DOMENICI. Yes. Now, look, I want to go through two or three more, and, Chairman, you stop me whenever I am supposed to stop, all right?

One, I want to say to you in terms of health care costs in America, health care costs distort everything. For instance, if you equate how much health care cost there is in an automobile, you can kind of say, well, you open the trunk and the health care cost is in the trunk, and you put a dollar sign on, and it turns out that in some instances it makes the automobile that you are talking about noncompetitive in the world market because you have added too many hundreds of dollars in health care costs. That is a very serious problem, is it not?

Mr. WALKER. The last numbers I saw is that there is more health care cost in the cost of an automobile than steel.

Senator DOMENICI. Right. That is incredible. You could not even fit that in the trunk so you would have to use some other approach, as you talk about it.

Mr. WALKER. That is for U.S. auto makers.

Senator DOMENICI. Correct. Have you seen the proposal that the Chairman and Senator Gregg have with reference to a bipartisan approach to the entitlement program, resolution of the entitlement program?

Mr. WALKER. I have.

Senator DOMENICI. And have you analyzed it sufficiently to tell me whether you think it is a good approach or not?

Mr. WALKER. I think it is a good approach. My personal view is that I think if you look at Chairman Conrad's approach, it is a very positive approach. I think if you look at his, if you look at Senator Voinovich's bill, at both the Cooper-Wolf bills in the House, and your bill with Senator Feinstein, doing a combination of these actually would even be better, and I would be more than happy to work with any of you on that.

Senator DOMENICI. I would just pass the word to the Chairman. No question in my mind because he is Chairman, his takes on a little stronger impetus, and I have a good one that I worked hard on, but I think his might be better. Mine is Domenici-Feinstein. I am more than willing to forget mine and work with him and Senator Gregg. It must be done. You know, we sit around figuring somebody will be courageous enough to pass a law. It really is not courageous or non-courageous. It is almost impossible for a legislator to do this. There has to be a new process invented, and the process is what we are speaking of at this point. Normally, processes do not solve big problems. But in this case, it will solve a big problem. If you use it and it gets carried out such that the entitlement group does what Congress says and you put smart people on there and people who want to work only for the country and not for a party, it has a chance of fixing, Social Security could be fixed. You could do that first. You could do that in a year with no question. Medicare is harder and more urgent, but people do not believe that, but it is. But you have to do both of them. You cannot do just one and leave the other one out there.

Mr. WALKER. And, Senator Domenici, I believe it is totally unrealistic to expect that we are going to make significant progress on this $53 trillion imbalance through the regular order. It is policy, players, and process, and process matters.

Senator DOMENICI. You bet.

Mr. WALKER. In my opinion, you need to address at least four things through any task force or commission that you come up with:

No. 1, tough budget controls, if you have not done it before then.

Second, comprehensive Social Security reform where you are not preprogrammed to have to come back. In 1983, we were preprogrammed to have to come back. We do not want to do that again.

No. 3, round one of health care reform.

And No. 4, round one of tax reform.

If you do those four things as a package, with everything on the table, I believe we can achieve at least a $12 trillion downpayment on our $53 trillion imbalance. Now, think what that would do for the credibility of the Congress. Think what that would do for confidence and trust. Think what that would do for the ability to hopefully make more progress and to sustain momentum over time.

Chairman CONRAD. I thank the Senator.

Senator DOMENICI. I want to say to you, sir, I remember when you came, we had some rough edges between you and some of us. That is natural. We kind of wonder what you are doing fooling around in our business. You kind of wonder why we are not accepting your recommendations because you think it is your business. Things are getting better. We are listening to you, and you are doing a terrific job, and we thank you for it. We need your kind of clear-headedness speaking to the people, and thank you for it.

Mr. WALKER. Thank you, Senator. I like your new international look, too. You look very distinguished.

Senator DOMENICI. Oh, thank you.

Chairman CONRAD. Senator Whitehouse?

Senator WHITEHOUSE. Thank you, Mr. Chairman.

I would suggest that if we are going to get credit for the $12 trillion downpayment, the first thing we have to do is make the people of America understand that they have this $53 trillion liability out there. And I applaud you for getting around to 25 States, soon to be 26. But I can tell you that in my experience, there is almost no

American you could stop on the street and ask that number and get anything resembling a confident or knowledgeable answer. So I think we have a large public relations mission ahead of us to put this into the right context.

With respect to the trust fund, I enjoyed your description of how the phrase ”trust fund“ used in this context does not in the fashion meet the legal fiduciary definition of a trust fund. Just to explore that a little further, I would suggest that since it has no funds and cannot be trusted, you do not even have to get to the fiduciary level. You just get to the pure, you know, Webster's street corner definition of those words and it fails.

I may be oversimplifying this, but it strikes me that this is ultimately really a cash proposition. The people who need Social Security need the money now. It goes out. When we take the Social Security so-called trust fund and when we take the cash out of it and spend it on other things and put an IOU back in, there is really nothing there, because the IOU, it strikes me, is an IOU to ourselves. And for somebody who is watching this who has a family budget, it would be like saying, well, I know we need to pay for my daughter's braces, I know we need to set aside money for college for both the kids, I know we have these expenses coming, but I am going to spend all the cash that I have, all the money that comes in on this other stuff, but then I am going to write myself an IOU for some of it. The problem is when the dentist comes and when the college bill comes, you do not have the cash, and the IOU does not matter.

Is that a fair parallel to where we are with Social Security? And if it is, shouldn't we just start setting up a proper trust fund and just force that issue by putting some money aside?

Mr. WALKER. First, I think we are masking the size of our deficits and our debt problems by not being more transparent with regard to what we are really doing. Let me clarify.

The bonds in the trust fund are backed by the full faith and credit of the U.S. Government. They are guaranteed as to principal and interest. In my view, they will be honored. They must be honored. They should be deemed to be a liability of the United States. But you are correct——

Senator WHITEHOUSE. Well, from our point of view, we still have to go find the cash——

Mr. WALKER. You are correct, absolutely, from an economic standpoint in recognizing that they are nothing more and nothing less than a priority claim on future general revenues, that you must do one of three things: either raise taxes, cut spending, or go out and borrow more money from Japan, China, OPEC nations or somebody else to be able to convert that to cash. Cash is key, and we need to be focused on cash-flow more than we are now.

Senator WHITEHOUSE. So in a perfect world, what would the trust fund look like?

Mr. WALKER. Well, Norway has a pretty good idea, but I do not think we probably will ever get there because I think we have waited too long. Norway saw that they had a demographic challenge, just like we did, and Norway knew that in order to try to be able to meet the bow wave of the tsunami of spending, they needed to invest early so that they did not put an undue burden on future generations. They actually created a real trust fund, and it actually is something you can trust and it actually has real funds in it, real investments in it. It is their sovereign wealth fund. It is a very large fund to try to help reduce the burdens of the retirement of their baby-boom generation.

Now, we have waited maybe too long to do that. We could consider that as an element, but as you know, the surplus will start to go down in 2009. We go negative cash-flow in 2017. So, you know, the really good years are behind us, and so we are going to have to do more than that.

Senator WHITEHOUSE. On health care, it strikes me that there are a trio of areas where there is huge ground to be gained. One is with health information technology, and I think the sooner we start looking at our health information technology infrastructure as infrastructure and treat it that way, the quicker we will be able to resolve the problems of health information technology. The second is quality reform, which you have talked about in the best practices context.

I would like to suggest to you that as a Nation we really have not developed a very significant skill set yet in quality reform in health care. And if you are going to go out and develop these best practices, figure out how to apply them, how to enforce them, there is a process component to it as well. There is a substantive component on what the best practice is. We are in a very, very baby-step stage in that.

So as you talk about this, I would urge you to consider what the best process is, consider trying to make it as broad as possible. I worry if people talk about this and the solution that people think of is, well, we will set up a best practices, you know, place in Washington, and we will start doing them one by one in Washington. I do not think we have that kind of time, and I do not think we can limit ourselves that much in terms of experimentation.

I would like to see a mechanism set up so that every State under the authority of its own health department, so that it is kept legitimate and safe, can engage in best practices research and figure out a way to enforce and incent that and allow benefits to accrue from it. And then you can get 50 teams working on it, and you can learn from each other, and the whole thing moves a lot more rapidly. So I would just urge you to think about that, that the sort of Federalist doctrine really would make a lot of sense there.

The last thing, the third piece, is on reimbursement. We send idiotic price signals into the health care system and are surprised when we get idiotic responses. It strikes me that there is a correlation between the things that America is good at, as you were discussing with Senator Allard, and the things we pay for. The money is there for high-end procedures; we do a great job. The money is not there for prevention; we do a horrible job.

And it strikes me that an underlying problem is that we have taken the question of what gets paid for in health care, and we have taken that choice, and we have moved it to the private sector, specifically to the insurance industry. It strikes me that the insurance industry is colored with massive conflicts of interest in this respect, both having to do with their own business strategy and having to do with the fact that, for instance, every insurer in this country looks at getting rid of all of their customers into Medicare at some point, and many of them are looking just from a turnover point of view at a 5-, 6-, 7-year customer relationship, so they have no financial interest in prevention and welfare except as a means to attract big-employer customers who are really driving this.

I think if we can address these three things together—quality reform, information technology, and solving these reimbursement problems—we can set up virtuous cycles that will yield rewards beyond what we are even now forecasting. I would just like your reaction to that. I know I have gone over my time. I apologize.

Mr. WALKER. Senator Whitehouse, let me just briefly say that leveraging technology, focusing on quality, and also looking at our reimbursement practices are subsets, in my view, of the four pillars. And I do think they are important, and we will focus them.

Senator WHITEHOUSE. I would love to work with you.

Mr. WALKER. Thank you.

Chairman CONRAD. Let me just followup on the Social Security discussion very briefly to say in the private sector, if you were taking the retirement funds of your employees and using them to pay operating expenses, which is what we are doing, you would not be on your way to the White House or the House of Representatives. You would be on your way to the Big House because that is a violation of Federal law.

I must say, when I first came here from positions in a financial arena, I was so amazed and really stunned by the way we operate here. I mean, the financial reporting is just a complete fiction around here.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. And we want to thank you again for all of your good work and especially on health care. We are now up to 12 Senators on the Healthy Americans Act as cosponsors—6 Democrats and 6 Republicans, the first bipartisan effort in the Senate in literally decades. And if you track the legislation, it is sure pretty close to what you have been out talking about, and we just thank you for all your leadership. And I think when this country fixes health care—and I believe we can get it done this time—a big part of it is going to stem from the fact that you have been out prosecuting the case around the country, trying to lay out the choices for people.

Let me, if I might, talk about some of the biggest issues that we are going to be wrestling with, starting with the development in the last 24 hours. It looks like the California proposal is not going to be able to go forward. They have done an awful lot of good work and tremendous commitment and passion, the Governor and legislators of both political parties. But it just does not look like it is going to be able to move at this point.

My sense is that the message out of California—and I would be interested in your assessment—is that the States cannot fix health care by themselves. The biggest hurdles have, in effect, been put out there by the Federal Government, specifically the Tax Code, the ERISA statute, the Employee Retirement Income and Security Act,and Medicare. I think this is pretty much consistent with your thinking, and I think it would just be helpful to get this on the record, because I do not want the country to say, well, it is the

States' fault. I think it is quite the opposite. I think the States have done some very good work given how little bandwidth within which they have to operate. And I think it would be just helpful to get your thoughts on the record about how important it is that the Federal Government be a better partner in terms of working with the States in fixing health care.

Mr. WALKER. I think the States have their own significant challenge with regard to health care. They have a challenge with regard to their portion of the Medicaid costs. They have a challenge with regard to their employees, et cetera, and the uninsured population. I think there is an opportunity for more federalism, but I do not think they can solve the problem by themselves, by no means. I think the Federal Government has a major responsibility.

Being a CPA, I am very familiar with the tax provisions. I was former Assistant Secretary of Labor for ERISA, and I was a trustee of Medicare. So there is no question that those are three major challenges that must be addressed by the Federal Government.

Senator WYDEN. Let us talk about the Tax Code because, of course, that involves judgments that were literally made more than 60 years ago. And I think what is at stake here is modernizing the employer-employee relationship. That is how I would characterize it. What we have done today does not work particularly well for either employers or workers. The employer spots the global competition, you know, 15, 18 points the day they open their doors, and workers, unlike, for example, Members of Congress, usually, if they are lucky enough to have coverage—and many of them do not have coverage at all—simply get the one offering of their employer and do not have the benefits of being able to use their clout in the marketplace.

So what we try to do in the Healthy Americans Act is to try to give some relief to both the employer and the employee in terms of modernizing this relationship and, of course, make the changes in the Tax Code, redirecting the Tax Code primarily so we do not reward inefficiency and subsidize the most affluent.

What is your sense about the importance of modernizing the relationship between employers and employees which largely governs pretty close to 250 million people, if you set aside Medicare and the military?

Mr. WALKER. Just as I do not think the States can solve this problem alone, employers are not going to solve this problem. I think we need to modernize the relationship between employers and employees and also the Government. I think we need to stand back and refocus on those four pillars, and that means modernizing the relationship for employers, employees, and Government.

Senator WYDEN. With respect to the individual—and I have really been pleased that you have been constantly bringing back this matter to the individual because I think not only is personal responsibility important, but we have pretty much divorced individuals from much of the decisionmaking process. The employer buys the health care, and the worker says, "I hope my insurance covers it," and we go off and call it a day. And, of course, we try to change that as well in the legislation by, in effect, making sure that the employee sees that there are actually rewards in terms of shopping efficiently.

But on the question of quality—and Senator Whitehouse has done very good work on this. He and Senator Stabenow have really been our leaders. I want to ask you about something that I am talking to people at home about and around the country, and that is the consequences of buying health care that is not particularly cost-effective or is not high quality.

I get the sense that Americans, if they feel they are getting good information—in other words, we are doing the kinds of things Senator Whitehouse is talking about, making sure people get good information—I think they are prepared to say, "All right, if I want to go to so-and-so and it is not the best buy in terms of dollars or at the top of the quality list," I think they are prepared to say we ought to pay a little bit more for that, as opposed to the offerings that might be higher on the chart with respect to quality and cost-effectiveness.

What is your thinking with respect to consequences for individuals of buying quality when, in fact, we have put in place the kinds of reforms that Senator Whitehouse is talking about so that people can actually get good information?

Mr. WALKER. It is appalling to me how outdated and how inadequate the information that we have on health care is, given the size of health care spending as a percentage of our economy and given the importance to a variety of players. Clearly, we need more timely, accurate, and useful information on cost and quality in health care. And when you use the words, "are we willing to pay for it," I assume you mean the individuals, are they willing to pay for it, because I think part of the problem we have right now is that the "we" is future generations.

Senator WYDEN. Individuals, but starting to weave this through the system. We say, for example, in the Healthy Americans Act, that under Medicare, you know, seniors who do things to lower their blood pressure, their cholesterol, stop smoking, they are going to be eligible for lower Part B premiums. I am interested in your thoughts about making sure that individuals really see that there are some actual financial underpinnings for buying smart.

Mr. WALKER. I strongly support that concept, and it is fully consistent with the four pillars that I talked about. When I talk about, personal responsibility and accountability, it means incentives for people to behave properly; and if they do behave properly, they achieve some benefit. And if they do not behave properly, there is some consequence.

I think for any system to work—a health care system, a tax system, a corporate governance system, whatever—you have to have three things that we are touching on: incentives for people to do the right thing, and that does not necessarily mean tax incentives, by the way; second, transparency to provide reasonable assurance they will do the right thing because somebody is looking, and it could mean the public, the consumer; and, third, accountability if people do the wrong thing.

So if we build around the four pillars of health care and those three universal concepts, I think we can achieve some great things, but it is likely to have to be done in installments.

Senator WYDEN. Well, that is, I think, a topic for another day. I hope that we will recognize that health care is like an ecosystem.

If you move it over here, you are going to have effects over there. And the history, of course, of going at this piecemeal is not particularly good. If you look, it is not just after 1993 when, of course, the plan went down during, you know, other periods of time, and I actually looked at the history. You know, what we almost always say is, well, we have to do it, you know, this piece and that piece. I think that is very hard to do. We have now got 12 United States Senators who I think are making that judgment that this is an ecosystem. A lot of the people who have coverage are one rate hike away, you know, from losing it, and that there are reasons now to intertwine the interests of those with coverage and those who do not have coverage. In the past, they were often pitted against each other.

I think if you keep doing the outstanding work you are doing to make sure that people understand what the choices are in areas like we have talked about this morning, that the Federal Government has to be a better partner so that we do not see the Californias and other States that are trying so hard, see their proposals go by the boards. I think this time, after 60 years of jawing on this, I think this time we are going to be able to thread the needle, and a big part of it when we do is going to be the fact that you spent so much time and effort educating the public on our choices, and I thank you for the good work.

Mr. WALKER. Senator, I want to thank you for your leadership on health care area. I know you have been really dedicated to this for a long time. And, again, the two issues we are talking about here are directly interrelated. Our fiscal challenge is driven primarily by health care. In many ways, what you are saying is, just as Chairman Conrad has said that he believes there is a need to have some type of task force or commission in order to be able to deal with the multiple elements at once, you are saying you believe you need to deal with multiple elements at once in order to try to achieve meaningful health care reform that treats it like an ecosystem, which I think is an interesting analogy.

I am just saying I do not think that you will pass one bill and say, ”We are done.“

Senator WYDEN. Fair enough.

Mr. WALKER. That is all I am saying. But I am all for trying to make progress on as many of those pillars as possible.

Senator WYDEN. Chairman Conrad has given me a lot of extra time. I think it is fair to say—and I think the Chairman said it—we expect as members of the Budget Committee and the Finance Committee to be working on health care throughout our time in public service. There is not going to be one shot and it is done.

Thank you for your outstanding work and for the extra time, Mr. Chairman.

Chairman CONRAD. Yes, sir, Senator Wyden. I very much respect the extraordinary effort that you have made in this area and also the very substantive contributions of Senator Whitehouse. I really appreciate the special dedication that you have given to what really is the greatest challenge that we face in all this, which is the health care sector. That is the 800-pound gorilla. That is what could swamp the boat.

In that regard, on Thursday we are going to be having a hearing especially dedicated to long-term health. I hope both of you will be here. We are going to have Dr. Orszag here from the Congressional Budget Office who has done a good deal of work. I know the two of you have both worked with him closely.

Tomorrow, we are going to be doing a hearing on the economic stimulus package, and with respect to that, I would like to ask one more question. You have said the stimulus package ought to meet the test of the three T's: timely, temporary, and targeted.

With respect to the third, targeted, we now have a proposal before the Senate Finance Committee to take the income caps off of the rebates. The White House and the House of Representatives leadership had agreed to caps that begin at $150,000 for a couple, $75,000 for an individual. Under the Senate proposal, as I understand it, those caps would be completely lifted, which would mean we would have the spectacle of the Federal Government sending $1,000 checks to Bill Gates, Donald Trump, Barry Bonds, Members of Congress.

What do you think about that?

Mr. WALKER. Even though it is obviously not to my personal advantage, I do not believe that meets the definition of "targeted."

Chairman CONRAD. Nor do I. I think, you know, we have to show some discipline around here, and if we are going to start sending checks—in fact, I asked the first—I asked about it. "You mean, you are telling me my wife and I are going to get a check?" I mean, you know, we do not need a check. Wouldn't spend it if we got it, so that does not stimulate the economy. Sending a check for a thousand bucks to Bill Gates is not going to stimulate the economy. Sending $1,000 to Donald Trump is not going to stimulate the economy. I have high regard for both of them, but that is not going to stimulate the economy. I think at some point we would become ridiculed if we start just sending checks regardless of whether it has any stimulative effect.

Would it, in your judgment, have any stimulative effect to be sending checks to the highest-income individuals in our country?

Mr. WALKER. I think you should target the action to those that are most likely to consume the funds quickly, and the persons you talked about have plenty of funds. They do not need $1,000.

It would be interesting if maybe at the time you sent out the $1,000 refund check, if you sent out the $175,000 bill, which is the per capita burden for the $53 trillion, that might get people's attention. "Here is the good news and the bad news."

Chairman CONRAD. Yes, "Here is your thousand bucks. By the way, you owe net $175,000."

Mr. WALKER. We need to think outside the box on how we can start communicating some of this information in forms that people might read it. And, Senator Whitehouse, one of the things that I think we ought to be doing, the national debt clock shouldn't be based on $9.2 trillion. It should be based on $53 trillion. And why do I say that? Because if you make a $12 trillion downpayment, you get credit if you have a $53 trillion clock. If you have a $9.2 trillion clock, you do not get any credit because you are not reducing the current debt. You are reducing the future burden.

So I do think we have to think about how we can end up using opportunities to communicate more effectively with the American people. And I am only halfway kidding. Maybe we ought to think about—you know, you know they are going to open the check. You know they will open that, and they will read that. Maybe they will read a stuffer.

Chairman CONRAD. I tell you, it is really sobering, the situation that we are in. Every time we hold these hearings, it becomes increasingly apparent that we are on a course here that is utterly unsustainable. And it is time to act. The reason it is so important we take action sooner rather than later is the longer we wait, the more draconian the solutions become. And, you know, I understand my colleagues. I cannot tell you—just in the last week I have had a number of my colleagues come to me and say, "You aren't really going to go to markup on your proposal, are you? You are going to insist we actually vote?" Yes, I am going to insist we actually vote, because this is a situation that we simply must address. And so we are going to vote. And I am sorry if that causes discomfort to some of my colleagues, but, look, this cannot be kicked down the road again. Why not? Because the time for action is the early part of the next administration, whoever leads it—you know, you think about this. They are going to come into office in 2009. At the end of their term, the trust funds will have gone cash negative.

You know, this is it. We have kicked this can down the road about as long as it can be, and it will absolutely bedevil the next administration. The time to act is the first year. It will not happen the second year because we will be right back in an election year. And the time to act is next year. And the only way we are going to do that is if we have a process established.

Now, I am open to the thoughts of colleagues about how the proposal that Senator Gregg and I have offered might be changed. We have heard three complaints:

One, timing, because we had called for the report to be done this year, in anticipation of the work being done this year. Obviously, that is not going to happen, so the timing needs to be changed.

Second, we have heard criticisms that there ought to be the possibility for amendment. Let me just say we will resist that because we have set up a process that requires super majorities to have a report, super majorities to pass, and, of course, the President retains the right to veto. That would require a two-thirds vote to overcome. If we start having amendments, we know what will happen. There will be amendments offered which will have no revenue. There will be amendments offered that have no benefit reductions, and people will vote for one of those and say, "Gee, we did something." You know, one will have revenue as part of a package and one will not. One will have benefit reductions. One will have benefit reductions that are insufficient to do the job. And so people will vote for one or the other and then have an excuse not to vote for the one that would actually do something. We all know how this works.

The other question—we have the question of timing. We have the question of amendment. We have the question of whether a supermajority vote is required in the House. That I am open to consideration on because the House does not have a tradition of requiring a super-majority vote. They are concerned about setting the precedent. They are concerned about turning the House into the Senate, because in the Senate, obviously, there is a right to filibuster, there is a requirement for a super majority. So there is going to have to be a super-majority vote here. But, look, at the end of the day we need to get this resolved.

The other question is whether there are outside persons involved. I personally do not think that is wise with respect to the membership. I do think it is required that we have outside advisers. For example, I believe there should be certain ex officio members. Dr. Walker, you would be among the most prominent that I think ought to be ex officio advisers who would be involved every step of the way with respect to providing advice and counsel to the members of this task force.

With that, I want to conclude this hearing and again thank you for your contributions to this Committee and, more importantly, to the country.

Mr. WALKER. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you. We adjourn the hearing.

[Whereupon, at 12:02 p.m., the Committee was adjourned.]

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON THE BUDGET
"The Long-Term Budget Outlook"
January 29, 2008

Thank you, Mr. Chairman.

I appreciate the opportunity to hear testimony from David Walker today about the long-term budget outlook.

As Mr. Walker points out, the two major credit rating agencies recently both have issued warnings that the United States must change course if we wish to maintain the "Aaa" rating on U.S. government bonds. A reduction in our credit rating would be calamitous, and I am confident that we will not allow it to happen.

This unwelcome development highlights the seriousness of the task before us. We must make changes to restore the confidence of worldwide investors in the soundness of our policies, but the magnitude of the changes necessary is daunting.

A recurring theme in these discussions is the dramatic increase in government health care costs over the past decade. There are many reasons for this, and I look forward to Mr. Walker's diagnosis of the problem and recommended solutions.

Another theme is the structure of our tax code and the incentives it creates for inefficient spending in health care. Finally, Mr. Walker points out that the Social Security surplus that has been reducing the unified budget deficit for many years will - - as soon as 2009 - - begin to decline for the first time. That is only a short time away. I agree completely with Mr. Walker's warning that we must begin making changes now to avoid more difficult changes later on.

Thank you.

ECONOMIC STIMULUS: BUDGET POLICY FOR A STRONG ECONOMY OVER THE SHORT AND LONG TERM

WEDNESDAY, JANUARY 30, 2008

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

The Committee met, pursuant to notice, at 10:01 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Murray, Nelson, Menendez, Cardin, Gregg, Domenici, and Bunning.

Staff present: Mary Ann Naylor, Majority Staff Director; and Denzel McGuire, Minority Staff Director.

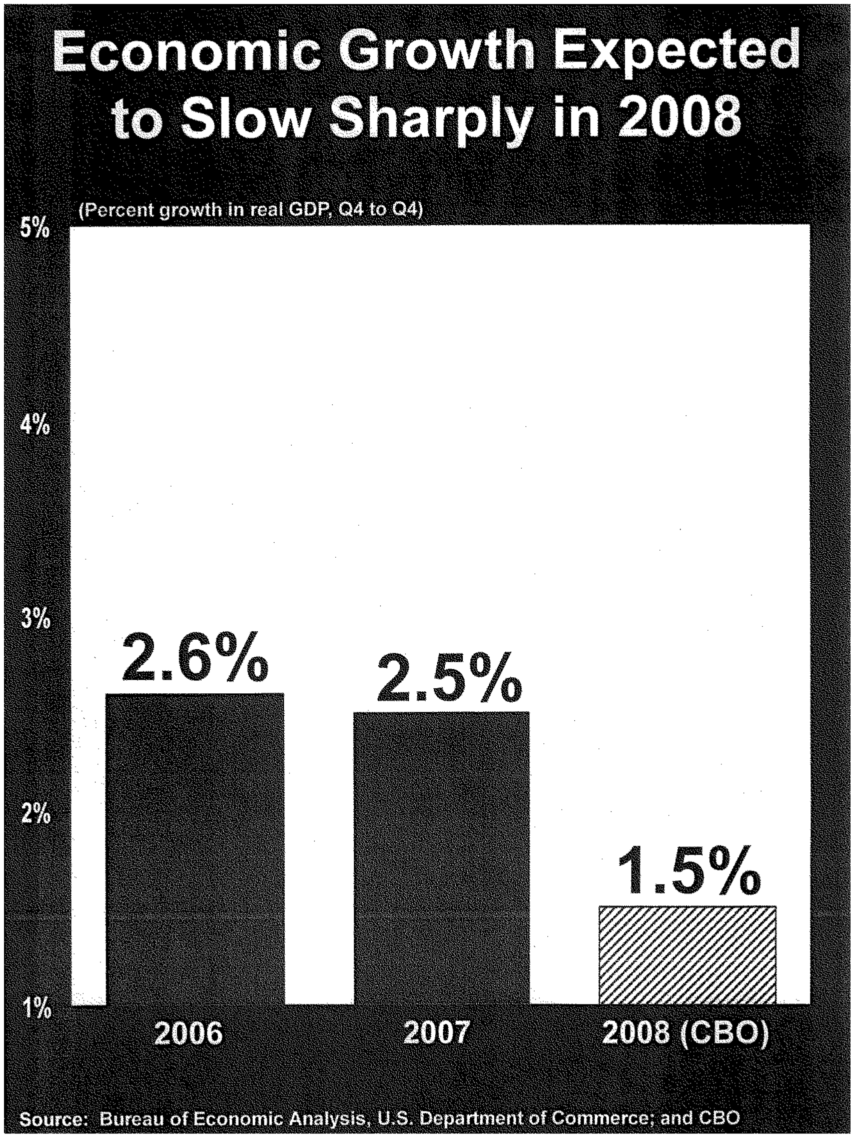
OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

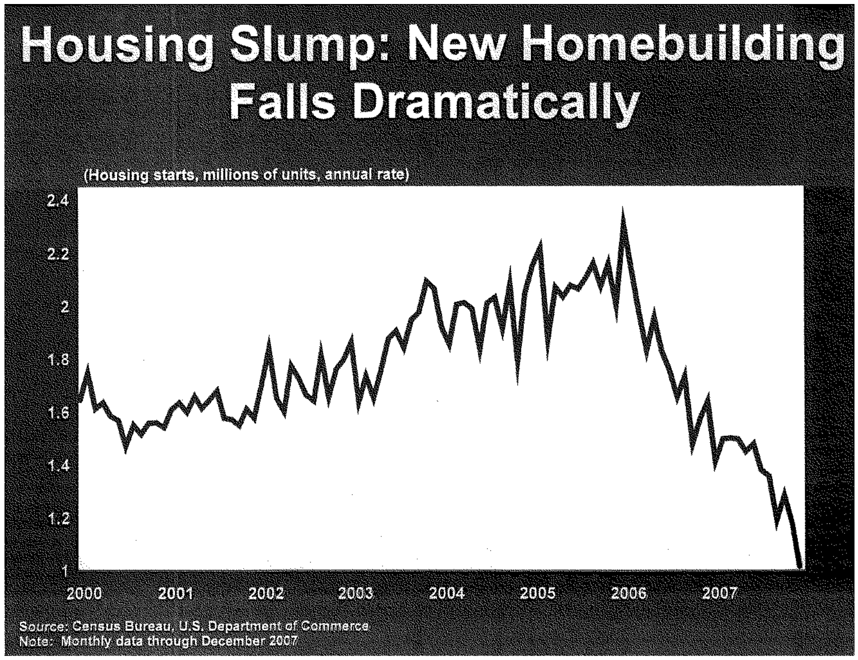
I want to thank our witnesses for being here today. It turns out that this hearing is very timely because the Finance Committee is going to mark up the stimulus package this afternoon. So this, largely through serendipity, proves to have been held at precisely the right time.

Let me just try to put a frame on this morning's hearing and then go to Senator Gregg for his observations and then turn to our witnesses.

We see, if we go to the first slide, that economic growth is expected to slow sharply in 2008. In fact, we have just received the news that gross domestic product grew at an annual rate of only six-tenths of 1 percent in the final quarter of last year. Over the course of 2007, GDP grew 2.5 percent, down slightly from the fourth quarter of 2.6 percent in 2006. We see that CBO is telling us they anticipate growth in 2008 at 1.5 percent.

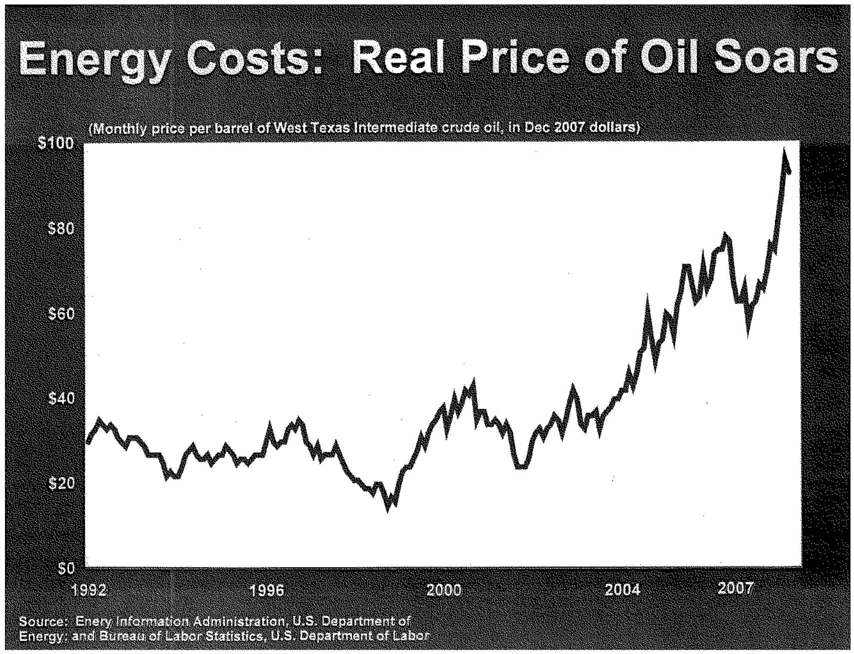


Let's go to the next slide.

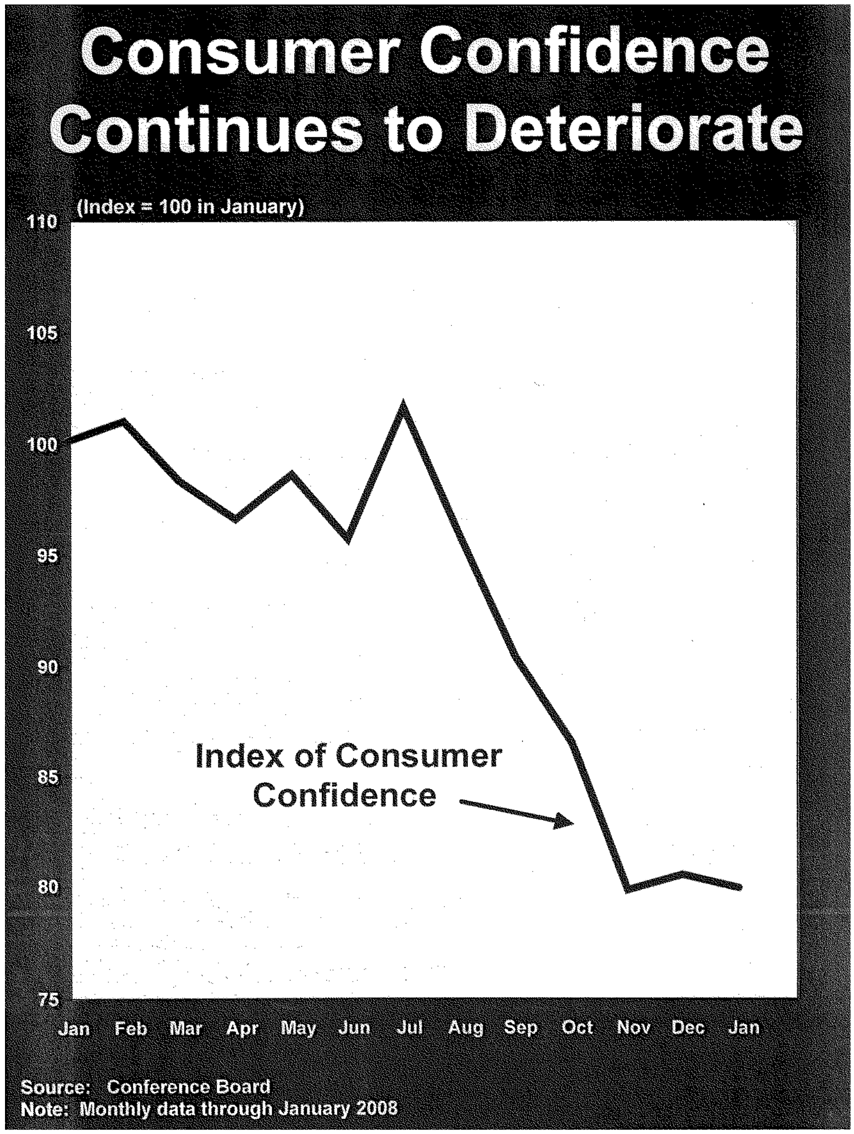


We all know that the subprime mortgage crisis, as some have described it, has been at the heart of the economic slowdown. It has obviously spread from the subprime area to other areas of credit. We see new home building falling dramatically through 2006 and continuing into 2007. I had a delegation of home builders come to see me yesterday, telling me about they see their industry not in a recession but in a depression, as they described it.

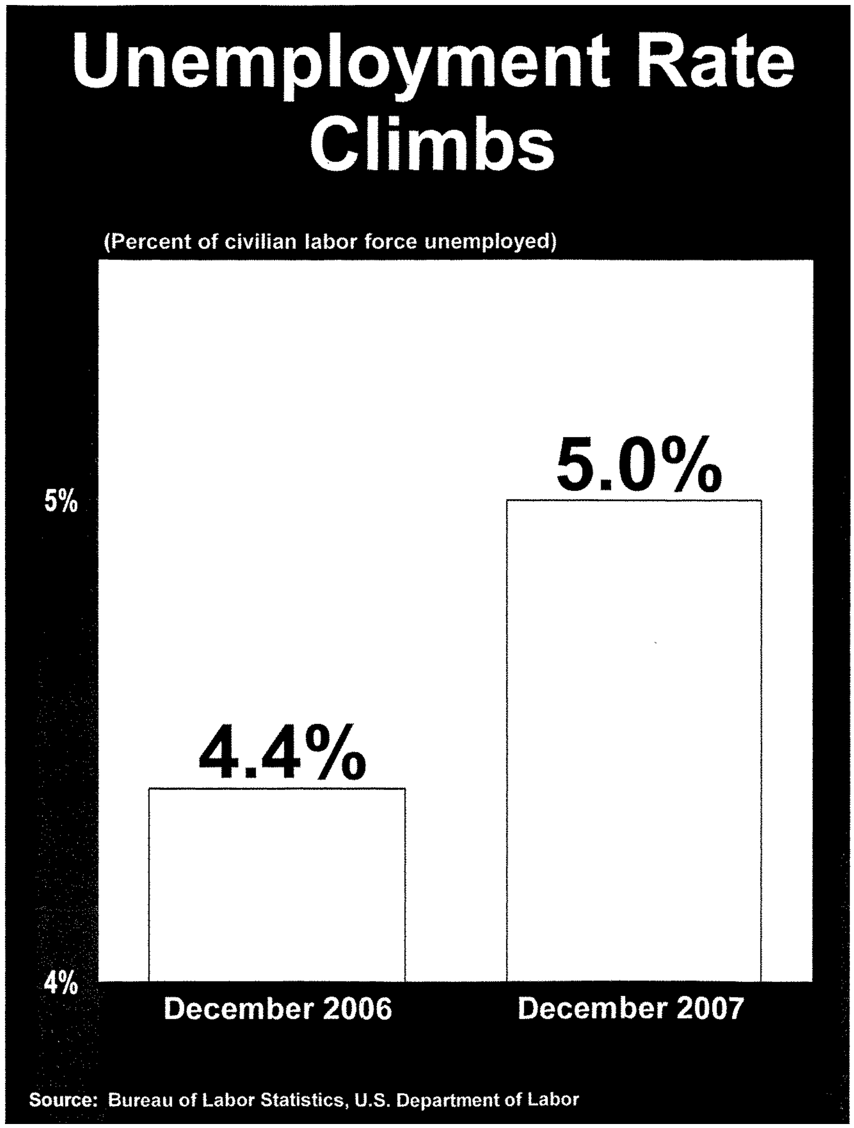
Let's go to the next slide.



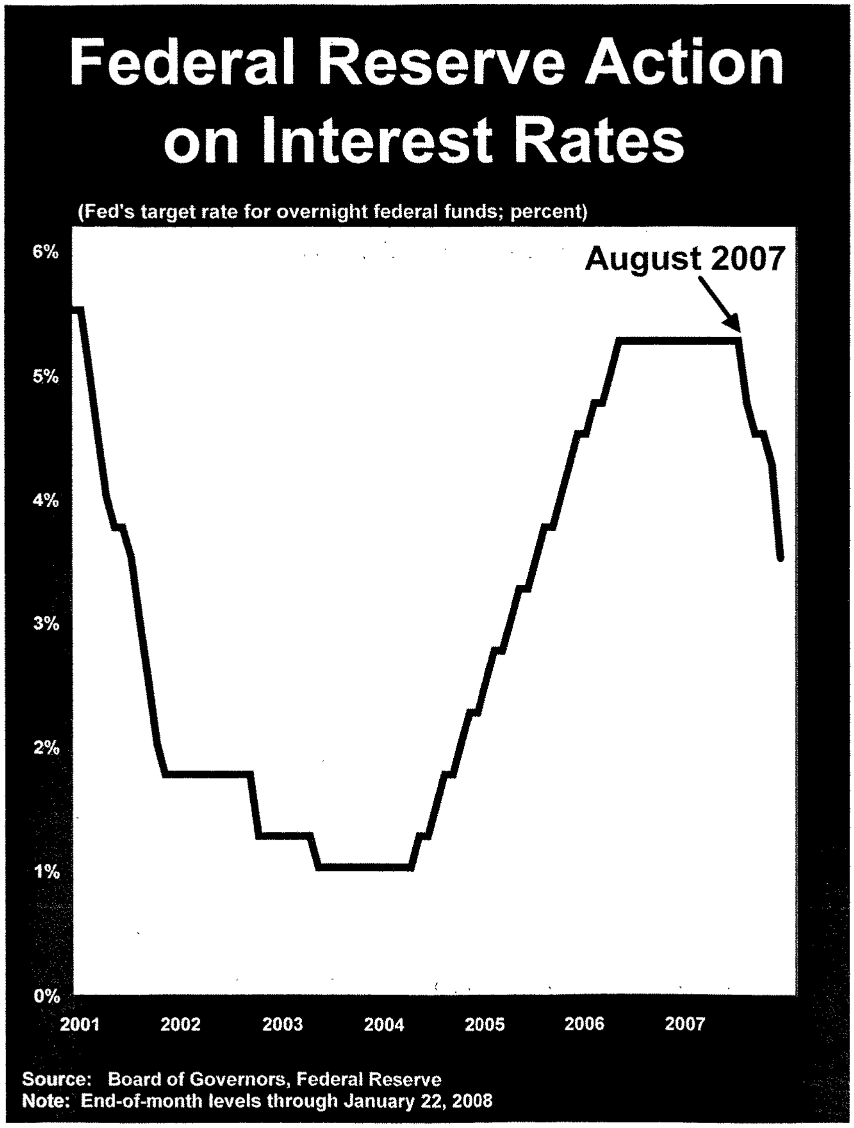
In the midst of all this, we also have soaring energy costs affecting people when they go to gas up at the pump, affecting them when they pay their utility bills. I certainly noticed it in my utility bills this last month. Energy costs, with the real price of oil soaring, oil at one point at $100 a barrel, all of this affecting consumer confidence. We see a continuation of declines in consumer confidence: after declining sharply last summer, consumer confidence has remained depressed into this year.



Unemployment has jumped. In December of 2006, the unemployment rate was 4.4 percent. In December of 2007, it had jumped to 5 percent.



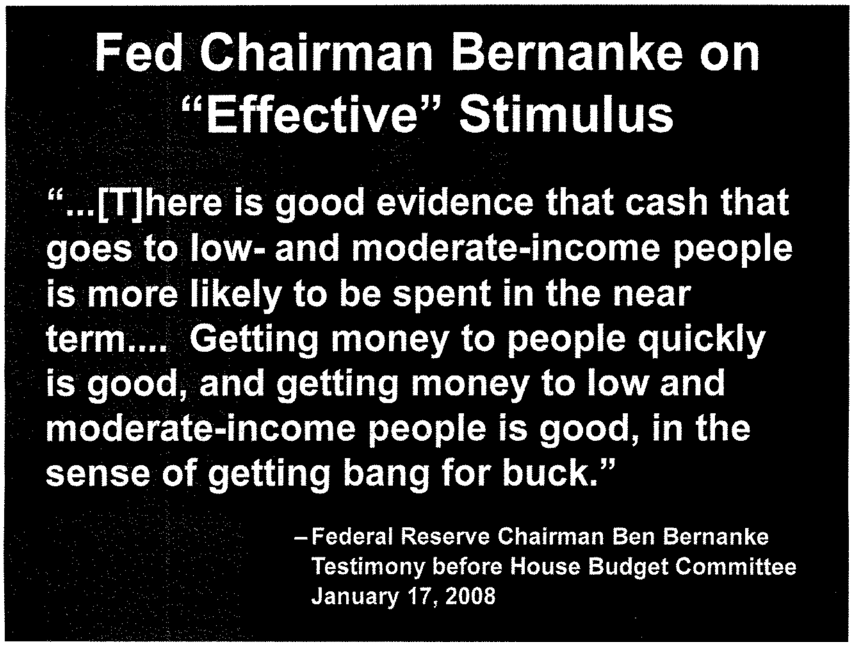
As a result of this, the Federal Reserve, as we all know, recently took emergency action between meetings to lower its target, Federal funds rate by three-quarters of 1 percent.



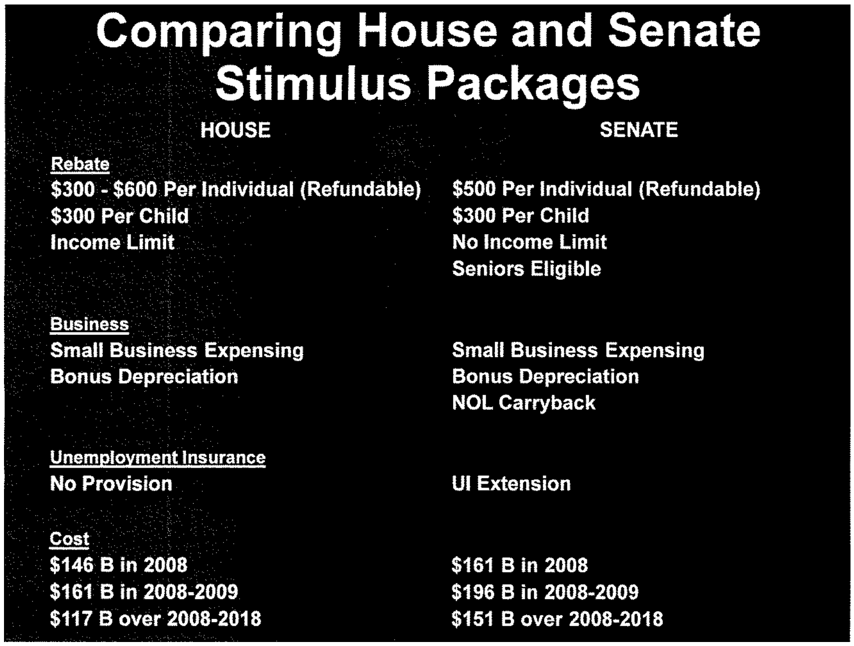
Let's go to the next slide, if we could.

The Chairman of the Federal Reserve has called for an explicitly temporary stimulus measure. He said, and I quote, "Any program should be explicitly temporary, both to avoid unwanted stimulus beyond the near-term horizon and, importantly, to preclude an increase in the Federal Government's structural budget deficit."

Let's go to the next slide, which is also a quote from the Chairman of the Federal Reserve. He said, in January of this year, before the House Budget Committee, "There is good evidence that cash that goes to low- and moderate-income people is more likely to be spent in the near term... Getting money to people quickly is good, and getting money to low- and moderate-income people is good, in the sense of getting bang for the buck."



Let's go to the final slide that compares the House package and the Senate package. We know in terms of rebates that more people would be eligible for the Senate rebate. There is no income limit. Seniors are eligible. On the business side, the significant difference is that the Senate package provides for net operating loss carrybacks. And on unemployment insurance, while the House does not have a provision, the Senate does.



And then in terms of cost, the Senate package obviously costs somewhat more: $161 billion in 2008 compared to $146 billion for the House package. Over 2 years, the Senate package costs $196 billion compared to $161 billion on the House side.

I am delighted we are having this hearing with such distinguished witnesses today so that we can discuss the views of the members and the views of the witnesses with respect to what a stimulus package might include and how we might think about those issues.

With that, I want to turn to my very able colleague, the Ranking Member of this Committee, the former Chairman of this Committee, Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Thank you, Senator Conrad, and many of the numbers that you have cited are numbers which set the table appropriately relative to the issue of the economic slowdown. But the question is, What should the Federal Government do? And any stimulus package, in my humble opinion, should be a real stimulus package, and that means it should be targeted on this quarter, the next quarter, and the following quarter—the first three quarters of this year.

My guess is that most of what the Fed is going to do—and this was testimony actually from Dr. Orszag—will have an impact beginning aggressively in the third and fourth quarters of this year. And we need to be careful that the stimulus package is well focused as a result of that and does not end up incurring costs and stimulus outside of what is the period when we expect the slowdown to occur.

We also have to understand that any stimulus package is going to be funded by debt, and I noticed in your numbers—and I presume that this is reasonable—that you did not calculate in the interest, I do not think, on the debt that all this is going to cost, but our calculation is that a $150 billion stimulus package today over 5 years will have about a $36 billion debt cost and over 10 years will have about an $80 billion debt cost. I think those are the numbers. Is that right? OK.

So you are talking packages which are truly going to cost our kids around 200 billion bucks. And what are they going to get for that? What is the economy going to get for that? Well, I am not a great fan of the House package, but it appears to be the high watermark when you compare it to the Senate package, because the Senate package, for some unknown reason, is now lifting the cap and saying let's send $500 to everybody. So we will fly across the country in a plane and throw money out of the plane to everybody. And what are the practical implications of that?

Well, with high-income people, first off, it is unlikely that that rebate is going to get out the door very quickly. If it gets out by the middle of June, we would be fortunate, and that means it is probably not going to impact us until the third quarter. And with high-income people, it is probably going to be saved. It is probably not going to go into demand stimulus, which is what usually you are looking for.

Second, as a very practical matter, if you extend the unemployment insurance, as is proposed in the Finance Committee package, you end up with a situation where we are at 5-percent unemployment right now in most of this country—in some places well under 5 percent, like in New Hampshire—and it is very hard to defend extending unemployment insurance as an economic stimulus event because if you are in what is a relatively full-employment economy, it just simply creates more of an incentive for people not to go out and find a job. Most of the jobs that are—most people find their jobs in the last couple weeks of their insurance running out. If you extend it for a year, which is what is proposed in the package, you basically end up with a situation where, if that extension occurs in States where you have fairly close to full employment, you are not going to get much stimulus out of that package. Thus, there should definitely—any unemployment extension should, in my humble opinion, be tied to a trigger which says it occurs in States where the unemployment has reached a historic level which is deemed to be not full employment, such as 5.7 or 5.8 percent, which is the historic number we have been looking at.

There is no trigger, however, in the proposed package here, and it is a bigger package as a result of that. Also, I am not sure how this NOL in the Senate Finance package works. I have heard different statements that you get the NOL if you do not take advantage of the accelerated depreciation. But if you take advantage of the accelerated depreciation, then you cannot take the NOL. I am not sure what the economic impact of that is.

I will say that, from my own personal standpoint, if you are going to do something to create long-term efficiencies in the economy, expensing, accelerated depreciation, NOL carryback are probably positive things. But they are not going to have an immediate economic stimulus. But they will at least have a long-term effect. Whereas, simply giving people a rebate check, in some instances giving them a check even though they do not pay taxes, is probably not going to have any significant stimulus on the economy other than the psychological stimulus, because much of what will be purchased with that stimulus will be manufactured outside the United States. And as Dr. Orszag testified yesterday, if it is manufactured in China, the $500 is spent on a television manufactured in China, the stimulus to our economy is basically nonexistent.

So this stimulus package is really, in my humble opinion, more about building confidence that the Government can act and that a divided Government can come together and take action than about actually having stimulus effect in the next two to three quarters, which is when we need it. In that context, the package which does the most good from a standpoint of the "Kumbaya" factor is the House package. And the package which does the most harm from that standpoint is probably the Senate package because it divides an already agreed to understanding. But I have reservations about both, obviously.

However, that being said, I look forward to hearing from the witnesses as to what they think should be done, and that is why they are here and they are experts, and they are highly regarded in their field, and we appreciate them taking the time to testify.

Chairman CONRAD. Thank you, Senator Gregg, and thank you for your observations.

I must say when we have identified all along the three T's as what we should be doing with the stimulus package—targeted, timely, and temporary—to start taking——

Senator GREGG. "Kumbaya."

[Laughter.]

Chairman CONRAD. To start taking the income cap off and sending $1,000 checks to Bill Gates and Barry Bonds and Donald Trump and Members of Congress, I think we have really lost our way.

Senator GREGG. I agree.

Chairman CONRAD. I mean, that just cannot be the answer here.

Senator GREGG. Once again, bipartisan agreement in the Budget Committee.

Chairman CONRAD. OK. We have agreement here.

Senator GREGG. I do not know. We did not ask Senator Bunning.

Senator BUNNING. Yes, I agree 100 percent.

Senator GREGG. Two Finance Committee members agree.

Chairman CONRAD. We welcome Alan Blinder, the Gordon. Rentschler Memorial Professor of Economics and Public Affairs, and Co-Director of the Center for Economic Policy Studies at Princeton University. Dr. Blinder has testified before this Committee before, and we welcome you back. We also have with us Mark Zandi, the Chief Economist and Co-Founder of Moody's Economy.com. I am very glad to meet you, sir, because I very much enjoy reading your work. And Daniel Mitchell, a Senior Fellow at the Cato Institute. Welcome all. We are delighted that you are here.

Dr. Blinder, why don't you proceed, and then we will go to Dr. Zandi and then to Dr. Mitchell.

STATEMENT OF ALAN S. BLINDER, GORDON S. RENTSCHLER MEMORIAL PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, AND CO-DIRECTOR, CENTER FOR ECONOMIC POLICY STUDIES, PRINCETON UNIVERSITY

Mr. BLINDER. Yes, thank you, Mr. Chairman, members of the Committee. I appreciate the opportunity to testify here on this particular day on this particular issue, which is, of course, an important issue for the Budget Committee, by definition, and also something that is on the immediate Senate agenda. But at the end I want to raise a couple of things that are not quite on the immediate agenda, but that I think are more important.

The testimony, which is much too long to deliver in 7 minutes, is organized around five questions. I am going to boil them down to three for purposes of this morning.

The first is something that Senator Gregg was just implicitly asking, which is: Should we enact a fiscal stimulus package now at all? I think the answer to this is probably yes, but, frankly, the case is not airtight. The Federal Reserve, as you know, is cutting interest rates aggressively. We are normally accustomed to leaving these sorts of tasks to the Fed. But the problem is that the Federal Reserve's medicine works slowly, as you mentioned, Mr. Chairman. And so that says that, if the economy starts deteriorating very rapidly in front of your eyes, the Fed can act very quickly, but it will not actually give the economy a boost in a sufficiently timely way. So the question is: Is the economy actually slipping down very rapidly?

Again, I would say the answer is that there is a reasonable likelihood of that, but we do not know for sure. It is certainly not as clear as many people are saying. I would be much more convinced if, 2 days from now, when we get the next employment report, it looks as bad as the previous one, or worse, rather than much better, which I think is the current guessing. And I would also be more convinced if I saw one more month of weak retail sales. We have only really seen one so far. The real issue here for the economy is the infection of what I like to call "the 96 percent" by "the 4 percent." The 4 percent is the housing sector, which, as the Chairman mentioned, quoting someone else, is really in a depression. There is not any question about that. Up to now, the 96 percent is holding up well. But there are fears that it is not going to last.

So I think it is wise to get a stimulus package designed and ready to go immediately, basically. I do not imagine—although the House and the Senate are moving with incredible speed on this—that this is going to be enacted before February 13th, anyway. But I could be wrong about that. I cannot remember seeing this body move as quickly as it is moving right now. You are all better judges of that than I am.

The second question, which is always of interest to the Budget Committee is about this idea of paying for it and how does this square with PAYGO. When it comes to stimulus, the answer to the question "should we pay for it?" Is a resounding no. Paying for it takes away the stimulus with one hand that you are putting in with the other hand. That said, this Committee's longstanding concerns with budget deficits is very, very valid. But what needs to be understood is that it pertains to long-run issues. We want to keep the budget deficit down in order to spur capital formation, to improve technology, to keep real interest rates low in the long run, and so on. These all have to do with the economy's ability to supply goods and services.

In a short-run emergency, the focus is not on supply but on demand, on getting spending higher—or preventing it from sagging, which amounts to the same thing. And it is that thinking that leads to the three familiar principles that Senator Conrad just alluded to, the three T's. And the one that I want to emphasize in that context is targeted to produce spending. The other two are equally important, and temporariness is especially crucial to the question of how much deterioration in the long-run budget picture are we causing by a stimulus. The answer is quite little. The numbers that Senator Gregg was just citing on the interest burden were suggestive of around $4 billion a year, or something in that kind of a range—which, of course, in a budget the size that we have is extremely small.

The third question, which is the one that Congress is wrestling with literally right at this minute, I guess, is what elements of a stimulus package make sense. I want to answer that two ways—first sort of generically, just in the abstract, thinking about stimulus; and then, second, how can we tailor this to the circumstances of 2008?

So, generically, I would give the grade of A, in terms of inclusion on a stimulus package, to two things which, unfortunately, were left out of the House package: the extension of unemployment benefits and Food Stamps. The reasons, again, have to do with bang for the buck. When you give money to people that have lost their jobs, you are giving money to people who are trying to maintain their previous standards of living. It is hard to imagine anything that has greater surety of getting spent right away than that—except maybe giving it to Food Stamp recipients who are literally living hand-to-mouth. The basic principle is that you want to give the money to people who are going to spend it right away, if and when your objective is stimulus, which I think is the case now.

After that, I would give a grade of B to sending out checks, e.g., tax rebate checks, especially to low- and moderate-income people—as Senator Gregg mentioned, not to high-income people—who are less likely to spend it. But it is important not to limit the checks to people who have enough income to pay income tax, and it was a good idea that the House package was designed that way. And I think it was also a good idea that the House package capped the payments at certain income levels. There is no magic number there, but the principle of capping is very important if you care about bang for the buck. And I think we need to care about bang for the buck.

It will not have escaped your attention that this list of recipients who would get moneys that were labeled, by me anyway, and other people, too, A's and B's are the people most in need. We all know about Franklin Roosevelt's famous aphorism about bad morals being bad economics. When it comes to stimulus, good morals turn out to be good economics as well. That is where the "Kumbaya" factor comes from, and it is perfectly appropriate in this case.

Moving down the list, and very briefly, I would give the grade of C, which is still a passing grade, to transfers to State and local governments who otherwise are going to be raising taxes and cutting spending and making the situation worse.

I would give the grade of D, with charity, to business tax cuts, which may or may not have good rationales for long-run reasons, but which are not going to provide short-run stimulus. That is all in general.

What about the specifics of 2008? As the Chairman mentioned, two things, and mainly one, are contributing to the current economic travails: higher oil prices and housing, which is a multifaceted problem. So what might we do specifically in such circumstances that we might not want to do in more generic circumstances?

Well, in terms of energy prices, there is a program that you all know about called LIHEAP that is specifically designed to send money to poor people who are having trouble paying their energy bills—which, of course, have mounted substantially. This is by the same reasoning as for Food Stamps, likely to lead to checks sent by the Government that lead to spending by people extremely rapidly.

On the housing front, it is quite a bit more difficult, since there is no ready-made institution for doling out the money to the particular types of people having difficulties with their houses—for example, forestalling of foreclosure—that would guarantee very rapid turnaround of spending. There are some steps in this direction in the House bill, and I think they are fine. I think the Congress, both Houses, and the executive branch need to keep working on this significantly. As I will say in a moment, I think some new institutions are probably necessary. But you do not do that in a stimulus bill. You do that after a stimulus bill.

But what I want to close with is just a minute or two of what maybe should happen after the stimulus—as a natural followup because of the specific and longer-term difficulties we are having with housing. I will be very brief on this.

To start, I am very much in the Alan Greenspan school. You may have noticed that he told an interviewer—I cannot remember who it was—a few days ago that one thing we know the Government can do is send cash to help alleviate this problem. So how could you send cash? Well, one way is cash transfers to help poor people make their mortgage payments and avoid foreclosure. Another is giving assistance to State and local governments and community organizations who are trying to prevent neighborhoods from being blighted by abandonment. And this is happening. A third is to put more counselors, and especially workout specialists, into the field to help people who can avoid foreclosure to actually avoid foreclosure, perhaps by refinancing their mortgages on more reasonable terms than the ones that they now have.

But, unfortunately, the current financial problems extend well beyond subprime mortgages and, indeed, beyond mortgages as a whole. As I think you all know, the credit and fixed-income markets are in a tizzy right now, and some of them are barely functional at all. That is what is motivating the Federal Reserve's actions, I think, more than anything else. But in any case, my personal worry is less about recession—actually showing negative GDP growth as opposed to positive 0.6 percent—and much more about our economy's ability to mount a vigorous recovery after the period of sag. That is what plagued us in the years 2002, 2003, and 2004. It was not that we had a terrible recession in 2001. We had a minuscule recession. But we just did not climb out of the hole as rapidly as we had in the past.

Now, in terms of fixing these markets, it would be nice to see and appropriate to see private capital rushing in to do the job. Unfortunately, this crisis is now about 6 months old, and this does not seem to be happening to any great degree. Instead, what you see is incredible risk aversion ruling the markets, bid-ask spreads for fixed-income securities that are gigantic, amazing. When they are that large, that means the market is basically not functioning. And a scarcity of bargain hunters coming in to take advantage.

This is a dangerous situation, and that is what leads me to say that Congress ought to start thinking, after the stimulus bill, about establishing potentially new Federal agencies. One that I would think about would be analogous to but not identical to, because the problems are different, the RTC, the Resolution Trust Company that Congress started in order to fix up the mess left by the savings and loan debacle. The job here would be to get these fixed-income markets functioning again and then go out of business, as the RTC did.

The other thing I think Congress should be thinking about is something analogous to what was done in the Great Depression, the last time we had a housing problem this bad. The HOLC, Home Owners Loan Corporation, existed for about 3 years and was focused on refinancing homes to prevent foreclosures. This is not going to get done in 24 hours. It is probably not going to get done in a month. But it is something I think the Congress needs to think about for the future.

Thank you all for listening.

[The prepared statement of Mr. Blinder follows:]

On Designing a Fiscal Stimulus--Quickly

Testimony of
Alan S. Blinder
Gordon S. Rentschler Memorial Professor of Economics and Public Affairs
Princeton University
to the
Senate Budget Committee
January 30, 2008

Mr. Chairman, members of the Committee, I'd like to thank you for the opportunity to testify here today on the fiscal stimulus issue. This is not only an important question for the Budget Committee, but one that the Senate needs to deal with almost immediately.

I'd like to organize my testimony around five questions:

1. As a generic matter, when and why should Congress think about enacting fiscal stimulus?
2. Do these conditions apply today?
3. Should a fiscal stimulus package be paid for?
4. As a generic matter, how should a stimulus package be designed?
5. How should those general guidelines be modified to tailor the package to current circumstances?

1. When and why should there be fiscal stimulus?

For the most part, we rely on the Federal Reserve to regulate the macroeconomy, cutting interest rates when the economy looks weak and raising them when the economy strengthens. As a general matter, the Fed has performed this function admirably over the past 25 to 30 years. So when and why should Congress seek a role in this job?

First, under normal circumstances, *it shouldn't*. It is important to preserve the independence of the Fed so that it can do its job in an apolitical, technocratic way.

But there are circumstances in which the Fed either cannot or should not go it alone. I'll spare you an exhaustive list and focus on the one that presumably applies today:[1] namely, when the economy deteriorates rapidly and unexpectedly, the Fed's medicine—interest rate cuts—may be too slow-acting to cure the patient. Let's be clear about this. The Fed can take action on a moment's notice, as it did just eight days ago. (The FOMC is expected to cut rates again in a few hours.) But six months to a year elapses before interest rate changes have any substantial effects on economic activity. If the economy starts sliding downhill fast, that may be too long to wait.

This simple observation already suggests the first crucial design principle for fiscal stimulus:

Fiscal stimulus must be fast-acting, or else it loses its basic rationale.

It is important to realize that the term "fast-acting" encompasses three distinct aspects, and they all matter. First come the *political lags*. For a stimulus to be effective, Congress must enact it quickly—in the current context, I would say we need a bill by the end of this quarter. Fortunately, Congress seems to be acting with amazing speed on this matter. In terms of program design, political lags suggest concentrating on items for which a bipartisan consensus exists or can be cobbled together quickly.

Next come *implementation lags*. For stimulus to be timely, there must be minimal administrative barriers and delays involved in implementing whatever policies are enacted. That probably precludes, for example, starting new government programs from scratch.

[1] For more detail, including other possibilities, see Alan S. Blinder, "The Case Against the Case Against Discretionary Fiscal Policy," in R. Kopcke, G. Tootell, and R. Triest (eds.), *The Macroeconomics of Fiscal Policy* (MIT Press: 2006), pp. 25-61.

Last, but not least, come *expenditure lags*. For stimulus to be effective, the policies, once promulgated, must induce more spending promptly. I'll have more to say about the implementation and expenditure lags when I talk about specifics of program design later.

2. Do we need a fiscal stimulus now?

Years ago, I kept a corny card pinned to my bulletin board. It read: "My final decision is maybe." I am feeling a bit that way about stimulus right now, though I'd change the "maybe" to "probably." Let me explain why.

Under the consensus forecast, the U.S. economy is in for two, maybe three, rocky quarters: especially the fourth quarter of 2007 and the first quarter of 2008. Then things will start to improve. Furthermore, the first of these rocky quarters is behind us, and we are already living in the second. So if the consensus forecast comes true, there is little reason for fiscal stimulus. Similarly, the latest CBO forecast, issued just a week ago, predicts an average real GDP growth rate of 1.5% from the fourth quarter of 2007 to the fourth quarter of 2008, and an average unemployment rate in 2008 that is more or less where it is now.[2] These are not forecasts of recession.

But there are a few problems. First, forecasts are not that accurate. Second, the consensus forecast itself is being marked down. Indeed, the main reason why the new CBO forecast is below consensus is that it is so recent. Third, these markdowns are probably not over; the recent news has been bad. Fourth, a number of observers believe we are in for much worse than the CBO foresees: a recession or even a severe recession (which we have not experienced since the early 1980s). I myself would put the

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[2] See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, January 2008, page 22.

probability of recession around 50%. If the economy performs much worse than the current CBO forecast, fiscal stimulus will certainly look wise in retrospect.

So how does Congress, lacking a crystal ball, decide what to do *now*? Consistent with my corny motto, my preference right now is to watch and wait, though not for long, and then to act with great dispatch if the need becomes clear. The wait I am talking about is very short. I would like to see one more employment report (which is coming out in two days) and one more report on retail sales (which is coming out in two weeks). If the January numbers are as bad as the December numbers, I'd recommend fiscal stimulus immediately. But if incoming data suggest that December was a fluke,[3] we may want to hold our fire for a bit.

To speed up the legislative process, I would recommend a specific "fast track" procedure under which Congress agrees on a stimulus program as soon as possible, writes the legislation, but does not put it into effect just yet. Instead, we let a little more time go by to see if we really need stimulus. At that point, Congress should hold a straight up-or-down vote on whether to put the previously-designed stimulus package into effect. If the data for January look bad, this delay will amount to nothing. But if they come in unexpectedly strong, I'd advise waiting another month or so.

Some economists have suggested a similar but different approach: creating a trigger mechanism that would put the stimulus package into effect when, say, the unemployment rate rises by a certain amount (or for a certain number of months).[4] I've never been a big fan of mechanical triggers; they miss all the nuances. And it doesn't now appear to be

[3] Or if the bad news gets revised away, as sometimes happens.
[4] See, for example, Martin Feldstein, "How to Avert a Recession," *The Wall Street Journal*, December 5, 2007.

needed to speed up the Congressional process. But if it is, I'd sign on to the trigger idea. That is best left to your judgment.

3. Should the stimulus be paid for?

My answer here is a clear *no*. But to explain why, I need to be a bit pedantic--for just one paragraph. So, with due apologies…

Mainstream economists believe that GDP is basically *demand-determined* in the short run but *supply-determined* in the long run. That means, roughly, that if you want to influence where GDP will be two or three *quarters* from now, you can pretty much ignore capital formation, labor force, technology, productivity, and other determinants of aggregate *supply* and simply work on aggregate *demand*—that is, on spending. On the other hand, if you want to influence where GDP will be five *years* from now, you can pretty much ignore aggregate demand and focus instead on the determinants of aggregate supply that I just mentioned.

The point of this pedantry is that fiscal stimulus is inherently a *short-run* policy that must therefore focus on boosting *spending*, not on boosting productivity—even though the latter is what we care about in the long run. So, while there may be many good reasons to favor policies--like deficit reduction, infrastructure building, or permanent changes in the tax code--that can bolster long-term growth, the second good design principle for stimulus is:

Fiscal stimulus should have maximal short-run impacts on spending.

The concerns with excessive budget deficits that are so familiar to this Committee make pay-go an attractive idea, one that I have long supported. But these worries revolve around aggregate supply and long-run growth. You all know the arguments. When the government borrows too much, it pushes up real interest rates, which impedes capital formation and, hence, future productivity.

But the relevant time frame here is long. To justify a fiscal stimulus, the nation must be facing a short-run emergency. And in such cases, it's best to set aside our long-run concerns about deficits *temporarily,* and concentrate instead on solving the short-run problem. Paying for stimulus by, say, raising taxes or cutting spending elsewhere would rob the stimulus of much of its punch.[5]

That said, our valid long-run concerns about budget deficits do dictate that the stimulus should be short-lived, which is the third design principle:

A fiscal stimulus package should be temporary.

In the current context, I'd say it should last no longer than a year. A little budget arithmetic is useful here. A stimulus package that raises the deficit by, say, $150 billion for just one year will increase the national debt by $150 billion *just once.* And that will, in turn, add perhaps $5 billion or so to the annual debt service bill. That's not much. And if the Committee is absolutely determined not to raise the long-run deficit at all, the necessary offset would be only $5 billion a year.

4. Designing a stimulus package: general guidelines

You may recognize these three principles—fast-acting, targeted to boost spending, and temporary—as the three emphasized in the excellent recent report from The Brookings Institution's Hamilton Project.[6] That's not entirely a coincidence, since I am a member of the project's Advisory Council.

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[5] In principle, one could have a balanced-budget stimulus by, say, cutting taxes that have strong effects on spending while raising taxes that have weak effects on spending. In practice, this is quite difficult.

[6] Douglas Elmendorf and Jason Furman, "If, When, How: A Primer on Fiscal Stimulus," *Hamilton Project Strategy Paper*, January 2008.

To what sorts of concrete policies do these general principles lead? Mainly to reductions in existing taxes (rather than newly-designed tax cuts) on, and to increases in existing transfer payments (rather than new types) to, those people who are most likely to spend the money quickly. Loosely speaking, that means people who live from paycheck to paycheck, if indeed they get a paycheck at all.

That logic leads me to start the list with two programs that the President and the House somehow left out: Unemployment Insurance and Food Stamps. It is hard to think of a group of Americans who are more likely to spend the marginal dollar than families that have been forced by job loss to scale back their normal standards of living. Unemployment benefits have long been stingy in the United States--in coverage, in duration, and in the level of benefits. Each could be enhanced. The duration is easiest to extend on short notice; indeed, that used to happen regularly in recessions.[7] More generous Food Stamps would also have high bang for the buck. It's an extremely well-targeted program whose benefits go largely to families that are—quite literally—living hand to mouth.

After those two, I'd think next about temporary reductions in either income or payroll taxes aimed at low- and middle-income households—which is, of course, the centerpiece of the House proposal. Since many of these people earn too little to owe income tax, I was happy to see that the so-called income tax rebates will be at least partially refundable.[8] We don't want to design a stimulus program that leaves out tens of millions

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[7] In the longer term, we should be extending UI benefits to part-time workers.
[8] Another approach, of course, would be to use payroll tax rebates.

of low- and moderate-income households.[9] They are both in greater need and more likely to spend the money than the average income-tax-paying household. To turn Franklin Roosevelt's well-known maxim on his head, in the case of fiscal stimulus, good morals are also good economics.

Finally, on the spending side, one of the most plausible ways to induce a quick spending response is to boost federal payments to hard-pressed state or local governments. (Medicaid is one commonly-suggested vehicle.) These governments typically operate under balanced-budget mandates, and so are forced to follow pro-cyclical fiscal policies when weak economies make their revenues sag. Federal support can help head off tax hikes and/or expenditure cuts designed to balance state and local budgets. That, too, constitutes stimulus.

Notice that I have left business tax cuts off my list. These sorts of measures have their place. But to think that they will provide the kind of quick jolt that we need now is a triumph of hope over experience.

5. Designing a stimulus package for today

I haven't yet said anything about magnitudes, because that depends entirely on the specifics of the case. Here are two quick back-of-the-envelope calculations that lead to a package of roughly the size the President and the House have agreed to.

Suppose the economy grows at a 1% annual rate during the first half of 2008 and a 2% annual rate during the second half, which is roughly the CBO forecast. As I noted earlier, this below-consensus forecast does not embody an outright recession. Still, if trend growth is about 2¾%, we would lose about 1¼% of GDP relative to trend under this

[9] The Center on Budget and Policy Priorities estimated that fewer than 60% of households would receive full benefit from a rebate that went only to income taxpayers. (See their website, www.cbpp.org, for details.)

scenario. A stimulus of around 1% of GDP then seems about right in that case. A second way to get to the same number is to calculate the reduction in GDP growth that stems directly from the slump in housing (the "residential investment" component of GDP). That, too, has been running strikingly close to 1% of GDP for almost two years now.

Now, there is nothing magical about exactly 1% of GDP, which is roughly $140 billion these days. Think of it as a reasonable benchmark instead. $140 billion sounds like a lot of money—it's almost as large as the entire FY2007 deficit. But this is a very big economy we're trying to turn around. Furthermore, the $140 billion would be spread over two fiscal years. While we should try to cram as much as possible into FY2008, realistically half or more of the outlays will probably carry over into FY2009.

What about tailoring the package to current circumstances? Two factors account for most of the current economic weakness. One is that we have been experiencing a rolling "oil shock" for some years now, with oil prices recently touching the $100/barrel mark before receding. The implied "tax" that high oil prices impose on American consumers creates many problems, one of which is that some low-income families have trouble paying their heating bills. The LIHEAP program was explicitly designed to alleviate such hardship, so the current situation strongly suggests expanding that program immediately. As in the case of Food Stamps, more funds for LIHEAP will put money into the hands of those who will spend it quickly—many of whom will not benefit from an income tax rebate.

But the bigger problems for our economy today, as everyone knows, have their roots in the housing and mortgage markets—especially sub-prime mortgages and related financial instruments. The families facing foreclosure (or already in default) on sub-prime mortgages are primarily low-income households with little or no access to credit. Thus they are precisely the types of households whose spending propensities are likely to be high, and helping them keep their homes should therefore carry high bang for the buck. Unfortunately, we have no pre-existing program, tailored to this constituency, that can be used to funnel payments quickly to those in need.

CBO's excellent recent paper on stimulus notes, quite correctly, that fiscal stimulus need not be applied in the areas in which spending is weakest. That's true. As an example, during 2007 rising net exports helped offset the drain on GDP growth caused by the housing slump. For that reason, CBO says, possible actions "to address problems in the housing and mortgage markets... should therefore be evaluated primarily with regard to their effectiveness in correcting identifiable failures in those markets—and not necessarily with regard to their value in counteracting economic weakness."[10]

Here I'd like to disagree, and CBO gives the reason why in the very next sentence: "Policy actions affecting the housing and financial markets may, however, help the economy by reducing the risks of a self-reinforcing spiral (of less lending, lower house prices, more foreclosures, even less lending, and so on) that could further impair economic activity..." In other words, if we can figure out a way to ease the plight of families who might otherwise lose their homes, we will not only help some people in dire need, but also help the economy avoid a recession and help the financial markets get back

[10] Congressional Budget Office, *Options for Responding to Short-Term Economic Weakness,* January 2008, page 1.

on their feet. I believe that trifecta is sufficiently alluring that we should try for it, even if doing so requires some compromises with our principles of good stimulus design.[11]

But what to do? The House bill is a start, but this is really a question for a separate hearing and a much longer testimony. So let me just close with a few brief thoughts.

First, I am very much in the Alan Greenspan school on this issue. Mr. Greenspan, you may recall, told an interviewer that one useful thing the government can do is send cash. Send cash how? There are a variety of ways. One is cash transfers to help people make their mortgage payments and avoid foreclosure. Another is assistance to state and local governments and community organizations trying to prevent neighborhoods from being blighted by abandonment. A third is to put more counselors and workout specialists in the field to help people avoid foreclosures, perhaps by refinancing on more reasonable terms.[12] And so on.

But, unfortunately, the current financial problems extend well beyond sub-prime mortgages and, indeed, well beyond mortgages more generally. The credit and fixed income markets are in a tizzy, with some of them barely functioning. As Federal Reserve Chairman Bernanke has noted, these problems in the credit-granting mechanism pose a grave threat to the entire economy. Indeed, I think that is what is mainly motivating the Fed to cut interest rates so rapidly. My personal worry is less about recession and more about our economy's ability to mount a vigorous recovery unless the dysfunctional credit markets are repaired.

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[11] The main compromise is that we will probably have to create new programs rather than utilize pre-existing ones. That said, long-established agencies like the FHA, Fannie Mae and Freddie Mac are probably well-positioned to help out.

[12] Substantial value is lost whenever a foreclosure takes place. It is therefore in the interests of *both* the homeowner *and* the mortgage holder to renegotiate the terms in order to keep the homeowner in the house—and making at least *some* payments.

It would be nice to see private capital rush in to do the job. But the crisis is now about six months old, and this does not appear to be happening to any great extent. Instead, extreme risk aversion rules the roost, bid-ask spreads are gigantic, and bargain hunters are scarce. This is a dangerous situation, and that danger leads me to suggest that Congress start thinking about establishing two new federal agencies. One would be somewhat analogous to the Resolution Trust Corporation (RTC), but quite different in details. Its job would be to get the fixed income markets functioning again—and then go out of business. The other would be analogous to the Home Owner's Loan Corporation (HOLC), which existed for three years during the Great Depression. Its job would be the same as it was in the 1930s: to refinance homes to prevent foreclosures.

I wish I was in a position to spell out all the details of these two proposed institutions for you today. But I have had neither the time nor the resources to work out the details. And there is probably no perfect design, anyway. I simply want to plant the thought.

Finally, to link these longer-run ideas about the housing and financial markets back to the stimulus issue, I would urge Congress not to wait for a brainstorm on the sub-prime and broader financial problems. First, let's put a simple stimulus package together as quickly as possible, without any new institutions aimed at the sub-prime problem or the financial markets. Sensible actions on those two fronts are badly needed, but they will take time to develop and implement. Once Congress passes a stimulus package, they should be the next order of business.

Thank you all for listening.

Chairman CONRAD. Thank you, Dr. Blinder.

Dr. Zandi?

STATEMENT OF MARK ZANDI, CHIEF ECONOMIST AND CO-FOUNDER, MOODY'S ECONOMY.COM, INC.

Mr. ZANDI. Thank you, Mr. Chairman. Thank you, members of the Committee. My views that I am expressing today are my own, not those of the Moody's Corporation. And let me say none of this is my fault.

[Laughter.]

Mr. ZANDI. I have a slide show, and I am going to make four points with my slides.

Point No. 1, I do think the economy is on the edge of recession, or very close. I think the economy contracted in December. It may have very well contracted in October, grew in November, and it feels very soft coming into 2008. The most telling statistic is the increase in unemployment. As you can see here, this is the percent change a year ago in the number of unemployed. You can see the recession boars—I think you can see them. Yes. Every time we have seen a measurable increase in unemployment, a recession has ensued, and it has never falsely predicted a recession. And there is logic to it. When unemployment rises, it undermines consumer confidence. The consumers pull back on their spending. Businesses respond by curtailing their hiring and investment. That causes unemployment to rise further, and you are in the middle of a very self-reinforcing negative economic cycle. And it appears, if history is any guide—and sometimes it is not, but it is useful to examine—this would suggest strongly that we are entering into that very strong self-reinforcing negative cycle.

I do believe there are many parts of the country that are already in recession. As you know, the National Bureau of Economic Research determines recessions nationally by looking at a plethora of data and determine based on that data whether we are experiencing a persistent, broad-based decline in economic activity. I take on that responsibility at a regional level using the same methodology, and you can see I think a handful of States are in recession already. California, Nevada, Arizona, Florida, and Michigan are in recession. The States that are in orange are very close, and I suspect they will fall into recession in the next couple 3 months.

The key to whether the national economy actually falls into recession is the Northeast corridor from Boston to D.C. New York City is now struggling quite significantly because of the layoffs and lost compensation on Wall Street. I do not know if you are shedding any tears over Wall Street, but they are having all kinds of problems. So I do think there are significant regional economic problems that are developing and that highlight the recession risks.

Point No. 2, the problem is housing. It goes beyond just construction, though. This is the most severe housing downturn literally since the Great Depression. To give you a sense of that, as a percentage decline, peak to trough in house prices, nominal house prices, home sales, new and existing, and housing starts, this is the percentage decline peak to trough in the early 1980's downturn when unemployment was in the double digits. You can see housing starts fell 60 percent peak to trough, home sales 50; nominal house prices did not fall. That was a period of significant inflation. Real prices fell, but nominal prices did not.

This is the early 1990's downturn in housing. You can see how that stacks up, not quite as bad as the 1980's downturn.

This is the current downturn so far. To date, housing starts are down 55 percent from their peak. That was your chart. Home sales are down 35 percent. New home sales are down measurably more than that. It just cratered in December, 600,000 home sales back to 1995 levels.

House prices are down 8 percent nominal. That is unprecedented nominal price declines.

This is where I think things are going to end up. I think the downturn will continue throughout 2008. Fundamentally the market is awash in unsold inventory. We got new data yesterday from Census. The inventory increased. We have almost a million of excess housing units. It is not getting any better. It is getting worse because of the collapse in home sales and the surge in foreclosures. So we are going to see continued declines in construction, home sales, and housing, particularly housing—most importantly housing values.

Just to give you a sense of the magnitude, an 8-percent decline is equal to roughly $1.5 trillion of household net worth. If we decline 15 percent, you can do the math. It is quite significant in terms of the impact on household wealth.

This is where the declines are most serious. These are all 381 metropolitan areas across the country. The areas that are in red are crashes. These are house price declines that are over 10 percent. This understates the decline. These are measured house prices. If you can consider non-price discounts that sellers and builders are giving to homeowners, the price declines are 5 to 10 percent more than this in these very distressed markets.

Two-third of the Nation's housing markets are experiencing persistent price declines. That is two-thirds of the Nation's housing markets. This is unprecedented in terms of its scale and scope.

And adding to it, of course, and contributing to the problems is the surge in mortgage credit problems that Dr. Blinder talked about. They are stunning. We have very high quality data that we collect based on consumer credit files maintained by Equifax. We take a 5-percent random sample at the end of every month of all the credit files across the country and construct very high quality data on delinquency and default across all kinds of consumer product lines, including mortgages.

As you can see, as of the last week of December, which is the last data point in this chart, there were 1.8 million first mortgage loan defaults at an annualized pace. Nothing ever—we have never seen anything close to this, and you can see it is going straight up.

Thirty-day, 60-day, 90-day, 120-day delinquency are all rising. It is everywhere. There are five metropolitan areas out of the 381 that are not experiencing increasing delinquency and default, and they are on the border with Mexico in Texas and in Oklahoma. North Dakota is doing OK, by the way. All 500,000 North Dakotans are OK. But outside of that, everyone is experiencing some pain, significant pain.

The third point, all the risks are to the downside. Risk No. 1, the problems in the housing, in market economy markets has infected the global financial system. The banking system is under severe pressure. That will not go away, in my view. To give you a sense of the exposure in the banking system, this is data from the Federal Reserve Board. It shows the amount of residential real estate assets on the books of the Nation's large commercial banks. The blue bar represents billions of dollars. That is the left-hand scale. We are at just under $2 trillion worth of residential real estate whole loans and mortgage securities. As a share of their assets, it is falling now because their balance sheet is ballooning out because of all of the stuff coming up from their exposure to the global financial system, the SIVs and other problems that they have. But you can see it is still very high, so the banking system is, in my view, going to remain under tremendous pressure.

This does not include construction and land development loans, which we have heard nothing about, which are under—these are loans to home builders. They have to be under tremendous pressure. This does not include the consumer loans that are under a lot of pressure as delinquencies are rising on auto loans and credit card loans and student loans and consumer finance loans.

Risk No. 2 is the infection in the housing market is bleeding into the consumer sector. Consumers are sensitive to what is going on in the housing market. You can see that relationship here. The red line represents house price growth year over year percent change a year ago. That is the left-hand scale. Retail sales, the growth in retail sales is the blue line, right-hand scale. The twist here is that house prices lead consumer spending 6 months, by 6 months. There is a lag between what happens in the housing market and how it affects the willingness and ability of consumers to spend. And one of the reasons why is because of their ability and willingness to take out equity from their home. This shows you the amount of cash they are pulling out of their homes. Back at the peak of the cash withdrawal in late 2006, early 2007, it was $900 billion annualized. It is about 10 percent of disposable income. And you can see, as you would expect, it is crashing now because of the decline in housing values and the tightening of borrowing rate standards. So my view is that when we get Dr. Blinder's read on retail sales, it will be a very negative one. Christmas sales are going to be weak, and it will be measurably weaker as we make our way into 2008.

My final point is I think fiscal stimulus is absolutely necessary. You know, I do not know that it is going to forestall recession. Even under the best of circumstances, the checks you write will go out in June. But I think it could make a very large difference between a long recession or short recession, a 12-month recession or a 9-month recession. It could be the catalyst to push us out of a recession. It could make a difference between a weak recovery and a reasonably good recovery. So just because you cannot get it out there in the next couple three, 4 months and forestall an actual economic downturn does not mean that you should not do it.

Now, I have simulated the economic consequences of two different packages of stimulus programs. The blue bar represents the contribution to real GDP growth, and the first bar is in the second half of 2008 when the stimulus actually will take effect, and the first half of 2009 is the second bar. I say "likely stimulus." That is my forecast of what happens. And this does not mean it is going to happen, but I am usually accurate in my forecasting. But who knows?

This package is exactly what the President and the House agreed to with the addition of an extension of UI benefits similar to what you have proposed—or what the Senate Finance Committee has proposed. You can see that it will add about 1.5 percent to annualized real GDP growth in the second half of the year. That is important. That will make a big difference. That could be the difference between negative numbers and positive numbers and a significant effect on jobs.

The red bar is my optimal package. In that package, I have a tax rebate plan that is very similar to what is proposed by the House and the President. But it has no depreciation benefits or other tax incentives for businesses, and I use that money to finance extension of UI benefits, food stamps, which are—I will reinforce the point that Dr. Blinder made—are extremely important and very efficacious policy. And just listening to some of the folks that operate these programs, they can get that out into the world very quickly, within 4 to 6 weeks, and that will make a big difference. And aid to the State governments, I think if that happens now, that would be very, very timely. Half the States are now going to have budget shortfalls, and there will be significant cuts in spending, which I think will be very pernicious, particularly on things like education and Medicaid. So if I were King for the Day and I designed my own package, that is the red bar, and you get a sense of the GDP impact.

And, finally, what it means for jobs. In the likely stimulus, by June of 2009 it means 662,000 more jobs than would have otherwise been the case; in the optimal stimulus package, close to a million jobs.

Finally, one other point just to reinforce something that Dr. Blinder said. I do not think monetary and fiscal stimulus is all that should be focused on here because he is absolutely right, we may get to the other side of this and the economy, you know, struggles through a couple 3 years of very weak economic growth. And that is very possible because underlying our problems is what is going on the housing and mortgage markets, and until we address those with more targeted types of policy, I think that is going to be a significant weight on our economic growth prospects.

Thank you.

[The prepared statement of Mr. Zandi follows:]

Written Testimony of Mark Zandi
Chief Economist and Co-Founder
Moody's Economy.com
Before the Senate Budget Committee
Hearing on "Economic Stimulus: Budget Policy for a Strong Economy Over the Short and Long-Term"
Wednesday, January 30, 2008

Mr. Chairman and members of the Committee, my name is Mark Zandi; I am the Chief Economist and Co-founder of Moody's Economy.com.

Moody's Economy.com is an independent subsidiary of the Moody's Corporation. My remarks represent my personal views and do not represent those held or endorsed by Moody's. Moody's Economy.com provides economic and financial data and research to over 500 clients in 50 countries, including the largest commercial and investment banks, insurance companies, financial services firms, mutual funds, manufacturers, utilities, industrial and technology clients, and government at all levels.

I will make four points in my remarks.

First, the economy is on the edge of recession if not already in one. Real GDP growth slowed sharply during the last quarter of 2007, and the economy appears to be contracting in early 2008. The job market has stalled, retailers are struggling, and manufacturing activity is declining.

The substantial threat of recession is evident in the recent increase in unemployment. The unemployment rate has risen 0.6% between its 4.4% cyclical low last March to 5%

in December. Recessions are always preceded by such a rise, and such a rise has never occurred and a recession not ensued. The economic reasoning behind why higher unemployment is the catalyst that sets off the vicious cycle that characterizes recession is that increased joblessness undermines consumer confidence and thus consumer spending. Businesses respond to flagging sales by cutting back their investment and payrolls, and unemployment rises further. A negative self reinforcing cycle begins.

A number of large state economies are already in recession, including Arizona, California, Florida, Michigan and Nevada.[1] These states account for one-fourth of national GDP. Alaska, Arkansas, Connecticut, Minnesota, Missouri, Ohio, Rhode Island, Vermont and Virginia are on the edge of recession. These states account for an additional over 15% of national GDP. The large metro area economies of the Northeast, extending from Boston to Washington DC are still expanding, but growth is sharply slowing, particularly around New York City which is being hurt by Wall Street's travails. If these economies devolve into recession, then a national recession will occur.

My second point is that the most fundamental source of the economy's problems is the unprecedented housing downturn and resulting surge in mortgage loan defaults and foreclosures. Housing activity peaked two and half years ago, and since then home sales have fallen by approximately 35%, housing starts by nearly 50%, and house prices by 8%. Some two-thirds of the nation's housing markets are currently experiencing substantial price declines, with double-digit price declines occurring throughout Arizona, California, Florida, Nevada, the Northeast Corridor and the industrial Midwest.

[1] Regional economies are determined to be in recession using a similar methodology as employed by the National Bureau of Economic Research in determining national recessions. Payroll employment and industrial production are the two principal economic indicators used for the basis of whether a regional economy is experiencing a persistent broad-based decline in economic activity.

Further significant declines in housing construction and prices are likely through the end of the decade as a record amount of unsold housing inventory continues to mount given the ongoing turmoil in global financial markets and its impact on the mortgage securities market and thus mortgage lenders and the recent weakening in the broader economy and job market. There is now a broad consensus that national house prices will fall by no less than 15% from their peak to their eventual trough.[2] Even this disconcerting outlook assumes that the broader economy will avoid a full-blown recession and that the Federal Reserve will continue to ease monetary policy.

Residential mortgage loan defaults and foreclosures are surging. Falling housing values, resetting adjustable mortgages for recent subprime and Alt-A borrowers, tighter underwriting standards, and the weakening job market are conspiring to create the current unprecedented mortgage credit problems. According to very accurate data based on consumer credit files, there were 450,000 first mortgage loans in default (the first step in the foreclosure process) as of year-end 2007.[3] This equates to some 1.8 million defaults at an annualized pace. Even if mortgage loan modification efforts increase measurably in coming months, I expect almost 3 million mortgage loan defaults this year and next. Of these, 2 million homeowners will go through the entire foreclosure process and ultimately lose their homes. The impact on these households, their communities, and the broader economy will be substantial.

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[2] See "Aftershock: Housing in the Wake of the Mortgage Meltdown," Moody's Economy.com, December 2007.
[3] The source of this data is a 5% random sample of all the nation's consumer credit files maintained by credit bureau Equifax. The sample is drawn at the end of every month.

The unraveling of the housing and mortgage markets continues to undermine the fragile global financial system. Estimates of the mortgage losses global investors will eventually have to bear range as high as $500 billion.[4] The losses publicly recognized by financial institutions to date amount to no more than $150 billion. Losses on construction and land development loans made by the banking system to homebuilders are sure to increase measurably in coming quarters and the credit problems on other consumer loans are rising rapidly, particularly in those parts of the country in recession due to the housing downturn. These stresses are also exposing other weak spots in the financial system, including the monoline insurance industry and the credit default swap market. Given the opacity of the global financial system, it is unclear who are at most risk, and as such players in credit and equity markets remain on edge; unwilling to extend credit to each other. The availability of credit has been impaired and the cost of capital has risen for nearly everyone, good credits and bad, and the negative economic repercussions are mounting.

The housing downturn is also undermining consumer spending. Even a modest pull-back by consumers will push the economy into recession, as such spending accounts for 70% of the nation's GDP. The odds of such a retrenchment are high given that the saving rate of the one-third of households who are homeowners and have borrowed against their homes in recent years is an estimated negative 10%.[5] If this group, which also accounts for about one-third of all consumer spending, simply matches its' spending to its income

[4] See "Leveraged Losses: Why Mortgage Defaults Matter," Jan Hatzius, Goldman Sachs US Economic Research, November 15, 2007. "A Macro Look at Subprime Losses, ARMs and Convexity Hedging," Alec Crawford, RBS Greenwich Capital, November 2007.

[5] The personal saving rates for difference groups within the population is derived based on data from the Federal Reserve's Survey of Consumer Finance and Flow of Funds. Renters and homeowners who have not cashed-out homeowners' equity, each accounting for about one-third of the population, have close to zero saving rates.

over the next several quarters, the negative impact on overall consumer spending will be substantial.

My third point is that while a recession may be unavoidable in coming months, it will take deft and aggressive monetary and fiscal policymaking to ensure that if the economy suffers a downturn it will be short and modest.

Indeed, the last two recessions in 2001 and 1990-91 were short and mild by post World War II standards, but only because of the aggressive monetary and fiscal stimulus provided to shore up the economy. In the early 1990s downturn, the real federal funds rate fell from 5% to 0% and the federal budge deficit increase from 3% to 5% of GDP. Early in this decade, the real funds rate fell from 4% to -1% and the deficit from 2% to -4%. So far in the current period the real funds rate has fallen from 3% to 1.25% and there has been no fiscal policy response.

Policymakers should act quickly to provide more stimulus to the unraveling economy. The Federal Reserve has become much more aggressive, slashing the federal funds rate target quickly from last summer when it stood at 5.25%. Even more rate cutting will likely be needed given that monetary policy has seemingly become less effective in stimulating growth in the current environment.[6] The most immediate conduit between monetary policy and the economy runs through the housing market. Housing is the most interest-rate sensitive sector of the economy, and historically it would receive a quick boost from monetary easing. This boost will be much more muted today given the

[6] This point is well articulated in "Housing, Housing Finance, and Monetary Policy," Martin Feldstein, presented at the Jackson Hole conference of the Federal Reserve Bank of Kansas City, September 2007 http://www.kansascityfed.org/publicat/sympos/2007/PDF/2007.09.05.Feldstein.pdf

ongoing problems in the mortgage securities market. Issuance of bonds backed by subprime, alternative-A, and jumbo mortgage loans has collapsed. Save for conforming fixed-rate loans which are only loosely tied to Fed actions, lenders are unable and unwilling to extend mortgage credit at any interest rate.

Various fiscal automatic stabilizers are also now beginning to kick-in as the economy falters. Tax revenue growth is already measurably slowing and spending on various transfer programs will soon ramp up. Even if policymakers do nothing in response to the eroding economy, the budget deficit will increase substantially.

Doing nothing would be a mistake, however. Fiscal policymakers currently have a window of opportunity to provide a substantial amount of additional stimulus in a timely and targeted way. A well-designed tax rebate issued this summer and additional spending for financially-pressed households reliant on unemployment insurance and food stamps would be very helpful in shoring up the flagging economy.[7] This stimulus should be temporary so that while it will result in a larger deficit this fiscal year and next it will not weaken the nation's already daunting long-term fiscal prospects. Indeed, a well-timed, targeted, and temporary stimulus could ultimately be less costly to the Treasury as a debilitating recession will severely undermine tax revenues and induce more government spending for longer.

[7] A very good review of the various potential tax and spending elements of a fiscal stimulus plan are provided in "Options for Responding to Short-Term Economic Weakness," Congressional Budget Office, January 2008. http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf
For an analysis of the economic efficacy of various fiscal stimulus proposals, see "Assessing the Macro Economic Impact of Fiscal Stimulus 2008," Mark Zandi, January 2008.

My final point is that in addition to more monetary and fiscal stimulus, policymakers should continue to consider potential policy responses to the ongoing difficulties in the housing and mortgage markets. Expanding FHA lending authority, temporarily lifting the mortgage loan caps on Fannie Mae and Freddie Mac, and the Hope Now initiative are all laudable efforts, but may very well prove inadequate to reviving the moribund mortgage securities market, mortgage lending and the housing market. Until this occurs, the broader economy will continue to struggle regardless of the monetary and fiscal stimulus provided.

What policymakers decide to do or not do in the next few weeks will determine whether millions of Americans lose their job this year and will have a significant bearing on the economic well-being of everyone else.

The Economic Outlook

Presented by:

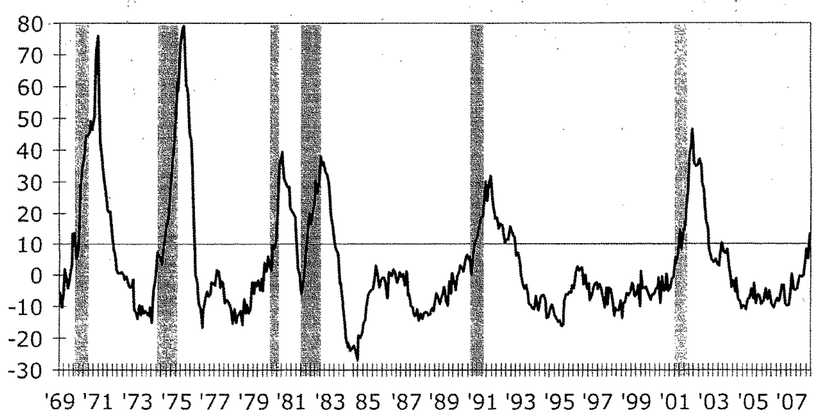
Mark M. Zandi,
Chief Economist

January 30, 2008

Moody's | Economy·com

Rising Unemployment Signals Recession...

Year-over-year % change in unemployment



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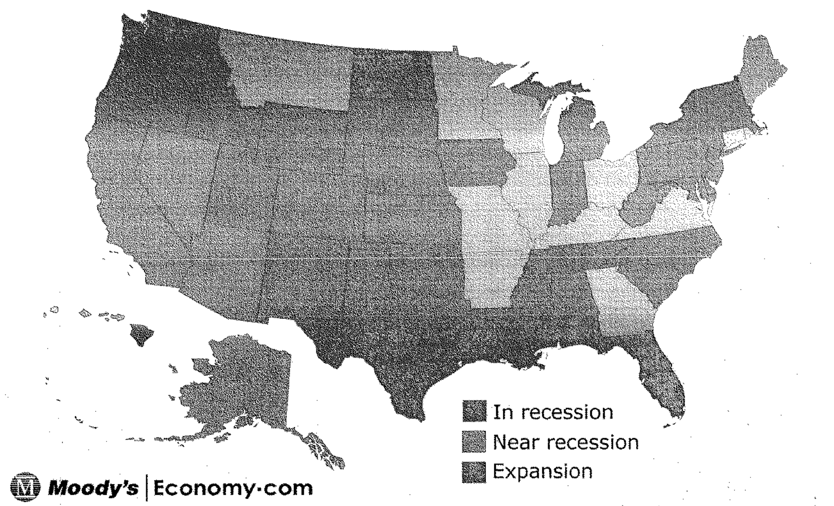
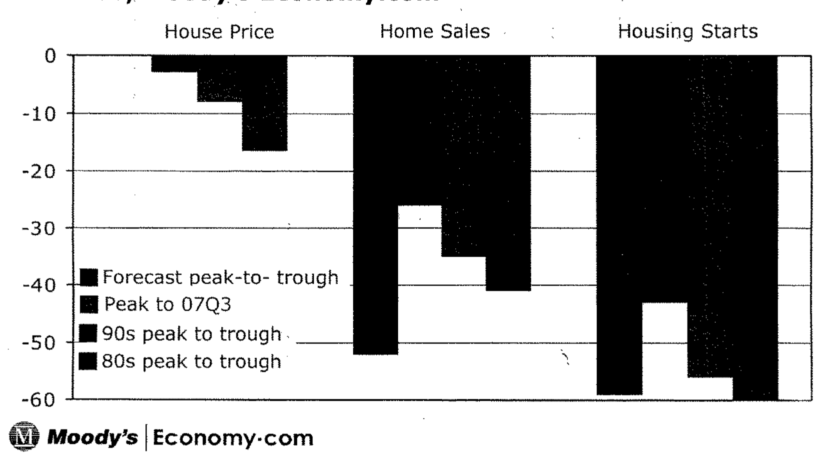
Source: BLS

...Which Already Plagues Parts of the Country



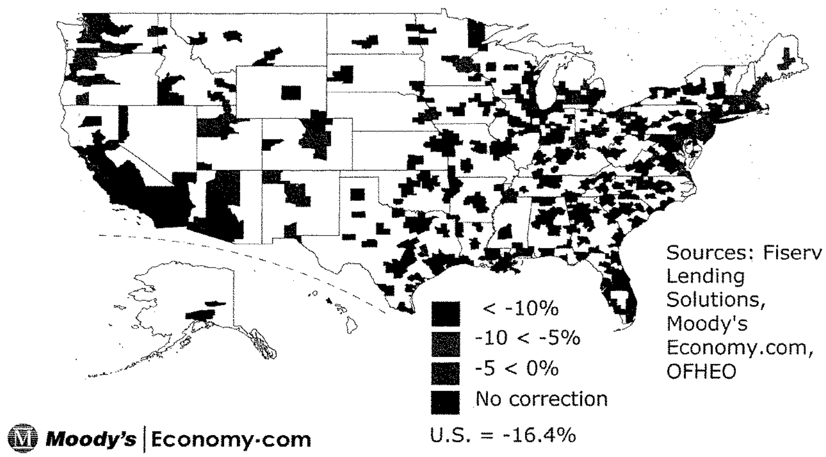
An Unprecedented Housing Downturn...

% change from peak, Sources: Fiserv Lending Solutions, Census, Moody's Economy.com



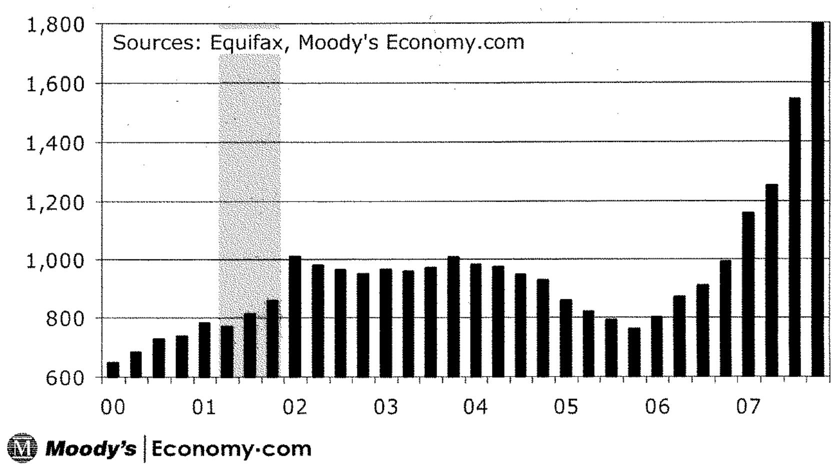
...Throughout Much of the Country...

Projected peak-to-trough house price decline, %



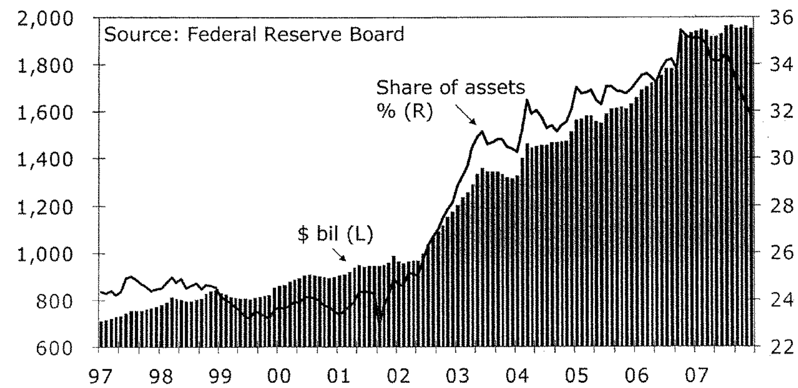
...Inducing An Unprecedented Surge In Defaults

First mortgage loan defaults, ths, SAAR



The Banking System Is At Significant Risk

Residential RE assets of large commercial banks



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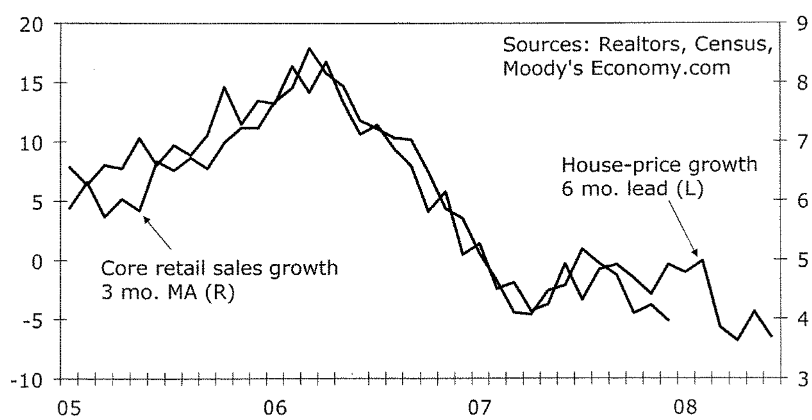
Consumers Struggle with Falling House Prices...



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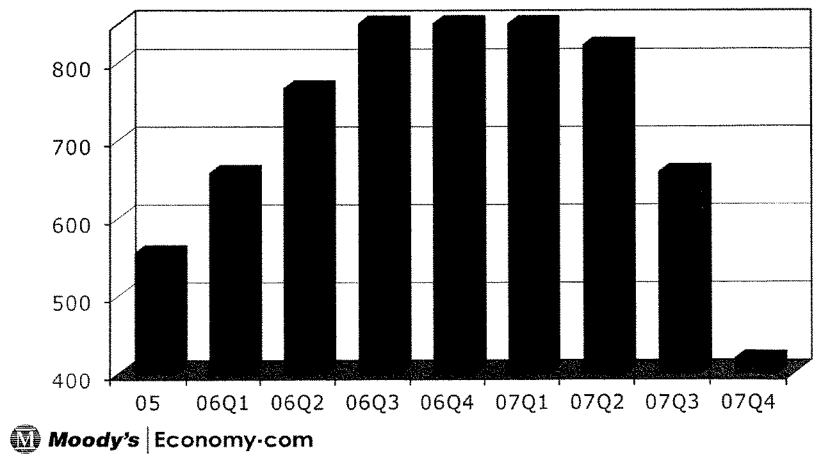
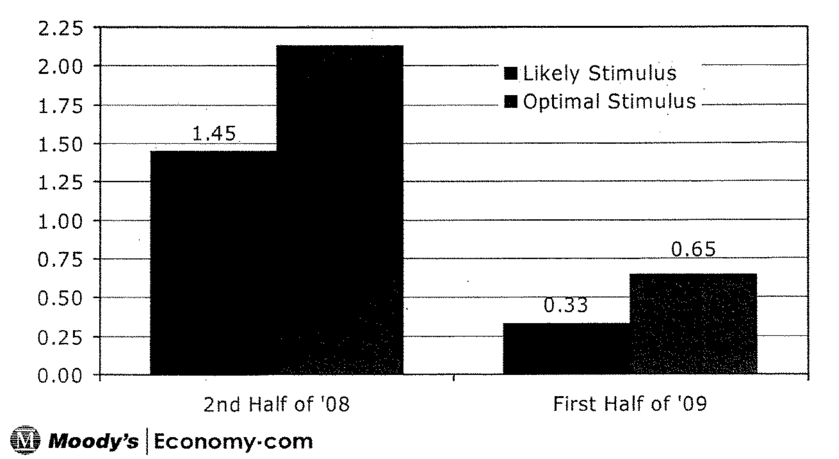
...Due (in Part) to Fading Equity Withdrawal

Gross equity extraction, $ bil, Source: Moody's Economy.com



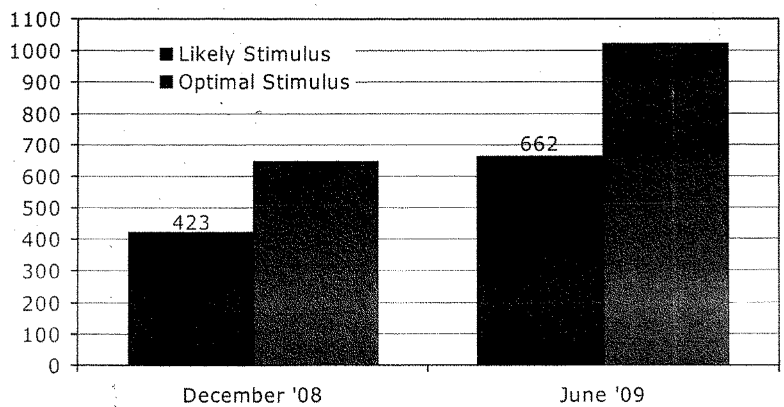
Quick Fiscal Stimulus Would Support GDP...

Contribution to real GDP growth, average annual % change



...And Lift Employment

Change in payroll employment, thousands



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Chairman CONRAD. Thank you, Dr. Zandi.

Dr. Mitchell, welcome.

STATEMENT OF DANIEL MITCHELL, SENIOR FELLOW, THE CATO INSTITUTE

Mr. MITCHELL. Well, thank you very much, Mr. Chairman, members of the Committee. My name is Mitchell. I am a Senior Fellow at the Cato Institute. I will summarize some of the key points of my testimony.

I feel like this is the Monty Python show from my youth, and I am going to say, "And now for something completely different."

I do think that Government policy, fiscal policy, does have a large impact on the economy. I think the level of taxes and spending matter a lot. I think changes in the level of taxing and spending matter a lot. And I think the actual composition of spending and taxes matter a lot. Some programs help the economy, some hurt the economy. Some taxes have worse effects on the economy than others. So I think all these things matter. But I think they matter for the long run. I do not think that Government through fiscal policy has a whole lot of influence and ability to affect short-term economic performance.

Now, economists do not do a very good job of predicting the economy. If we did, we would all be on the beach in the Cayman Island rather than testifying here. So I will not try to add to the profession's embarrassment by making my own predictions. But let's assume for the sake of this testimony that we are heading into a recession. The question is: Can fiscal policy—let's set aside the Fed and other issues like that, but can fiscal policy help ward off a downturn, or at least alleviate its impact? And I think the most realistic answer is no. Again, this is not because fiscal policy does not affect economic performance but because in the short run, you are probably not going to have any effect. And what we are really talking about here is a debate over something I thought had sort of vanished into history, and that is Keynesian economics, the notion that Government can go out, borrow money, give it to people somehow—through tax policy or spending policy—and that this is going to stimulate economic growth.

Specifically, one of the notions of Keynesian economics is borrow money, give it to people, they go out and spend it, especially consumer spending, that is supposed to be the key. I think this is rather fanciful. Consumer spending tends to be a function of economic growth, a result of economic growth, not a driver of economic growth.

I think the key reason to be skeptical about Keynesian stimulus is that it only looks at one-half of the equation. Everyone says we are going to go around the country and give everyone $500, $1,000, whatever the amount is, and everyone says that is great. If you send me a check, I will certainly cash it. But the question is: Where does that money come from? And whether you are giving money directly to people or whether you are spending it on programs like UI or food stamps, which ultimately, of course, is supposed to go to people, where does the money come from? Obviously, Government is borrowing it. And so any money that the Government is putting in the pockets of Person A or any money that the Government is putting into Program B necessarily is going to come out of the pocket of Person C. Person C is the person who is going to buy the Government bonds.

Now, admittedly, we can start thinking, well, what if it is foreign pension funds and sovereign wealth funds and the Chinese? Yes, all sorts of people outside the U.S. might borrow the money, and so yes, that might complicate the issue a little bit. But, in general, what happens when the Government borrows money from Person C and gives it to Person A or Program B, you are simply redistributing the use of national income. You are doing nothing to increase national income.

Now, some people say, well, but it is really important that if you give the money to people who spend it, that makes a big difference. Well, again, let's assume that the borrowers, the people who would go out and buy Government bonds so that you would then have this money to give to people around the country, if they do not spend the money, what happens to it? Well, through the process of financial intermediation, it is going to wind up in somebody's pockets. Banks do not put money under mattresses. They only earn profits and make money for their shareholders by lending the money out. And whether that money is being lent to consumers who, say, want to buy cars or whether it is being lent to businesses that want to build factories, and in that case you are purchasing investment goods instead of consumer goods, there is no net increase in the amount of money in the economy through Keynesian fiscal stimulus.

And I think that is borne out by looking at not only a lot of the academic evidence that is out there, but I think even more persuasive to people is let's look at the real world. Whether we are looking at the Keynesian episode back in the 1930's, whether we are looking at the rebates back in the 1970's, or whether we are looking at what happened in 2001, I think we have a hard time finding any evidence that taking money out of Pocket A and putting it into Pocket B has any beneficial effect on the economy.

I think the 2001 episode is particularly instructive. When you compare the 2001 Bush tax cuts with the 2003 Bush tax cuts, you found much better economic results after the 2003 tax cut. Why is that? Well, in 2001, the bulk of the money was in the form of Keynesian style policies: rebates, child credits, things that put money in people's pockets but did not change marginal tax rates on productive behavior. What happened? We did not have a very strong recovery or expansion? In 2003, by contrast, the tax cut focused on marginal tax rate reductions: lower tax rates on dividends and capital gains, and an acceleration of the good parts of the 2001 tax cut that were postponed until 2004 and 2006.

Again, we do not find evidence that Keynesian policies work, and I think that makes perfect sense when you think about the fact that all that is happening is a redistribution of existing national income, nothing to give people incentives to increase national income.

Now, what does work? What works is the policies that are good in the long run are also good in the short run. Admittedly, though, results tend to be small in the short run. I have an example in my testimony that if you did something that increased economic growth by four-tenths of 1 percent, in the first year it is not going to matter much at all. Even after 10 years, your level of income is not going to be that much higher. But over 50 years and over 100 years, because of compounding, even small changes in economic growth matter a lot. Those are things that you actually can control. You can make the economy grow faster or slower, depending on whether or not you have an environment that is more conducive to productive behavior.

And, finally, I want to close by just making a few comments on the amazing turnaround in the thinking in Washington, and the thinking is, I think, misguided both where you started and where we are heading now.

A couple years ago, everyone said that deficits were all that matters and, by God, we have to reduce deficits, we have to try to have surpluses, because then interest rates will be low and that is the magic nirvana for economic growth.

I never thought that really was as important as what is the size of Government, what is Government doing, what is the size of the tax burden, and how is that money being created. But everyone thought deficits were the most evil thing in the world. And now we are being told that deficits are the best thing in the world for the economy.

In reality, deficits are the least important—at least within the magnitudes that we are talking about in the U.S., deficits are far less important than the overall structure of spending and the overall structure of the tax burden. And if we want to focus on policies that increase economic growth, I think we should focus on the big picture of spending and taxes. What is the Government doing and how is it doing it? What can we do to make the economy grow faster in the long run that will help in the short run? But we do not really have any magic wands that will make the economy grow faster.

I will close by just giving the example of Japan. Japan for years, beginning in 1990 for over a decade, Japan tried one Keynesian stimulus program after another. They dramatically increased their deficits. They dramatically increased their debt. It was textbook Keynesianism, and Japan wound up mired in a 15-year stagnation. Now, I think Japan had problems that were insolvable by fiscal policy. They had major problems with overvalued assets, and when you run into that problem, which is, I think, where we are with housing, there is really not a whole lot you can do about it except let it work its way out of the system. Japan tried to avoid that, and I think they paid a heavy price with a much, much longer and deeper period of economic stagnation.

Thank you.

[The prepared statement of Mr. Mitchell follows:]

Statement of

Daniel Mitchell,
Senior Fellow,
Cato Institute

before the Senate Budget Committee,

Economic Stimulus: Budget Policy for a Strong Economy Over the Short- and Long-Term

January 30, 2008

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.

Government policy can have a large impact on economic performance. With regards to fiscal policy in particular, the aggregate levels of taxation and spending matter. Relative changes in the aggregate levels of taxation and spending also influence growth.

Equally important, the composition of taxes and spending matter. Some types of taxation cause more economic damage, per dollar raised, than others because they lead to a bigger deadweight loss. There are similar differences on the spending side of the fiscal ledger. Some types of spending are believed to enhance economic performance by creating an environment that is conducive to work, saving, investment, risk-taking, and entrepreneurship. Other types of spending are thought to hinder economic growth by, among other things, misallocating resources that could be used more efficiently if left in the productive sector of the economy.

Economists do a poor job of predicting future economic performance, and I have no desire to add to the profession's embarrassment by offering my own guess about whether the economy is heading into a recession. For purposes of this testimony, though, let us assume that a downturn exists. Can fiscal policy help ward off a downturn, or at least alleviate its impact?

The most realistic answer is no. While fiscal policy is very important, as discussed above, it is much more likely to have an impact on long-run growth than it is to affect short-run economic performance. And to the extent that fiscal policy can affect short-run economic performance, it is because good long-term policy also yields positive – albeit small – short-run results.

For all intents and purposes, today's stimulus debate is a new chapter in a long-running controversy about Keynesian economics. Based on the work of John Maynard Keynes, the theory asserts that government should borrow money and then inject it into an economy, causing additional consumer spending. Supposedly, this consumer spending means more demand for goods and services, which will cause more people to be employed to produce those goods and services.

There are several reasons to be skeptical about Keynesian stimulus. The key shortcoming is that it only looks at one-half of the equation. If the government sends a check to Person A, that person may run out and spend the money. And if the government spends money on Program B, that may result in an immediate outlay. But this type of analysis overlooks the fact that the government first has to borrow the money from Person C. In other words, any money in the pocket of Person A or any money spent on Program B is necessarily offset by less money in the pocket of Person C. There is no increase in the amount of income in the economy – unless the government monetizes the debt, and even that doesn't work since inflation simply reduces the value of existing money.

Some Keynesians admit that the money given to Person A or spent on Program B results in less money in the hands of Person C, but they then argue that the goal is to transfer money from people who are more likely to save and give it to people who are more likely to consume. Indeed, this is why there often is a focus on redistributing the money to those with less income. In theory, poor people will rush out and spend the money right away.

Once again, though, the theory ignores the real-world economy. When Person C saves money, those funds don't disappear. Through the process of financial intermediation, the funds are allocated to borrowers. Those borrowers either use the money to purchase consumptions goods or investment goods. In other words, government borrowing to finance so-called stimulus programs merely "crowds out" private sector borrowing and private sector spending. There is no increase in economy-wide spending.

To summarize, Keynesian stimulus plans do not work because they do nothing to increase national income. All that happens is that existing national income gets redistributed from one person to another. Another key point to understand is that consumer spending is a consequence of economic growth, not the cause of economic growth.

There are a number of academic studies showing that Keynesian stimulus is not effective, but real-world examples are probably more persuasive. There have been several episodes of Keynesian "pump priming," and there is little evidence that these attempts have been successful. Beginning with the surge of deficit spending during the Great Depression, continuing through to the rebates of the 1970s, and most recently with the rebates of 2001, Keynesian stimulus packages have not succeeded.

The 2001 episode is particularly instructive. The bulk of the 2001 tax cut – at least the part that took effect right away – was Keynesian-style rebates and child credits. These provisions put money in people's pockets, but, as explained above, redistributing national income is not the same as increasing national income. As such, the economy's growth was relatively anemic after the 2001 tax cut was adopted.

The 2003 tax cut, by contrast, was focused on "supply-side" provisions, including lower marginal tax rates on dividends, lower marginal tax rates on capital gains, and – by accelerating the income tax rate reductions scheduled for 2004 and 2006 – lower marginal tax rates on work and entrepreneurship. It is no coincidence that the economy performed much better after the 2003 tax cut than it did after the 2001 tax cut. That's because the 2003 tax rate reductions improved incentives to earn additional income by lowering tax rates on productive behavior.

To be sure, there are many factors that influence economic performance, so it is always appropriate to use caution when trying to interpret the impact of various policies. For instance, the economy's weakness during the 1930s presumably should not be blamed on the Keynesian policies. Expanding the size of government surely did not help growth, but bad monetary policy, protectionism, high tax rates, and regulatory intervention all played a role in hindering a recovery.

Policies That Work

If Keynesian stimulus does not work, what other fiscal policy options are available? In part, the answer is that there are no automatic fiscal policy solutions to an economic downturn – particularly when the economy's weakness is the result of non-fiscal factors such as poor monetary policy.

Good changes in fiscal policy help an economy grow faster, to be sure, but the short-run effect is not very large. Imagine, for instance, if the internal revenue code was replaced by a flat tax – much as nations ranging from Iceland to Mongolia have done. Moreover, imagine if that flat tax changes the economy's annual inflation-adjusted growth rate from 2.2 percent to 2.6 percent. In the short run, this does not have a big impact on living standards. Even after 10 years, the slight increase in the rate of annual growth does not translate into a big jump in national income. Indeed, it is only about 4 percent higher than it would have been.

But in the long run, the relatively small change in the rate of growth has a big impact on living standards. Because of compounding, changes that seem trivial become very large. After 100 years, an economy that grows 2.6 percent annually instead of 2.2 percent annually will have about 50 percent more income.

The lesson of the story is that policy makers should concentrate on reforms that will improve the economy's long-run performance. With regards to fiscal policy, that means less government spending, not more government spending. That means permanently lower tax rates, not gimmicky temporary tax rebates.

Are Deficits Good or Bad?

For years, some people have been arguing that deficits are terrible because they supposedly boost interest rates, and thus reduce capital formation. This is the so-called Rubinomics school of thought, though 1950s-era Republicans made the same arguments. Now, many people – sometimes the same people – are saying we need higher deficits to stimulate the economy.

So which is it? Are deficits good or bad? In reality, deficits are the least important fiscal policy variable.

If budget surpluses were a path to economic nirvana, nations such as Sweden would be role models. Instead, largely because taxes and spending consume more than half of that nation's output, Swedes have much lower living standards than Americans.

Likewise, if deficits were the key to prosperity, Japan should have been an economic powerhouse after 1990. Deficits skyrocketed and debt exploded, often because of explicitly Keynesian stimulus programs, but the economy remained mired in a long stagnation.

In third-world nations where debt is financed by printing money, deficits matter. In the United States, with a $14 trillion economy and government borrowing and debt at historically low levels, deficits qua deficits are largely irrelevant.

Deficits don't drive the economy. Indeed, it is the other way around. If the economy is strong, deficits tend to fall because tax revenues rise and people are not clamoring for government programs. And if the economy is weak, deficits rise because taxpayers have less taxable income and people are more likely to want money from the government.

In other words, what matters is the size of government and the structure of the tax system. If government is too big, diverting too many resources from the productive sector, growth will suffer. If the tax system is too punitive, discouraging work, saving, and investment with high marginal tax rates, growth will suffer. Whether or not total spending is more than total revenue, or vice-versa, is a secondary issue.

Conclusion

To conclude, Keynesian economics is bad theory. It's even worse in practice. It didn't work in the 1930s, and it didn't work in the 1970s. It didn't work earlier this decade. And it hasn't worked in other nations, such as Japan, that have tried to spend their way to prosperity. Thank you for this opportunity to testify. I will be happy to answer any questions.

Chairman CONRAD. Thank you, Dr. Mitchell.

Dr. Blinder, Dr. Zandi, is there anything that you heard from Dr. Mitchell that you would especially want to respond to?

Mr. BLINDER. Everything.

[Laughter.]

Mr. BLINDER. First, I think he should go over to the other side of town and tell this to the Federal Open Market Committee, which even as we speak is thinking about stimulating the economy, as they did last week, by what some people with pride and some people derisively call "Keynesian thinking." I think it is exactly the right thing. It does not mean it is right to every detail, but it is basically the right thing to do. When you have a dearth of spending, you do something that increases spending.

Most things that you would do in that context will not have profound effects on long-run economic growth. I mentioned that. That is true. But that is not the name of the game right now. This is about what is called stabilization policy, not about growth policy.

The specific instances that Dr. Mitchell mentioned—leaving aside Japan, which is a whole other story and still somewhat mysterious, I might add—are all evidence on the other side. I mean, when the United States finally got around to actual action instead of talk, that would be called in modern parlance "fiscal policy"—and this was mobilization for the Second World War—it had profound effects on the economy. There have been careful studies of the spending from the 2001 rebate that showed that a substantial amount of the money was spent in a relatively small amount of time. And most economists—obviously not all—think that that is one reason, though not the only reason why the 2001 recession was so shallow.

Chairman CONRAD. Dr. Zandi?

Mr. ZANDI. Yes, I think it is appropriate that Dr. Mitchell focused on deficits. I think that is going to be our most significant long-term issue for the next President. I think that will be very daunting. But I have two points.

First, I think it will cost the Treasury more if we do nothing and the economy slides away into recession. That will mean lost tax revenue. That will mean increased spending on transfer programs. The automatic stabilizers will be—they will kick in, and they will be quite costly. And if we can forestall a more severe recession, shorten a recession by some well-timed, targeted stimulus, I think it will actually cost the Treasury less in terms of what it means for deficits and debts. So I think that is point No. 1.

Point No. 2, what really matters, I think, for long-term growth is long-term deficits. Now, I do not think it really matters if we spend $150, $200, $250 billion, and it is temporary and everyone knows it is temporary. All the programs you are designing, they are not going to be with us a year from now, so that has no impact on anyone's thinking about long-run deficits. But I do think long-run deficits matter, and they matter very much, and we are going to see that very clearly, I think, in coming years.

Chairman CONRAD. I think anybody who was here at our hearing yesterday with the Comptroller General of the United States, it is about as clear as it can be. We are on a completely unsustainable course. Deficits and debt do matter. Of course, the Government can borrow money so it can kind of delay the effect. But we are on a course now in which virtually all Federal spending will be dedicated to three things: Medicare, Medicaid, and Social Security—crowding out everything else unless there is some affirmative action.

Let me go through, if I could very quickly, stimulus ideas that are going to be before the Finance Committee this afternoon. And before I do that, let me first ask about the size of the package: the package out of the House, basically $146 billion; the package in the Senate, $161 billion, roughly 1 percent of GDP. If I could just get one sentence from each of you in terms of the size of the package. Too big? Too small? About right?

Mr. ZANDI. I think that is an appropriate size, yes. I do.

Chairman CONRAD. Dr. Blinder?

Mr. BLINDER. I agree. You can get to that logic two ways. First, look at the forecast relative to trend and ask how much of a boost we could use—these numbers are in my testimony. You get a ballpark figure of 1 percent. Another way is to look at how much housing has knocked off of GDP growth. In the last seven or eight quarters, it is 1 percent. You come to the same number.

Chairman CONRAD. Dr. Mitchell?

Mr. MITCHELL. I do not think the size particularly matters because we are simply taking money out of the left pocket and putting it in the right pocket.

Chairman CONRAD. All right. Let me go to some very specific things, and, again, if I could get short answers, because these are going to be things that Senator Bunning and I are going face votes on this afternoon. One idea has been to do some infrastructure spending, largely highways. There has been a survey of State transportation industry—State transportation departments, rather, that found 2,700 projects with an estimated cost of $15.6 billion that could be——

Senator GREGG. Are those earmarks?

Chairman CONRAD. No.—that could be initiated within 3 months of a stimulus package enactment. If you could do those projects in 3 to 6 months or begin them, is that worthy of consideration as part of a stimulus package?

Mr. ZANDI. My view is that infrastructure spending does have significant bang for the buck, if you can cut the checks immediately. I am very skeptical that that happens and that it will occur in a timely way. But in theory, if you could cut them, I think it would provide a lot of stimulus, yes.

Chairman CONRAD. Dr. Blinder?

Mr. BLINDER. My answer would be no. I say that against the background that—I have been an advocate of more infrastructure spending since the late 1980's. This is not a new problem. We need it. Things are crumbling all over the place. We have Third World infrastructure in a lot of places.

That said, it is not so much the initiation—and I would be a little skeptical about that, anyway—but rather the spend-out rates. If you look at, say, $100 million spent on an infrastructure project, a highway or bridge or whatever, it spends out very slowly. These things have a natural rhythm. You have to build these things. And we do not want to tell people, oh, because we have a short-run need to spend cash, you should try to do in a day what really takes a month. If you do, you are not going to get a good bridge.

Chairman CONRAD. OK. Dr. Mitchell?

Mr. MITCHELL. I would not want to look at road building as a stimulus measure, and I certainly would be more favorable to the State and local governments doing it anyhow. But if a road project meets a cost/benefit test as a long-run infrastructure project, then by all means do it, but not because it is for stimulus.

Chairman CONRAD. OK. For that same reason that it does not get out quickly enough?

Mr. MITCHELL. Well, again, I am completely skeptical of the notion that we can borrow $100 billion from Person A and spend it on Persons or Programs B and C and that it is going to make any difference to the economy. So the whole fundamental concept of Keynesian economics I think is a fallacy.

Chairman CONRAD. All right. Energy taxes. There is going to be a proposal for a 1-year extension of the energy tax provisions that would otherwise expire at the end of the year. It costs $3 billion. Dr. Zandi?

Mr. ZANDI. You know, I do not have a view on that. I do not know the explicits—the explicit——

Chairman CONRAD. Credits for renewable electricity production, building efficiency, clean renewable energy bonds, solar fuel cell investment, wind.

Mr. ZANDI. I do not know that it adds any significant stimulus, no. I would not consider it.

Mr. BLINDER. I would say the same. I think Congress may want to do that for other reasons, but it is not going to provide short-run stimulus.

Chairman CONRAD. All right. Dr. Mitchell?

Mr. MITCHELL. I was just going to say, in a $14 trillion economy, I do not think $3 billion of energy tax provisions, whether they are good or bad, really matter.

Chairman CONRAD. Yes, so de minimis, that does not have much of an effect.

The mortgage revenue bond proposal, this goes to the issue of what is happening in housing. All of you have pointed to housing as a key component of the downturn. This would give States a 1-year, $15 billion increase in mortgage revenue bond authority that would be expanded to include refinancing of subprime mortgages as allowable use for those bonds.

Mr. ZANDI. I think it is a very laudable policy step. If it mucks up the process of getting a stimulus package through, I would not spend any time on it. But I think it is a good step, yes, and I think it would be helpful in mitigating some of the severe foreclosure problems we are having across the country.

Chairman CONRAD. Dr. Blinder?

Mr. BLINDER. I do not know the details of the proposal, but it is completely consistent with what I was saying before—that you have this very short-run need for stimulus, so let's get some spending, but we also have deeper problems in the mortgage and financial sectors which are going to need a variety of institutions and approaches. And that may be a good one.

Chairman CONRAD. Dr. Mitchell?

Mr. MITCHELL. The only thing I would say is to keep in mind that if you are going to divert more capital into residential housing, you are necessarily going to have less capital for other purposes. There are tradeoffs. There are cost/benefit analyses that should take place.

Mr. ZANDI. Can I say something? There is no capital going into housing now. We need a little bit of capital to go in.

Chairman CONRAD. All right. Senator Gregg?

Senator GREGG. Well, picking up on that point, this stimulus package has nothing in it which would encourage the drawdown of the present housing inventory that you have pointed to, Dr. Zandi. And if that is the underlying problem that is generating the economic slowdown, would we not focus on that? And I asked this question of Dr. Orszag, and he said, no, you have to focus on the large economy through demand, which is the Keynesian approach that has been debated here. And I guess my reaction is that we have so much policy in place which energizes purchasing of real estate, of homes, that is what got us into the problem to begin with. I mean, essentially the subprime event was driven in large part by tax policy and Federal policy on housing.

And I listened to you folks, Dr. Blinder specifically, and I have followed your comments for years, obviously, because you are someone with significant national influence. But it does appear that you sort of reject the idea of the market settling this issue out, that this was a classic bubble and that if we do not—and that allowing the market to work its will so that we basically clean out the inefficiency which created this initial bubble is the only way you are probably ever going to get the market right in the long run. The Japanese approach of trying to artificially under—support an economy which is totally overextended in assets which are overvalued does not work. I mean, the Japanese have proven that to us incontrovertibly, that you cannot through Federal policy basically try to redirect the efficiency of a market, that the market should be setting the efficiency. And we created a bubble. And the question is: What is the Federal role in trying to mitigate the harms being created by the bursting of that bubble? And it appears listening to you, Dr. Blinder, and to a certain extent Dr. Zandi, you are essentially saying that we should not allow the market to work. Am I wrong?

Mr. BLINDER. The last sentence was wrong. We should allow the market to work. The bulk of the cure of this set of difficulties is going to come from the markets one way or another, regardless of what Government does. The question is whether it is fast enough, whether the Government can push it along faster, and maybe even change its direction slightly. But I want to focus much more on the speed. The context in which I am worried, as I said, is our ability to recover nicely from whatever kind of a sag, recession, or whatever we may have.

If you look out there in the markets right now, you find panic, basically. Now, markets sometimes do this. You could call this a bubble in the other direction. We are having a bubble in the other direction.

Senator GREGG. Well, that is a classic reaction.

Mr. BLINDER. Sure.

Senator GREGG. I mean, I have been through this three times in my experience: back in the late 1970's and back in the late 1980's—when I was Governor, regrettably, it happened in the housing industry in New England and the country—and then in the late 1990's when we had the Internet bubble.

Mr. BLINDER. Yes.

Senator GREGG. I mean, it is a classic overreaction which occurs, which is that when one part of the economy gets overextended, the good part of the economy starts to contract because you try to rebuild your capital reserves.

But I guess my question is this stimulus package which we are proposing does not seem to get to any of this. I mean, you are talking about, by my calculation, spending $220,000 to add a job. That is the way it works out: 660,000 jobs, which is your high-level job number, which is over the President's estimate—he is saying half a million jobs—cost under this stimulus package $220,000 per job. I guess my question is do you even get that return, because if you give a person $500, are you getting a job in the United States? If they buy a TV made in China, you are getting a job in China. You cannot control where those dollars flow. What percentage of that goes out of the country?

Mr. ZANDI. Well, actually, if you look at total consumer spending, our entire budget, 10 percent is imported, so 90 percent is produced here.

Senator GREGG. So you are saying 90 percent produces activity here.

Mr. ZANDI. Yes, on average. I mean, yes——

Senator GREGG. You gave us some really startling figures on the housing side, which I suspect are absolutely accurate and I do not question that at all. But what percentage of the economy is housing versus trade? In other words, we have a dollar situation where trade is significantly increasing because the dollar has been weak. And the housing market is in—how much is the trade issue offsetting the housing collapse?

Mr. ZANDI. The contribution to the improvement in the trade deficit over the past year, not accounting for today's numbers because I have not had time to process them, but approximately a point to GDP growth. Over the same period, the decline in housing construction, just simply housing construction, has subtracted about a percentage point from growth. But housing's—that is not the end of the story. Housing's tentacles run deep into the economy. It is not just construction.

Senator GREGG. So does trade. I mean——

Mr. ZANDI. No. I mean, think about housing values and what they imply. When housing values are declining, they affect people's net worth and their willingness and ability to——

Senator GREGG. Psychology.

Mr. ZANDI. Well, no, it is not psychology. It is the ability to pull cash, to borrow to finance spending. Moreover, think about the property taxes your local governments are going to struggle with as their revenues are going to fall, decline.

Senator GREGG. But there is nothing in the stimulus package which addresses the issue of housing value.

Mr. ZANDI. Yes. Now, let me say something to that point, and it is a very good point. I think policymakers have to be working at—this is a substantive issue and problem. The economy is under significant pressure. So we cannot tackle it with one thing. There are three types of policy that should be brought to bear. The first and most obvious is monetary policy, and the Federal Reserve is working very aggressively on that end. But Dr. Blinder is correct. It works with a long lag, particularly given that the key conduit between monetary policy and the economy runs through the housing market and that has been short-circuited. So it is not going to be as efficacious in this current environment.

Senator GREGG. Well, if it allows loans to be—if it allows these ARMs to be refinanced to a level where they can be refinanced.

Mr. ZANDI. But it is not going to work as well as in the past.

Two, stimulus. I think that is a very appropriate policy response to what is happening. I think that will be very helpful in mitigating—not forestalling a recession but mitigating the severity of a recession.

But the third thing is that housing and mortgage policy should be focused on—and all the steps we have taken so far, that you have taken so far, are all laudable steps. HOPE Now, the mortgage bonds if they get passed, FHA expansion, GSE loan cap expansion temporarily, I think are all very useful. But they may not work because if you go into the securities markets and look at what has happened, they are literally shut down. The mortgage securities market, nonconforming—not the conforming market, not what Fannie and Freddie do. They are fine. But that is half the market in 2006. The other half is completely, literally, shut down. If you look at bond issuance of the nonconforming bonds, subprime, Alt-A, and jumbo loans, in the last 3 months of 2007 it averaged $10 billion per month. I mean, that is down from $250 billion a month at the peak. So it gives you a sense of the magnitude of the problem. It is not going to be solved easily by just letting the market work through.

Senator GREGG. And a stimulus package is not going to have an impact on that.

Mr. ZANDI. But that is the point.

Mr. BLINDER. No, Senator. That is why I raised the point, at the end of the testimony, that there is more to be done beyond the stimulus package——

Mr. ZANDI. Beyond the stimulus package.

Mr. BLINDER [continuing]. To address these market travails. The stimulus package is not going to solve that at all. It should contribute a little bit, because everything goes better if the economy is going uphill than downhill. But it is certainly not targeted on that problem.

Senator GREGG. What the stimulus package is, it is a feel-good event, and maybe that helps the confidence of consumers. But as a practical matter, the substantive impact on this underlying problem, which is the failure of the market over the issue of housing financing, is not going to be addressed by the stimulus package, in my humble opinion. And feel-good events are not bad. This is just going to be very expensive for our children, this feel-good event.

Chairman CONRAD. Well, I would just say, I think it is more than a feel-good event. It does give some modest lift to GDP, which may help avert a recession or make a recession more shallow. But we should not overstate—I agree with the Senator entirely. We should not overstate what this does.

Senator Murray?

Senator MURRAY. Thank you very much, Mr. Chairman. It is a fascinating discussion, and kind of following up on what Senator Gregg is talking about, sort of the housing foreclosure, rising defaults sort of brought us to this point where we are looking at economic stimulus. Senator Conrad is right. We should not overstate it. We all, I think, agree we need to move forward with some kind of short-term economic stimulus.

But what about the bigger picture? Dr. Zandi, you just listed a whole bunch of things we were looking at in terms of the housing issue, and you said, well, all that might not work. What do you recommend we do look at doing?

Mr. ZANDI. Well, my view—and it may sound a little bit out there, but I think we should be—so did ARM freezes 8 weeks ago sound kind of out there. And it goes to a suggestion that Dr. Blinder made.

I think that it would be appropriate to consider and start thinking about some type of Treasury-backed fund that would buy up mortgage loans and mortgage securities. This fund would operate under an auction process. As soon as it was operational, it would establish a price in the market. The reason the market is not working——

Senator MURRAY. Stabilizing house prices?

Mr. ZANDI. Well, not immediately. What it does is stabilizes the price for the mortgage loans and the mortgage securities. And as soon as that happens, then you will start to see credit flowing back into the housing market. And as soon as that happens, then people can get loans, then they can go buy a home, and then prices will begin to stabilize.

Right now the market is completely frozen. There is no activity in the market because everyone is scared to trade with each other. There is no price. If you have a market maker, the Treasury, step in and say I am going to make a market, as soon as that happens you will jump-start things. And, in fact, at the end of the day, it may not cost the Treasury anything because prices will probably rise, because Dr. Blinder is right, there is now panic in the market and the prices—if you force someone to sell, it will be at a much lower price than the underlying value of the security. Am I making sense?

Senator MURRAY. Yes, I am fine.

Dr. Blinder, did you want to add anything to that.

Mr. BLINDER. No. I agree. The basic symptom—you can see it in the market—is that the bid-ask spreads are incredible on a lot of these assets. When bid-ask spreads are like that instead of like that, it tells you the market is not working. It is not making a price, and there is no activity. So that is what prompted me, at the end of my testimony, to mention that I think we probably need two different sorts of institutions. One would be like what Dr. Zandi was just saying, picking up on what I had said, designed to try to get these markets functioning again. But the other would be aimed specifically at the bottom of the pyramid, so to speak, at the foreclosure problem.

We did this in the Great Depression, and as Dr. Zandi showed on his slides, we now have a housing problem as big as we had in the Great Depression. The rest of the economy looks much better than then, but the housing sector looks just as bad as it did then. And we had this thing called the HOLC during the Great Depression, which assisted in refinancing mortgages.

Now, none of that is going to happen in the next 2 days in a stimulus package. But in terms of addressing this longer-run problem, I think that is the direction in which the Congress ought to be thinking.

Senator MURRAY. Yes, OK. I did hear your testimony. I thought you said that the U.S. economy may recover after the next two to three fiscal quarters. I heard a lot of other people saying that this housing market crisis may last well into 2009. On what are you basing your thoughts that it may be shorter?

Mr. BLINDER. Well, both can be true. The housing sector is about 4 percent of the economy—and sinking, by the way. It is on its way to less than 4 percent of the economy. So things can get pretty terrible in the 4 percent, even worse than they are, and they are awful. But as long as the other 96 percent is doing pretty well, the economy will be ok. Exports were mentioned before as doing pretty well. Up until very, very recently, the consumer was holding up quite well. You could have a recovery, even a pretty good recovery, in the whole economy without having a recovery in housing.

Now, that said, it is not going to be that easy because the housing problems are deep and they seem to be getting worse, not better. And much more importantly, the thing that I emphasized, which brings me to the idea we are now toying with, is the credit-granting mechanism more generally—not just mortgages. There are lots of other types of credit. And every economy runs on credit. Those mechanisms are getting jammed up, and that is quite serious because it is part of the blood that flows through the economic body to make it function. And I worry about that, which takes us way beyond housing and really does go to this question. OK, once we bottom out, whenever that is, do we actually come up rapidly or do we trundle along the bottom for a while?

Senator MURRAY. Well, you have an intriguing fast-track procedure proposal that we would move forward on something but it would not be implemented unless there were other economic indicators coming out. What is the risk of not doing something quickly if we put in place something that is waiting for something else to happen?

Mr. BLINDER. You are quite right. There is always a risk of being too late, and nobody can deny it. There is also a risk of doing it when you do not need it.

I think the odds are that we probably do need it, and the specific indicators that I mentioned in the testimony—I think I also mentioned them verbally—are coming very, very soon. So far we have had one lousy-looking month of employment data and one lousy-looking month of retail sales data. It could be that those are flukes. They could even disappear in data revisions. Things like that happen. My guess is they will not, but I do not know that. I would just like to see one more readius on each, and we are talking about only 2 weeks from now when we will have seen one more on each.

Now, where your question might really come to the fore is here: Now suppose the next employment report comes in rather good-looking—say 100,000-plus jobs. And suppose the next retail sales report comes in rather good-looking. Then I think Congress might sit back and say, well, let's think about this. Do we actually need a stimulus or not?

Mr. ZANDI. May I respectfully disagree.

Senator MURRAY. Yes, Dr. Zandi.

Mr. ZANDI. Sorry.

Mr. BLINDER. That is all right.

[Laughter.]

Mr. ZANDI. Because the quality of the data that we are looking at is always suspect, even in the best of times. At turning points in the economy, it is very difficult to read, and these data are revised. The two he mentioned, employment payroll employment, and retail sales in particular—are notoriously revised significantly, and years after the fact.

So, for example, this Friday we are going to get an employment report that gives us a read on January employment, but we are going to have revisions to the data back more than 2 years, and there will be downward revisions, significant downward revisions based on what the BLS has already told us. So my point is that you—I think the downside—we cannot have—we have to be very careful of focusing on a data point or two. We have to take the plethora of information that is before us. I think most importantly consider sort of what are the downside risks if you do nothing, particularly in the context of what everyone now believes you are going to do. If you do not do that and follow through at this point, in my view, I think that would be a much more serious harm to confidence and to the general economy. I think it would be a huge mistake.

Senator MURRAY. OK. And I just have a few seconds left, but Senator Conrad was asking you about different proposals. What about unemployment insurance and food stamps?

Mr. ZANDI. In my view, they are the most efficacious form of stimulus. I mean, in terms of I put a dollar into extending UI claims, UI insurance or expanding the food stamp program temporarily, I am going to get back much more in terms of economic activity and GDP than any other thing that you can do.

Senator MURRAY. Dr. Blinder?

Mr. BLINDER. I agree with that. I put it right at the top of the list.

Senator MURRAY. Dr. Mitchell?

Mr. MITCHELL. I think it is the perpetual motion machine of fiscal policy. If unemployment insurance benefits were so great, we should ask companies to fire everyone so more people can get unemployed so we can get more stimulus. It is just a silly idea.

Senator MURRAY. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman. There are some really strange ideas going around.

First of all, I want to ask each and every one of you: When is the economy in recession? What is the definition of a recession?

Mr. ZANDI. The definition is a persistent, broad-based decline in economic activity. It is a judgment call by——

Senator BUNNING. Two quarters?

Mr. ZANDI. That is a rule of thumb.

Senator BUNNING. Rule of thumb.

Mr. ZANDI. Yes. It——

Senator BUNNING. It is not a fact.

Mr. ZANDI. No.

Mr. BLINDER. That is actually a media definition. The media——

Senator BUNNING. A media definition?

Mr. BLINDER. Yes.

Senator BUNNING. Well, I want to throw that out to start with. What is a recession, Dr. Blinder?

Mr. BLINDER. That is exactly right. There is an organization, as you know, called the National Bureau of Economic Research, which, well after the fact—so it is not so useful in real time—dates recessions. They do it based on a plethora of different time series data on the economy, focusing on sales, production, employment—am I leaving something out?

Mr. ZANDI. Real income—incomes less transfer payments.

Mr. BLINDER. Yes. Incomes less transfers—those would be sort of the big four. But they look at many other things.

Senator BUNNING. Dr. Mitchell?

Mr. MITCHELL. I have always thought the rule of thumb is that the most reasonable thing to—unless you want to go after the fact—and I already stated in my testimony I do not think economists do a very good job predicting, so it is really only looking for the rearview mirror that we can say these things with certainty.

Senator BUNNING. Thank you very much.

Dr. Blinder, many economists have expressed skepticism about a fiscal stimulus because Congress typically acts too late. I think we are proving that Congress can act quickly. Members can put aside their differences and work together for a common good when we face a dire threat to our economy.

You also said that stimulus must be fast-acting, but you caution us to wait for more employment report—one more employment report and one more report on retail sales. If we wait too long, isn't there a danger that the stimulus will be poorly timed and that will only result in a return to the 1970 style stagflation?

Mr. BLINDER. I do not think the latter. But, yes, if you wait too long, it will be poorly timed. The wait that I was talking about specifically in the testimony is about 2 weeks. So I do not think that is——

Senator BUNNING. In other words, for the Congress to act and pass and have the President sign a stimulus package?

Mr. BLINDER. The so-called fast-track proposal that I mentioned in the testimony and that Senator Murray brought up would have the Congress agree as soon as it can—and it looks like it is moving very fast—on what the package will be and then vote on it at the time, on a fast-track basis what it wants to put——

Senator BUNNING. One more question, Dr. Blinder. Should unemployment compensation benefits be taxed? Professor Feldstein, who testified before the Senate Finance Committee last week, believes they should be taxed. What is your opinion?

Mr. BLINDER. I guess I do not think it is that important an issue. This question is part and parcel of how generous should they be. If you tax them, people above certain income levels are going to get less. I do not have a big quarrel with——

Senator BUNNING. Wouldn't that get more money quickly into the economy if we did not——

Mr. BLINDER. You mean right now as part of——

Senator BUNNING. Oh, yes, as part of the package.

Mr. BLINDER. To the extent you tax it back, you get less. I thought—I was interpreting that——

Senator BUNNING. No, no, no. That is part of the package. You do not tax the additional.

Mr. BLINDER. Oh, I see. I see. You do not tax the additional. Yes, I think that would get more spending——

Senator BUNNING. OK. Thank you.

Mr. BLINDER. Right away. Yes. Sorry.

Senator BUNNING. Dr. Mitchell, in your testimony, you point out that bad monetary policy was partly responsible for the economic weakness in the 1930's. The Federal Reserve raised rates at the wrong time. What role do you think monetary policy has played in the current crisis? And would you agree with Professor Anna Schwartz, who recently argued that the Federal Reserve "failed to confront something that was evident," meaning the asset bubble in housing, and kept interest rates too low for too long?

Mr. MITCHELL. I agree with Anna Schwartz. I think one of the problems we have today is the housing bubble. One of the things that caused the housing bubble was artificially low interest rates by the Fed. As a matter of fact, I am a little bit worried about a return to stagflation because if you have an easy monetary policy, like we had in the 1960's and 1970's, combined with increases in the overall burden of Government—I do not think we are anywhere near where we were in the 1960's and 1970's, but I am worried that we are trending in that direction of the Fed not being focused on protecting the value of the dollar. I think the European Central Bank is doing a much better job than the Fed, and I think that shows up in the falling value of the dollar versus the euro, not to mention other currencies. And I also worry that certainly over the last several years we have had an increase in the aggregate burden of Government as a share of GDP, and I worry that is just not a good recipe unless we want to wind up like, you know, some of the slow-growth economies in Europe.

Senator BUNNING. We are going to have an FOMC meeting this week, the end of this week, and it is anticipated that a 50-basis-point reduction in the Fed rate will occur on top of an emergency 75-point reduction.

Dr. Blinder, since you were on the Fed, don't you think that is kind of a crisis management?

Mr. BLINDER. Oh, I do, yes. I think the Fed has been watching this rolling financial crisis that really erupted in the July-August of last year timeframe. One might have thought that the markets would have cured all of this by now, but they have not. And if anything, it is getting better in some dimensions; but it is getting worse in other dimensions, and new things keep happening. You may have noticed in the newspapers in the last few days there is a lot of discussion about the bond insurers and what could happen if they go under or are impaired. So, yes, the Fed is looking at this as a crisis. If, in fact, they lower the Fed funds rate another 50 basis points today—we will know in about 3 hours——

Senator BUNNING. 2:15, to be exact.

Mr. BLINDER. 2:15, exactly right. That would be incredible speed by Federal Reserve standards. You have to go back——

Senator BUNNING. Incredible?

Mr. BLINDER. Yes. You have to go back to the 1980's to see them moving interest rates that much in that short a timeframe.

Senator BUNNING. In my opinion, watching the Fed operate—and I have been a Fed watcher since you were on the Fed—it is total panic. Since they did not in normal operating procedures react, but with a 25-basis-point at their last meeting, all of a sudden in 2 weeks—are you kidding me? And we are to believe that they knew what they were doing?

Mr. BLINDER. I think, Senator, they concluded on the 22nd of January, or probably a little before, that they had done too little——

Senator BUNNING. No kidding.

Mr. BLINDER [continuing]. And they had some catching up to do. Yes.

Senator BUNNING. No kidding. Everybody was urging—urging them to do more the last time they met, and there was one dissent. And that dissent was not to do anything.

Mr. BLINDER. Well, the previous meeting, actually——

Senator BUNNING. Had one dissent, the same way, to do more. But I am telling you, 11 people in one room, or 12, depending how many people show up—well, that is a fact because some of our bank presidents do not get there in time or are absent and vote by telephone. I find the Fed inactivity, and now being very active, very disturbing to our economic well-being.

Thank you.

Chairman CONRAD. Thank you, Senator.

Senator Domenici?

Senator DOMENICI. Well, Mr. Chairman, as I told you privately, I have to go to a business meeting of the Energy Committee, and Senator Bingaman does not call those very often, so I probably only have two questions. I will only have time for that.

I would like to ask any of you this question: As I participate and read and see what I can—how I can catch on to this and is the House-passed package going to work, because it is going to pass, it is going to be law—and I am quite sure I could predict that today. But it seems to me that everybody is acknowledging that there is a very big problem in housing and that that problem is a very entangled one because, you know, the securities got away from everybody. It is not like they are sitting around in a nice place, that the negative ones are perking up all over the place where nobody ever even expected them. People are adding assets to their portfolio that are broke all over the place.

And I guess I am wondering if that is not bad enough that our typical anti-recession package, which is what we are doing and the House—all we are doing is doing it quickly and fooling everybody because the House did it bipartisan so quickly. Now the people are glad of that and are saying do something, do it. But I have a question. Is it not possible, even probable, that the housing mess may negate the effectiveness of this package that we are all talking about doing?

Let's start with you first, sir, in the middle.

Mr. BLINDER. I do not think so, but in the following sense.

Senator DOMENICI. Please.

Mr. BLINDER. We could imagine having the same sort of macroeconomic environment but, that housing had nothing to do with it, that we were just sagging for some other reason, in which case the House probably would have designed the package very much like what they designed, with the exception of those things about the FHA and a few other little things. But it basically would have been essentially the same, and its macroeconomic impact would have been essentially the same, too. The package is intended to give the economy some oomph in the short run from more spending to prevent the sag or to make it less than it otherwise would.

The housing mess, as you quite correctly characterize it, is a big set of complicated problems that we do not have our arms around yet because it does go way beyond housing into the fixed-income securities markets.

Senator DOMENICI. Yes.

Mr. BLINDER. For that, we need longer-range things, including perhaps some unusual Government interventions that we have been discussing in this hearing. That is where you see the uniqueness of the current situation coming to the fore. And you are quite correct, it is not going to be solved in a stimulus bill passed tomorrow.

Senator DOMENICI. Do you see any ideas around that are out of the ordinary? Since it is an out-of-the-ordinary securities problem, are there some ideas around of significance that you are aware of?

Mr. BLINDER. Yes, there are several. I saw you had to step back——

Senator DOMENICI. But they are not going to be in this package.

Mr. BLINDER. They would not be in this package because they take some thought about design. You know, these are the kinds of things in which truly the devil is in the details, and you do not want to try to design them in an overnight markup and pass it.

Senator DOMENICI. But you think they can be drawn?

Mr. BLINDER. I think so. I think so. There have been suggestions, for example, I mentioned earlier——

Senator DOMENICI. I am sorry I did not hear it.

Mr. BLINDER. It is quite all right.—of bringing back something like was done in the Great Depression, with the Home Owners Loan Corporation to stave off foreclosures. There have been suggestions made about having Government assistance, let's put it that way, to get the credit markets back functioning again, somewhat analogous to what the RTC did after the total collapse in the savings and loan industry back in the late 1980's and early 1990's. And there have been other suggestions like that. So there are ideas, somewhat out-of-the-box ideas, floating around.

Senator DOMENICI. We had some pretty big people involved with that. James Baker was involved, and Darman, who is deceased, he was involved. They thought that one through and did something extraordinary.

Mr. BLINDER. Absolutely.

Senator DOMENICI. That is what we need now.

Mr. BLINDER. And Bill Seidman, who is still around, was the head of the RTC then.

Senator DOMENICI. Right. Well, do you think the same thing, Dr. Zandi?

Mr. ZANDI. Yes, I do. I think Congress and the administration have done a number of good things. They are small, but they are all good things. I think HOPE Now is a useful process.

Senator DOMENICI. Right.

Mr. ZANDI. Give it a chance to work. I think FHA expansion and GSE loan cap expansion are good ideas.

Senator DOMENICI. Too small.

Mr. ZANDI. And I think we should prepare for the possibility that the problems are bigger than all this and that we need to do something—in a broad philosophical sense, I think what the Treasury has done so far is try to facilitate the market. It has not put itself on the line. I think we are at a point where the Treasury is going to have to put taxpayer dollars on the line and say we are behind this, and once that happens, I think the cost to taxpayers and the Treasury ultimately will be less.

Senator DOMENICI. Dr. Mitchell?

Mr. MITCHELL. I am a Fairfax County homeowner. I have enjoyed a lot of appreciation in the value of my house over the last 14 years, and I suppose I should be appreciative that you all are trying to prop up the value of my home, even if it is at the expense of low-income and young people who might be home buyers. But I think the problem we have in housing is that we did have a bubble, and the more the Government intervenes to try to prop up the value of homes, we will be making the mistake the Japanese made in not allowing the bad loans to work their way out of the system.

The only really good thing I can tell you about the overall stimulus package is that at least it is not intervening in the housing market because I do worry that we might make the mistake the Japanese made. I do not want my home to fall in value, but I also know that over the last 14 years, I am still way ahead of the game. And I know that if we had the Government intervene in propping up the value of homes, it is going to hurt people who are lot less well off than I am, or any homeowners in this room are.

Senator DOMENICI. Thank you very much. Thank you, Mr. Chairman. Thanks to all three of you.

Chairman CONRAD. Thank you, Senator Domenici.

I would like to go back to the housing situation. Dr. Zandi, I would like to go to your charts, if I could, and I would like to go to the chart that is headlined "Inducing an unprecedented surge in defaults."

Mr. ZANDI. Yes.

Chairman CONRAD. First mortgage loan defaults. I would like you to help us understand this chart more fully.

Mr. ZANDI. OK.

Chairman CONRAD. Take us just briefly, if you could, through the implications of this chart. This is showing us mortgage loan defaults. Is this by month or by quarter?

Mr. ZANDI. This is as of a certain—this is as of the last week of each quarter.

Chairman CONRAD. OK. As I read this chart, it tells me we have 1,800,000 mortgage loans in default.

Mr. ZANDI. In that last quarter.

Chairman CONRAD. That last quarter, and——

Mr. ZANDI. That is at an annual rate, though. I have annualized.

Chairman CONRAD. Annualized.

Mr. ZANDI. I think it was 450,000, if my math is correct.

Mr. BLINDER. You need to divide that by 4.

Chairman CONRAD. Yes. And then this thing is going up like a scalded cat.

Mr. ZANDI. That is a great way to describe it. I would not have come up with that, but OK.

Chairman CONRAD. So tell us what you think the implications are? And, you know, Dr. Mitchell has this view that, you know, let the market work. And, you know, if the Government intervenes to make this less of a crisis, all you do is, as I hear you, Dr. Mitchell—correct me if I am misstating your perspective—that if we interfere in market correction, all we do is really delay the day of reckoning.

Senator GREGG. Misallocate resources.

Chairman CONRAD. Am I fairly characterizing your position?

Mr. MITCHELL. Yes, I think the quicker we allow markets to work, the more efficient that capital allocation will be in the economy and the better our long-term rate of growth will be. There is a reason why countries with more laissez-faire capital markets grow faster than countries with more government intervention. It is because market forces, not political forces, are driving the allocation of resources. And I would not want us to travel down the path of countries that are less prosperous and growing less quickly than we are.

Chairman CONRAD. OK. And, Dr. Zandi, what would be your reaction to that?

Mr. ZANDI. I think that is a very appropriate principle for all of us to follow under—99 percent of the time. I think that is exactly correct. I think there are cases—and I think we are potentially in one of those cases—where the market does not work, or it will not work for a considerable amount of time and will create a significant amount of loss of wealth, income, and jobs. And there are other times when we faced that. The last time was in the early 1990's with the S&L crisis. I think it was beyond a solution for the market, or at least one that was financially palatable for us, and we decided that we were going to solve this problem collectively and put our resources on the line. And we solved that problem in a very, I thought, at the end of the day, incredibly efficient way. It cost the taxpayers a lot less than it certainly could have.

And I think there is a distinct possibility we are at one of those other points in time where we just cannot let the market do its thing because it is not going to do its thing in a reasonable amount of time. It is going to cost us a lot of wealth.

Chairman CONRAD. Let me ask you this, if I could. I have had major financial players in this country call me and tell me they are extremely concerned about a potential lockup of financial markets. And by that, what I took them to mean was that people pulled back from even good deals and that that has a cascading effect on the economy. And what they were sharing with me is their top economists telling them they think there is a 50–50 chance of a severe recession, and that it is in all of our interests, our collective interest, to try to prevent that from occurring.

What would be your reaction to that characterization of events? And I would ask each of you, starting with you, Dr. Zandi, and then Dr. Blinder, and then Dr. Mitchell.

Mr. ZANDI. I think that is a reasonable concern. Just looking at the marketplace today, and as Dr. Blinder mentioned, it has now gone well beyond the mortgage securities market. It has affected the asset-backed securities market where credit cards and auto loans and student loans are traded and financed. That is where a lot of capital for our credit cards come from. It has affected the commercial mortgage-backed securities market. So if you talk to anybody in commercial real estate, transactions are not happening because they cannot get financing.

Chairman CONRAD. Let me just say that that was confirmed for me by our—I was just sharing with Senator Gregg. A person who is in commercial told me the deals that were good deals typically get 80 percent financing without much of a problem. They are now struggling to get 50 percent financing, and as a result, that market is locking up, at least in parts of the country. I do not know how widespread that is or if you have evidence that that is beginning to happen.

Mr. ZANDI. Yes, it is happening across most of the commercial mortgage lending market, both in terms of the securities market and in terms of bank lending. It has not affected everyone. I mean, if you are a pristine borrower, meaning you have a lot of equity in your investment, your property, if you have good cash-flow, you still can get credit at a reasonable interest rate. But, increasingly, borrowers that you would deem to be reasonably good credits in normal times are not getting credit today. It is bleeding out into the corporate bond market, not in the high-grade, investment-grade market, but just one step below and certainly to the junk bond market it is happening. You know, credit spread are widening out. There is no bond issuance.

So the market is very, very fragile. In my view, we are one event away from a very significant financial problem. And if the securities markets do shut down, then as Dr. Blinder mentioned, credit is the mother milk of economic activity; if that shuts down, even for a brief period of time, it will have very significant economic implications. So I think that is a reasonable risk, yes.

Chairman CONRAD. Dr. Blinder?

Mr. BLINDER. I would say 50 percent odds on a recession. A severe recession? Of course, one does not quite know what that means, but let's say it is something like the early 1980's. That was a very severe recession. I would handicap that as very low probability. No one can say it is impossible, but low.

I am much more worried about a failure to snap back from the sluggishness, as I have said. You may remember the so-called head winds period in the early 1990's when, from somewhat similar but not nearly as serious problems in the financial sector, the economy just could not quite get the engine stoked. It was growing, but not growing very well for a while, and then it finally did start going up.

Regarding the question of whether the markets are locking up, to some significant extent they are already locked up. I mentioned the wide bid-ask spreads. That is a symptom that they are locked up. Another is to look at the rates at which the U.S. Treasury can sell debt at now. Why? That is the only thing anybody wants to buy. The financial markets are flooding into U.S. treasuries. They have beaten the rates down to incredibly low levels because they know the Treasury is going to pay them back, and they do not trust that the other so-called AAA credits are going to pay them back. So there is a tremendous amount of fear, which also leads to lock-up.

And I would just like to relate this to the point we were talking about before about interfering with home prices versus letting the market work itself out. As Dr. Zandi said, letting the market work itself out is almost always the right answer. It becomes the wrong answer when the whole economy is at risk. I do not want to sit here, and I certainly would not want my representatives in Congress sitting here and saying, you know, it is too bad, you all made mistakes and you are all going to suffer for it. I think that is one of the reasons we have a Government.

Falling housing prices are not the only problem, but they sit right at the base of the other problems. Why are we looking at foreclosures? A major reason is falling housing prices. Why are we worried about consumer spending sagging? A major reason is falling housing prices. Why doesn't anybody want to buy MBS anymore? Mortgage-backed securities. Falling housing prices. Why are these CDOs that have been built on top in complicated ways totally unmarketable these days? Falling housing prices.

So falling housing prices, for better or for worse—and it has been for worse, actually—have become central to this drama. And that is why I think it is appropriate for the Government to do things—not to go in and bail out particular people who have speculated and made bad bets. Certainly not. But to do things with the macroeconomy that make this market function better.

Chairman CONRAD. My time is—I am well over my time, so I am going to turn to Senator Gregg. And, Dr. Mitchell, I will come back to you on my next chance.

Senator Gregg.

Senator GREGG. Well, why don't you answer? Why don't you follow on since all three of you were asked the question.

Mr. MITCHELL. Well, I would simply add that in some sense falling housing prices are toothpaste that is out of the tube, and I do not know that anything that is going to be done is going to solve that problem. Instead, I look at what lessons can we learn and how can we avoid similar problems in the future. And I think that we have an awful lot of subsidies and programs and preferences for housing, and I think those are some of the things, combined with, I think, a lot of the blame with the Fed keeping interest rates artificially low, I think we should be cautious about programs, whether it is bailing out housing or bailing our Wall Street, we have to think about what sort of precedent we are setting and what sort of incentives that people in those markets are going to have in the future, if they think, well, we can go ahead and take a risk that might normally be imprudent because we think somehow the Government is going to be there to bail out our mistake.

And so, you know, the problem with housing, it is there, it already exists. I think a lot of policies are trying to push on the string. We are not really going to solve the current slump in housing prices. I am more worried about are we learning the right lessons so that we avoid similar mistakes in the future.

Senator GREGG. Well, we certainly got into the macro debate here, not much relationship to the stimulus package, which probably will have no effect on this exercise. But my frame of reference is this: I went through this as a bank attorney in 1978–79, and then I went through it—not a bank attorney. [I was a corporate attorney representing a bank.] And then I went through it again as Governor of New Hampshire in 1990 when seven of my—I had seven large banks in New Hampshire, and they were all insolvent. And my State revenues fell for 36 straight months in real terms. And what we saw was a contraction which was driven by the fact that the housing market collapsed as a result in New England not of fraud, as occurred in Texas, but because the mutual banks had converted to commercial banks, and they did not know how to make commercial loans, and they started throwing money at condo projects that did not have any viability. And so they collapsed, and what that led to was what Dr. Zandi was talking about, which is that people were not able to—the good loans were not able to be made because everybody had to rebuild their capital. And so it was a self-fulfilling problem.

I guess my interest in this effort today is what have we learned from that. And it seemed to me that one thing we learned was that you did not concentrate the debt in the hands of the banks so that you spread the risk. And I think that has happened in this event. It appears to me that rather than having most of the banks in New Hampshire owning the loans that they made, they are probably owned by somebody in China or somebody in Europe, to a large extent. So we have spread this risk. So the capital issue on our banking community may not be as severe.

But you have this chart here, Dr. Zandi, that seems to imply that we are going to have very serious problems with our capital structure of our banking system. And I guess since we are talking macro here, I would like to know—this is your chart entitled “The Banking System Is at Significant Risk.” I am wondering if that is true if we talk about the traditional banking system. With FIRREA in the 1990’s, we basically forced better capital structure. We do not have the smaller banking community—community banking, and I am talking about the less than $3 billion bank—with serious lending practices, because they did underwriting probably fairly well.

Doesn’t this really apply more to the banking houses who were not forced to maintain capital, such as Bear Stearns and Merrill, rather than the big banks that are traditionally—and the banking community that has traditionally been the strength of our economy? Because if our banking community is in serious—if this chart is true to the banking community, then we do have a huge problem because they are going to start significantly ratcheting down this economy in order to get their capital position back.

So I want to know where is this—what are the specifics of this chart? Is it banking generally? Or is it more the banking houses?

Mr. ZANDI. Well——

Chairman CONRAD. Could we just interrupt? Could we get up on the——

Senator GREGG. Maybe you can punch that up.

Mr. ZANDI. It is on my slide.

Chairman CONRAD. “The Banking System Is at Significant Risk.”

Mr. ZANDI. Yes, so this is data from the Federal Reserve that shows that there is just under $2 trillion worth of—these are residential real estate whole loans and residential mortgage security——

Senator GREGG. But do they go to the capital structure of our banks?

Mr. ZANDI. Yes, that is a good question. This is large commercial banks, so this is roughly the 30 largest banks in the country. They have asset bases of tens of billions of dollars. They are the most exposed.

Senator GREGG. But is their capital position addressed?

Mr. ZANDI. I believe it is, yes. And their capital position is measurably better than when you were advising a bank, the banks—or you were Governor of New Hampshire in the early 1990's. Back then the bank capital/asset ratio was 6.5 percent. Before all this here in this period, it is 8.5 percent. But there have been some very positive developments. Every time a large commercial bank reports a loss on these assets that I am showing to you, they are able to fill the capital void by an equity investor, sovereign wealth fund or—so far it has been mostly foreign money coming in to fill the equity void.

Senator GREGG. Well, I think Bank of America went out and financed it. But, anyway——

Mr. ZANDI. Yes, and, you know, Fannie Mae and Freddie Mac are going around and issuing various kind of equity to fill the void. So there is capital coming in.

My concern, though, would be that if there are continued mortgage losses—and not only mortgage losses, it is now—if you listen to the banks, they are telling you it is in their credit card portfolio, it is in their auto lending portfolio, even in their CNI loan portfolio. B of A came out and said we are seeing a deterioration in our small business lending portfolio, which is the first time I had heard that.

So the next time they come out with major losses—and this is a risk. I do not know if this is going to happen, but this is what I am concerned about—they will not be able to fill the void. Even though they have an 8 percent equity/capital ratio, they have to take a multi-billion-dollar writedown, and they are unable to fill the hole with another equity investor. They say, "No, I am going to wait."

Senator GREGG. Given that as a potential, there is nothing in the stimulus package that is going to address that.

Mr. ZANDI. No, sir. No, sir.

Senator GREGG. And is there anything the Government theoretically can do? You have your RTC idea here basically, right? I mean other than that.

Mr. ZANDI. Well, in my view, I do think that it would take a philosophical leap but in terms of dollars and cents a small step to establish a fund that would buy up—say I am going to buy mortgage loans, whole loans, and mortgage securities, and I am going to establish a price in this marketplace.

Senator GREGG. Well, why isn't that the Japanese approach?

Mr. ZANDI. The Japanese approach is they had no——

Senator GREGG. Basically underwriting——

Mr. ZANDI. No, sir. The problem in Japan was—no, they left the—they did not solve their problem. They left the bad assets on the banks' balance sheet for years, and it impaired the capital position of the banks and their ability and willingness to extend credit. What I am proposing to do is clean that out right now. As soon as you establish a price in the marketplace, then the banking system has to mark down to that price, and we clean it out. Right now they are not marking because they do not know what to mark to so they are having trouble.

Senator GREGG. Obviously, Dr. Mitchell, you have a different view——

Mr. BLINDER. If I could just put in two footnotes to that. In the Japanese case, they finally did get the problem mostly solved—it is not 100 percent solved even to this day—with massive government intervention. They put public funds at risk. They nationalized some banks and then de-nationalized them. They did a lot of things. It took them a long, long time to get to that. For a long time they dithered and really did not do anything, and that was part of the problem.

Second footnote. You asked, will the stimulus package do anything to help this set of problems? Not directly. But to the extent the economy improves, all problems shrink. One of the reasons that the RTC wound up spending much less taxpayer money than almost anybody thought at the beginning—it was still a lot, but the numbers that were bandied about were much higher—was that the economy started to improve as we got into 1992 and 1993. As the economy starts to improve, bad loans become good loans, just as it works in the other direction. And when the economy starts to deteriorate, good loans become bad loans.

And so doing something to boost macroeconomic activity, which is what the Fed is up to and which is what the stimulus package is about, will at the margin also contribute to this particular problem.

Senator GREGG. I am sorry. Dr. Mitchell? And I know, Ben, you have been——

Mr. MITCHELL. I actually will agree completely that if the economy does better, that helps everything. If the economy does worse, that hurts everything, and that is why I think the focus should be on what is good long-term policy, because I do not think it is under your control with a stimulus package to affect the short-term economic results.

In terms of the Federal intervention in housing, I will repeat what I said before. I am very worried about what signal may be sent. If people in the future think that, well, maybe the Government is going to step in and prop up house prices at a certain level, I just worry that that is going to have implications for the overall efficiency of capital markets and what is being allocated where. And I think it is also going to probably lead people to take more risks than they otherwise would take because they think there is a possibility of the Government stepping in if somehow things go south. And I just think that is not a good signal to send in terms of long-term economic performance.

Senator GREGG. I appreciate it.

Chairman CONRAD. Senator Cardin, yes, I join the Ranking Member in thanking you very much for your patience.

Senator CARDIN. Well, thank you, Mr. Chairman. I have found this discussion to be very, very helpful. But I could not help but think of how the typical person in my State of Maryland would be responding to this discussion. The typical family in Maryland is concerned about energy costs, health care costs, and perhaps even job security. The stimulus package that passed the House is a conventional approach to try to restore some confidence in our economy, and to me it is helpful.

But the point that has been raised here about the housing market is of particular importance to Maryland. Maryland does not have an high unemployment rate, but we have a high foreclosure rate. Foreclosures are increasing in our State, up significantly in the last quarter. Bankruptcies are also up in Maryland. The trigger for the economic problems we are experiencing right now is clearly the housing market. And I can tell you, having visited several parts of Maryland, that in the Washington suburbs, there are many homeowners with subprime loans that are behind and in danger of foreclosure.

So I would say to Mr. Mitchell: the toothpaste is not out of the tube yet for them. They can still save their homes. And they are looking to this Congress to do something to give them hope that they will be able to restructure their mortgages, and be able to stay in their homes and not be forced into foreclosure.

I was in Salisbury on Monday. It is in a rural part of our State. I asked the local leaders whether there was a problem with the housing market in rural Maryland. They told me that people cannot sell their homes, and inventories are very high.

I was in Baltimore talking to a young family who cannot find a mortgage to buy a home. They want to buy a home. They cannot. So the credit crunch is real. It is affecting our economy today.

So as we look at the stimulus package this afternoon on the floor of Congress, I believe we have a responsibility to do something about the housing crisis. And I was very much interested in our witnesses' comments that if we can do something to ease the credit crunch, if we can do something that gives some degree of optimism, then maybe that will have an impact.

When the Federal Reserve reduces the prime rate, we all know it has some direct impact, but it is also a signal. It is a signal of concern and confidence. And my own gut feeling is, for the people whom I visited in Maryland, they want this Congress to do something about the housing crisis. They do not want us to just sit back and say you cannot affect private contracts; we do affect the economy here.

So I will leave that as an open-ended question. What we can do in the short term—and the long term, but we have the short term before Congress right now—to, first, help that person who has a subprime loan today in the Washington area, who is trying to make payments, but has fallen behind, has a good job, is creditworthy, and needs help. What can we do in the short term to assist those people?

Mr. ZANDI. Well, I think one thing you can easily do is raise the loan caps temporarily for Fannie Mae and Freddie Mac. I think that has been proposed, and I think that would be very efficacious, particularly for your State, Senator. If you look at the 2006 data on mortgage originations, which is the latest full year of data we have, and you look at all the loans that were originated above $417,000—that is the current loan cap—about 10 percent of the borrowers in Maryland in that order of magnitude would be affected by that. They would be able to get Fannie- and Freddie-backed credit if we changed this rule. Right now they cannot get any credit because the market is frozen outside of what Fannie and Freddie are doing.

So I think it is a very easy, very laudable thing to do, and I think it would be effective. It would have been more effective 6 months ago when Fannie and Freddie were in better financial situations. They have their own capital problems now, and that is going to limit their ability to use this and help the market. But it would still be helpful.

Expanding FHA, I think that is a slam-dunk. I do not know why we do not immediately increase FHA to allow homeowners into homes. I think that would be very helpful.

I think the proposal to allow for increased issuance of municipal bonds to finance State funds, to help in refinancing efforts of people who face payment resets on their mortgages to refinance into another loan is a very effective way, and it allows the States to—because they are on the ground with these folks, and they know and can help decide who gets this.

So these are not big things, but they are things that can be done very quickly and would be very helpful now.

Senator CARDIN. Thank you. Any other suggestions? I agree. First of all, the indirect impact that it will have will be positive.

Mr. ZANDI. Right.

Senator CARDIN. Additionally, it will demonstrate that we are taking action, which can feed on itself.

Mr. BLINDER. Well, just a couple of quick points. I think your point about giving people the feeling that something is going on can be helpful in a variety of dimensions. Regarding some of the things we were talking about earlier about getting the capital markets functioning again, I am "convinced"—nobody really knows what the future will bring, but I am relatively convinced—that if we could get these markets functioning so there are actually prices for these assets at which people knew they could buy and sell, then private capital would come pouring in, and the Government would have to do relatively little in the end. It is sort of an igniter in that sense.

The other thing that I wanted to mention is that the refinancings are only one part of the issue. The other part of the issue is the debt workout. There are people who haveten themselves into debts that they are not going to be able to pay. This happens all the time. When it is banker to customer, the banker knows that if it goes to foreclosure, there is going to be value destroyed. If you think about how much value the banker and the homeowner together have, it is going to go down in a foreclosure. Bankers know that, and so they try to get workouts. How much can you pay? Stretch it out. Lower the interest rates. Whatever.

The problem we are having now is that most of these mortgages have been securitized, sliced and diced, put into CDOs, MBSs. They are all over the world. And so some of your homeowners in Maryland may actually have mortgages that are owned by a pension fund in Italy or something. That pension fund does not even know that they own this mortgage of your homeowner in Maryland. So you get a very difficult coordination problem.

Now, in the fullness of time, the markets are going to solve those problems, no doubt. But the question is how full we want time to be, and I think there is a case for the Government coming in acting as a coordinating mechanism, as a catalyst to get this hypothetical pension fund in Italy and the homeowner in Maryland together to do something that will actually be in their mutual benefit—if only they knew each other.

Senator CARDIN. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

A couple of quick things before we end. One, Dr. Zandi, you mentioned $250 billion of—I took it to be mortgage refinancings that have been typical in previous periods, and now we are down to $10 billion. Was that your reference? Was it to mortgage refinancing?

Mr. ZANDI. No. That was to bond issuance.

Chairman CONRAD. Bond issuance.

Mr. ZANDI. Bond issuance. And just to give you the——

Chairman CONRAD. Bond issuance in a particular sector or just broadly?

Mr. ZANDI. In the nonconforming market, so that would include——

Chairman CONRAD. Nonconforming. That is over $417,000.

Mr. ZANDI. And all the subprime and Alt-A and all the jumbo. That was half the market in 2006. In fact, in 2006, there was $1 trillion, give or take a billion, in bond issuance to finance those loans, which obviously many of those loans should not have been made.

In the fourth quarter of 2007, to give you context, there were less than $200 billion altogether, and by December we were down to, you know, nothing essentially—I mean, very little bond——

Senator GREGG. Can I ask a question?

Chairman CONRAD. Yes, absolutely.

Senator GREGG. And the rollover number I have heard is that there is a half a trillion of subprime coming due this year and a half a trillion coming due next year.

Mr. ZANDI. Yes, well, this year it is subprime. In 2009 and 2010, it is the option ARMs, which are some subprime, but some are jumbo. You know, prime borrowers, they just have these balloon payments coming. But they are going to have a great deal of difficulty because they got in with housing values at a certain level, their mortgages were right up to the value, and now they are underwater. So this is a problem that is not going to end in 2008. It is going to extend into 2009 and 2010.

Chairman CONRAD. And what could we do about that problem? I take Dr. Mitchell's entreaties. But if one was concerned about that becoming an even bigger problem in the economy than it might otherwise be, taking his entreaties seriously that largely you want to market to deal with this, what steps could we take that would help the market resolve it in a less cataclysmic way?

Mr. ZANDI. OK. Well, there is a multifaceted way, approach to this, and it is not just one thing. Some are small, some are large. The RTC idea, the RTC-like idea is a large idea that takes a lot of thought, but may be needed. But when you give permission to the State governments to issue more tax-exempt bonds for refinancing, that will help. That is going to go to help refinance people who are facing these ARM resets. So the more funds you can provide into that program, the more helpful that will be.

HOPE Now, which is the initiative that Treasury has set up to facilitate the modification process, is a good idea. It is going to be very small, though. And one caveat I just want to throw out there so that you are aware of this, most of the effort so far has been in establishing so-called repayment plans. They do not help the homeowner at all. All a repayment plan does is say to the homeowner, You did not pay me the last few months, I am going to take the interest you owe me and the fees and roll it back into the principal, and you are going to be put on a new payment schedule, which, in fact, in most cases will have a higher mortgage payment.

So when you hear that HOPE Now has resulted in a quarter million repayment plans, that is in my view not helping at all. That is going to be more of a problem—not years ahead—in months ahead. These people are not going to be able to make good on it. But HOPE Now, broadly speaking, is a laudable process.

But, ultimately, the only way this problem is going to be solved is if there is more—if credit starts to flow into the mortgage market, that lenders are able to extend out credit to good potential homeowners, to first-time buyers, to people who under normal circumstances would not be able to get a loan. Not the investor, not the subprime borrower who had no chance of making good, but reasonably good credits. And anything you can do to improve that flow of credit I think is going to help.

Chairman CONRAD. Let me go to one other thing because we are running out of time here, and that is longer term. Senator Gregg and I have a proposal to have a task force, eight Democrats, eight Republicans, that would have the responsibility to come up with a plan to deal with our long-term fiscal imbalances, deal with the entitlement shortfalls that we all know exist, and that if 12 of those 16 members could agree on a plan, that plan would come to Congress for a vote. It would not be a commission that just comes up with a recommendation and nothing ever happens, because we have concluded that the normal legislative process simply is not going to take on these very tough, overarching issues absent some change in process.

I would just ask each of you for your reaction. Do you think that is something that would be helpful? Would it be a confidence builder to markets to see the United States was facing up to its long-term mismatch between commitments and revenue?

Mr. ZANDI. So the idea is that you would have a commission that would come with a proposal that is binding, it is up or down, kind of like a BRAC Commission process?

Chairman CONRAD. Yes.

Mr. ZANDI. You know, fundamentally that is absolutely—something like that has to happen because the only way we are going to come to a solution to this long-term problem is there has to be tax increases and spending cuts, a combination, and that is going to be very painful to get through any legislative body. And the only way is some kind of process outside of the current process.

Mr. BLINDER. I agree with that very much. I have written about this also. It is a certainty that the ultimate long-run budget fix-up, whatever it is, is going to have in it so many things that every single Member of Congress will not like something in it. And so, you know, the genius of the Base Closing Commission was exactly to sort of bundle it all together. That was also the secret to the Tax Reform Act of 1986, which had lots of things in it that individual members did not like. But somehow everybody came together and we got a very good tax reform.

I do not have a personal opinion on whether the exact details of what you just said is the right way to do it. But maybe it is. But something that is philosophically like that needs to be done. And let me just add an obvious codicil to that. To the extent that partisanship can, not disappear but sort of be put in the closet for a little while, that would be a good thing, because in truth, in many of these cases it is partisanship that prevents the agreement from going forward. And if you could, you know, as a thought experiment, get a handful of nonpartisan people together, I think you would get agreement on many things without a great deal of difficulty. But that is hard to get done in Washington, I know.

Chairman CONRAD. Dr. Mitchell?

Mr. MITCHELL. I certainly applaud the attention that the two of you are giving to fiscal issues, long-term fiscal issues. I am a tad bit worried that the focus is on the imbalance as opposed to the growth of government. If we look at country like Sweden, they have a budget surplus, but government is consuming more than 50 percent of GDP, and their per capita disposable income is only 65 percent of American levels. SO I would not want to trade places with Sweden even though they have a surplus and we have a deficit.

So I would certainly hope that such a commission would focus on, if it ever was passed and wound up producing recommendations, it would focus on how to control the size of government and keep it where it is now, as opposed to become like Sweden with a surplus but a much poorer society because government is too big.

Chairman CONRAD. Let me just say in answer to that, I think the honest answer here is we are going to have to have some more revenue. I would prefer it to be in areas that are not actually tax increases, at least the first place we look for revenue not tax increases. But there are also going to have to be benefit adjustments. And if you look at the math, I think it is very clear that the heaviest part of the load is going to have to be on the benefit adjustment side of the house. We have a runaway train here, especially on the health care accounts, and that is the 800-pound gorilla that can swamp this boat.

We talk about what is happening here. We have had repeated testimony before this Committee by Chairman Bernanke, the head of the Federal Reserve, by the head of the Congressional Budget Office, by the Comptroller General of the United States, and economists of all stripes telling us we are on an unsustainable course, and the quicker we make a course correction the better.

Senator Gregg?

Senator GREGG. Well, let me associate my comments with your comments. Again, Mr. Chairman, you are right on. And I thank the panel. I found this to be extremely informative and also entertaining and worthwhile, and I appreciate the point of views. And I like the fact that there were different folks, different views here expressed. I wish we had a magic wand, but we do not. But hopefully we can get through this.

Thank you.

Chairman CONRAD. Thank you. Thanks to my colleague Senator Gregg. Thanks to each of the witnesses. I have enjoyed this very much. Dr. Zandi, Dr. Blinder, Dr. Mitchell, I think you all made an excellent contribution to the work of this Committee, and we thank you for it.

Mr. ZANDI. Thank you.

Mr. BLINDER. Thank you.

Mr. MITCHELL. Thank you, Senators.

Chairman CONRAD. We are adjourned.

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

Jim Bunning

STATEMENT FOR SENATOR BUNNING

SENATE COMMITTEE ON THE BUDGET

"Economic Stimulus: Budget Policy for a Strong Economy Over the Short and Long-Term"

January 30, 2008

Thank you, Mr. Chairman.

I appreciate the opportunity to hear testimony from three distinguished economists about the economic stimulus package. This is the third hearing I have attended on this topic, and I believe every hearing has been useful and has added to our collective knowledge.

It is important to recognize the major reason why we are here today, because that will inform our decisions. The Federal Reserve played a large role in creating the asset bubble that we are beginning to work through today, and that has created the need for a stimulus package. I believe the Federal Reserve's monetary policy was too accomodative. The Governors also virtually ignored the lending practices that are at the heart of the problem.

All of this is unfortunate, but we should not allow innocent American families to suffer for the Federal Reserve's increasingly apparent mistakes. That is why I am glad we are coming together on a bipartisan basis to enact a timely stimulus package.

Thank you.

Russ Feingold

Senate Budget Committee Hearing
January 30, 3008
Statement by Senator Russ Feingold

Thanks you Mr. Chairman and Senator Gregg. I'm pleased the Budget Committee is holding this hearing. More than any other committee, the Budget Committee is responsible for keeping its collective eyes on the long-term budget impact of our fiscal policies, and with that in mind I join our Chairman in expressing my strong preference for offsetting the cost of any stimulus package we enact in a suitable way, perhaps over five or ten years.

However, it is apparent that the current mood in Congress is not to worry about the long-term cost of a stimulus package, and it is extremely unlikely that any stimulus package we enact will have any meaningful offsets in it. Instead, Congress and the White House will just add the cost of the stimulus package to the tab we've already rung up for future generations. We will be heaping more debt onto the already mountainous level we are leaving our children and grandchildren to pay in the form of higher taxes or lower levels of government services.

Given that we are likely to enact something that adds to the debt, at a minimum we have a special duty to those future generations who will bear the burden of that debt to get the most out of what we are doing. We should include policies in a stimulus package because they will be effective at stimulating the economy, not just because they are popular tax cuts or spending programs.

We are all familiar with the alliterative trio of tenets - "timely, targeted, and temporary" – that we are told should govern our evaluation of potential stimulus package provisions. I certainly agree with those principles, and will add one more that others have proposed – getting a good "bang for the buck." One of today's witnesses, Dr. Mark Zandi, has refined the "bang for the buck" measure by providing an estimate of how much demand is generated for every dollar a tax or spending provision costs. This is especially helpful when we have to choose from a host of popular tax and spending policies that may have merit in some other context.

It was one of the reasons I've advocated a temporary boost in food stamp benefits.

Various estimates put the demand generated for every $1 of increased food stamp benefits in the range of $1.60 to $1.75, among the highest of any fiscal policy. It can be implemented quickly – in just 30 to 60 days by one estimate. And of course those who receive food stamps are among the most in need and are among the most likely to be adversely impacted by an economic downturn.

I sent a letter to the Majority and Minority Leaders encouraging the inclusion of such a provision in the Senate package that was signed by 18 others, including 5 members of this Committee.

Given the economic bang for the buck from this program, along with the benefit it would provide to many vulnerable Americans, it makes little sense to omit increased food stamp benefits from a stimulus package.

United States Senate
WASHINGTON, DC 20510

January 25, 2008

Senator Harry Reid
Majority Leader
United States Senate
Washington, D.C. 20510

Senator Mitch McConnell
Minority Leader
United States Senate
Washington, D.C. 20510

Dear Majority Leader Reid and Minority Leader McConnell,

We are concerned by recent reports that the draft economic stimulus package may not include an increase for the Food Stamp program. If these accounts are accurate, we urge you to reconsider and encourage you to include a significant increase in Food Stamp benefits for current recipients in the final package. Many experts have indicated that such an increase would be one of the most effective ways to stimulate the economy, in addition to addressing the well-documented needs of low-income Americans. Increasing Food Stamps provides a high per-dollar benefit to the economy and we hope that the final stimulus package will put a priority on this and other high-impact programs.

As you probably know, the Senate Finance Committee heard testimony earlier this week from Congressional Budget Office Director Peter R. Orszag that extra Food Stamp benefits are likely to be spent quickly after their receipt, providing a more immediate stimulus. Experts have cited returns of around $1.73 for every $1.00 invested in the program, making this a cost-effective proposal. In addition, these benefits go to the Americans likely to be hit the hardest by turbulent economic times.

Further, the House and Senate each overwhelmingly passed comprehensive increases and improvements to the Food Stamp program as part of a Farm Bill last year. Given the tight financial constraints on new spending for the farm bill, these parallel increases are a testament to the pressing needs and value of the program. Clearly, there is strong bipartisan support for an increased investment in Food Stamps in the long-term. A short-term increase in a stimulus package would therefore have the double benefit of more quickly making up some of the gap created over the last decade as Food Stamp benefits have eroded.

We understand that there are a number of proposals to stimulate the economy, and we hope you will make increased Food Stamp benefits a significant piece of the final legislation.

Sincerely,

Russ Feingold

Elizabeth Dole

Bernard Sanders | Ron Wyden
Carl Levin | Susan M. Collins
Hillary Rodham Clinton | Joe Biden
Bob Casey, Jr. | Chris Dodd
Robert Menendez | Dick Durbin
Herb Kohl | Jack Reed
Jon Tester | Sheldon Whitehouse
Barbara Boxer | Debbie Stabenow
Frank R. Lautenberg

THE LONG-TERM OUTLOOK AND SOURCES OF GROWTH IN HEALTH CARE SPENDING

THURSDAY, JANUARY 31, 2008

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

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

Present: Senators Conrad, Wyden, Gregg, and Enzi.

Staff present: Mary Naylor, Majority Staff Director; and Scott Gudes, Staff Director for the Majority.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

We would like to thank Dr. Orszag for being with us once again. You have been very busy, yesterday at the Finance Committee on the stimulus package. I think we all know the jobs data out this morning provides more evidence of critical need for us to take action on fiscal stimulus. And we hope that that can be done expeditiously.

The turnout is not as strong as it might otherwise be because the leadership called a special caucus for 10 o'clock this morning to discuss the stimulus package. So we apologize for that, but we thought it was important to proceed, given what we are trying to do in terms of schedule on this committee this year.

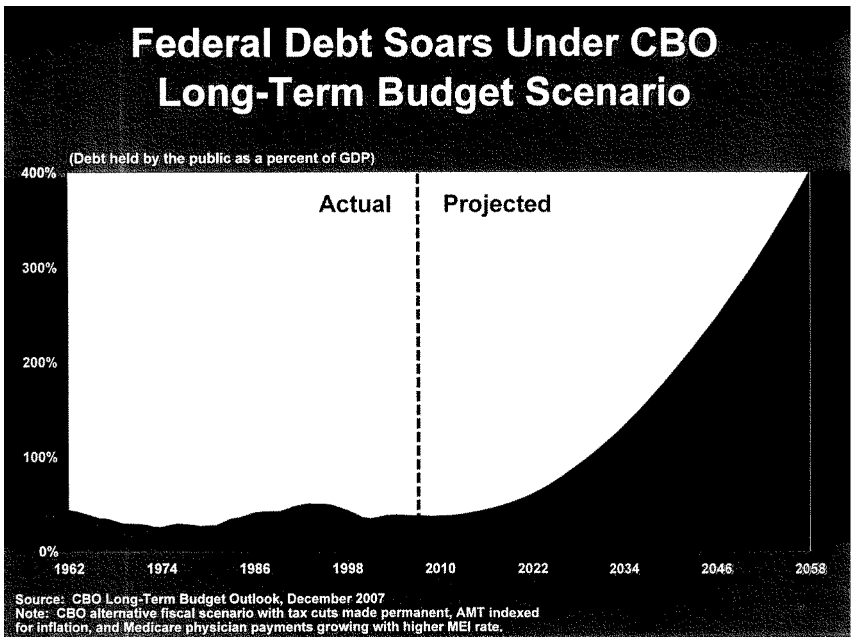
Let me just take a moment to inform colleagues and their staffs that it will be my intention to complete action on the floor on the budget resolution before the March break. That is an ambitious schedule but I think it is imperative that we do that. That would mean markup would occur the week before, and it would be our intention to do it on the Wednesday and Thursday in the Committee, then go to the floor the next week before the March break. So you might inform your members that that is the schedule.

I have visited previously with Senator Gregg about that. He, as always, is wanting to move the work of this Committee in an expeditious way, as well. So that will be our intention.

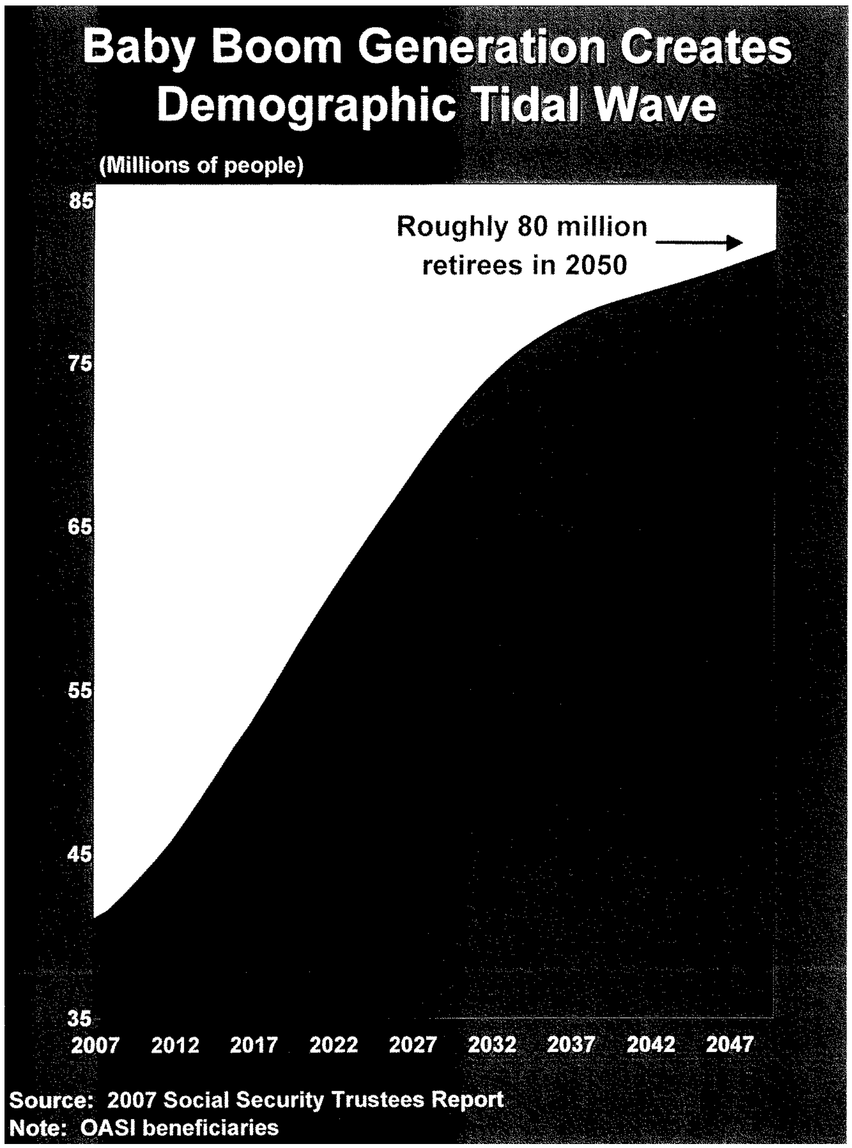
With that, we want to turn our attention to the health care circumstance that we confront that really is the 800-pound gorilla. We have said it many times in this Committee. That is where we have the biggest disconnect between the commitments that have been made and the resources that are available. This requires our urgent attention.

This is a matter of not only Medicare and Medicaid, but also veteran's health care. All of the health care accounts in the Federal Government are jumping dramatically in cost.

Let's turn to that first slide. This is CBO's long-term budget outlook from December of last year. This takes their scenario, makes the tax cuts permanent, provides for an indexing of the Alternative Minimum Tax, and Medicare physician payments growing with the higher MEI rate. This is all to try to reflect some notion of what the President has called for, coupled with CBO's long-term outlook.

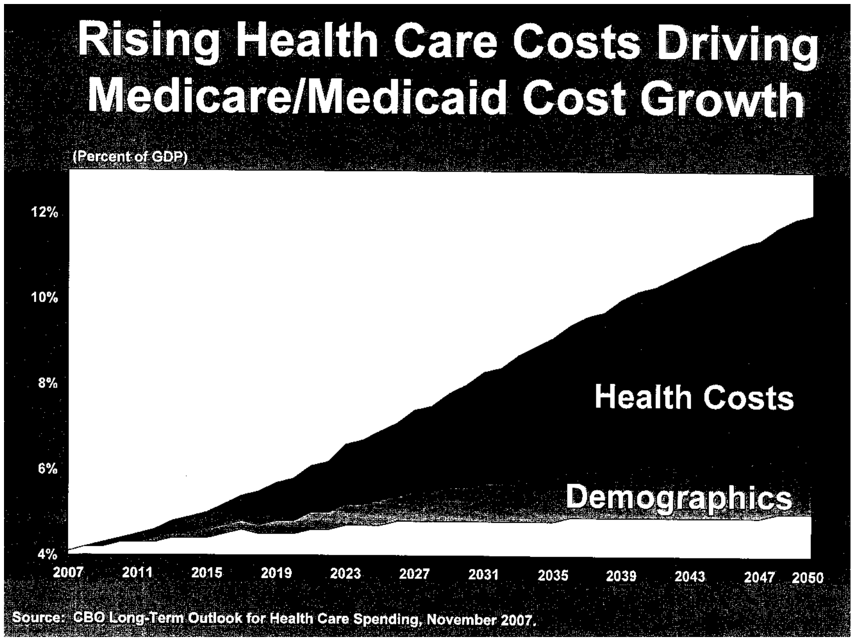


And this is what it shows. It is a total runaway train, in terms of debt. Let's go to the next slide.



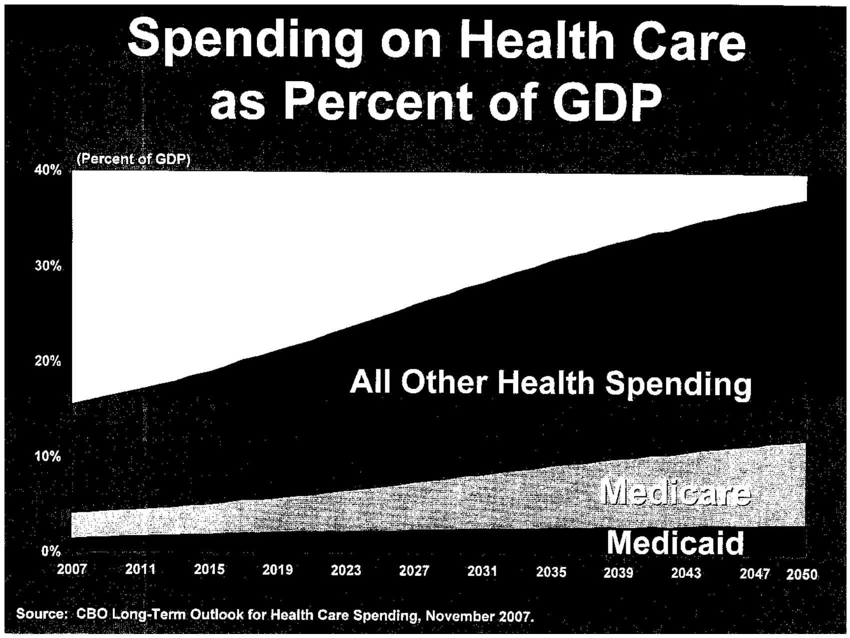
We all know that one of the key drivers is the demographic tidal wave. We are going to have roughly 80 million retirees in 2050, up from about 40 million now.

That, coupled with this next factor, which is health care costs, a point that the Director of CBO has made to us repeatedly, that this not just a demographic phenomenon, although that is certainly a component. The even larger component is rising health care costs. You can see that with Medicare and Medicaid alone, we are heading for 12 percent, nearly 12 percent of GDP by 2050 if the current trend lines continue.



That is almost incomprehensible. But that is the course we are on. And we simply cannot permit that to play out.

If we look at spending on health care as a percentage of GDP, including Medicare and Medicaid but also adding in all other health care spending, we would be approaching 40 percent of gross domestic product just on health care.



I know that Senator Enzi is working on an initiative in this area. Senator Wyden is, as well. Senator Whitehouse is deeply engaged in this. This is going to require our attention because we are clearly on a course that is unsustainable.

Reform of Medicare and Medicaid Requires Overall Health Care Reform

"[F]ederal health spending trends should not be viewed in isolation from the health care system as a whole.... Rather, in order to address the long-term fiscal challenge, it will be necessary to find approaches that deal with health care cost growth in the overall health care system."

– Government Accountability Office Comptroller General David Walker
Testimony before House Budget Committee
February 2005

This is what the Comptroller General said to the House Budget Committee in February of 2005: "Federal health care spending trends should not be viewed in isolation from the health care system as a whole. Rather, in order to address the long-term fiscal challenge, it will be necessary to find approaches that deal with health care cost growth in the overall health care system." I think he got it exactly right. Let's go to the next slide.

Health Care Reforms with Potential for Long-Term Savings

May Have Upfront Costs

- **Expanding comparative effectiveness research**
- **Widespread adoption of Health IT and e-prescribing**
- **Coordinating care for chronically ill**
- **Changing provider incentives and beneficiary cost-sharing**
- **Promoting healthy lifestyles and preventive care**

Health care reforms that have potential for long-term savings, even though they may have up front costs, include expanding comparative effectiveness research, something that I believe is critically important because we see this tremendous variance across the country in terms of approaches to health care. We see, in some treatment regimes, a five-to-one spending difference and no improvement in health care outcomes. Five-to-one difference in terms of expenditure with no evidence of better outcomes.

No. 2, widespread adoption of health information technology and e-prescribing. The RAND Corporation has told us we could save as much as $80 billion a year if that were appropriately deployed.

Third, coordinating care for the chronically ill. This is something that jumps out to me as being a key factor. Roughly 5 percent of beneficiaries are using roughly half of the budget. Now in business school, I was taught when you have that kind of statistic, you had better focus on it like a laser.

Fourth, changing provider incentives and beneficiary cost-sharing.

And fifth, promoting healthy lifestyles and preventive care.

Federal Reserve Chairman Bernanke on Budget Outlook

"... [O]ne might look at these projections and say, 'Well, these are about 2030 and 2040 and ... so we don't really have to start worrying about it yet.' But, in fact, the longer we wait, the more severe, the more draconian, the more difficult ... the adjustments are going to be. I think the right time to start is about 10 years ago."

–Federal Reserve Chairman Ben Bernanke
Testimony before Senate Budget Committee
January 18, 2007

The Chairman of the Federal Reserve, on the budget outlook, told the Senate Budget Committee last year "One might look at these projections and say well, these are about 2030 and 2040, and so we really do not have to start worrying about it yet. But in fact, the longer we wait, the more severe, the more draconian, the more difficult the adjustments are going to be. I think the right time to start is about 10 years ago."

I will end on that note and turn to my colleague, Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman. Again, I congratulate you for holding a hearing that is critical and topical to what is the primary fiscal problem we confront as a Nation and obviously it involves a lot of social policy, too. And that is the cost of health care and the way it is going to affect the capacity of this Government to be affordable for our children and our children's children.

It is nice to have the former chairman and the ranking member of the Health Committee here, because he is obviously playing a huge role in how this gets moved forward.

The Chairman has touched base on a number of key areas and I would just reinforce what he has said by taking a slightly tangential approach. Health care is not like Social Security. Social Security has five or six moving parts. We know how to fix Social Security; all it require is the political will. If you put the right people in the room, we could solve Social Security in probably half an hour, or significantly improve it.

Health care, on the other hand, is an incredibly complex matrix of moving parts, which is constantly evolving and changing. Because of the fact that diseases change, the ability to know how to address them changes and life expectancy changes. And of course research and development in health care is having a massive impact on both cost and quality, in many ways positive and in some ways not so positive on the cost side.

But in any event, it is not something that there is a magic wand for. There are not four or five adjustments.

So I do not subscribe to the Big Bang Theory of solving the health care issue. I think you have to do it with major incremental steps, find an area where you can address something that you know is not working, and try to improve it.

For example, working with Senator Clinton, we introduced something called the Medicare Quality Enhancement Act, and with the assistance of Senator Enzi, a version of it was passed out of Senator Enzi's Committee. The bill would make available to purchasers Medicare statistical data that would be collected in a central place and then be available to people who wanted to purchase health care so that they would know whether this hospital or this group of physicians or this procedure was more cost efficient and produced better quality than the other hospital or group of physicians or procedure.

That type of information is critical. It is part of the transparency effort. Unfortunately, it is being held up now in a bigger issue with the health IT bill.

In addition, things that are being done, for example, by the Dr. Wennberg at Dartmouth, where they are basically developing an atlas of how much it costs and what type of results occur across this country in different health provider groups, is absolutely critical information. Then using that information effectively through transparency and making it available to the people who purchase the goods, the health care services, is absolutely critical.

So there are specific things we can do. And we should do them and line them up and knock them off one by one.

And one of the things we can do, and I mentioned this yesterday, is use the reconciliation instruction strength of this Committee to start to move on specific areas where we can take action which will help bring into balance the cost of health care. I point again to the proposal from the Administration last year, which I think was terribly reasonable, that we require high income individuals to pay a higher portion of their Part D premium. It just is beyond me why a person working in a restaurant or a person working in a factory or a person working at any job that does not get paid dramatic sums of money, should have to underwrite people who do make dramatic sums of money such as Warren Buffet or Bill Gates' father. Not to pick on those two people, but the fact, is they can afford to pay a larger percentage of their Part D premium and they should.

Also, I think the Administration proposal last year to recover some of the effeciencies that have resulted in the health care community as a result of technology improvements and cost savings. Not all of that benefit is being asked to be recovered, but the taxpayers ought to get some of that back.

So there are specific things we could do using the reconciliation instructions to energize that effort. And I hope we will look at that as we mark up the budget.

But I think in making these decisions, what we need is good information. You cannot make decisions unless you have good information. That is why what Dr. Orszag and his team are doing at CBO in this area is critical. And that is why I think this hearing is so important, because it will give us the information off of which, hopefully, we can build some of this significant instrumental policy to try to get this issue under control.

So I think Dr. Orszag for being here today.

Chairman CONRAD. Thank you, Senator Gregg.

Again, welcome, Dr. Orszag, to the Committee and please proceed with your testimony.

STATEMENT OF PETER R. ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. ORSZAG. Senator Conrad, Mr. Gregg, members of the Committee, the rising costs of health care represent the Nation's central long-term fiscal challenge. As my first slide shows, over the past four decades, health care spending overall has roughly tripled as a share of the economy from about 5 percent of GDP in 1960 to more than 15 percent today.

Costs per beneficiary have been rising about 2 percent faster than income per capita. This metric, which is often referred to as excess cost growth—which, by the way, does not necessarily mean excessive cost growth, it just means that costs are rising faster than income—has been roughly the same in Medicare, in Medicaid, and the rest of the health care system, which underscores that many of the same factors driving up costs in our public insurance programs are also driving up costs in the rest of the system.

The report that we released today examines studies that have concluded that the most important factor driving up costs historically has been the emergence, adoption, and widespread diffusion of new medical technologies and services, including new drugs, new devices, again new services, as well as new clinical applications of existing technologies.

The bottom row of the next slide shows you that available estimates suggest that approximately half of the growth in long-term health care spending, or spending in health care over the long-term, has been associated with these technological advances. Those estimates are arrived at largely through the process of elimination. That is, trying to account for all other possible causes of spending, and then what you are left with is attributed to changes in technology.

One example of another——

Senator GREGG. Can I ask a question before he goes on?

Chairman CONRAD. Absolutely.

Mr. ORSZAG. Absolutely.

Senator GREGG. That is up to today? In other words, you are not counting the baby boom population?

Mr. ORSZAG. I am going to get to that.

Senator GREGG. OK.

Mr. ORSZAG. Right. This is historical.

Older people do have higher health care costs than younger people. But if you look back over the past several decades that factor only accounts for a small share of the overall increase in health care spending, in part because the population has not been aging that rapidly yet. You can see a variety of studies suggesting only a couple of percentage points.

Other factors that contribute to higher health care spending include the growth in personal income and the expansion in health insurance coverage and the resultant reduction in out-of-pocket costs as a share of total health care costs. Both of these tend to raise demand for health care. You can see, though, that they again only explain a minority of the total increase.

Some other factors, which we could have a longer discussion about, include defensive medicine and physician-induced supply, also do not appear to explain a large share of the growth in spending according to published studies. We can come back to a more nuanced discussion about that.

The conclusion from these studies, therefore, is that most of the growth, or at least about half, has occurred because of the expansion of technologies. That is, we can do more things now than we were able to do previously.

Another cost increasing factor, which is illustrated in the next slide, has to do with changes in chronic disease and, in particular, changes in obesity. We know that obesity raises an individual's risk of serious illness, including cardiovascular disease and diabetes. And the share of the population that is obese or morbidly obese has risen dramatically.

In 2001, as this chart shows, spending per obese person was about $3,700. Spending per morbidly obese person was $4,700, relative to spending of a normal weight person of about $2,800. So it is natural to think that the roughly doubling of the share of the population that is obese or morbidly obese has significantly raised costs.

Most of the increase in spending on obese or morbidly obese people has occurred because we are spending more per obese person rather than because we now have more obese people. In particular, if health care spending per capital remained at the levels that we saw in 1987 and we just ramp up the prevalence of obesity that we have experienced, you can only explain about 4 percent of the total increase in health care spending that actually occurred.

The bigger factor has been that the spending per obese person has gone from $2,700 to $3,700, or for a morbidly obese person from $2,700 to $4,700. And that comes back probably to the same story. The technologies that we are now applying for those beneficiaries have changed and we are now spending more per person, rather than it primarily being that the population hasten more obese.

Stepping back again, though, the bottom line from these analyses is that the single most important factor driving historical increases in health care costs involves medical technologies which, on average, have brought very significant improvements in health outcomes. But the technologies then often get applied in lots of settings where they may not be yielding significant benefits. And that drives up costs without improving health quality, a topic I will come back to briefly at the end.

Turning to the future now, Senator Gregg, we also project forward that in the absence of any significant change in these long-term trends national spending on health care is going to grow substantially. You can see the chart, and Senator Conrad already put this up so I will not belabor the point. One thing I do want to note, however, is that the projections are based on current Federal law, and therefore they are not a prediction of the future but rather an illustration of what will occur if you do not change Federal statutes and Federal policies.

Health care spending will roughly double as a share of the economy by 2035 and spending on Medicare and Medicaid will rise from about 4.5 percent of the economy today to roughly 12 percent by 2050 and almost 20 percent of the economy by the end of our projection window in 2082. That is the entire size of the Federal Government today.

As has already been noted, most of that increase is not due purely to the fact that the population is getting older, but rather that we will be spending more per beneficiary. So again, just like the story with increased obesity prevalence, most of this spending increase is occurring because of increases in costs per beneficiary rather than the number of beneficiaries.

All of these projections, as has already been noted, raise fundamental questions of economic sustainability. These increases are the largest driver of spending increases over the long term. If you combine that with projections on the revenue side, you get explosions in debt, which is shown in the next slide.

The key question then becomes what can be done? Given that future health care cost growth is the most important factor driving our fiscal future, CBO is devoting increasing resources to assessing options for reducing such spending in the future. I think a few things are worth noting.

First, straightforward changes to Medicare and Medicaid can save money for the Federal budget, in part by shifting costs to households. Ultimately, those kinds of cost-shifting approaches will not be sustainable if you want to maintain widespread access to the public programs over time. So the key is trying to restrain or reduce overall health care spending over the long term.

In that light, two potentially complimentary approaches to reducing health care spending, rather than just reallocating it across different parts of the system, involving generating more information about what works and what does not, and then aligning incentives for better care rather than just more care. Today, most of our incentives are to provide more care, regardless of whether it is better.

And I would just end by noting the final slide, rather than the geographic slide that I usually walk around with, I want to just highlight this final slide. We have very substantial variations, as has already been noted, in costs per beneficiary across parts of the United States, even at our top medical centers. If you look at beneficiaries within the last 6 months of life, costs per beneficiary at UCLA Medical are twice as high as costs per beneficiary at the Mayo Clinic for reasons that are not correlated with quality outcomes. That is to say, quality is actually better by the measures that we have at the Mayo Clinic.

And I would just again end by saying taxpayers are paying for that difference. And we do not know what we are getting in exchange for the higher expenditures. So if there were a single thing that we could do, both to make sure that taxpayers are getting their money's worth out of the dollars that we are putting into these programs, and also to help future generations address the key factor affecting long-term budget spending, figuring out why we have this kind of variation and, in particular, what we are getting for it and how we can do that better, I think is absolutely essential.

And that will likely involve changes in information. It will likely involve changes in incentives. And it will likely involve changes in health behavior that will take a long time to pay off.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Orszag follows:]

CBO TESTIMONY

Statement of
Peter R. Orszag
Director

Growth in Health Care Costs

before the
Committee on the Budget
United States Senate

January 31, 2008

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Thursday, January 31, 2008. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

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

Chairman Conrad, Senator Gregg, and Members of the Committee, thank you for inviting me to testify this morning on the rising costs of health care, which represent the nation's central long-term fiscal challenge. No other single factor will exert as much influence over the federal government's long-term fiscal balance as the future growth rate of costs in the health care sector.

Medicare and Medicaid account for a large and growing share of federal spending. In the years to come, federal spending on health care will rise sharply—mostly because of increasing costs per beneficiary but also because the aging of the baby-boom generation will significantly raise the number of beneficiaries. If health care spending grows as projected under current law, future budget deficits will rise to levels that will seriously jeopardize long-term economic growth unless policy-makers sharply reduce other projected spending, substantially increase revenues as a share of gross domestic product (GDP), or do some combination of the two.

Many of the same forces that drive the growth of federal health care spending also affect private health care spending, and the effects of rising health care costs are not limited to public programs. The rising cost of health benefits can limit the growth of cash earnings for workers with employer-based coverage and make individual private coverage prohibitively expensive.

My testimony, which draws upon the Congressional Budget Office's (CBO's) *The Long-Term Outlook for Health Care Spending* (released in November) and the study *Technological Change and the Growth of Health Care Spending* (released today in conjunction with this hearing), makes the following key points:

- For most of the past four decades, per capita health care spending grew much more rapidly than per capita GDP.

- Most analysts agree that the most important factor driving the long-term growth of health care costs has been the emergence, adoption, and widespread diffusion of new medical technologies and services by the U.S. health care system.

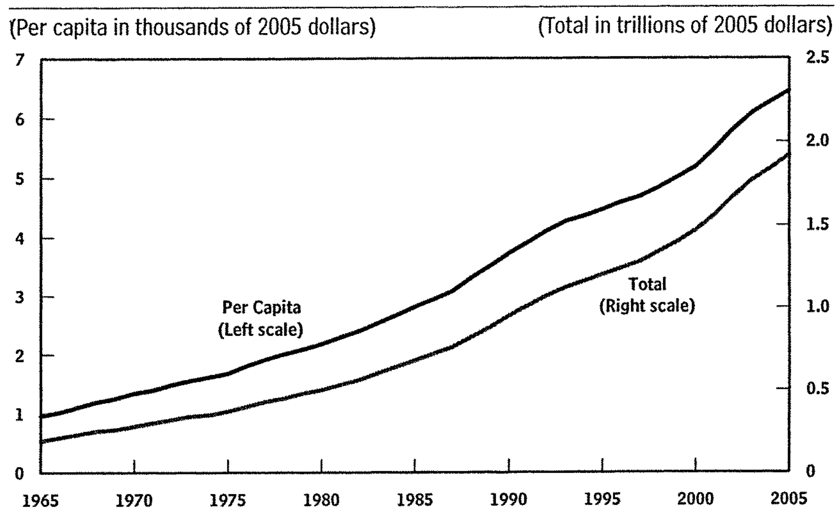
- Other factors, including rising personal income, a growing share of health care costs borne by third-party payers, and the aging of the population, contributed to historical spending growth by increasing the demand for medical services. Even taken together, however, those factors appear to explain less than half of long-term spending growth.

- Technological advances are likely to yield new, desired medical services in the future, fueling further spending growth and imposing difficult choices between health care and other priorities.

- CBO projects that, without changes in law, total spending on health care will rise from 16 percent of GDP in 2007 to 25 percent in 2025 and 49 percent in 2082. Federal spending on Medicare (net of beneficiaries' premiums) and Medicaid would rise from 4 percent of GDP in 2007 to 7 percent in 2025 and 19 percent in 2082.

Figure 1.

Total and Per Capita Spending on Health Care, 1965 to 2005



Source: Congressional Budget Office based on data on spending on health services and supplies, as defined in the national health expenditure accounts, maintained by the Centers for Medicare and Medicaid Services.

Note: Spending amounts are adjusted for inflation using the gross domestic product implicit price deflator from the Bureau of Economic Analysis.

- The bulk of the projected increase in spending on Medicare and Medicaid is not due to demographic changes (such as increases in the number of beneficiaries) but rather to ongoing increases in costs per beneficiary.

- Opportunities appear to exist for constraining the growth of health care costs over the long term without harming the overall quality of health care delivered, but taking advantage of those opportunities will probably prove difficult from both a medical and a political economy perspective.

Historical Growth in Health Care Spending, 1965 to 2005

Spending on health care in the United States has grown substantially over the past four decades (see Figure 1). In 1965, that spending amounted to $187 billion (in 2005 dollars). It more than tripled in real (inflation-adjusted) terms over

20 years, reaching $666 billion in 1985. Over the next 20 years, spending nearly tripled again, reaching roughly $1.9 trillion in 2005.[1]

Spending has also risen rapidly on a per capita basis, with growth averaging around 4.9 percent per year in real terms over the past four decades. By contrast, per capita GDP grew, on average, by only 2.1 percent per year during that period. As a result, health care spending is now a much larger proportion of GDP—nearly 15 percent in 2005 compared with 5 percent in 1965.

Although the growth of health care spending has been continual, the pattern of growth in the mid- to late 1990s differed from that of previous decades (see Figure 2). From 1965 to 1990, annual growth in real per capita spending averaged about 5.5 percent. Despite brief periods of relatively slow growth during that time, growth rates never remained low for a sustained period. That pattern changed during the 1990s; from 1994 to 1999, annual real growth never exceeded 2.8 percent. Some analysts attribute that lull to greater enrollment in managed care plans as well as to excess capacity among some types of providers, which increased health plans' negotiating leverage.[2] That period of relatively slow growth in health care spending also coincided with relatively rapid overall economic growth. As a result, the share of national income devoted to health care during those six years remained unchanged (see Figure 3). Since then, however, a combination of slower economic growth and accelerated spending on health care has led to a sharp increase in health care costs as a share of GDP—from 12.5 percent in 1999 to 14.5 percent in 2005.

The United States spends more on health care per person than do other industrialized countries. Data from the Organisation for Economic Co-operation and Development show that per capita health care spending in the United States in 2005 was nearly twice that in France, Canada, and Germany and roughly two-and-a-half times that in the United Kingdom, Italy, and Japan. Although the *level* of spending per capita in the United States contrasts sharply with that of other wealthy countries, the *growth rate* of spending in the United States is less unusual. Most industrialized countries—even those with a financing system quite different from that in the United States—have experienced a substantial long-term rise in real spending on health care.

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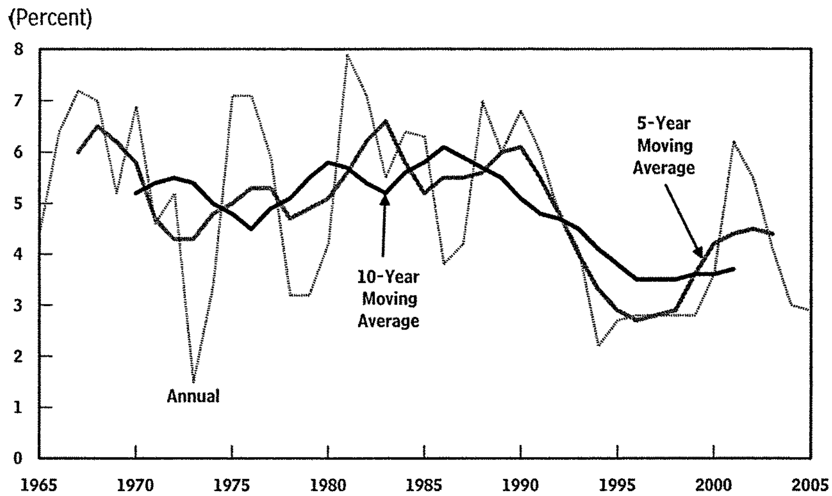
1. Figures represent spending on health care services and supplies, as defined in the national health expenditure accounts, maintained by the Centers for Medicare and Medicaid Services.

2. See, for example, Katharine Levit and others, "National Health Expenditures in 1997: More Slow Growth," *Health Affairs*, vol. 17, no. 6 (1998), pp. 99–110.

Figure 2.

Growth in Real Per Capita Spending on Health Care, 1965 to 2005



Source: Congressional Budget Office based on data on spending on health services and supplies, as defined in the national health expenditure accounts, maintained by the Centers for Medicare and Medicaid Services.

Notes: Spending amounts are adjusted for inflation using the gross domestic product implicit price deflator from the Bureau of Economic Analysis.

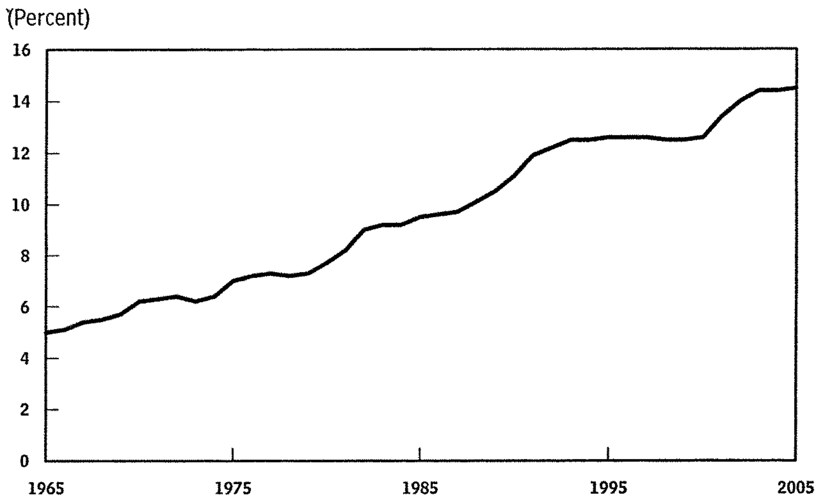
The data represent compound moving averages. For example, for the five-year moving average series, the 1990 figure represents the average annual growth from 1987 to 1992; for the ten-year moving average series, the 1990 figure represents average annual growth from 1985 to 1995.

Factors Underlying Historical Growth in Health Care Spending

The large increase in health care spending over the past several decades was caused by many factors, and accounting precisely for all of them is difficult. Nonetheless, the general consensus among health economists is that growth in real spending on health care was principally the result of the emergence of new medical technologies and services and their adoption and widespread diffusion by the

Figure 3.

Total Spending on Health Care as a Percentage of Gross Domestic Product, 1965 to 2005



Source: Congressional Budget Office based on data on spending on health services and supplies, as defined in the national health expenditure accounts, maintained by the Centers for Medicare and Medicaid Services.

U.S. health care system.[3] Advances in medical science have made available to patients and physicians a wealth of new medical therapies, many unheard of in even the relatively recent past. Some medical advances permit the treatment of previously untreatable conditions, introducing new categories of spending. Others, relative to older modes of treatment, improve medical outcomes at added cost, expanding existing spending. Available empirical estimates suggest that

3. For this analysis, CBO defines technological advances as changes in clinical practice that enhance the ability of providers to diagnose, treat, or prevent health problems. Technological advances take many forms. Examples include new drugs, devices, or services, as well as new clinical applications of existing technologies (providing a particular service to a broader set of patients, for example). Other technological advances are newly developed techniques or additions to knowledge.

Table 1.

Estimated Contributions of Selected Factors to Growth in Real Per Capita Spending on Health Care, 1940 to 1990

(Percent)

	Smith, Heffler, and Freeland (2000)	Cutler (1995)	Newhouse (1992)
Aging of the Population	2	2	2
Changes in Third-Party Payment	10	13	10
Growth of Personal Income	11–18	5	<23
Prices in the Health Care Sector	11–22	19	*
Administrative Costs	3–10	13	*
Defensive Medicine and Supplier-Induced Demand	0	*	0
Technology-Related Changes in Medical Practice (Residual)	**38–62**	**49**	**>65**

Sources: Sheila D. Smith, Stephen K. Heffler, and Mark S. Freeland, "The Impact of Technological Change on Health Care Cost Increases: An Evaluation of the Literature" (working paper, 2000); David M. Cutler, "Technology, Health Costs, and the NIH" (paper prepared for the National Institutes of Health Economics Roundtable on Biomedical Research, September 1995); Joseph P. Newhouse, "Medical Care Costs: How Much Welfare Loss?" *Journal of Economic Perspectives,* vol. 6, no. 3 (Summer 1992), pp. 3–22.

Notes: Amounts in the table represent the estimated percentage share of long-term growth that each factor accounts for.

< = less than; > = greater than; * = not estimated.

approximately half of all long-term growth in health care spending has been associated with the expanded capabilities of medicine brought about by technological advances.[4]

Other factors have also contributed to increases in health care spending. One example is the aging of the population. Among adults, health care spending generally increases with age. As the number of elderly people increased over time, health care spending naturally grew. However, the population aged only gradually over the past half century, and aging played only a minor role in the large increases in spending that occurred. Published analyses suggest that aging can account for only about 2 percent of all spending growth from 1940 to 1990, for example (see Table 1). As the baby-boom generation reaches retirement age, the effects of aging

4. See Joseph P. Newhouse, "An Iconoclastic View of Health Cost-Containment," *Health Affairs*, vol. 12, Supplement (1993), pp. 154–171; David M. Cutler, "Technology, Health Costs, and the NIH" (paper prepared for the National Institutes of Health Economics Roundtable on Biomedical Research, September 1995); and Sheila D. Smith, Stephen K. Heffler, and Mark S. Freeland, "The Impact of Technological Change on Health Care Cost Increases: An Evaluation of the Literature" (working paper, 2000).

will increase, but the course of technological innovation will have a far greater effect on cost growth. (Another factor—the rising share of the population who are overweight or obese—has also probably contributed to the growth in health care spending. See Box 1 for a discussion of obesity and its effect on spending growth.)

Other examples of factors contributing to spending growth include the growth in personal income and the rising share of health care costs paid by third-party insurers over recent decades; both of those trends contributed to spending growth by increasing demand for medical care. Because medical care is a desired service, people naturally purchase more of it as their income increases. And health insurance, as economists are fond of pointing out, effectively drives down the cost of care from the consumer's perspective, resulting in a higher quantity of services demanded than would otherwise be the case. But estimates suggest that under an assumption of no changes in medical technology, historical changes in such factors could explain only part of the long-term rise in health care spending (see Table 1). Income growth and expanded health insurance may have contributed indirectly to spending growth, however, by encouraging the development of more cost-increasing medical technologies. Other factors such as defensive medicine (which refers to medical tests or procedures of little or no clinical value that are ordered by physicians primarily to avoid lawsuits) and physician-induced demand (which refers to spending that is brought about at least in part by providers' desire to augment their own income) do not appear to explain a significant part of the growth in spending, according to published analyses (see Table 1).

It is occasionally suggested that advances in technology can lead to reduced spending, and that might be the case in some instances. Vaccinations, for example, may sometimes offer the potential for savings, and certain types of preventive medical care may help some patients avoid costly acute care hospitalizations. But, overall, examples of new therapies for which long-term savings have been clearly demonstrated are few. Improvements in medical care that decrease mortality by helping patients avoid or survive acute health problems often paradoxically increase overall spending on health care, as those (surviving) patients live to use health services through old age. New curative therapies with one-time costs could potentially reduce spending if they obviated the need for costlier treatments. Many advances in medical science, however, do not fall into that category. In fact, many of the most notable medical advances in recent decades involve ongoing treatments for the management of chronic conditions such as diabetes and coronary artery disease.

CBO's Projections of Future Spending on Health Care

In the absence of an unprecedented change in the long-term trends, national spending on health care will grow substantially over the coming decades. The magnitude of that growth is highly uncertain, even over short periods, let alone a period as long as 75 years. CBO's projections of health care spending assume that federal

Box 1.

The Rising Prevalence of Obesity and Its Impact on Health Care Spending

The fraction of Americans who are overweight or obese has increased in recent years. Obesity raises an individual's risk of serious illnesses such as cardiovascular disease and diabetes, and obese persons incur greater health care costs. In 2001, for example, spending for health care per person of normal weight was $2,783, compared with $3,737 per obese person and $4,725 per morbidly obese person (see the table to the right). A rise in the prevalence of obesity is therefore a likely contributor to the growth of health care spending.

One method for estimating how the rising prevalence of obesity affects health care spending is to ask how much that spending would have risen if the prevalence of obesity was the only factor that changed over time. If health care spending per capita remained at 1987 levels for each category of body weight but the prevalence of obesity changed to reflect the 2001 distribution, health care spending would have risen by only 1.4 percent per capita on average. Because actual spending per capita rose by 34.6 percent, this estimate would imply that the change in the prevalence of obesity could account for about 4 percent of all spending growth from 1987 to 2001. (Note that "prevalence of obesity" here refers to changes in the fraction of persons in all categories of body weight, including those who are underweight. The fraction of underweight persons—who incur costs that are slightly higher than those of persons of normal weight—actually fell during this period.)

law affecting Medicare or Medicaid does not change.[5] Those projections should thus be interpreted as providing a measure of the scope of the potential problem posed by rising costs rather than a prediction of future developments, because the magnitude of the problem will ultimately necessitate changes in the government's

5. CBO's projections for Medicare also assume that the program will continue to pay for benefits as currently scheduled, notwithstanding the projected insolvency of the Medicare Hospital Insurance Trust Fund. Moreover, CBO assumes that future Medicare spending will not be affected by the law that requires the Medicare trustees to issue a "Medicare funding warning" if nondedicated sources of revenue—primarily general revenues—are projected to account for more than 45 percent of the program's outlays; that law does not require the Congress to respond to such a warning by enacting legislation that would reduce Medicare spending. For a detailed discussion of CBO's long-term projections of health care spending, see Congressional Budget Office, *The Long-Term Outlook for Health Care Spending* (November 2007).

Box 1.

Continued

Distribution of Population Aged 19 or Older and Health Care Spending by Weight Category

	1987		2001	
	Percentage of Population	Spending Per Capita (Dollars)	Percentage of Population	Spending Per Capita (Dollars)
All Persons	100.0	2,352	100.0	3,166
Underweight	3.6	2,695	1.8	3,092
Normal	51.6	2,259	38.6	2,783
Overweight	31.4	2,322	35.8	3,103
Obese	12.2	2,655	20.7	3,737
Morbidly Obese	1.3	2,674	3.1	4,725

Source: Congressional Budget Office analysis using the National Medical Expenditure Survey (1987 data) and the Medical Expenditure Panel Survey (2001 data).

Note: Weight categories are defined using the body-mass index (BMI)—a measure of body fat based on height and weight that applies to adult men and women—as follows: underweight (BMI is less than or equal to 18.5); normal (greater than 18.5 and less than 25); overweight (greater than or equal to 25 and less than 30); obese (greater than or equal to 30 and less than 40); morbidly obese (greater than or equal to 40).

Another way to examine the effect of obesity on spending is to ask how much would be saved if the prevalence of obesity returned to that of 1987, given the 2001 levels of spending for each respective category of body weight. That approach implies that changes in the prevalence of obesity account for around 12 percent of the spending growth between 1987 and 2001. The different results generated by the two methods reflect the change in the relative magnitude of spending on obese persons compared with spending on persons of normal weight. In 1987, spending per morbidly obese person was about 18 percent higher than spending per person of normal weight, but by 2001 it was 70 percent higher.

programs. They are also subject to the inherent uncertainty surrounding any long-term projections, especially regarding health care.[6] Nevertheless, they provide a useful reference in showing the consequences of current law and assessing the impact of changes in law.

6. For simplicity, the projections assume that the projected growth in health care spending has no effect on the future growth of GDP.

Table 2.

Assumptions About Excess Cost Growth Over the Long Term

(Percentage points)

	2018 Rate (Historical Average)	Annual Decline in Rate, 2018–2082 (Percent)	Average Rate, 2018–2082	Rate in 2082
Medicare	2.4	1.1	1.7	1.1
Medicaid	2.2	3.4	0.9	0.2
All Other Spending on Health Care	2.0	4.6	0.6	0.1

Source: Congressional Budget Office.

Note: Excess cost growth refers to the number of percentage points by which the growth of spending on Medicare, Medicaid, or health care generally (per beneficiary or per capita) is assumed to exceed the growth of nominal gross domestic product (per capita).

In CBO's current long-term projections, spending for Medicare, Medicaid, and other health care—including Medicare premiums, Medicare beneficiaries' cost sharing, and the states' share of Medicaid spending—is based largely on the growth and aging of the population, growth in per capita GDP, and assumed rates of cost growth per beneficiary relative to GDP growth per capita (a differential referred to as "excess cost growth").[7]

In selecting the *initial* rates of excess cost growth for its projections, CBO used the average rate in the past. Specifically, the rate of excess cost growth for each of the three categories (Medicare spending, Medicaid spending, and all other spending on health care) in 2018 is assumed to equal the average of the rates from 1975 to 2005 (as presented in Table 2).[8]

For later years, one option would be to adopt the historical averages indefinitely. Although that approach is attractive for its simplicity (the results from such an extrapolation are presented in Figure 4), it has significant shortcomings. For example, simply extrapolating prior growth rates would result in total spending on health care that eventually exceeded 100 percent of GDP. Furthermore, even in the absence of changes in federal law, spending growth would probably slow eventually, as health care expenditures continued to rise and displaced increasing amounts of consumption of goods and services other than health care. In other words, pressure to slow cost growth will mount as health care accounts for a larger share of the U.S. economy.

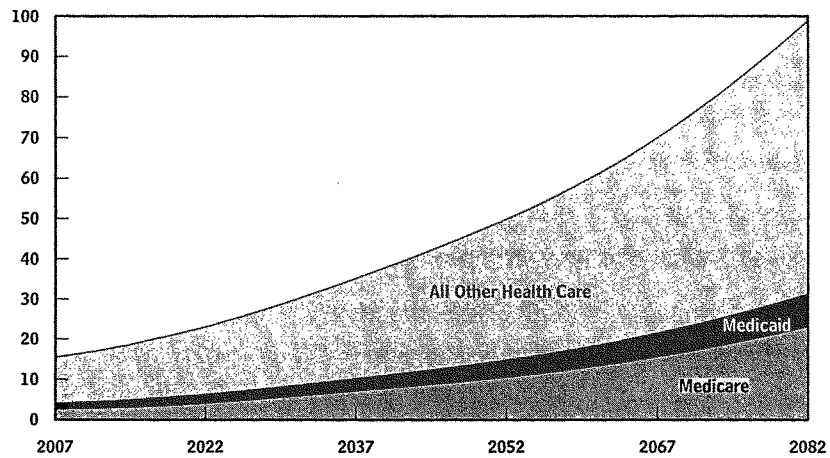
7. CBO constrained Medicare premiums and cost sharing to grow at the same rate as federal spending on Medicare; it constrained state Medicaid spending to grow at the same rate as federal Medicaid spending.

8. The historical average is also used to compute spending on all other health care through 2017. Medicare and Medicaid projections for that period are taken from CBO's standard 10-year budget outlook.

Figure 4.

Projected Spending on Health Care Under an Assumption That Excess Cost Growth Continues at Historical Averages

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: Excess cost growth refers to the number of percentage points by which the growth of spending on Medicare, Medicaid, or health care generally (per beneficiary or per capita) is assumed to exceed the growth of nominal gross domestic product (per capita).

Amounts for Medicare are net of beneficiaries' premiums. Amounts for Medicaid are federal spending only.

In response to rising health care costs, various policy changes in the private sector and by state governments would be likely. Employers would probably intensify their efforts to reduce their own costs—for example, by working with insurers to make health care more efficient or by reducing insurance coverage. They would also probably raise premiums and out-of-pocket charges. Employees would then react to the higher charges either by shifting to plans with lower premiums—and more restrictive coverage—or by limiting their consumption directly in response to the higher out-of-pocket charges.[9]

It is not possible to know precisely how such a process would unfold and how much cost growth could slow. Among various plausible approaches, a simple and transparent one is to assume that, within the projection period, households will not

9. In its projections, CBO assumes that the share of health care spending that will be in the form of premiums in employment-based plans—and thus is tax preferred—will remain at approximately 58 percent of non-Medicare, non-Medicaid spending on health care.

be willing to spend so much more on health care that, from one year to the next, the increase in such spending alone will be greater than the total increase in productivity. Therefore, under the assumption that the consumption of items other than health care does not decline, at the end point of CBO's projection period, in 2082, per capita consumption would continue to grow because of increased productivity, but the additional economic resources would be devoted entirely to health care. That assumption, to be sure, is not the only reasonable one, and other assumptions could generate higher or lower amounts of spending on health care in the long term. The approach, though, has the virtue of considering future levels of spending on both health care and other goods and services.[10]

Under the scenario that CBO presents, the slowdown in excess cost growth would not be painless and would not occur simply through improved efficiencies given the current structure of the health sector. Households would probably face increased cost sharing; new and potentially useful health technologies would be introduced more slowly or used less frequently than would occur without a slowdown in excess cost growth; and more treatments or interventions might not be covered by insurance. Nevertheless, Americans would still face steadily increasing health care costs. In other words, even though the growth rate might decline, the real level of health care costs would continue to rise—to the point of accounting for all of the increase in productivity. Therefore, real average consumption of goods and services other than health care would stagnate.

Such a slowdown in the growth of non-Medicare, non-Medicaid spending on health care might be particularly difficult to achieve in the absence of changes in federal law (as assumed in the projections). But at some point, the pressure on that portion of the health care system would probably become so severe that measures to slow growth would be taken. State governments and the private sector would almost certainly have more flexibility to respond to that pressure than the federal government would have without a change in federal law. The steps taken to slow growth in the non-Medicare, non-Medicaid sectors of the health system, in turn, would probably exert some downward pressure on growth rates in the public programs because the programs are integrated to a significant degree with the rest of the health care system. To the extent that actions by individuals and businesses resulted in lower-cost "practice patterns" by physicians, slower development and diffusion of new technologies, and cost-reducing changes to the structure of the health care system, Medicare and Medicaid would experience some reduction in their own growth—but the extent of that spillover is uncertain.

10. For related discussions, see Michael E. Chernew, Richard A. Hirth, and David M. Cutler, "Increased Spending on Health Care: How Much Can the United States Afford?" *Health Affairs*, vol. 22, no. 4 (2003), pp. 15–25; and Glenn Follette and Louise Sheiner, *The Sustainability of Health Spending Growth,* Finance and Economics Discussion Series No. 2005-60 (Washington, D.C.: Board of Governors of the Federal Reserve System, 2005).

Moreover, CBO assumes, under current law, the federal government would make regulatory changes aimed at slowing the growth of spending on federal health programs and that Medicare beneficiaries' demand for health care services would decline as Medicare premiums and cost-sharing amounts consumed a growing share of their income. On the basis of discussions with health and policy experts, CBO assumes that—without changes in law—the combined effects of those factors would be to reduce Medicare's excess cost growth by one-fourth of the reduction in the growth of non-Medicare, non-Medicaid spending on health care. (As discussed below, it is unlikely that Medicare and Medicaid will actually experience a significantly higher growth rate than the rest of the health care sector over an extended period of time, but changes in federal law would be necessary to avoid that outcome.)

CBO assumes that excess cost growth will decline more rapidly for Medicaid, which is a joint federal/state program, than for Medicare. In addition to the spillover effects and possible federal regulatory changes noted above, states are likely to take actions to reduce the growth of Medicaid spending even without changes in federal law. State governments would probably respond to growing fiscal pressures by limiting the services they chose to cover or by reducing the number of their beneficiaries by tightening eligibility. In its projections, CBO assumes that the rate of decline in Medicaid's excess cost growth will be three-fourths of the reduction in the growth of non-Medicare, non-Medicaid spending on health care. In sum, CBO's projection methodology for excess cost growth from 2019 through 2082 is based on the following set of assumptions:

- Excess cost growth in 2018 for Medicare, Medicaid, and all other health care will equal the historical averages;

- Total real per capita consumption of goods and services other than health care will not decline during the 75-year projection period; and

- The annual reduction in excess cost growth in Medicare and Medicaid will be, respectively, one-fourth and three-fourths of that for all other health care.

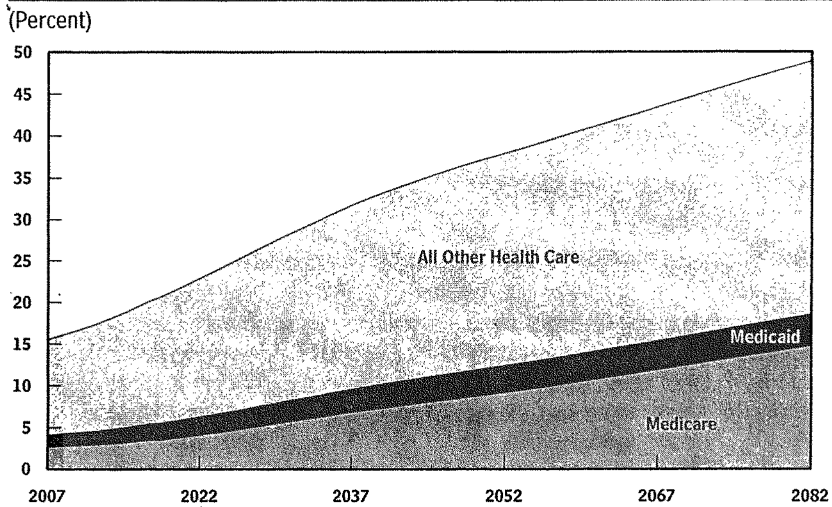
Under these assumptions, the rate of excess cost growth for non-Medicare, non-Medicaid spending on health care declines by 4.6 percent annually (see Table 2).[11] By 2082, that rate drops to 0.1 percentage point. For Medicare, excess cost growth declines to 1.1 percentage points that year, and for Medicaid, to 0.2 percentage points. The average rates for excess cost growth between 2018 and 2082 are 0.6 percentage points for non-Medicare, non-Medicaid spending; 1.7 percentage points for Medicare; and 0.9 percentage points for Medicaid.

The projected differential growth in Medicare and Medicaid relative to the rest of the health care system under these current-law projections may appear unrealistic,

11. Specifically, $ECG_y = ECG_{y-1} \cdot 0.954$.

Figure 5.

Projected Spending on Health Care as a Percentage of Gross Domestic Product



Source: Congressional Budget Office.

Note: Amounts for Medicare are net of beneficiaries' premiums. Amounts for Medicaid are federal spending only.

but that observation highlights the core problem—the unsustainability of current federal law. (The inherent tension in making long-term projections for a federal health care system that cannot be sustained in its current form must manifest itself in some way.) In reality, changes in federal law as well as in practices in the private sector are likely to slow the growth of health care spending such that growth in per capita Medicare and Medicaid spending does not diverge greatly from growth in other spending on health care.

Over the past 30 years, total national spending on health care has more than doubled as a share of GDP. Under the assumptions described above, according to CBO's projections that share will double again by 2035, to 31 percent of GDP. Thereafter, health care costs will continue to account for a steadily growing share of GDP, reaching 41 percent by 2060 and 49 percent by the end of the 75-year projection period (see Figure 5).

Spending on Medicare and Medicaid is projected to grow as a share of total spending on health care—as the assumed rates of excess cost growth for those programs under current federal law slow less quickly than does the rate for other spending on health care and as the population ages. Net federal spending on those programs now accounts for about 4 percent of GDP, or 26 percent of total spending on health care. By 2035, those figures grow to 9 percent of GDP, or 30 percent of total spending on health care, and by 2082, to 19 percent of GDP, or 38 percent of total spending.

The Long-Term Budget Outlook

The rise in health care spending is the largest contributor to the growth projected for federal spending over the long term, but the aging of the population will exacerbate fiscal pressures. For example, future growth in spending on Social Security will largely reflect demographic changes; CBO projects that such spending will increase from about 4 percent of GDP today to 6 percent in 25 years and then will roughly stabilize at that rate thereafter.[12] Federal spending on programs other than Medicare, Medicaid, and Social Security—including national defense and a wide variety of domestic programs—is likely to contribute far less, if anything, to the upward trend in federal outlays as a share of GDP.

Although aging contributes to the projected spending growth, excess cost growth will remain the dominant factor. The effect of aging on spending growth for Medicare, Medicaid, and Social Security can be estimated by asking how much spending would rise if aging were the only factor driving that growth. This approach computes the increase in spending for Medicare, Medicaid, and Social Security when the population profile is allowed to change over time as the population ages but excess cost growth is constrained to be zero. Aging accounts for 29 percent of the total projected increase in Medicare, Medicaid, and Social Security spending as a share of GDP through 2050 and 22 percent through 2082. The relative effect of aging is projected to decrease over time as the impact of excess cost growth accumulates.[13]

All of these projections raise fundamental questions of economic sustainability. If outlays increased as projected and revenues did not grow at a corresponding rate, deficits would climb and federal debt would grow significantly. Substantial budget deficits would reduce national saving, which would lead to an increase in borrowing from abroad and lower levels of domestic investment that in turn would hold down income growth in the United States. In the extreme, deficits could seriously harm the economy. Such economic damage could be averted by putting the nation

12. Congressional Budget Office, *The Long-Term Budget Outlook* (December 2007).

13. An alternative way to measure the effect of aging on spending is to ask how much lower spending would be if the aging factor was removed from the projections. Suppose that excess cost growth was consistent with the assumptions underlying CBO's long-term health projections but the population profile was constrained not to change over time. Under that method, spending on Medicare, Medicaid, and Social Security as a share of GDP through 2050 would be 40 percent lower than it would be if the population's aging was a factor in the calculations; through 2082, that spending would be 39 percent lower. The effects on spending that can be attributed to aging would be greater under this alternative approach because excess cost growth would amplify those effects.

on a sustainable fiscal course, which would require some combination of less spending and more revenues than the amounts now projected. Making such changes sooner rather than later would lessen the risk that an unsustainable fiscal path poses to the economy.

Policy Options to Constrain Future Spending on Health Care

Given that future health care spending is the single most important factor determining the nation's long-term fiscal condition, the Congressional Budget Office is devoting increasing resources to assessing options for reducing such spending in the future. Straightforward changes to the Medicare and Medicaid programs—such as more stringent eligibility criteria, greater cost sharing, or changes in provider payments—could reduce federal spending in part by shifting costs from the federal government to households. Ultimately, however, such cost-shifting approaches are unlikely to be sustainable, and controlling federal spending on health care while maintaining broad access to care under these programs will therefore almost certainly need to be associated with slower cost growth in the health care sector as a whole.

Future increases in spending could be moderated if costly new medical services were adopted more selectively in the future than they have been in the past and if the diffusion of existing costly services was slowed. Although this approach would mean fewer medical services, evidence suggests that savings are possible without a substantial loss of clinical value. Currently, the added clinical benefits of new medical services are not always weighed against added costs before those services enter common clinical practice. And newer, more expensive services are sometimes used in cases in which older, cheaper alternatives could offer comparable outcomes for patients.

Two potentially complementary approaches to reducing total health care spending—rather than simply reallocating spending among different sectors of the economy—involve generating more information about the relative effectiveness of medical treatments and changing the incentives for providers and consumers of health care. In addition to those changes, a variety of approaches to changing health-related behavior could improve health outcomes at a given level of costs.

The current financial incentives facing both providers and patients tend to encourage or at least facilitate the adoption of expensive treatments and procedures, even if evidence about their effectiveness relative to existing therapies is limited. Costly services that are known to be highly effective in some types of patients are sometimes provided to other patients for whom clinical benefits have not been rigorously demonstrated. More information on the "comparative effectiveness" of alternative medical treatments could offer a basis for ensuring that future technologies and existing costly services are used only in cases in which they confer clinical benefits that are superior to those of other, cheaper services.[14] Analysis of comparative effectiveness is simply a comparison of the impact of different options that are available for treating a given medical condition for a particular set of patients.

To affect medical treatment and reduce health care spending, the results of comparative effectiveness analyses would ultimately have to change the behavior of doctors and patients—that is, to get them to use fewer services or less intensive and less expensive services than are currently projected. Bringing about those changes would probably require action by public and private insurers to incorporate the results into their coverage and payment policies in order to affect the incentives facing doctors and patients.

The Medicare program has not taken costs into account in determining what services are covered and has made only limited use of data on comparative effectiveness in its payment policies; but if statutory changes permitted it, Medicare could use information about comparative effectiveness to promote higher-value care. For example, Medicare could tie its payments to providers to the cost of the most effective or most efficient treatment. If that payment was less than the cost of providing a more expensive service, then doctors and hospitals would probably elect not to provide it—so the change in Medicare's payment policy would have the same practical effect as a coverage decision. Alternatively, enrollees could be required to pay for the additional costs of less effective procedures (although the impact on incentives for patients and their use of care would depend on whether and to what extent they had supplemental insurance coverage that paid some or all of Medicare's cost-sharing requirements).

Even in the absence of more information about comparative effectiveness, changes in incentives could help control health care costs, but such measures would be more likely to maximize the health gains obtained for a given level of spending if they were combined with improved information. On the provider side, greater bundling of payments to cover all of the services associated with a treatment, disease, or patient could reduce or eliminate incentives to provide additional services that might be of low value. Such approaches, however, may raise concerns about the financial risk that providers face and about their incentives to provide too little care. On the consumer side, a landmark health insurance experiment by RAND showed that higher cost sharing reduces spending—particularly when compared with a plan offering free care—with few or no adverse effects on health.[15] However, compared with more typical health insurance plans (which do not offer free care), high-deductible designs have more modest effects on health care spending;

14. For a discussion of comparative effectiveness, see Congressional Budget Office, *Research on the Comparative Effectiveness of Medical Treatments: Issues and Options for an Expanded Federal Role* (December 2007).

15. See Willard G. Manning and others, "Health Insurance and the Demand for Medical Care: Evidence from a Randomized Experiment," *American Economic Review*, vol. 77, no. 3 (June 1987), pp. 251–277.

such approaches also raise concerns about the financial burden on individuals with significant health problems (again reflecting trade-offs between providing insurance protection and maintaining incentives to control costs).[16]

Finally, the ultimate objective of any health care system is to promote health, whether by treating diseases that arise or by preventing them from occurring in the first place. Despite the cost of the nation's health care system, many concerns exist about the degree to which it is attaining that objective. Indeed, concerns about rising health care costs might not be so prominent if more evidence showed that those expenditures were yielding commensurate gains in health. In part, those shortcomings in the system's performance relate to the concerns noted above about whether patients are receiving the most effective or most cost-effective treatments—reflecting a lack of information, among other factors. Concerns also exist, though, about steps that are *not* being taken today to prevent the onset of disease, even when clear evidence is available about their benefits. In that context, proposals that encourage more prevention and healthy living can help promote better health outcomes, although their net effects on federal and total health spending are uncertain. Moreover, bringing about substantial changes in behavior could require actions outside the formal health care sector, and even then might be very difficult to achieve.

Nonetheless, reform proposals could encompass preventive measures and efforts to encourage healthier lifestyles. Broadly speaking, three basic policy approaches could be adopted. First, more information about the consequences of unhealthy behavior or the factors contributing to it could be made available, in forms that could affect individual behavior or even social norms. (Nutritional information, for example, is readily available for packaged foods but more difficult to come by for other sources, such as restaurant meals.) Second, financial incentives could be modified to encourage healthier living and to discourage unhealthy activities. For example, cigarette taxes could be increased, which would discourage smoking, especially among teenagers. In addition, an increase in the federal tax on cigarettes of 50 cents per pack would raise about $5 billion per year, according to the Joint Committee on Taxation. Third, regulatory steps could be taken to encourage healthy behavior and discourage poor health habits. For example, recent efforts have been aimed at improving the nutrition and reducing the calories of school lunches and snacks available in schools. In addition, some research suggests that changing the presentation of food choices can encourage healthy eating. There could be great value in exploring these and other mechanisms that offer the potential of constraining health care spending without diminishing the quality of care that people receive.

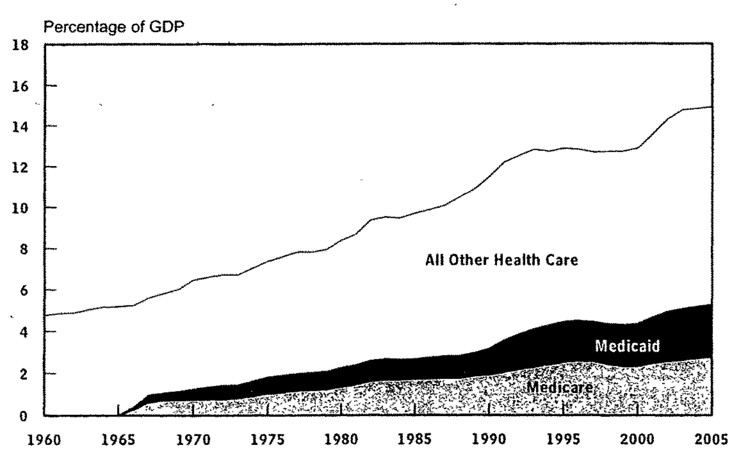
16. See Congressional Budget Office, *Consumer-Directed Health Plans: Potential Effects on Health Care Spending and Outcomes* (December 2006).

Congressional Budget Office

Growth in Health Care Costs

January 31, 2008

Spending on Health Care



Excess Cost Growth in Medicare, Medicaid, and All Other Spending on Health Care

Percentage Points

	Medicare	Medicaid	All Other	Total
1975 to 1990	2.9	2 9	2.4	2.6
1990 to 2005	1.8	1 3	1.4	1.5
1975 to 2005	2.4	2 2	2.0	2.1

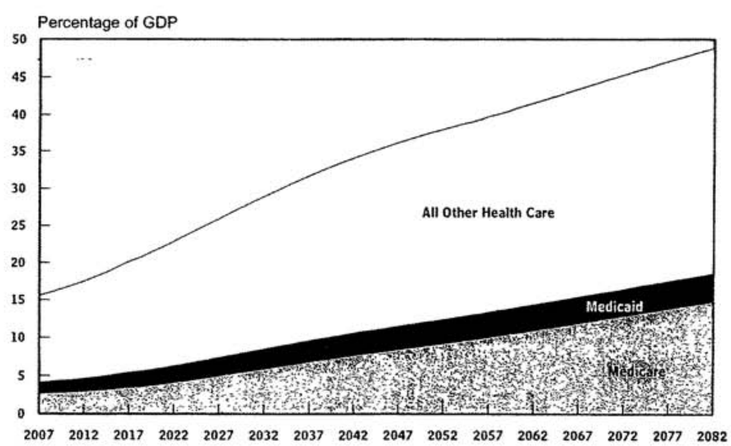
Estimated Contributions of Selected Factors to Long-Term Growth in Real Health Care Spending per Capita, 1940 to 1990

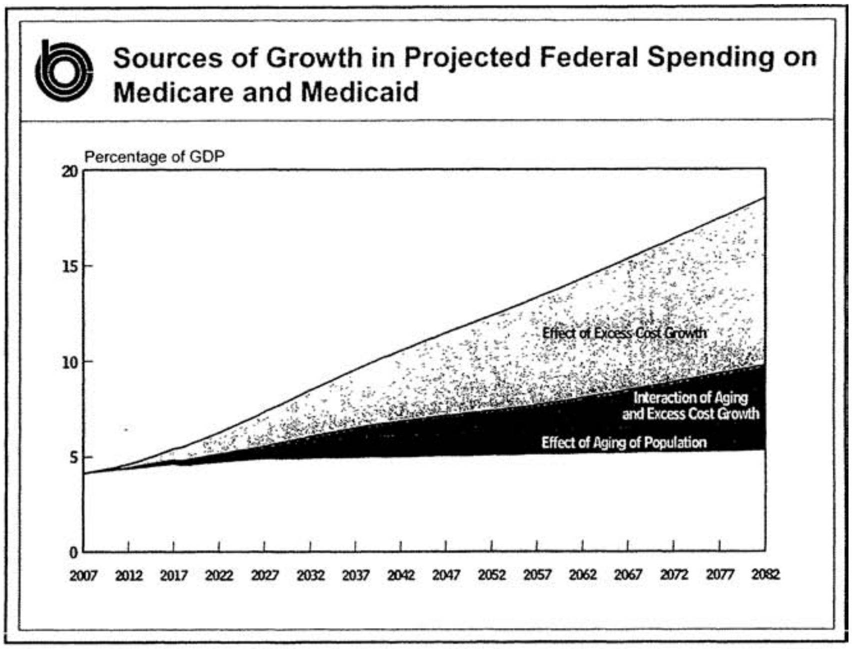
	Smith, Heffler, and Freeland (2000)	Cutler (1995)	Newhouse (1992)
Aging of the Population	2	2	2
Changes in Third-Party Payment	10	13	10
Personal Income Growth	11-18	5	<23
Prices in the Health Care Sector	11-22	19	Not Estimated
Administrative Costs	3-10	13	Not Estimated
Defensive Medicine and Supplier-Induced Demand	0	Not Estimated	0
Technology-Related Changes in Medical Practice	38-62	49	>65

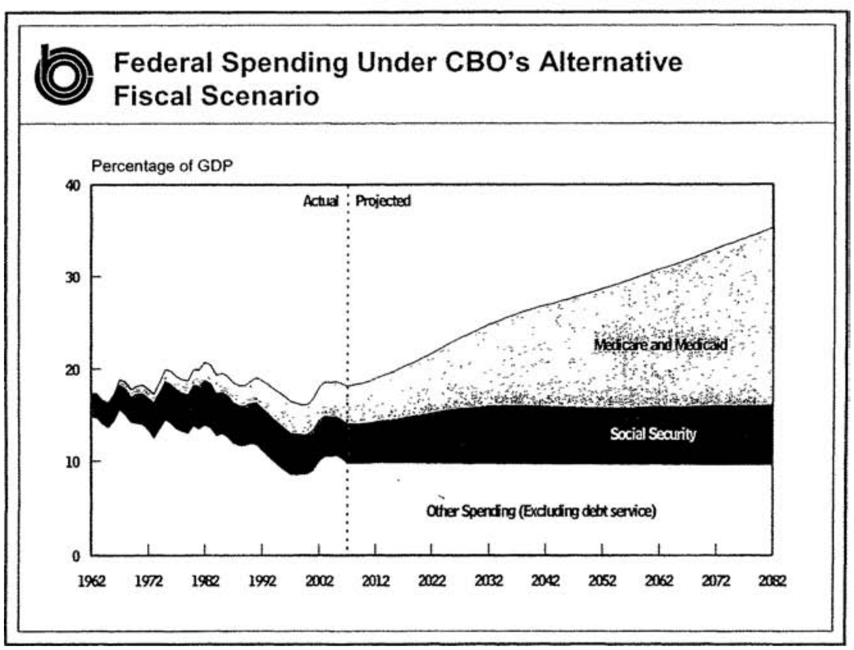
Distribution of Population and Health Care Spending by Weight Category

	1987		2001	
Weight Category	Percentage of Population	Spending per Capita (Dollars)	Percentage of Population	Spending per Capita (Dollars)
All Persons	100	2,400	100	3,200
Underweight	4	2,700	2	3,100
Normal	52	2,300	39	2,800
Overweight	31	2,300	36	3,100
Obese	12	2,700	21	3,700
Morbidly Obese	1	2,700	3	4,700

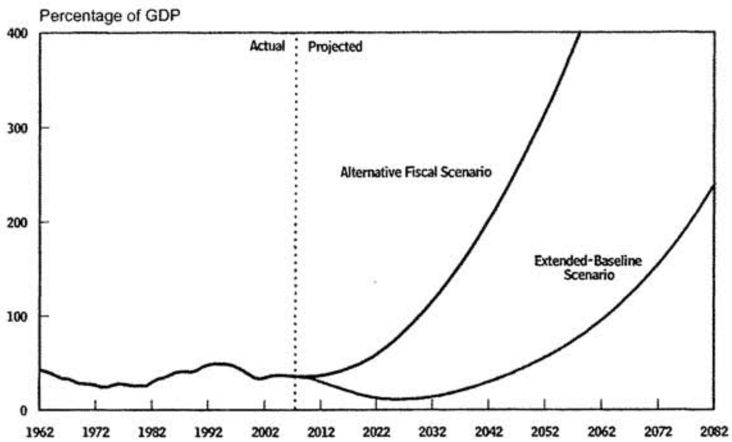
Projected Spending on Health Care




Sources of Growth in Projected Federal Spending on Medicare and Medicaid
Percentage of GDP
20
15
10
5
0
Effect of Excess Cost Growth
Interaction of Aging and Excess Cost Growth
Effect of Aging of Population
2007
2012
2017
2022
2027
2032
2037
2042
2047
2052
2057
2062
2067
2072
2077
2082


Federal Spending Under CBO's Alternative Fiscal Scenario
Percentage of GDP
40
30
20
10
0
Actual
Projected
Medicare and Medicaid
Social Security
Other Spending (Excluding debt service)
1962
1972
1982
1992
2002
2012
2022
2032
2042
2052
2062
2072
2082

Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios



Variations Among Academic Medical Centers

Use of Biologically Targeted Interventions and Care-Delivery Methods Among Three of U.S. News and World Report*'s "Honor Roll" AMCs*

	UCLA Medical Center	Massachusetts General Hospital	Mayo Clinic (St. Mary's Hospital)
Biologically Targeted Interventions Acute Inpatient Care			
CMS composite quality score	81 5	85.9	90.4
Care Delivery—and Spending—Among Medicare Patients in Last Six Months of Life			
Total Medicare spending	50,522	40,181	26,330
Hospital days	19.2	17.7	12.9
Physician visits	52 1	42.2	23.9
Ratio, medical specialist / primary care	2.9	1.0	1 1

Source: Elliot Fisher, Dartmouth Medical School.

Chairman CONRAD. It is pretty sobering, is it not?

Mr. ORSZAG. Yes.

Chairman CONRAD. I mean, you look at these things, it is really sobering.

So, the question is what can we do about it? And as you know, Senator Gregg and I have a proposal to have a task force that is given the responsibility to come up with a long-term fiscal plan. If we were able to get that task force in place, would you have proposals that you think could have a significant effect in altering what we see as the future here?

Mr. ORSZAG. Let me answer that by saying two of the most significant activities that CBO will be undertaking in this area this year are intended to produce two volumes, hopefully by the end of this year or perhaps early 2009. One is something that we are calling Critical Topics in Health Reform. The goal there is to go through systematically many of the major topics that people are talking about, disease management, care coordination, pay-for-performance, what have you, and provide some guidance to the Congress about what our views are in terms of what the effects may be. Probably in ranges, rather than specific, you know 22.2 kind of point estimates.

This could be $10 billion to $20 billion a year and if you do it this way you are more likely to be closer to the $20 billion, if you do it that way you are more likely to be closer to the $10 billion.

And then, in addition to that, we intend to pull out of the budget options volume that we do every other year and produce a separate health options volume that will provide for more detailed specific proposals, precise point estimates of what the budgetary and other impacts would be.

We have a major cross-agency undertaking to provide that kind of information. So I guess it would depend when your commission started operating.

Chairman CONRAD. Well, our intention now is that it would be next year.

Mr. ORSZAG. Well, that timing works.

Chairman CONRAD. In terms of the conclusion of your work, I heard you say either late this year or some time early next year?

Mr. ORSZAG. Yes.

Chairman CONRAD. Well, the earlier it was done next year, the better for the purposes of what we are trying to do. And I think, you know, if you look at the reality here, you get a new administration, whatever it is. They are going to have no choice but to tackle these issues because their whole presidency, I think, could potentially be defined by how they grapple with these challenges.

As you think about this yourself, how serious a threat do you see these long-term projections to be to not only the fiscal stability of the country but the economic strength of the country?

Mr. ORSZAG. If we were ever to actually wind up on the kind of debt path that is illustrated in the chart before this one, the economic consequences would be orders of magnitude much more severe than anything we are currently experiencing, which is obviously generating—in some quarters—concern.

So that kind of path simply cannot happen. It would be an economic disaster.

Chairman CONRAD. I hope the word gets out, you know? Our colleagues have to join us in this effort. There is no sitting on the sidelines this time, I do not think. So I am calling my colleagues, through their staffs that are here, I hope they are paying very close attention to what we have just heard here.

And I hope this moves them to support the proposal that Senator Gregg and I have made. If they have ideas for change, let's hear them. But I want to once again state that we are going to go to markup on this proposal. To me, this cannot be kicked down the road anymore. This has to be—we have to have the beginning of facing up to this.

And I do not pretend for a moment we are going to be able to solve all of the problem on the first bite at the apple. But it needs to be a big bite and it needs to be very serious and it needs to be bipartisan.

Dr. Orszag, I would ask you, do you believe that an initiative along these lines is important and important to do now?

Mr. ORSZAG. Yes, and I would also just add one other thing that Senator Gregg mentioned: in this key area of health care, we currently do not have the specific proposals and the specific information that you would need to alter that path immediately. We need to be building that infrastructure and being much more aggressive, just orders of magnitude more aggressive, in getting under the hood and finding out exactly what works and what does not, and trying different things and evaluating them.

We cannot afford to just wait and kind of say well, we do not really know because we do not have the information base. We will not have it when the time comes unless we are building it now.

Chairman CONRAD. Senator Gregg?

Senator GREGG. Following up on that, do you think the Dartmouth studies are of value in this area?

Mr. ORSZAG. The Dartmouth studies are of unbelievable value, which is why I walk around with their results all the time. But I would note that even the Dartmouth studies are hampered by data limitations and by data imperfections. We could be doing a lot more of that kind of research. I think they are path breaking and are leading the way. But we need the artillery to come in behind them and really bring this back down to a more serious thing.

We should not be relying so much on a very dedicated but small group of researchers at Dartmouth University for this kind of absolutely key—

Senator GREGG. Dartmouth College.

Mr. ORSZAG. Oh my goodness, I am sorry, Dartmouth College—for this kind of key information.

Can we strike that from the record?

Chairman CONRAD. Yes.

Senator GREGG. Otherwise, you will be beaten with hockey sticks.

[Laughter.]

Mr. ORSZAG. I have been to New Hampshire, I know. I do not want to do that.

Senator GREGG. Well, as a result of those studies, I tried to figure out what can we do with this information. And what we came up with was this MQEA initiative, which is essentially to have this clearinghouse where the information is gathered and we get over this hurdle of not having this information generally available.

I mean, what good is it for Medicare to have all this information about the quality of providers if people cannot get access to it? We have this proposal which Senator Enzi has been kind enough to report out of his committee but has been tied up in the middle of the health IT bill. I do not know what is wrong with the health IT bill but somehow it got tied up.

Is this not the type of thing we need to do—get information in a centralized place where it is easily accessible and transparent? It is good solid information so that an insurer or a business that has a lot of employees who have health insurance can go to that data bank and say well, if we send our employees to this hospital they are going to get this amount of care at this quality level at this cost. If we send them over here we are going to get better quality, better cost.

Mr. ORSZAG. It is absolutely the kind of thing we need to be doing. We need to be getting better and more information and more transparency.

I would also add, one of the limitations with many existing efforts, not necessarily the one that you are describing, of combining insurance claims data bases, which can be helpful, is that they often lack the quality part of the equation. And we need more information there, too.

And, in fact, I think it is entirely plausible that one of the biggest payoffs to health information technology on a broader scale will not necessarily be the internal efficiencies of ordering fewer tests and what have you, but rather that you will have an information base for evaluating what works and what does not on a much more comprehensive basis.

I would also note, however, that I think there is a major debate in the medical profession that also will have to occur. We are not going to be able to rely on randomized trials for all of the array of information that we are going to need. And that is unfortunate because randomized trials are better. They are the gold standard. But it is not practical to think that we are going to be able to study whether you should go back and see the doctor four times a month or twice a month and all the sorts of things that you are going to need to examine just using randomized control trials it will be too expensive and to impractical to do.

Senator GREGG. But the Government's role, really, is going to be to create a playing field where this information is available, where it continues to be able to be brought forward in a flexible way so that there is constant updating and it is substantive, useful, visible and transparent, I think.

On another subject, in this out-year period, where the prices are driven dramatically, I saw an estimate that said the Part D premium had an $8 trillion unfunded price tag to it. If that is true, and the total Medicare unfunded price tag is somewhere in the $34 trillion range, the Part D premium issue is a big part of this problem, is it not?

Mr. ORSZAG. Well, I could come at that another way and say our long-term fiscal gap, that is the sort of collapsed imbalance between spending and revenue under our so-called alternative fiscal scenario, is about 7 percent of GDP. The Part D program accounts for about 1 percent of that. So it is not a trivial share.

Senator GREGG. No, that is pretty big.

And I guess, wouldn't it be logical to, at least, structure the payment process for that Part D premium along the lines of the Part B premium, where there is some larger percentage participation by the wealthier recipient?

Mr. ORSZAG. I guess I would say that something has to change, and that is a policy decision. Clearly, you need some combination of more revenue and cost restraint, and that is one way of getting it.

Senator GREGG. The issue which Senator Conrad has often spoken about, which elected governments find almost impossible to address, is the issue of the last 6 months of life and how you deal with that. The fact that you said, 40 percent of the cost is in the last 6 months is very hard for an elected official in a democracy to deal with.

Other Western democracies, not even Western but industrialized democracies, have done it through basically rationing. That is what they do in Canada. That is what they do in England. They have a nationalized system where if you reach a certain age, your capacity to get certain treatments and devices is, if not curtailed, it is made very difficult. There is a time lag that is significant.

Do you have thoughts on this area? Because it is such a big part of the whole overall issue?

Mr. ORSZAG. Yes, and let me bring up that final slide again because that is literally for beneficiaries in the last 6 months of life. Maybe even a broader theme that I would suggest might be beneficial, given the very substantial differences we have within the United States, many of the cross-country comparisons that we often do are difficult to do. There is so much variation within the United States, even just within Medicare, which is the same insurance program—that I think we can probably get a lot farther by trying to examine exactly why that is happening and maybe ease up a little bit on the cross-country comparisons that are difficult to do well.

That having been said, look at those data. Again, beneficiaries in the last 6 months of life, if you try to measure quality or outcomes or even how beneficiaries feel they are being treated, you do not appear to be getting anything for spending an extra $25,000 per beneficiary at one of our leading medical centers relative to another.

It is what Elliott Fisher at Dartmouth College has said: how can the best medical care in the world cost twice as much as the best medical care in the world for those last 6 months of life? That is obviously a kind of cute way of saying it, but it is a very deep question that we need to be getting under the hood of.

Senator GREGG. How do we?

Mr. ORSZAG. That then raises the question—

Senator GREGG. I mean, do we say to UCLA, at St. Mary's they can do this for half the price you do it, so you better start doing it for that price?

Mr. ORSZAG. I think there are several ways of getting to this. Why is the regional variation occurring?

I think a key reason why the regional variation is occurring is that we have a payment system that accommodates the more intensive approaches, even when they do not help. And we have different norms among practitioners in different parts of the country so that you have, in some parts of the country, much more intensive approaches without any medical evidence backing those approachs. And the payment system accommodates it, which gives you these huge variations in costs without any improvement in quality.

There are lots of ways of trying to get at that. One way of getting at it is to note that this variation occurs most dramatically where we do not know what works or what does not. We do not know whether the MRI is indicated or how beneficial it is in this kind of diagnostic setting.

In some parts of the country—for example, in the darker parts of the country, the parts with the higher spending according to the researchers at Dartmouth College—I am never going to make that mistake again—physicians are much more likely to order an MRI when someone has back pain—or says they suffer from back pain and there is some indication of nerve damage——than in the areas of the country with lower spending.

If we had clearer guidance on when the MRI made sense and when it did not, I think the variations would be narrowed. And I believe they would likely be narrowed toward the lower spending regions.

So one benefit from the kind of information agenda that you have already embraced involves, I think, that the more information we have and the more clarity about guidelines for the medical profession, the less variation there seems to be.

A simple example again, is variation in imaging and in diagnostic tests. Things like MRIs, where there is a lot more ambiguity about when it should be applied, there is a lot of variation. Simple things that have been shown to work, like administering an aspirin for heart attack victims when they show up at the hospital, there is not a lot of variation. Where it is very clear what should happen, physicians tend to do that.

Senator GREGG [presiding]. Thank you.

Senator ENZI.

Senator ENZI. Thank you. I want to congratulate you for your efforts to provide us with answers to deal with the growing health care costs. Those that have been suggested this morning might make a difference.

I do have a statement that I would like to be part of the record.

Senator GREGG. So moved.

[The prepared statement of Senator Enzi follows:]

Statement of Michael B. Enzi

Michael B. Enzi

Long Term Budget Outlook and
Sources of Growth in Health Care Spending

January 31, 2008

I would like to thank Chairman Conrad for calling this hearing today, as well as thank Director Orszag for his testimony—this is his second appearance before the Committee in as many weeks.

I think we can all agree that health care spending is not on a sustainable track. According to CBO, outlays for Medicare, Medicaid and Social Security account for 45% of all federal outlays, and are continuing to grow at a faster rate than the economy.

Ongoing increases in health care costs, along with the aging of the population, are expected to put substantial pressure on the budget in coming decades. And we can't count on economic growth alone to alleviate that pressure, because Medicare, Medicaid and Social Security cost more and more under current law.

As an accountant, I think this is a dangerous situation that must be addressed. And as a former business owner, I know it would be hard for a company to manage its books in a situation like this.

What we are talking about here today is unsustainable growth in mandatory spending in the federal government. Congress has an obligation to address this challenge, instead of punting difficult choices to our children and grandchildren.

We need to be talking more about solutions. One thing the Congress can do to help contain health care costs is enact the health information technology legislation that I introduced last June. Beyond saving lives and saving time, more effective use of health IT also could save billions. A Rand study suggested that health IT has the potential to save the health care system $162 billion a year. In order for these savings to be realized, we must create an infrastructure for interoperability. My legislation is the first step toward building that infrastructure.

I hope that this year we can work across party lines to enact health IT legislation this year, as well as address the fiscal challenges with Medicare and Medicaid. I was disappointed that the FY2008 Budget Resolution had no meaningful mechanism to contain health care spending. I didn't support the Resolution because it failed to address the very issues we are discussing here today. In fact, last year the HELP Committee, where I serve as the senior Republican member, was the only Committee to receive a deficit reduction reconciliation instruction, and it required less than $1 billion in spending cuts.

My hope is that this is a year of new beginnings, and that my colleagues will reach across the aisle and work together on meaningful health care and entitlement reform. We all know that 2008 is a big election year, and that national politics will be in play. But for the American people, especially our children and grandchildren, we owe it to them to get our fiscal house in order. The hearing today is a good start.

Senator ENZI. Senator Kennedy and I have been working primarily on education issues last year because the HELP committee handles everything from birth to retirement. And since most of those issues needed authorization, we are trying to get that done. We are about to finish up the Higher Education Act, I think. The House is taking it up next week.

So now we will be able to concentrate more on health care. It is not that we have not been doing anything on it the last year. I was tasked with looking at the different ways people in both parties say that we should be dealing with health care issues, and what they feel we ought to be doing.

And across the aisle I have compiled a list of 10 different things that we could do to improve access and the quality in health care, in addition to getting every American insured. And if we did all 10 of them, that would be the result.

It is proposed as 10 pieces because we seldom do anything really comprehensive around here. Because if you have 10 pieces, one of them will have five people that do not like it, another one will have eight people that do not like it, another one 11 people that do not like it. Pretty quickly you are at 51 and you cannot get it done.

But if you pick out the one that has five people against it, 95 to five is not too bad and we can get it done.

One of the key pieces in this is health IT. That is the great idea supported by Senator Gregg that seems to have stalled out. One of the reasons it has stalled is because the bill was scored as costing $47 million in 2008 and $317 million over 2008 to 2012.

Yet the RAND Corporation says that this interoperability in health IT would save $162 billion a year—a year. Even if we had some costs associated with that, it seems to me that there would be a couple of bucks left over...

[Laughter.]

Senator ENZI. ...even with the way we do accounting here.

But that is what I want to ask about. I want to know why it does not save any money? And what can we do with the bill to change it so that it will get a score that shows savings and still do the things that we need to have done? All we have in there is a small grant program to get it kicked off—eliminating that does not seem to do anything toward the $162 billion a year.

Mr. ORSZAG. Thank you for that question. Let me first say that we will be coming out at some point early this year with a full report on health information technology and the evidence on what it does and what it does not do. I think a general theme is that there are many things that by themselves do not do very much, but that in conjunction with other features or other changes would have larger effects.

For example, installing a health information technology system in a system that is relatively integrated likely has a lot different effects than installing a health information technology system in a part of the health sector that is not particularly integrated.

We have had the RAND folks in so we have scrubbed those numbers. I think it is fair to say that there is, in many of the major items, skepticism about the specific magnitudes involves in some of those estimates.

I again come back to saying that because our health system is so decentralized and fragmented, if you will, installing health information technology more broadly, by itself, may not have as big a pay out as it would in conjunction with other changes——for example, using the health IT system as a basis for gathering information for comparative effectiveness research and then tying provider payments and incentive payments to that information. A health information technology system that is feeding data to some other effort—whether it is private or public or a combination thereof—to then study what works could, over the long term, significantly reduce costs.

But if you just put the health information technology stuff in by itself, you do not get that big of a pay out because in a fragmented system it does not look like it is that beneficial.

So the political economy of splitting up the 10 pieces that you described perhaps accurately, unfortunately under the scoring side may lead to problems because we have to score each proposal by itself.

Senator ENZI. OK. Of course, in the Senate, we run into a little bit of a problem because we tend to work on jurisdictions and the doctor evaluation—which I prefer to call the pay-for-best practices—actually comes under the jurisdiction of the Finance Committee. And if the finance piece is combined with the health piece, then the Finance Committee may not get sufficient credit. But that is a problem that we—

Mr. ORSZAG. These are problems I cannot solve.

Senator ENZI. I understand that. But I will be asking some more questions in depth on how you come up with just evaluating the $47 million instead of giving even an iota of credit on $162 billion worth of savings. I mean, that—they do say that to put in that integrated system would cost about $40 billion, one-time. And it does have to be an interoperable, integrated system.

And the reason we are trying to get this piece through is to enable us to reach that interoperability so that we do not have one system in Wyoming, another one in New Hampshire, a different one in Massachusetts, and a different one in Florida that will not interoperate, giving up a huge portion of that $162 billion.

I always worry that somebody from Wyoming is going to come out to Washington and get in a wreck and because their medical records are not available, they will die. This would be a way for them to carry a card with all of their information on it.

Mr. ORSZAG. Senator, if I could just add quickly— and I do appreciate the question. One of the reasons we are coming out with this report is this is among the various topics where I think CBO scores in the past have raised questions about how can it be so different than other estimates that you all have seen?

One of the things I am trying very hard to do is to make sure that while you may not always like the answer, I want you to understand why we reached the conclusions that we did. The report and other things will attempt to do that.

Senator ENZI. It probably would be helpful to have those at the time that we get the valuation on the bill instead of almost a year later.

One of the biggest savings, probably, in health care comes from prevention. But when CBO looks at the cost of health care and medical technology, does it take into account what savings might result as diseases are prevented or if they are caught at very early, more treatable, stages when it would be less expensive? Is there a cost savings in the scoring if a disease or injury such as a stroke is dealt with early before it leads to major disability?

Mr. ORSZAG. There can be. For example, there was tobacco legislation that we scored yesterday or the day before. The reduced rate of teen smoking that would occur under the bill would have an effect on low birth weight children, which would then have an effect on Medicaid spending. And that was part of our score.

One of the challenges in many of these settings, such as prevention, is that a lot of times those effects do not show up within a 10-year window or do not show up dramatically within a 10-year window. There may be quality improvements but the cost savings—to the extent they do occur—often may occur down the road, which is not within the window that has been chosen for evaluating the budgetary impact.

Senator ENZI. That is probably the problem that we have in trying to reward doctors for keeping people healthy, as well.

I have some other questions but I will submit them in writing.

Senator GREGG. Thank you, Senator.

The Chairman needed to go to a meeting, that is fairly important, of his caucus since he is very much involved in the stimulus package and has a couple of key amendments that were in the Finance Committee.

I certainly want to thank you, Dr. Orszag, for what you are doing. I think it is exactly what we need to have done. And the more information and the faster you can get it to us with some direction on how we can use it successfully is really, really important.

I am hopeful that the Chairman's and my proposal on a task force is fast-tracked and will be approved. If it is, it is going to need this type of information. Even if it is not, we are still going to need it because we are going to have to take action.

So I congratulate CBO for doing this. I congratulate you for your leadership in this exercise. And we want to work with you and give you whatever you need to be successful here. Thank you very much.

Mr. ORSZAG. Thank you.

Senator GREGG. Thank you for your time.

[Whereupon, at 10:48 a.m., the Committee was adjourned.]

CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Peter R. Orszag, Director

Responses to Questions for the Record
Submitted by Senator John Ensign
For CBO Director Dr. Peter R. Orszag
The Long-Term Outlook and Sources of Growth in Health Care Spending
January 31, 2008

Question #1: *In a January 5 National Journal article, you stated, "What I hope to accomplish is to provide enough resources so that when there is a solid rationale, especially when there's solid evidence, we'll 'score' savings." You further elaborate how you applied a unique scoring technique to the House SCHIP bill resulting in a score of zero in the tenth year. How does this scoring differ from static scoring?*

CBO's estimate for the House legislation related to the State Children's Health Insurance Program (SCHIP) took into account potential behavioral responses to the proposed law, as is standard practice in CBO cost estimates. Indeed, CBO incorporates behavioral responses regularly and frequently in cost estimates for many legislative proposals—ranging from an assessment of land use decisions by farmers in response to changes in commodity price supports to an evaluation of the likely production plans of auto makers in response to new fuel economy standards.

The term "dynamic" scoring, by contrast, has typically been used within budget circles to mean the incorporation into a cost estimate of macroeconomic feedback effects (for example, a change in GDP and resulting changes in tax revenues). Following longstanding estimating procedures used by the Congress, CBO does not reflect the impact of possible macroeconomic changes in its scoring legislation. Hence, the SCHIP estimate did *not* incorporate such macroeconomic feedback effects on GDP. In that sense, it was "static."

The difference thus involves the type of behavioral and other responses: CBO always attempts to incorporate in its estimates the budgetary effects of changes in behavior and other interactions at the level of individuals or sectors of the economy that would stem directly from implementing a legislative proposal, but it does not incorporate behavioral responses at the macroeconomic level.

Our estimate for nearly every provision in the House SCHIP bills involved behavioral responses at the level of individuals or sectors of the economy (but again not at the level of the overall economy). For, example, our estimates for the provisions increasing SCHIP allotments incorporated judgments about decisions that individuals, firms, and state governments would make in response to the bill, resulting in:

- Savings in the Medicaid program, because some children who will be covered under Medicaid in the absence of increased allotments would instead be covered by SCHIP; and

- Increases in federal revenues, because some children who would be covered by employer-sponsored insurance in the absence of increased allotments would instead be covered by Medicaid or SCHIP—which, in turn, would result in a reduction in the proportion of compensation that is tax-advantaged (health insurance premiums) and an increase in the proportion that is taxable (wages and salaries).

Likewise, our estimate for the provision to create a Center for Comparative Effectiveness Research took into account evidence on variation in practice patterns and associated costs, and concluded that better information about which health care services and procedures are ineffective or less effective than alternative services would lead to savings in federal health care programs, primarily through changes in physicians' practice patterns.

Question #2: *To what extent do you believe that policies designed to strengthen long-term economic stability would help or hurt the economy in the short run?*

Well-designed policies that address long-run budget problems or try to enhance long-run economic growth could be beneficial to growth even in the short run, and at the very least, would not necessarily weaken the economy in the short run. For example, efforts to reduce projected deficits could be phased in over a long period of time or temporarily delayed when the economy is weak. Such efforts could potentially boost the economy even in the short run by reducing long-term interest rates. Policy-makers need to be careful, however, about timing: For example, policies to raise national saving *immediately* (which would be beneficial in the long run) would be counterproductive in the short run when the economy is weak.

Question #3: *What is your average response time to Member scoring requests?*

Under the Congressional Budget Control and Impoundment Act of 1974, which created CBO, the agency's primary job is to provide budget-related information to all committees of both Houses, with priority given to the needs of the Committees on the Budget and of the Committees on Appropriations, Ways and Means, and Finance. The law also requires CBO to prepare several budget projections each year and to perform studies of budgetary issues. In addition, CBO must prepare estimates of new budget authority, outlays, or revenues that would result from bills or joint resolutions reported from committees of either House, and of the costs that the government would incur in carrying out the provisions of the proposed legislation.

In addition to those statutory requirements, CBO also undertakes a number of analytic studies at the request of the Chairman or Ranking Minority Member of committees or subcommittees; the Congressional leadership; or, as time permits, individual Members.

Under the statute, CBO is expected to respond to committees' requests and to provide individual Members with information developed in the course of its work for the committees. Nevertheless, we make every effort to respond to as many requests from individual Members as we can, given our limited staff resources and the heavy workload imposed by our statutory responsibilities. Our response time may be as short as a day or two if the inquiry does not require intensive analysis. However, some responses may take months if extensive work is required and the relevant CBO staff is occupied responding to requests from committees or preparing estimates for pending legislative action.

In the health area, for example, many of the requests we receive from individual Members' staff can be answered—and are answered—in the course of one or two telephone conversations shortly after they are received. For requests that require more substantial analysis, CBO's efforts are by necessity directed primarily toward satisfying our statutory obligations to the budget, tax, and other authorizing committees. We rely on those committees to establish priorities among their many requests for estimates. We produce estimates for many proposals offered by individual Members; however, we generally produce such an estimate when the committee makes that proposal its priority.

Hiring additional health care staff would improve our ability to respond to scoring requests. Our capacity to conduct analyses has not grown as fast as the demands that are placed on us by the budget, tax, and other authorizing committees.

Question #4: *A few months ago, I asked CBO to score my bill which would means-test Medicare Part D (S. 2414). I have not yet received a response. Can you please provide me with a date certain in which I should expect to receive a CBO score? How would the hiring of additional healthcare staffers improve response time to Member's scoring requests?*

In this case, as in many others, CBO staff responded promptly to your request by communicating informally with your staff. S. 2414 is similar to a provision described in CBO's February 2007 "Budget Options" volume (Option 570-17—Increase Premiums Under Medicare's Drug Benefit for Higher-Income Enrollees). In the course of several telephone conversations, both last fall and more recently, CBO staff advised yours that, after adjusting for a later effective date, that estimate could be used. We will be happy to update that estimate for you under our new March 2008 baseline as soon as it is available.

You also requested an analysis of the distributional effect of the bill. That is a much more complicated and time-consuming undertaking, in part because the available data are scanty, and we have not yet been able to devote the necessary resources to such an analysis. We will follow up with your staff to determine the priority that should be attached to this analysis, in the context of our other responsibilities.

As noted above, hiring additional health care staff would improve our ability to respond to scoring requests. Our capacity to conduct analyses has not grown as fast as the demands that are placed on us by the budget, tax, and other authorizing committees.

Question #5: *Is the CBO currently conducting any healthcare studies that did not originate as a result of a Member request? If so, please provide a description of each study and rationale.*

The vast majority of CBO's work on health care and other topics is in response to a specific committee or Member request.

CBO is currently working on two studies in the health care area that are not the result of a direct and specific request from a Member of Congress. Both of those studies are aimed at laying the analytical groundwork so that CBO will be able to respond with sound analysis, as quickly as possible, to future questions about the impact of various types of health care proposals. Even these two studies, moreover, have been described both in private and in committee hearings to staff and Members on the Budget Committees and other committees, and those descriptions have been met with significant support.

The first of those studies will address critical topics that arise in proposals to make significant changes in health care. The study will prepare CBO to respond to future requests to analyze such proposals, provide guidance to Members and staff who are designing such proposals, and provide greater transparency to Members and the public as to the reasoning and evidence behind CBO's analyses of such proposals. A second study will present a compendium of options and projected budgetary costs of a variety of health policy interventions. That study will both help CBO to respond to future requests in a timely fashion and inform the Congress of the costs of various options.

Question #6: *Is it possible for a Medicare balance billing proposal to save money?*

In general, CBO would probably estimate Medicare savings for a proposal that would shift program costs to beneficiaries or otherwise increase beneficiaries' out-of-pocket costs—such as a balance billing proposal or limiting first-dollar coverage by Medigap policies. Our estimate would, of course, have to take into account the specific details of any particular proposal.

Question #7: *Given that the Medicare Board of Trustees has issued a Medicare funding warning for the second consecutive year, the Medicare Modernization Act of 2003 requires the President to submit legislation to respond to the warning. What steps do you believe need to be taken to ensure Medicare's long-term fiscal stability?*

The greatest potential for reducing Medicare spending in the long-run while preserving beneficiaries' access to high-quality care is through approaches that target the underlying sources of spending growth. (Policymakers have often sought to slow the growth of Medicare spending by reducing the updates to payment rates for providers of medical services. That approach can generate savings in the short run, but it does not obviate the need to address the underlying sources of long-term spending growth.)

Two potentially complementary approaches that could reduce Medicare spending as well as overall health care spending involve generating more information about the effectiveness of medical treatments and changing the incentives for providers and consumers of health care.

More research on the comparative effectiveness of alternative medical treatments could offer a basis for making it more likely that new technologies and existing costly services are used only in cases in which they confer clinical benefits that are superior to those of other, cheaper services. Public and private insurers could incorporate the results of that research into their coverage and payment decisions to affect the incentives facing doctors and patients. For example, if changes in law were made, Medicare could refuse to cover treatments that are less effective or less cost-effective than available alternatives. Or Medicare could tie its payments to providers to the cost of the most effective or most efficient treatment. If that payment was less than the cost of providing a more expensive service, then doctors and hospitals would probably elect not to provide it. Alternatively, beneficiaries could be required to pay for the additional costs of less effective procedures.

Designing policy options that achieve those objectives will not be easy, and making such substantial changes in the delivery of health care could prove difficult and controversial. Given the time necessary to conduct the research on relative effectiveness, to alter incentives in a manner reflecting the results, and to affect behavior through those changes, any potential for substantial cost savings from new research would probably take a decade or more to materialize.

Responses to Questions for the Record
Submitted by Senator Michael B. Enzi
For CBO Director Dr. Peter R. Orszag
The Long-Term Outlook and Sources of Growth in Health Care Spending
January 31, 2008

Question #1(a): *I have worked with many of the members of the Senate Budget Committee on my health information technology bill. I think everyone recognizes that smarter use of technology in health care systems will save lives and money.*

Despite studies indicating more widespread use of health IT will save money, your office scored my health IT bill as a spender. What components would need to be in the bill for it to score a savings to the Federal government?

S. 1418, the Wired for Health Care Quality Act of 2005, would have modified and codified activities being undertaken pursuant to an Executive Order to promote the adoption of health information technology (IT). CBO's estimate for that bill reflected our assessment of the administrative costs the agency would incur to carry out the activities authorized under the bill.

Determining the potential impact of such legislation on spending for federal health care programs like Medicare and Medicaid is much more complicated, however. The expanded use of information technology in the health sector will likely produce improvements in the quality of the health care provided to U.S. residents. CBO expects that the use of such technology will continue to grow under current law, and that legislation that would accelerate the use of such technology could affect the nation's health care system in a number of ways. Over the long term, it might lead to administrative efficiencies, which could reduce administrative costs for the government (which, in the case of Medicare, come from discretionary spending) and for health care providers (which, under current law, generally would not affect the amount they get paid by the government). It might also result in more effective health care. In some cases, that might mean less use of medical services; in other cases, it might mean an increase in utilization. CBO is continuing to collect and evaluate evidence to refine our estimates of whether a particular legislative proposal would result in a net change in direct spending for government programs as a result of these other effects.

#1(b): *The press has quoted you recently as saying you are disappointed with the results of recent Medicare demonstration programs because you don't think that they were designed in a way that gets you the data you need to most efficiently score future proposals. How can we prevent the data problems you encountered with the demos from happening in the future with other programs? Are there specific demonstration programs we could design relating to health IT that will help get the data you need for scoring proposals like mine as saving the Federal government money? Are there specific laws that need to be changed so that your office can access the information you need to score upcoming proposals?*

First, it is important to be clear that access to information stemming from demonstrations has not been a problem for CBO; we have a very productive relationship with CMS. The broader issue is that, while some Medicare demonstrations have been very informative, others have not been designed in a way that will yield useful information about potential changes in Medicare. Further, for a variety of reasons, there are a number of important policy issues that could be explored in demonstrations, but have not been addressed--- including, but not limited to, health IT.

With respect to health information technology, a series of well-designed demonstration projects would provide an important opportunity to identify approaches to expanding its use in a way that would be most effective in improving quality and controlling costs. Such projects would need to be designed to produce results that can be generalized to the whole program. Providers are already adopting health IT, so it would be important to design the demonstrations to be able to distinguish the results of the experiment from underlying program trends. In addition, those projects would have to examine the effects of such elements as:

- The characteristics of the providers who participate--- the extent to which the results are broadly applicable will depend on those characteristics; those who volunteer may be early adopters of technology generally, or may be clustered in a particular specialty where the benefits of IT are clear;

- Who "owns"---and who has access to---various elements of the data and the information system (for example, the patient, providers, payer, or centralized network);

- Varying the degree to which uniform or customized standards are developed and used.

The issues in deploying health information technology are complex. A strategy of experimenting, identifying elements of the experiments that offer promising results, and conducting further experiments to refine the promising approaches would likely yield substantial benefits by improving both the quality of care and the efficiency with which our health dollars are spent. That process would take some time, however.

#1(c): *If Congress changed the rules on scoring and asked CBO to report on long term savings to the Federal Government, do you think that would play a role in the health care reform debate?*

Rising health care costs and their consequences for Medicare and Medicaid constitute the nation's most fundamental long-term fiscal challenge. Meeting that challenge will require greater attention to the long-term effects of policy choice, and CBO is committed to providing policymakers and others with more analyses of health care issues and assessments of the long-term effects of policy choices.

Question #2: *It's clear that overall U.S. health care costs are spiraling out of control. It's also clear that the U.S. is a world leader in developing technology and applying it in areas of health care, including finding diseases at very early stages when they are most treatable—at a lower cost.*

Can you tell me, when CBO looks at the cost of health care and medical technology, does it also take into account what savings might result if diseases are prevented or if they're caught at very early, more treatable stages? In your opinion, is there a cost savings if a disease or injury, such as stroke, is dealt with before it leads to major disability?

Is the cost savings associated with prevention of major disease or disability taken into account by CBO in the scoring process?

CBO's estimates for proposals to provide preventive benefits in Medicare routinely include an offset for savings from lowering spending for those beneficiaries who achieve better health outcomes because of the preventive benefits. In general, we estimate that those beneficiaries constitute a modest fraction of the beneficiaries who would receive Medicare-paid preventive services. In most cases, the government would incur additional costs for preventive benefits for many people, while saving money on the treatment of a much smaller number of people. As a result, such coverage often does not result in a net reduction in Medicare spending.

Nevertheless, we are firmly committed to reflecting savings in our cost estimates, whether in health care or any other area, when (a) there is relevant evidence suggesting such savings, (b) the savings accrue to the federal government rather than to other parts of the economy, and (c) the savings occur within the relevant budget windows. Unfortunately, many examples that advocates cite as offering potential savings do not meet at least one of those three necessary conditions.

Offsetting savings that do meet those conditions were incorporated in CBO's cost estimate for the tobacco legislation (S. 625) that was reported by the Senate Committee on Health, Education, Labor, and Pensions. Our estimate for that legislation includes savings to Medicaid from a reduction in low-birth weight babies triggered by reduced smoking among pregnant women. As the estimate notes:

"CBO anticipates that the decline in smoking due to FDA's regulation of tobacco products also would reduce the number of women on Medicaid who smoke during pregnancy. This reduction would lead to lower spending by the Medicaid program - which covers about 40 percent of all pregnancies in the United States - because women who do not smoke are less likely to have miscarriages, experience complications during pregnancy, and give birth to children with low birth weights. A variety of research indicates that children with low birth weights have higher medical costs, particularly at birth, but also later in life. Savings of some such costs would be partly offset by higher costs for additional live births because of the decline in miscarriages. On net, CBO estimates that FDA's regulation of tobacco products would reduce federal Medicaid spending by $78 million over the 2009-2018 period."

Question #3: *It seems to me that Medicare reimbursement policies reward doctors for providing "sick care." Sadly, the focus isn't on "health care" and ways to keep patients healthy.*

If Congress can come up with a way to shift reimbursement policies to reward doctors for keeping patients healthy and paying for best practices, do you think that CBO would score that as achieving long term savings in entitlement spending?

As is often the case, the answer depends crucially on the details of the policy proposals. If CBO concluded that a particular proposal offered a significant potential for reducing entitlement spending within the timeframe relevant for scoring legislation, we would try to estimate such savings. The fact that there are large differences across the country in spending for the care of similar patients suggests that efficiency gains in the health care system are possible.

CBO has identified some approaches that could ultimately yield substantial reductions in health care costs. In particular, two potentially complementary approaches that could reduce both federal and overall health care spending involve generating more information about the relative effectiveness of medical treatments and enhancing the incentives for providers to supply, and consumers to demand, effective health care.

More research on the comparative effectiveness of alternative medical treatments could offer a basis for making it more likely that new technologies and existing costly services are used only in cases in which they confer clinical benefits that are superior to those of other, cheaper services. Public and private insurers could incorporate the results of that research into their coverage and payment decisions to affect the incentives facing doctors and patients. For example, if changes in law were made, Medicare could refuse to cover treatments that are less effective or less cost-effective than available alternatives. Or Medicare could tie its payments to providers to the cost of the most effective or most efficient treatment. If that payment was less than the cost of providing a more expensive service, then doctors and hospitals would probably elect not to provide it. Alternatively, beneficiaries could be required to pay for the additional costs of less-effective procedures.

Designing policy options that achieve those objectives will not be easy, and making such substantial changes in the delivery of health care could prove difficult and controversial. Given the time necessary to conduct the research on relative effectiveness, to alter incentives in a manner reflecting the results, and to affect behavior through those changes, any potential for substantial cost savings from new research would probably take a decade or more to materialize. The precise impact of such changes would depend on several factors and is difficult to predict.

Question #4: *With regard to biologic therapeutics and biosimilar molecules, do you have a figure of how much those molecules will save the health system?*

The development of an expedited process for approving follow-on protein products ("biosimilar molecules") would ultimately result in substantial savings to the health care system. The magnitude of those savings, and the speed with which they would be realized, would depend critically on policy choices involving the process by which those biologics would be approved for marketing, the rules governing resolution of patent disputes and other issues related to market exclusivity, and the extent to which the follow-on products would be substitutable for the existing biologics. CBO is working with Congressional staff who are grappling with those policy choices and consulting with stakeholders and other experts, in order to be prepared to produce a cost estimate soon after staff complete the design of their legislative proposal.

Question #5: *I believe tobacco use is one of the greatest public health threats facing our nation. You mentioned at the hearing that S. 675, the Family Smoking Prevention and Tobacco Control Act, scored a savings to the Medicaid program as a result of a reduction in smoking by pregnant women. This savings would total $78 million over a 10-year period. The score for the bill indicates a 10 percent reduction in youth smoking and a 2 percent decline in adult smoking over 10 years, as those young people age. These are very minor reductions in the number of smokers. I have an alternative tobacco proposal, S. 1834, the Help End Addiction to Lethal Tobacco*

Habits, that would institute a cap-and-trade system for reducing the number of US smokers. My bill would reduce smoking by significant levels—30 percent in the first 8 years, and by 90 percent over 20 years. Based on this model of scoring, wouldn't my proposal result in greater savings to Medicaid than S. 625?

CBO's estimate of the effect of S. 625, the Family Smoking Prevention and Tobacco Control Act, on Medicaid spending was based on the effect of the bill on the number of pregnant women in Medicaid who are smokers. That estimate relied on strong evidence that demonstrates that: (a) women who do not smoke are less likely to have miscarriages, experience complications during pregnancy, and give birth to children with low birth weights, and (b) children with low birth weights have higher medical costs, particularly at birth, but also later in life.

CBO estimated that S. 625 would reduce smoking by adults overall by amounts reaching about 2 percent after 10 years. If the cap-and-trade mechanism that S. 1834 would institute resulted in a larger reduction in the number of pregnant women in Medicaid who are smokers, CBO would estimate larger Medicaid savings.

THE PRESIDENT'S FISCAL YEAR 2009 BUDGET PROPOSAL

TUESDAY, FEBRUARY 5, 2008

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

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

Present: Senators Conrad, Murray, Feingold, Nelson, Menendez, Lautenberg, Cardin, Sanders, Whitehouse, Gregg, Allard, and Bunning.

Staff present: Mary Ann Naylor, Majority Staff Director; and Denzel McGuire, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

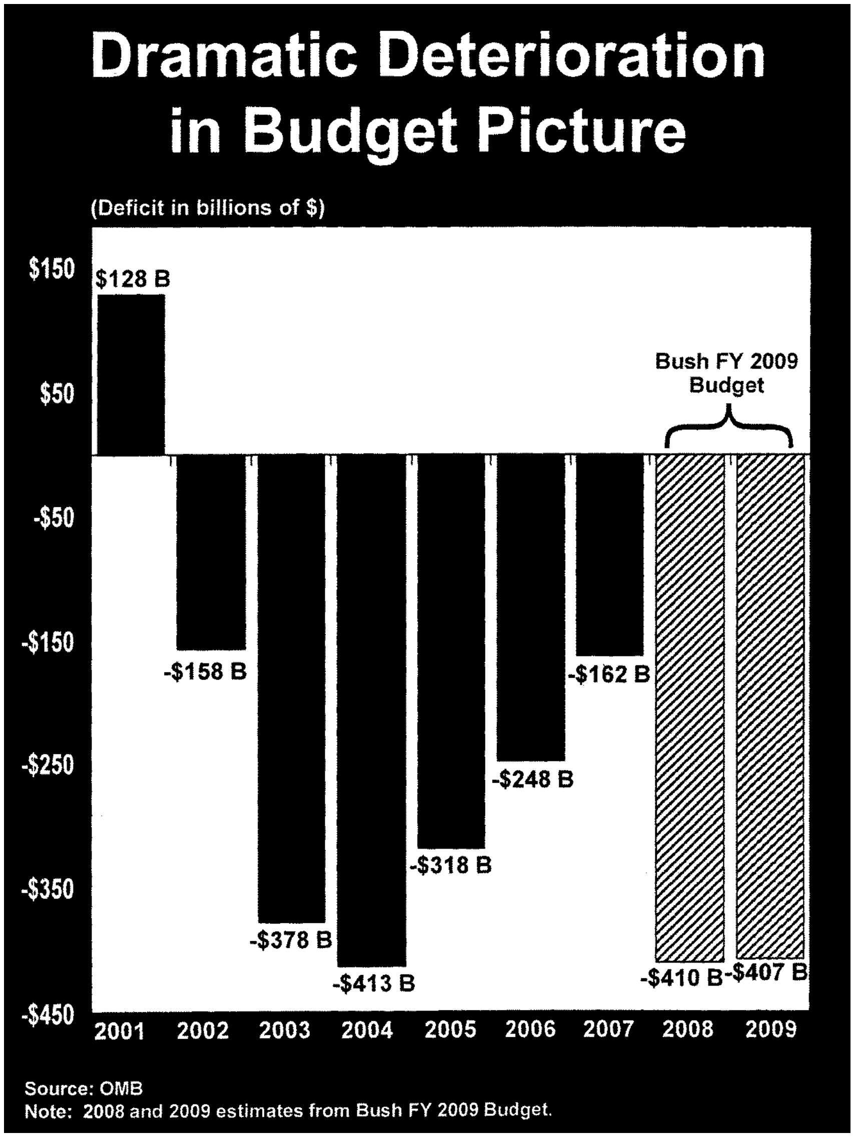
Chairman CONRAD. The hearing will come to order. Senator Gregg is experiencing some flight delays, so he will be somewhat detained but will be joining us shortly.

I want to welcome the Director of the Office of Management and Budget, Jim Nussle. This is Director Nussle's first appearance before the Budget Committee since his confirmation, so we want to especially welcome him. He has, I think, the unenviable job of coming here to defend the President's budget, but I have no doubt that he will do his best.

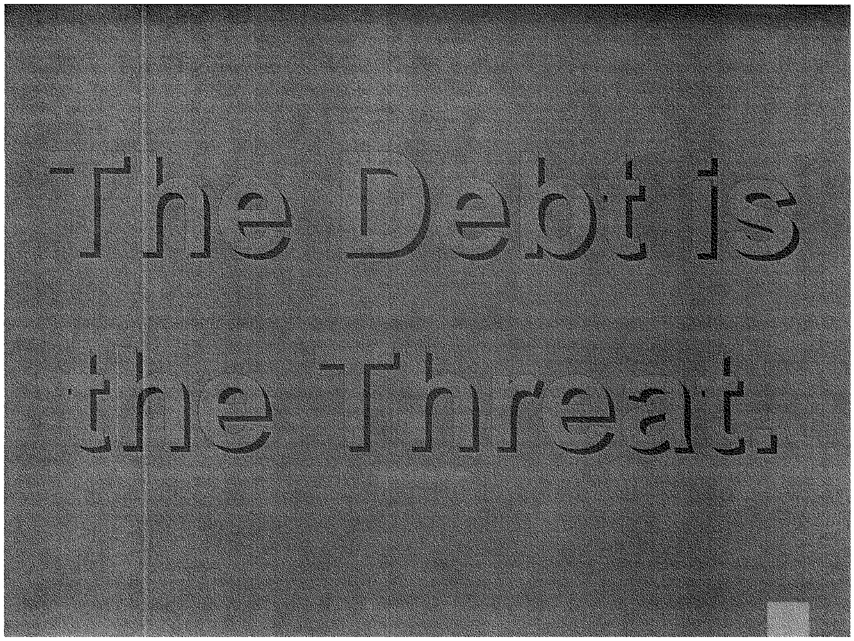
As I said yesterday, we have seen this script before, and it is a script and a play that leads us to, I think, an unfortunate ending: more deficit spending, greater debts, and, unfortunately, a fiscal circumstance that will leave the next President inheriting what I believe will be a fiscal meltdown.

Let me just go to the background in terms of what we see as the deterioration in the budget picture.

The President's budget indicates that for 2008 the deficit will be up to $410 billion, near record terms and dollar amounts; for 2009, at about the same level.



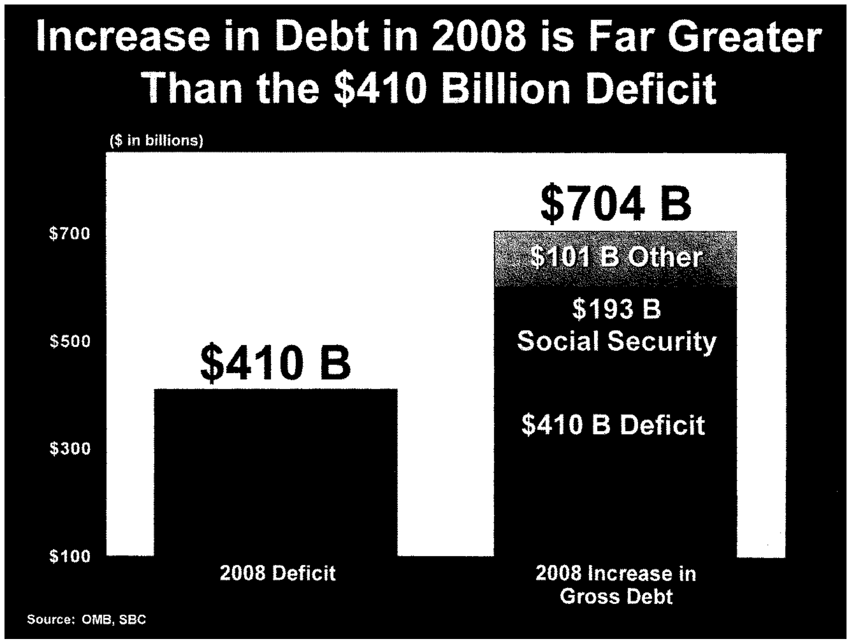
But I think that really misses the point, and to me, the media coverage and much of the analysis misses the biggest problem that we confront, which is the growth of the debt. I really believe increasingly the debt is the threat, and let me indicate why.



While the President is saying that the deficit for 2008 will be $410 billion, the debt will increase by more than $700 billion in 1 year. The total debt of the United States is now over $9 trillion, as we meet here today, some $9.2 trillion. By the end of this year, we could be approaching a gross debt of $10 trillion.

Now, I see this all the time, a confusion between the deficit and the debt. The deficit is the difference on an annual basis between spending and revenue, but it neglects to take into consideration the money that is being taken from Social Security to pay other bills—some $200 billion this year alone, none of which is counted in the deficit, every penny of which is counted in the debt, every penny of which has to be paid back.

And so when I read in the news media over and over and over "deficit of $400 billion," I do not see a word mentioned about the increase in the debt. And I never hear the word "debt" leave the President's lips. Never.



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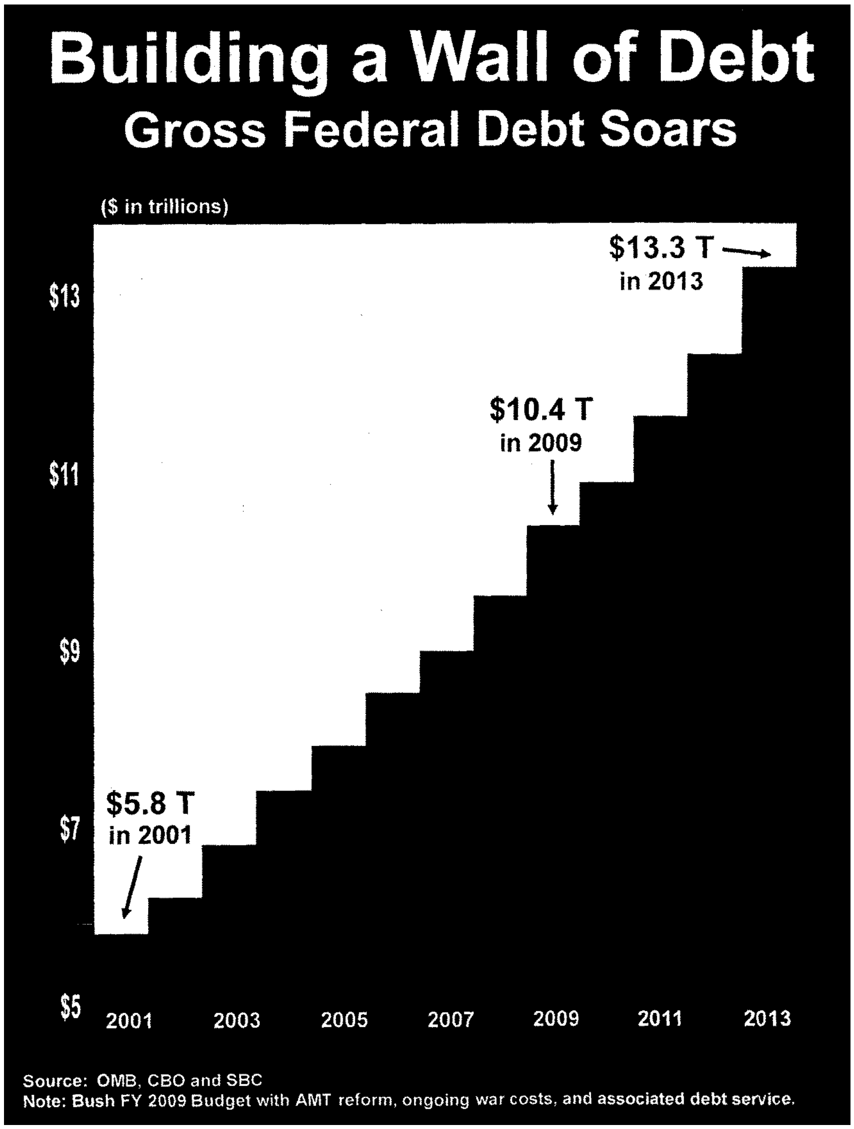
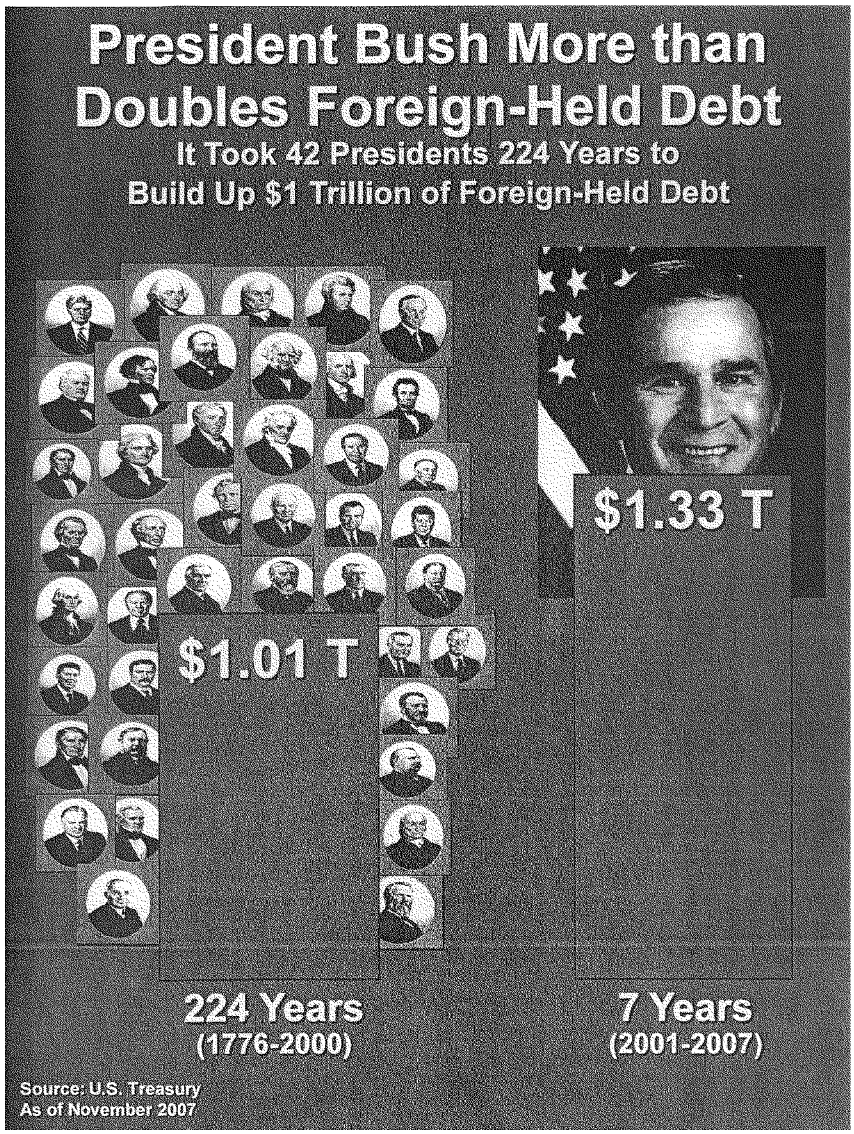
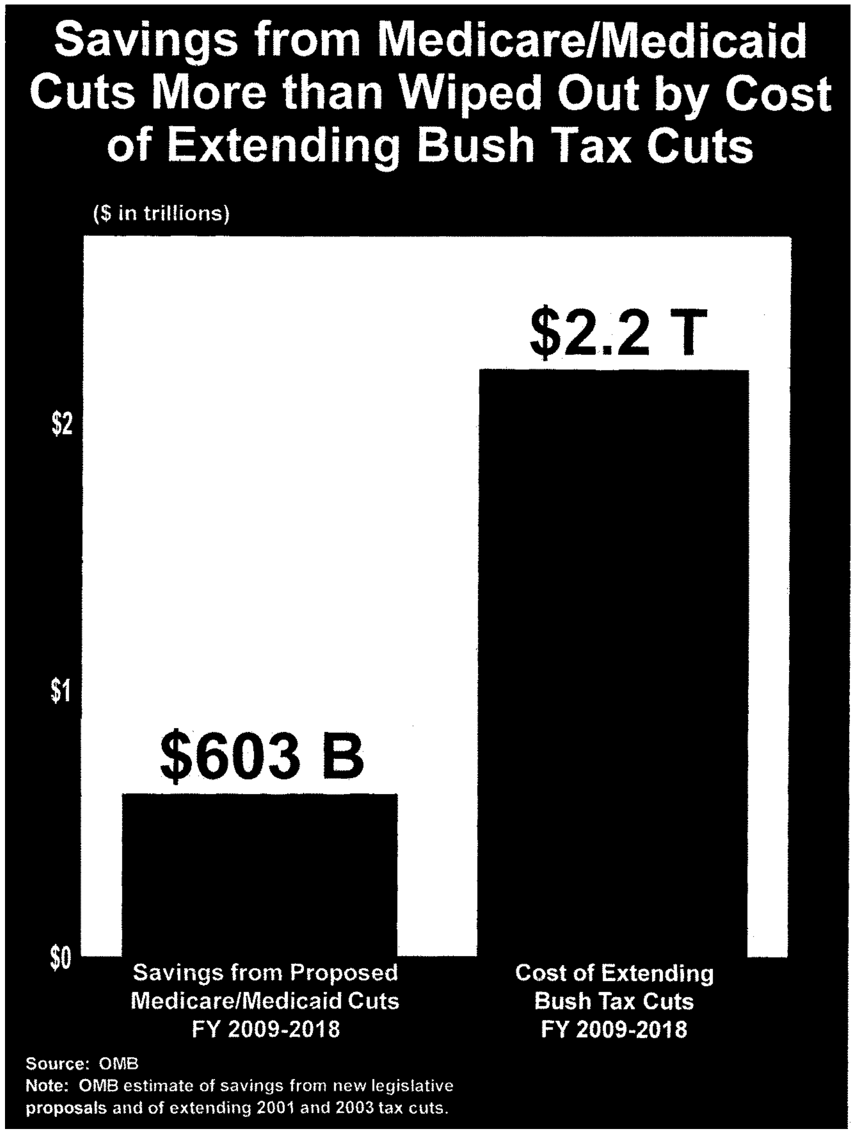
The result of all this is that the gross debt of the United States is going up like a scalded cat. As I indicated, by 2009 we now anticipate the debt will be over $10 trillion, headed for $13 trillion, and this is the sweet spot of the budget cycle. This is before the baby boomers retire. What is going to happen when you put on top of this legacy of debt the retirement of the baby boomers?



And even more startling is foreign holdings of U.S. debt and what has happened there. I have shown this chart before, but it becomes even more dramatic as we include the latest numbers. It took 42 Presidents 224 years to run up $1 trillion of foreign-held debt. This President has more than doubled that amount in just 7 years. So, increasingly, we owe hundreds of billions of dollars to the Chinese, the Japanese, and all around the world.



Now the President brings us a budget that says that as a result of all this, we have to cut Medicare and Medicaid some $600 billion over the next 10 years, and in the same document says, oh, by the way, cut taxes $2.2 trillion. Let's dig the hole deeper, more debt, more borrowing from China and Japan.



I think this is the way that great nations squander their strength and wind up greatly diminished. I look at this budget, and what I see is largely a fantasy: no war costs beyond the first half of fiscal year 2009; no alternative minimum tax reform beyond 2008; no spending policies beyond 2009, other than these very deep cuts in Medicare and Medicaid.

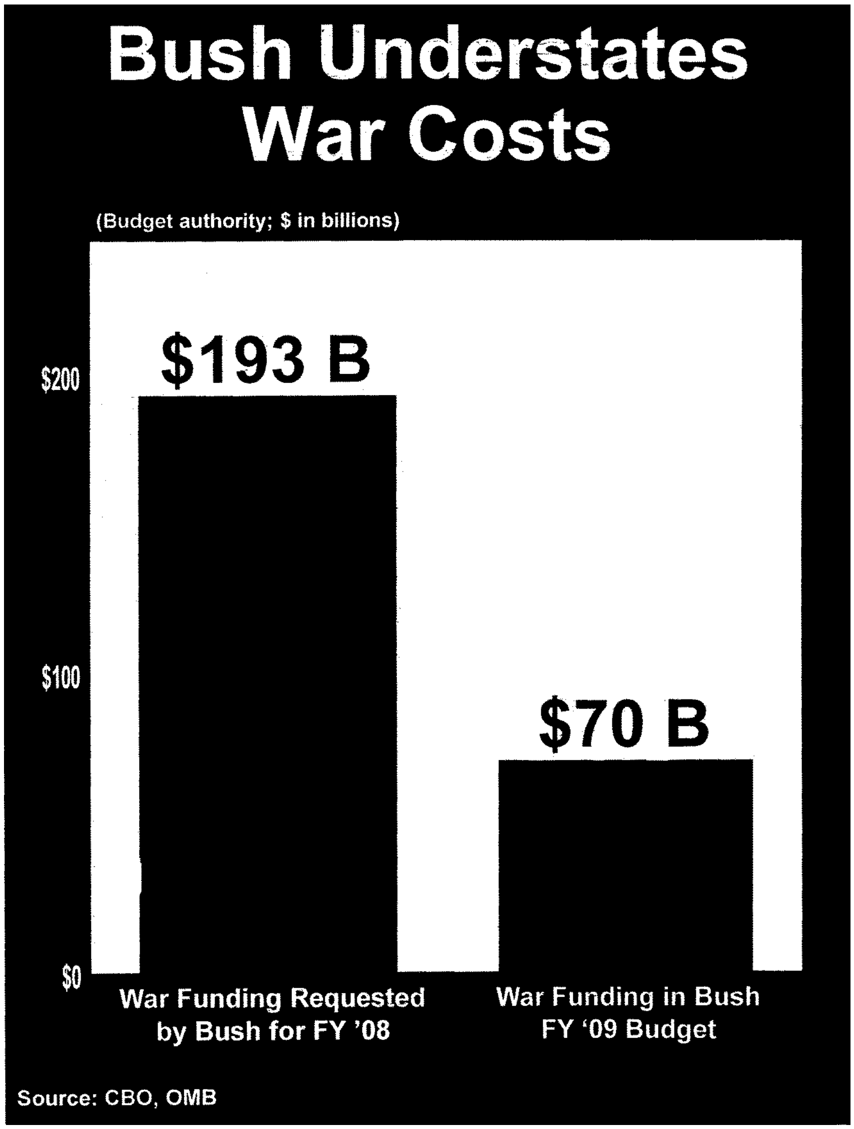
What's Left Out of Bush Budget

War Costs Beyond First Half of FY 2009

AMT Reform Beyond 2008

Spending Policy Details Beyond FY 2009 (Discretionary)

When I look at the war costs, the President says in this budget the war is going to cost $70 billion in 2009. Does anybody believe that? Does anybody believe that? In 2008, we are almost $200 billion. What is the President forecasting here? That there is an abrupt end to the war in Iraq? Is that the forecast? That must be the only possibility to see that kind of dramatic reduction, is that the President is forecasting an abrupt end to the war in Iraq.



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

When I look at the specific priorities here, again, the President trots out proposals that have been completely rejected by Congress in the past, both Democratic Congresses and Republican Congresses. The President says cut the COPS program 100 percent, cut weatherization assistance—not 50 percent, not 75 percent. The President says eliminate it. First responder grants—that is our fire, that is our ambulance squads—cut those 78 percent. Cut clean water grants 21 percent. Cut community development block grants that every mayor will tell you are the most flexible funds available to them to meet contingencies, cut those 20 percent. Cut low-income energy assistance program nearly 20 percent.

President Proposes Deep Cuts in Key Priorities

Program	% Cut
COPS	100%
Weatherization Assistance	100%
DHS State First Responder Grants	78%
EPA Clean Water Grants	21%
Community Development Block Grants (CDBG)	20%
Low Income Home Energy Assistance Program (LIHEAP)	17%

Source: OMB, SBC
Note: Percent cut below 2009 OMB baseline

When we look at the legacy of this President, I believe it will be summed up in three D's: debt, deficits, and decline. And that will be a tragedy—not just a tragedy for this President's legacy, but far more important, a tragedy for this country.

If we look back, this President inherited a record surplus, projected surplus of $5.6 trillion, which he touted at the time. Now what do we have? Deficits of $400 billion a year and debt increasing at more than $700 billion a year. He inherited a circumstance in which we were on track to pay down all publicly held debt. Instead, as a result of his policies, we have a debt that is exploding, a debt that will nearly have doubled on his watch. He inherited the strongest economy in three decades. Now we have an economy that is slowing sharply, so seriously that the Federal Reserve has taken emergency action, and this Congress is now contemplating a stimulus package.

Finally, this President had robust job growth when he came in. Now we have the weakest job growth since the Hoover administration. What a record.

What Bush Inherited		What Bush is Leaving Behind...
Record $5.6 T Surplus	→	$400 B Annual Deficits
On Track to Pay Down All Publicly-Held Debt	→	Exploding Debt Burden
Strongest Economy in Three Decades	→	Economy Slowing Sharply
Robust Job Growth	→	Weakest Job Growth Since Hoover Administration

But that is the fiscal record of this President and, again, tragedy for his legacy because at every step of the way he has been wrong. Every single year what he has said would be the outcome has been wrong. Not just a little bit wrong. Completely wrong.

You will recall when we started this exercise he said there would be no deficits. When that proved not to be true, then the President said, well, the deficits will be small and short term. When that proved not to be the case, he said, well, they will be small by historical standards. When that proved not to be true, he said, well, sometime down the road we will get back on track.

It has never happened. What has happened is an explosion of debt and deficit, a weakening economy, and this country's future fiscal condition gravely jeopardized. This President is going to hand off to the next President the worst fiscal condition, I think, in the history of this country when you take into account that we are also poised to have the baby-boom generation begin to retire, and that beginning to retire starts this year and next. And this President has done nothing to prepare for it.

Well, with that, I will end my opening statement and turn to our colleague, Senator Bunning, who will give the opening comment for the Republican side given that Senator Gregg is somewhat delayed.

OPENING STATEMENT OF SENATOR BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

For the first time this year, the President proposed a budget amounting to just over $3 trillion. Our population is now at just over 300 million. Therefore, the President's budget amounts to approximately $10,000 for every man, woman, and child in America.

Most Americans do not pay $10,000 in taxes, however. Because of our progressive tax system, only about 95 million individuals and families pay any net Federal income tax at all. Of this 95 million, only about 14 million have a Federal tax liability of more than $10,000. These taxpayers, more than 10 million of them, with incomes between $100,000 and $200,000 paid an average of $48,000 per return in 2006. This productive minority will be asked to pay a much higher percentage of their income if the blueprint outlined by the Chairman of the Ways and Means Committee is ever enacted into law. Its members face the more immediate threat of the alternative minimum tax in the current year and the prospect of the largest tax increase in history when the 2001 and 2003 tax rate reductions expire.

When Members of Congress called for more taxes on the rich, this group adjusted its behavior to the detriment of the remaining 286 million. The Federal Government is likely to suffer as well.

An interesting feature of this year's budget is that it is divided into three parts, with a little over one-third representing all discretionary spending—one-third discretionary spending—and the two remaining parts represent mandatory spending and interest on our more than $9 trillion in Federal debt. We tend to focus on the third representing discretionary spending, but this Committee is responsible for the entire budget, and we should focus on it as a whole.

I am pleased that the White House has again taken the challenge of entitlement spending seriously. I applaud the administration for tackling the issues of proposing to curb the unsustained growth in Medicare and Medicaid and Social Security spending. As a member of the Senate Finance Committee and Budget Committee, I look forward to examining the proposals in this budget thoroughly with the eye toward making changes that will put us on a path toward sustained entitlement programs, ones that we can live with, ones that will not bankrupt the country by the year 2030 if we do not do anything about them.

Thank you.

Chairman CONRAD. Thank you, Senator Bunning.

We will now turn to the witness, and, again, we want to welcome on a personal basis—we have strong disagreements with respect to budget policy, but this Committee has always treated our witnesses respectfully, and we certainly extend that to Director Nussle, who used to be the Chairman of the House Budget Committee, and we worked closely with him in that capacity.

We welcome Chairman Nussle to the Committee. Again, I think you have a pretty difficult task of defending what I see as the indefensible. But take a shot at it.

[Laughter.]

STATEMENT OF HON. JIM NUSSLE, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. NUSSLE. Well, Mr. Chairman, first of all, thank you for your hospitality. The more I have an opportunity to sit here, the fonder my memories of sitting where you are, and being able to grill the witnesses and take the testimony.

I want to start, if I may, by thanking the Committee and your staff for the respectful way I was treated during the confirmation process and the expedited way I was handled. I appreciate that, not only from you, Mr. Chairman, but from the members. We had things to discuss, we had challenges to overcome, but it was done in a very respectful way, and I appreciated everyone's help in that regard.

Second, if I may, just before I begin with my testimony, I would like to thank the people who make it possible for the budget to be created in the first place. You know, as I told you at the time of confirmation, I had just scratched the surface of getting to meet many of the extraordinary professionals who work at OMB and have done so in many instances for five, six Presidents going back. We had a gentleman—a couple who retired this year who would as far back as Nixon and Johnson, and they just have done a fantastic job. And so many of them labor in obscurity and without a lot of credit, but they just do a tremendous job. They do not just work on the inputs. They also talk about the outcomes. There is a lot of that that goes into a process that puts this together, and I just have nothing but high praise for the opportunity to work shoulder to shoulder with so many of them.

Chairman CONRAD. Mr. Director, I might just say some of them, after looking at this budget, may be glad for the anonymity.

[Laughter.]

Mr. NUSSLE. That is probably true every year, Mr. Chairman. And as you know, for the first time, this year we sent the budget in an electronic format, an e-budget, and we are proud of it. Now, we understand there were some who maybe did not like it. Change is always difficult. But I can tell you that the initial reaction from those who have had a chance to surf the Web and to use what I think is a much more user-friendly, fast, transparent, public way to display the President's budget and some of the priorities, I think it has been successful. Certainly there are improvements that can always be made, and we would look forward to hearing from not only Senators but also from your staff as to ways we can improve this going forward.

There is no question that as a result of the work we have done this year, we are just on the cutting edge of what can be, I think, a much better process moving forward if we stick together and say, hey, let's try and make this electronic and transparent.

Mr. Chairman, the President asked me to present a budget and in my preparation take into consideration five main goals that I displayed here for you in chart format.

First, he wanted to make sure we addressed the immediate economic challenges. This has been something that has been at the forefront for him since he first took office and dealt with a downturn in the economy, the bubble bursting in the dot-com and the stock market. He has been addressing economic challenges throughout his Presidency and did so this time in a bipartisan way with the Congress, and we look forward to that continuing.

Second, to sustain prosperity for the long term. We know what economic growth can do with regard to all of the challenges that you, Mr. Chairman, brought up. Whether it is the short-term deficits or whether it is the long-term obligations, economic growth is very important. You cannot grow your way out of it, as the old phrase used to say. However, economic growth is good, and growth can get you a long way in dealing with the challenges. And we want to continue to grow.

He wanted to make sure that we kept America safe. Obviously, that is job one of our Constitution as the Commander-in-Chief. It is the most important thing. Our economy cannot function; We cannot live in freedom or even have the kind of conversation we have today if America does not remain safe.

He wanted us to balance the budget by 2012 and in doing so not take our eye off the ball which he has promoted since he came to office, and that is, let's deal with the long-term entitlement problems, whether it be Social Security, Medicare or Medicaid. We have a challenge to meet. He has made proposals every year he has been President and will do so again this year. So let me turn to some of these.

First of all, continued economic growth is really the most critical element in reducing the deficit, getting back to balance and addressing our long-term challenges. Obviously, in a bipartisan way this year, the growth package that has been promoted, which we do include in this budget at $145 billion—the President asked for 1 percent of GDP, and so we included that in the budget—combined with a slowing economy does contribute to a much larger short-term deficit. There is no question about that. In fiscal year 2008, the deficit will be 2.9 percent of GDP. But in fiscal year 2009, with economic growth coming back and rebounding, we can see an improvement to 2.7 percent of GDP. But both of these upticks in the deficit can be temporary and I think can also be manageable if we keep taxes low, if we accelerate economic growth, and if we keep spending in check.

Second, let me just say I do not believe we are experiencing these short-term deficits because the American people are undertaxed. As this slide shows, the tax burden, if you measure it against the economy, GDP, it is 18.5 percent, which is higher than the 40-year historical average. Now, that may surprise a lot of people who think that because of the tax cuts in 2001 and 2003 that there obviously must be a lot less revenue coming into the Federal Government. Well, that was simply not the case. As the tax cuts took effect and the economy grew, actually revenue was quite strong and ran way ahead of GDP. In 2005, revenue grew at 14.5 percent, 11.8 percent in 2006, and we had revenue growth of 6.7 percent in 2007—all above GDP. And we can have that again if we continue to focus on economic growth.

Revenue has really never been the problem here. Spending is the problem. We must do more, I believe, to keep spending in check in order to balance the budget in 2012 and address our longer-term spending challenges. The budget proposes to keep non-security discretionary spending growth below 1 percent for 2009 and then hold it at a level pace for the next 4 years. If debt is the threat, then spending must be controlled.

Also in this budget, we need to terminate or significantly reduce 151 programs that we identify as programs that are either underperforming, have outlasted their usefulness, or could be better done at the State level or by the private sector. By doing so, we save over $18 billion in the first year alone—again, by getting spending under control. These are programs that are not just—you know, are not achieving results. Frankly, you cannot just throw good intentions alone as an answer to justify a program that is not working or no longer is a high priority. Focusing on outcomes, not just inputs, I think is the answer here if you want to control spending.

We also believe that earmark reform is necessary in order to change not only the culture in Washington, which has led to low-priority spending that has been, we believe, wasteful, but has also caused nearly 12,000 earmarks that have not been voted on by Congress, costing almost $17 billion.

In addition, mandatory spending, as the Chairman said and so many others have said, is really overwhelming the rest of the budget. Sixty-two percent now of all spending is on autopilot, it is automatic. It will occur if Congress and the Executive Branch do not take some specific action in order to control that spending. And these trends are just not sustainable. As David Walker testified before you last week, the trends are not sustainable. The Fiscal Wake-up Tour, which has traveled around the country to wake all of us up and wake up the American people to these disturbing trends, has suggested that in the next 25 years automatic spending could swallow the entire budget, not leaving with regard to revenue for some of our basic requirements and responsibilities under our Constitution, such as national defense and homeland security. The President, therefore, is proposing a mandatory savings package of $208 billion over the next 5 years.

Now, I realize, just reading the press accounts, that this may be challenging to Congress, but this package, I would remind my friends and members of the Committee, that we are proposing is smaller than the effort we took together in a bipartisan way in 1997 under the Balanced Budget Act of 1997. It is a smaller package. It is a bite-sized piece of what is a much bigger challenge. It is a downpayment. And so I would challenge Congress to take a fresh look at this. We cannot just put off until tomorrow what must be done today. My Dad always told me growing up that tomorrow never comes. And I can tell you in Washington tomorrow definitely never comes. You have to be able to start tackling those now if we going to manage those challenges in the future, and that is why within this package the President has proposed reasonable steps to get Medicare growth under control.

Medicare is growing. We propose $178 billion of savings from that growth. Medicare will continue to grow at 5 percent. We are just asking it to not grow at 7.2 percent. We believe this is a very responsible approach and one that was done in 1997 to bend the growth curve in order to get a handle on this problem.

So, in conclusion, I would say to the Committee, the President, I believe, addresses within this budget the immediate economic challenges that have been undertaken in a bipartisan way.

No. 2, it does, I believe, ensure sustained prosperity. Economic growth is the key in order to accomplish that. It does keep and continue to keep America safe, which we in a bipartisan and between branches believe is such an important issue. It balances by 2012, and it continues to address the long-term challenges that face our country.

Mr. Chairman, I am pleased to present the President's budget, and I look forward to an opportunity to address your and other members' questions. Thank you.

[The prepared statement of Mr. Nussle follows:]

Testimony of OMB Director Nussle

President's FY 2009 Budget
Budget Committee
United States Senate

February 5, 2008

Chairman Conrad, Ranking Member Gregg, and distinguished members of the Committee, it is good to be back in the hearing room with you. Thank you for having me before the Committee today to discuss the President's FY 2009 five-year budget proposal.

This is the first time I have been before the Committee since my confirmation in September. I would like to thank Chairman Conrad, Senator Gregg, and members of the committee for your support.

As was true when I was in Congress, I would not be here without the hard work and dedication of staff. Before I began my tenure as Director of OMB, I had respect and admiration for the OMB staff. This perspective has only grown stronger as I lead this team of talented, intelligent and dedicated professionals. It is truly a pleasure to come to work each day and roll up my sleeves next to them. I thank each and every one of them for their devotion to public service.

As you all know, for the first time the President submitted his Budget to Congress electronically. It is posted at www.budget.gov. We at OMB are excited to lead this effort for a few reasons: 1) it allows us to utilize technology to provide information in a user-friendly, fast and public way; 2) if others follow our lead, this step will result in conserving 20 tons of paper—saving over 480 trees; and 3) we finally have clean desk.

We are doing our part to provide transparency across the budget process, so thank you for indulging a few product promotions. To help Americans see where their money is being spent, we have launched a website called www.usaspending.gov. This is a result of the Federal Transparency Act that many of you championed. And to help Americans see the kind of results they are getting for their money, we launched www.expectmore.gov. I invite all Americans to log on and find out for themselves how their hard-earned tax dollars are being spent.

Let me turn to the budget itself. The President's FY09 Budget focuses our resources on our nation's highest priorities: the security of the American people and the prosperity of our economy.

The Budget invests substantial resources to protect the United States from those who would do us harm. Continuing our Nation's efforts to combat terrorism around the globe, the Budget provides our men and women in uniform the tools they need to succeed in Afghanistan and Iraq, and it furnishes the resources needed for our civilians to help those nations achieve economic and political stabilization. The Budget proposal also strengthens our overseas diplomatic capabilities and development efforts, advances our political and economic interests abroad, and improves the lives of people around the world.

Over the past seven years, we see the economy has successfully responded to substantial challenges, including a recession that began in 2000, terrorist attacks, corporate scandals, wars, and devastating natural disasters. It is a measure of our economy's resilience and the effectiveness of pro-growth policies that our economy has absorbed these shocks, grown for six straight years, and had the longest period of uninterrupted job growth on record. Yet mixed indicators confirm that economic growth cannot be taken for granted.

To insure against the risk of an economic downturn, the Administration urges Congress to quickly pass the bipartisan growth plan that will provide immediate, meaningful, and temporary help to our economy. The negotiated package provides approximately $100 billion in temporary relief that would allow Americans to keep more of their paychecks to spend as they see fit. It also provides direct relief to businesses – approximately $50 billion in near-term tax relief for business purchasing equipment to grow or sustain their capabilities. While this bipartisan package will add to the deficit in the short term, continued economic growth and continued spending restraint will help bring the Budget into balance in 2012.

Americans have real concerns about their ability to afford healthcare coverage, pay rising energy bills, and meet monthly mortgage payments. They expect their elected leaders in Washington to address these pressures on our economy. So this Budget puts forth proposals to make health care more affordable and accessible, reduce our dependence on foreign oil, and help Americans struggling to keep their homes.

Above all, the Budget proposal continues the pro-growth policies that have helped promote innovation and entrepreneurship. I join the President in his belief that higher taxes would only lead to more wasteful spending in Washington – putting at risk both economic growth and a balanced budget.

As we work to keep taxes low, we must do more to restrain spending to achieve balance by 2012. The Budget proposes to keep non-security discretionary spending growth below 1 percent for 2009 and then hold it at that level for the next 4 years. It also cuts spending on 151 projects totaling more than $18 billion that are not achieving results – because good intentions alone do not justify a program that is not working.

There is also the matter of earmarks. Earmarks have tripled in number over the last decade and have increased spending by billions of dollars. Most earmarks are not even included in legislative text and are not subject to an up or down vote of Congress. Last year, the President has called on Congress to voluntarily reform the earmarking process. Unfortunately, limited progress was made. That's why the President announced during his State of the Union Address that he will veto any annual spending bill that does not meet his goal of cutting earmarks in half from FY08 levels on a bill by bill basis.

The President also issued an Executive Order instructing federal agencies to ignore earmarks unless included in bill text that has been reviewed and voted on by Members of

Congress. This means earmarks will be subject to votes, which will better expose them to the light of day and help constrain excessive and unjustified spending. If Congress continues the process of earmarking in report language, those projects will have to compete for federal dollars before funding is provided based on merit. We believe these changes are necessary to reform the culture of earmarking that has led to wasteful and unjustified pork-barrel spending.

As we take these steps to address discretionary spending, we also need to confront the biggest challenge to the Federal budget: the unsustainable growth in entitlement spending. Many Americans depend on programs like Social Security, Medicare, and Medicaid, and we have an obligation to make sure they are sound for our children and grandchildren. I am the third Budget Director to come before you with this request. If we do not address this challenge, we will leave our children three bad options: huge tax increases, huge deficits, or huge cuts in benefits. And the longer we put off the problem, the more difficult, unfair, and expensive a solution becomes.

The Budget proposal works to slow the rate of growth of these programs in the short term, which will save $208 billion over 5 years. This step alone would reduce Medicare's 75-year unfunded obligation by nearly one-third. This is one of the most serious challenges that faces our country. I want to work with the members of this committee to address reforms that can avert the oncoming fiscal train wreck.

Before closing, I would like to take a minute to discuss funding for our troops. Last February, the President's Budget included a full-year estimate for FY08 GWOT funding. While some changes were made to the request in the fall, Congress has had more than three fourths of our request pending since February. This past December, Congress chose to only provide partial funding for our troops and they will soon need the remainder of the request to ensure that operations continue without interruption. I ask Members of Congress to quickly consider the remaining funding our military commanders have told us the troops need to do their jobs. The Budget includes an allocation of $70 billion for the Global War on Terror. A detailed request will be submitted to the Congress once we have secured the resources for FY08 and have better information on the changing conditions in the field from General Petraeus and Ambassador Crocker.

In the Budget, the President has set clear priorities that will help us meet our Nation's most pressing needs while addressing the long-term challenges ahead. With pro-growth policies and spending discipline, we will balance the budget in 2012, keep the tax burden low, and provide for our national security. And that will help make our country safer and more prosperous. Mr. Chairman, thank you for the time, and I look forward to your questions.

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FISCAL YEAR 2009

BUDGET

OF THE U.S. GOVERNMENT

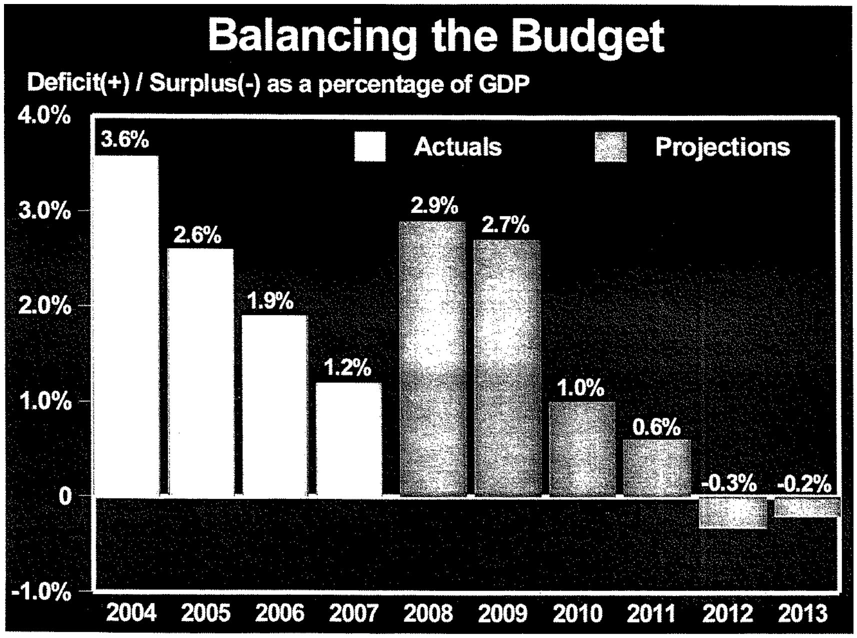
OFFICE OF MANAGEMENT AND BUDGET

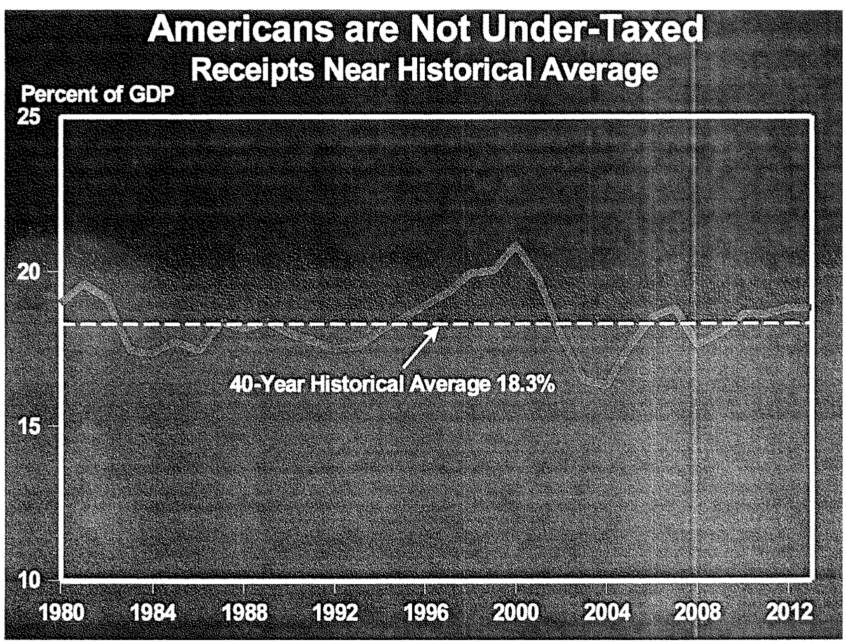
OMB Director
Jim Nussle

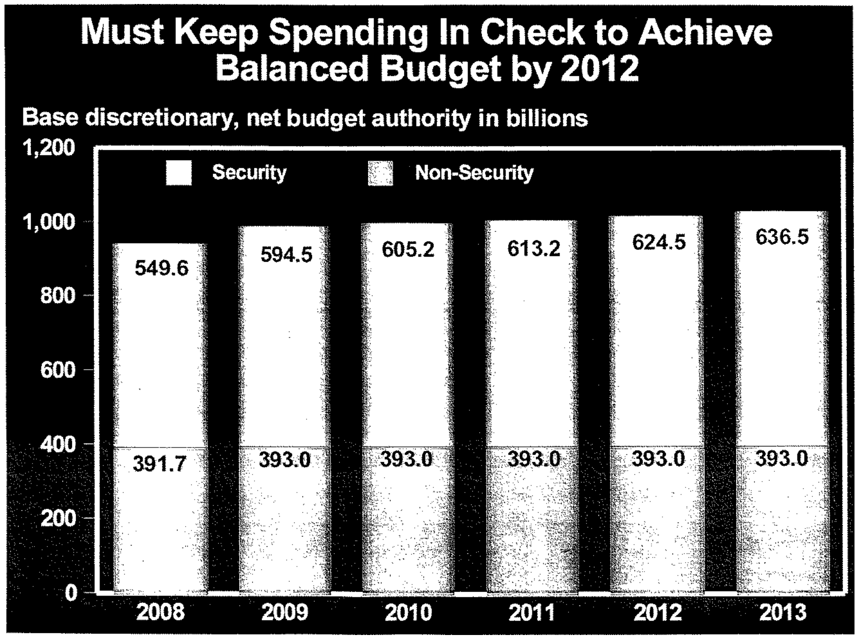
February 4, 2008

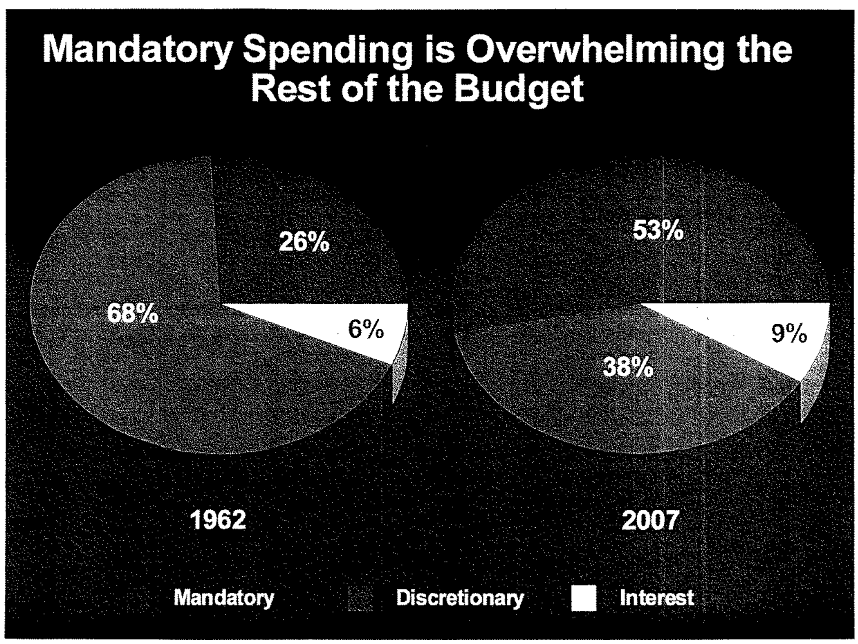
The President's FY09 Budget

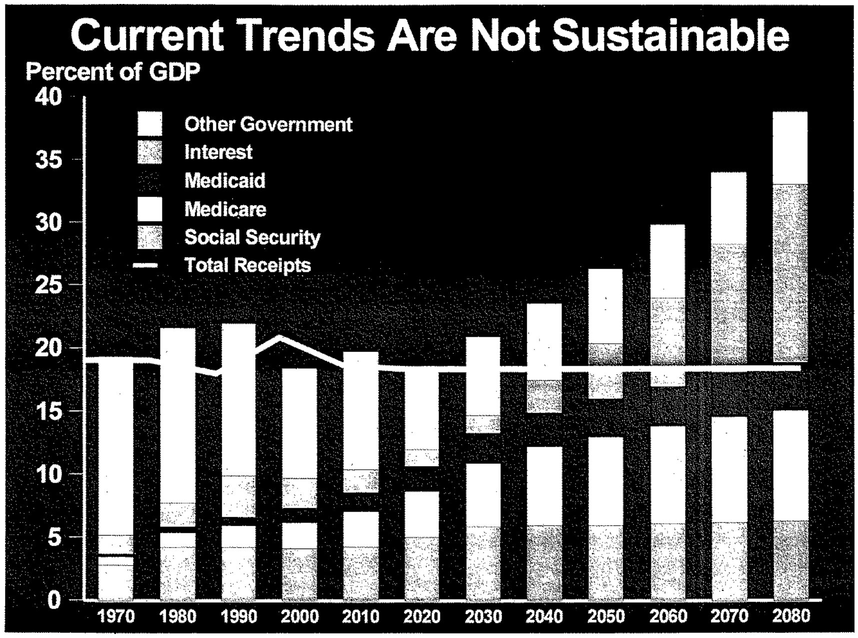
- *Addresses Immediate Economic Challenges*
- *Ensures Sustained Prosperity*
- *Keeps America Safe*
- *Balances the Budget by 2012*
- *Addresses the Long-term Spending Challenge*

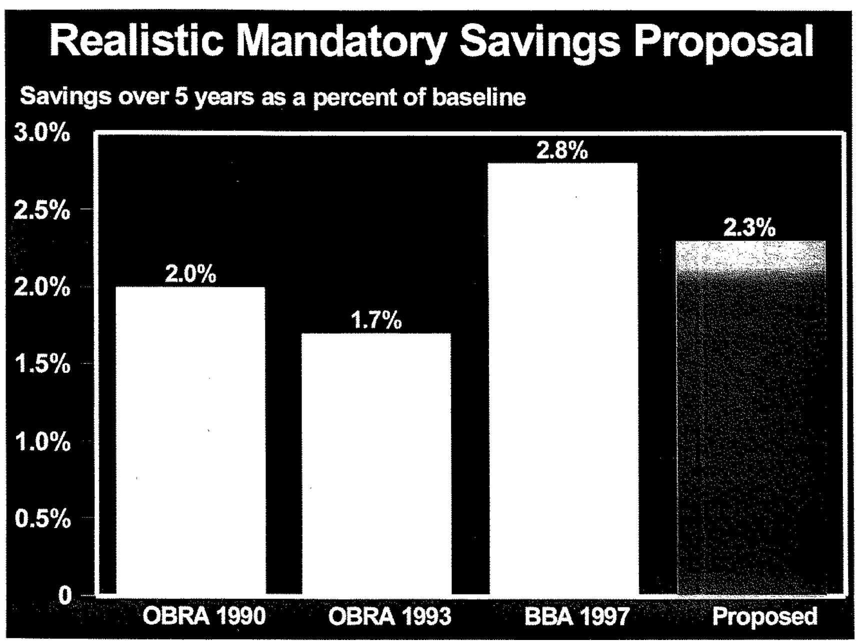

Balancing the Budget
Deficit(+) / Surplus(-) as a percentage of GDP
Actuals
Projections
4.0%
3.0%
2.0%
1.0%
0
-1.0%
3.6%
2.6%
1.9%
1.2%
2.9%
2.7%
1.0%
0.6%
-0.3%
-0.2%
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013

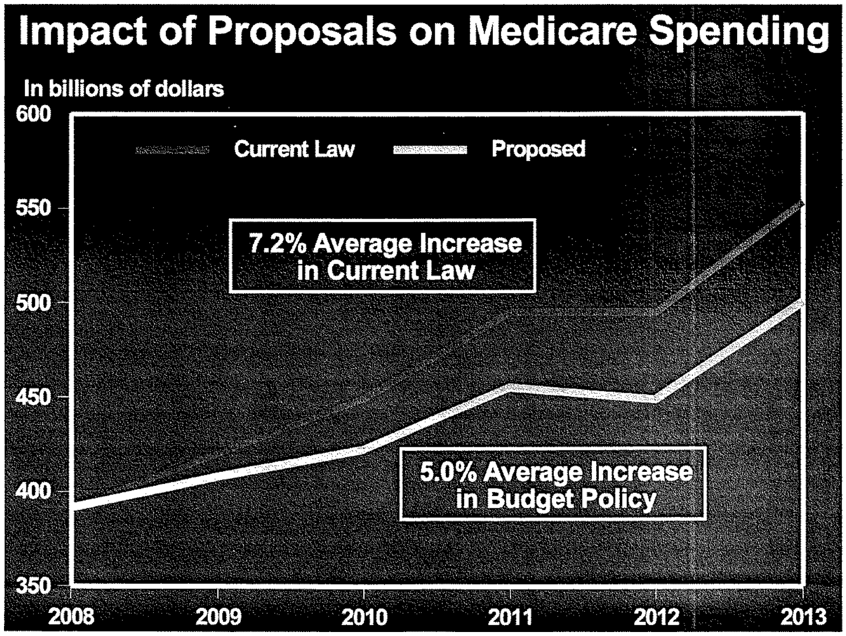

Americans are Not Under-Taxed
Receipts Near Historical Average
Percent of GDP
25
20
15
10
40-Year Historical Average 18.3%
1980
1984
1988
1992
1996
2000
2004
2008
2012


Must Keep Spending In Check to Achieve Balanced Budget by 2012
Base discretionary, net budget authority in billions
1,200
1,000
800
600
400
200
0
Security
Non-Security
549.6
594.5
605.2
613.2
624.5
636.5
391.7
393.0
393.0
393.0
393.0
393.0
2008
2009
2010
2011
2012
2013

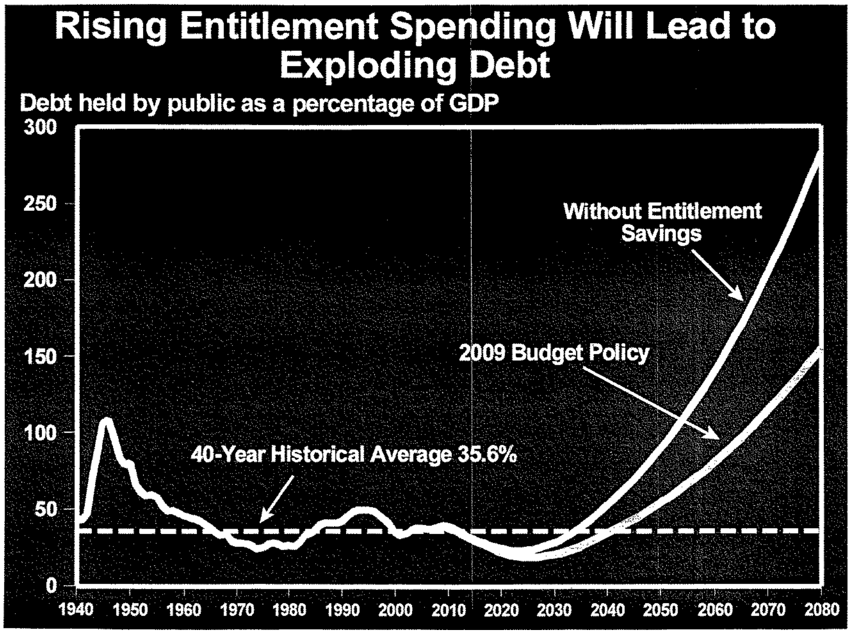

Mandatory Spending is Overwhelming the Rest of the Budget
26%
68%
6%
53%
9%
38%
1962
2007
Mandatory
Discretionary
Interest

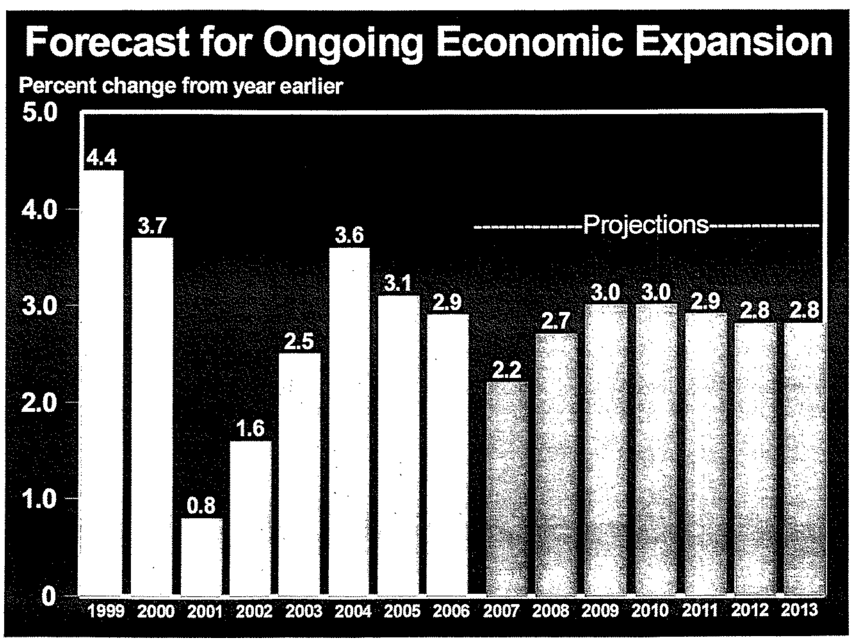

Current Trends Are Not Sustainable
Percent of GDP
40
35
30
25
20
15
10
5
0
Other Government
Interest
Medicaid
Medicare
Social Security
Total Receipts
1970
1980
1990
2000
2010
2020
2030
2040
2050
2060
2070
2080

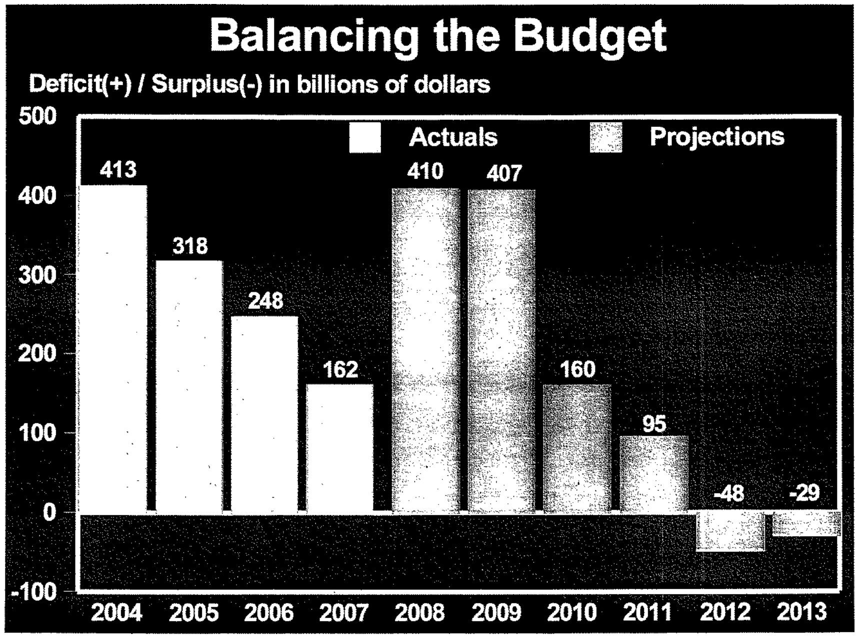

Realistic Mandatory Savings Proposal
Savings over 5 years as a percent of baseline
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0
2.0%
1.7%
2.8%
2.3%
OBRA 1990
OBRA 1993
BBA 1997
Proposed

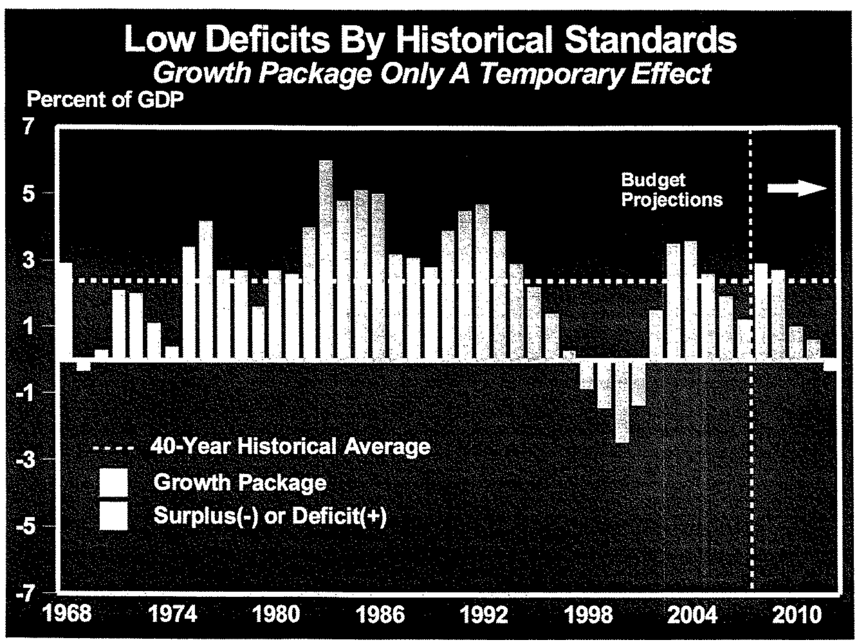


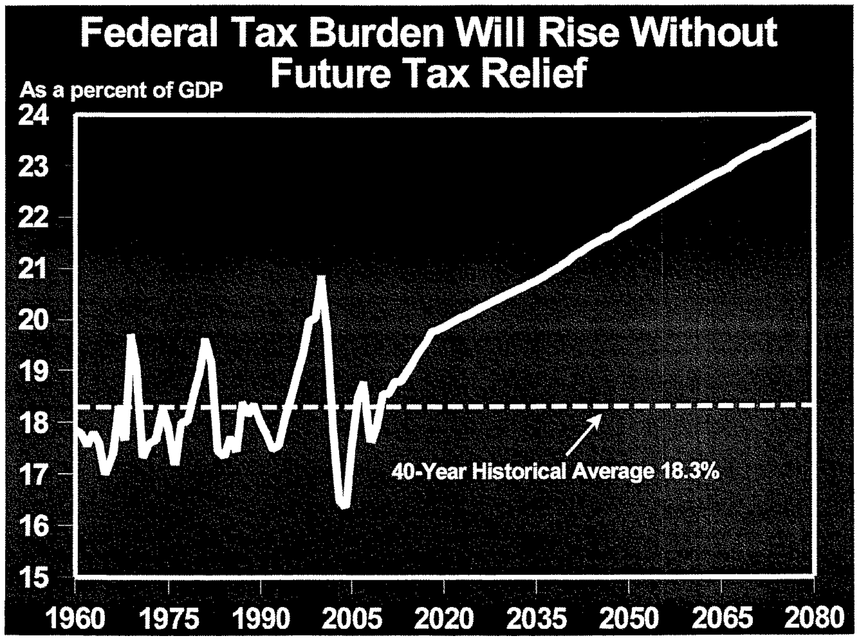
Background Charts

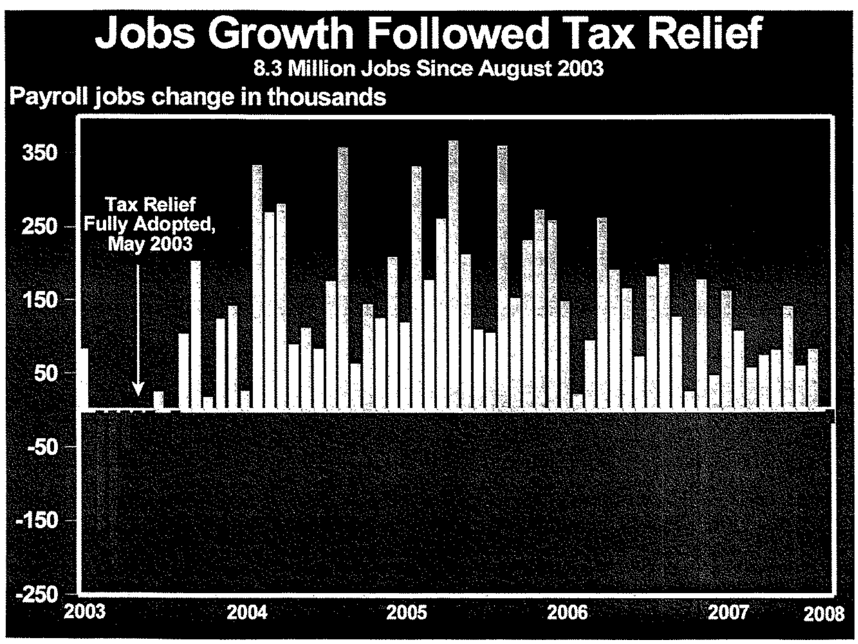

Rising Entitlement Spending Will Lead to Exploding Debt
Debt held by public as a percentage of GDP
300
250
200
150
100
50
0
Without Entitlement Savings
2009 Budget Policy
40-Year Historical Average 35.6%
1940 1950 1960 1970 1980 1990 2000 2010 2020 2030 2040 2050 2060 2070 2080

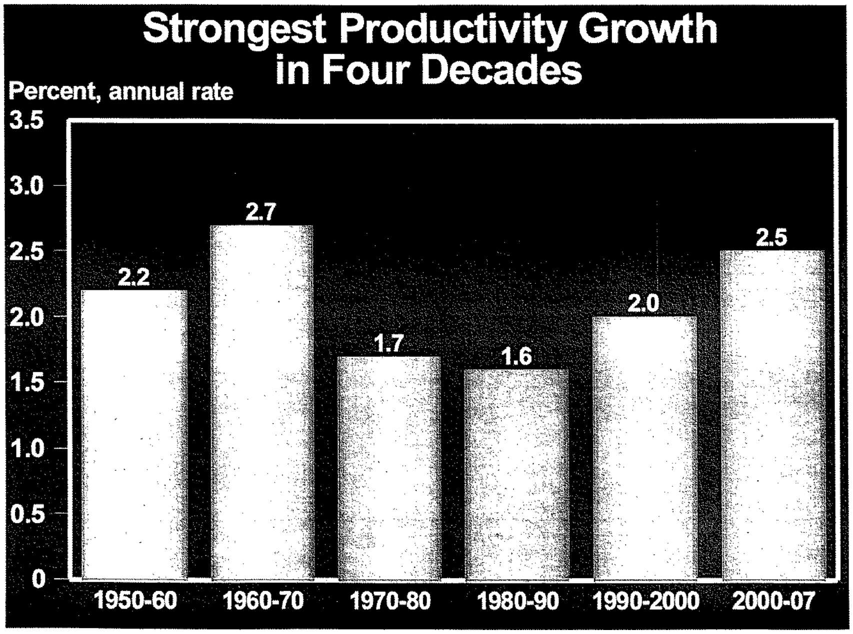

Forecast for Ongoing Economic Expansion
Percent change from year earlier
5.0
4.0
3.0
2.0
1.0
0
------------Projections------------
4.4
3.7
0.8
1.6
2.5
3.6
3.1
2.9
2.2
2.7
3.0
3.0
2.9
2.8
2.8
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013

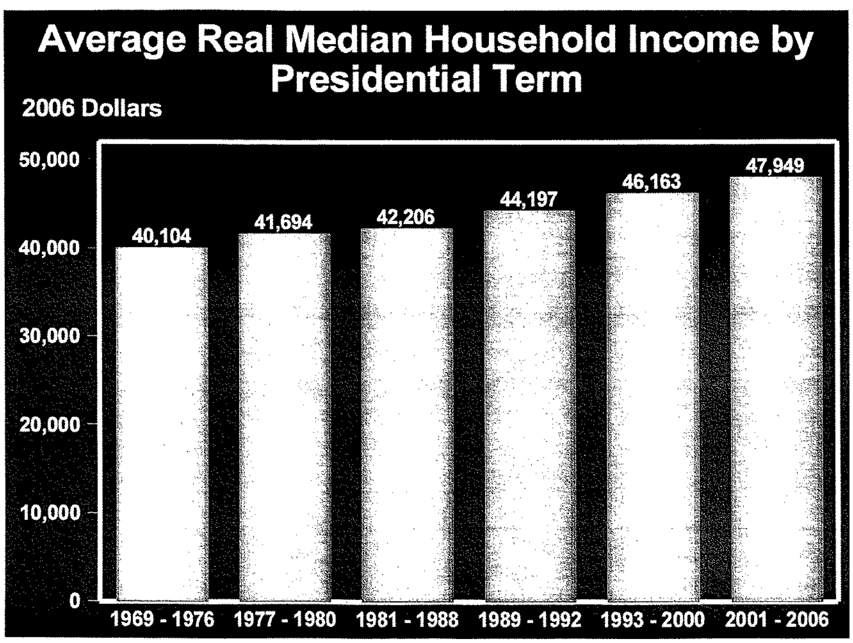

Balancing the Budget
Deficit(+) / Surplus(-) in billions of dollars
500
400
300
200
100
0
-100
Actuals
Projections
413
318
248
162
410
407
160
95
-48
-29
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013

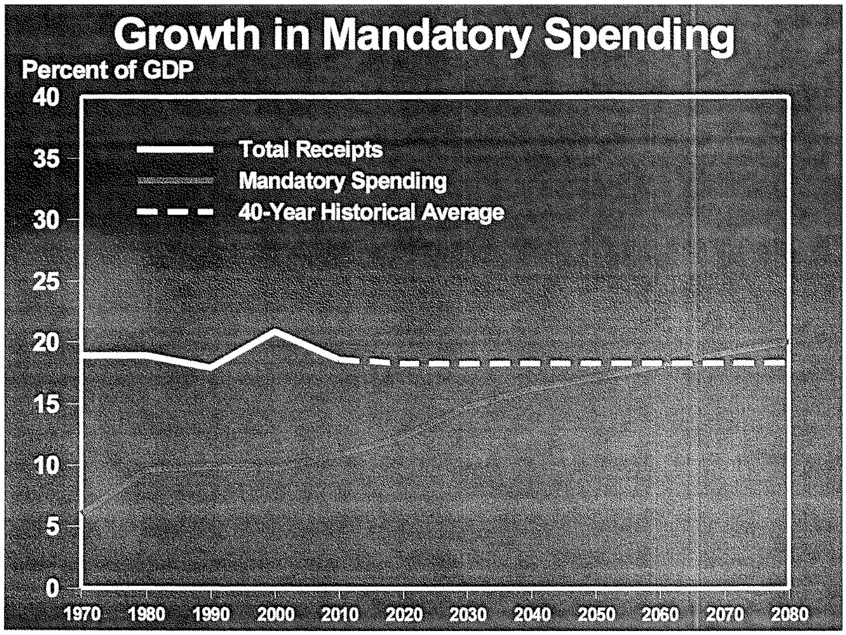

Low Deficits By Historical Standards
Growth Package Only A Temporary Effect
Percent of GDP
7
5
3
1
-1
-3
-5
-7
Budget Projections
40-Year Historical Average
Growth Package
Surplus(-) or Deficit(+)
1968
1974
1980
1986
1992
1998
2004
2010

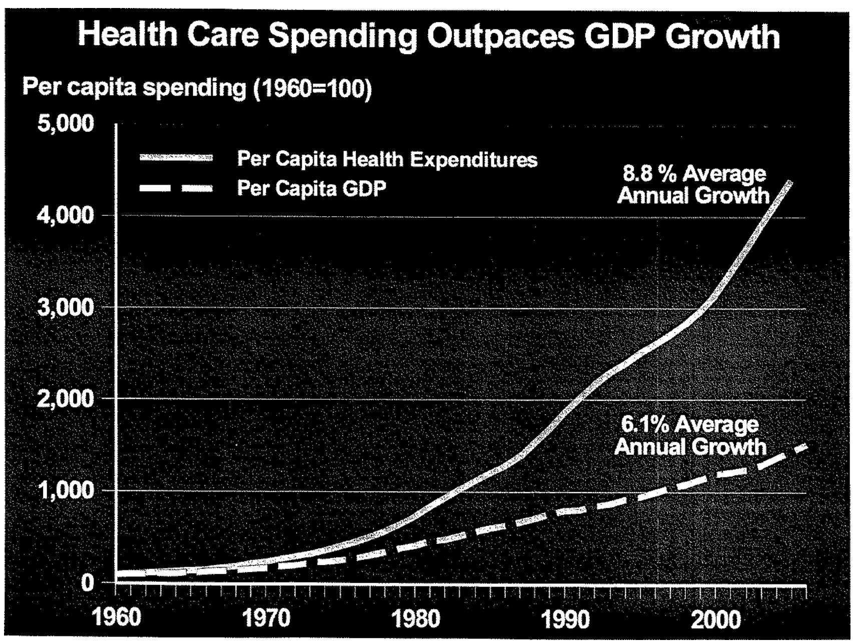

Federal Tax Burden Will Rise Without Future Tax Relief
As a percent of GDP
24
23
22
21
20
19
18
17
16
15
40-Year Historical Average 18.3%
1960
1975
1990
2005
2020
2035
2050
2065
2080

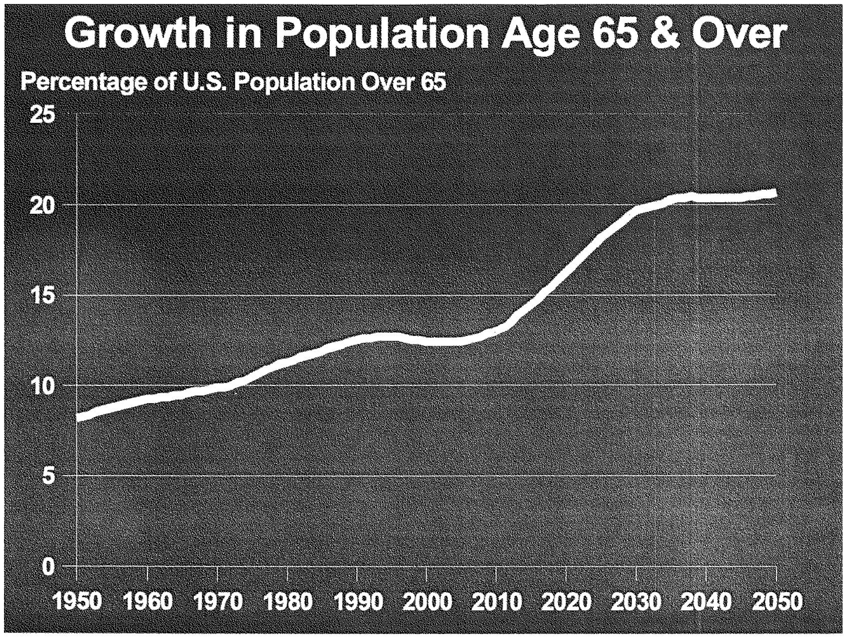

Jobs Growth Followed Tax Relief
8.3 Million Jobs Since August 2003
Payroll jobs change in thousands
350
250
150
50
-50
-150
-250
Tax Relief Fully Adopted, May 2003
2003
2004
2005
2006
2007
2008

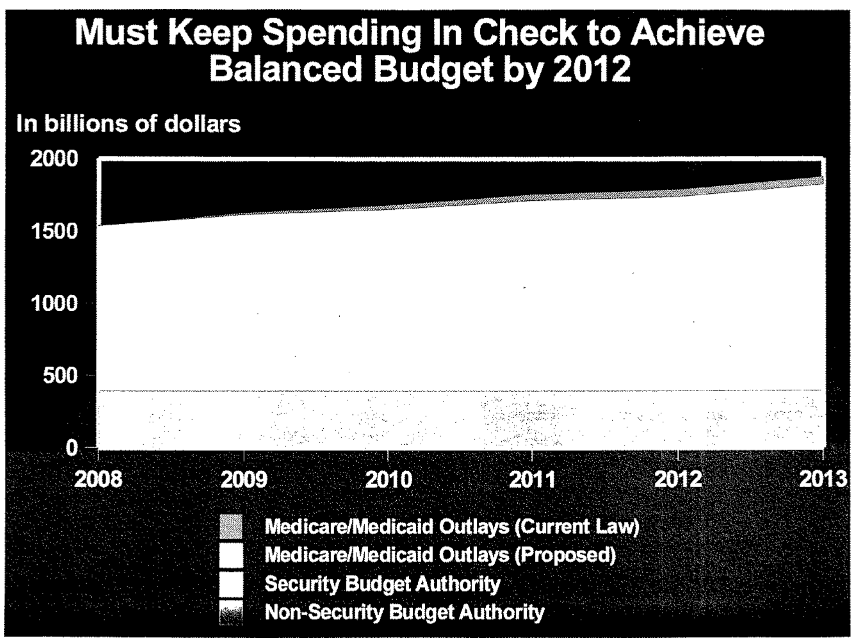

Strongest Productivity Growth in Four Decades
Percent, annual rate
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0
2.2
2.7
1.7
1.6
2.0
2.5
1950-60
1960-70
1970-80
1980-90
1990-2000
2000-07

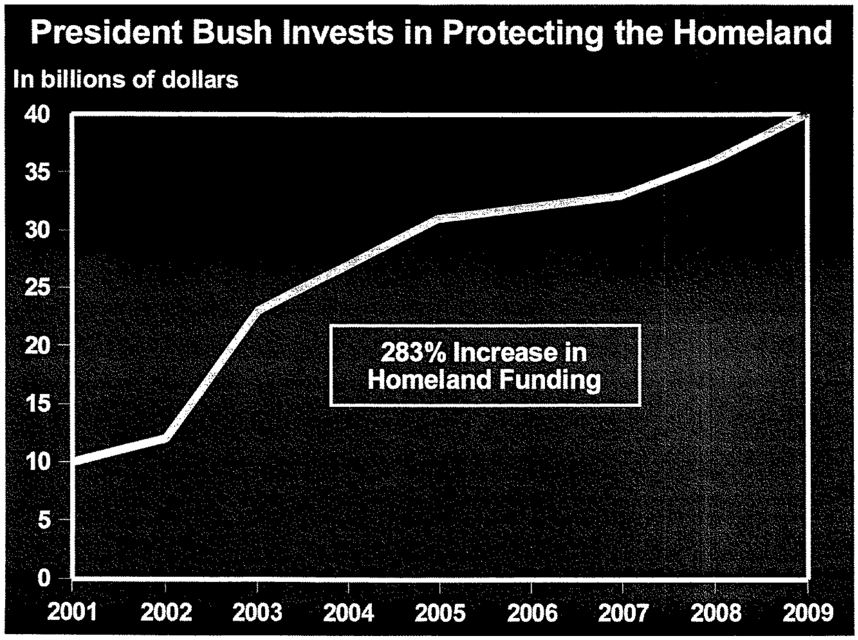

Average Real Median Household Income by Presidential Term
2006 Dollars
50,000
40,000
30,000
20,000
10,000
0
40,104
41,694
42,206
44,197
46,163
47,949
1969 - 1976
1977 - 1980
1981 - 1988
1989 - 1992
1993 - 2000
2001 - 2006

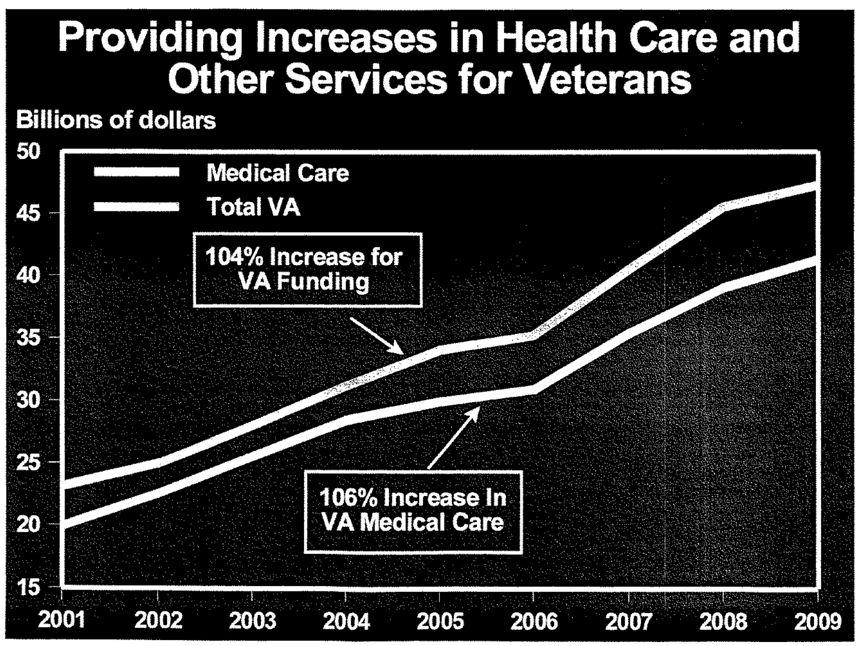

Growth in Mandatory Spending
Percent of GDP
40
35
30
25
20
15
10
5
0
Total Receipts
Mandatory Spending
40-Year Historical Average
1970
1980
1990
2000
2010
2020
2030
2040
2050
2060
2070
2080

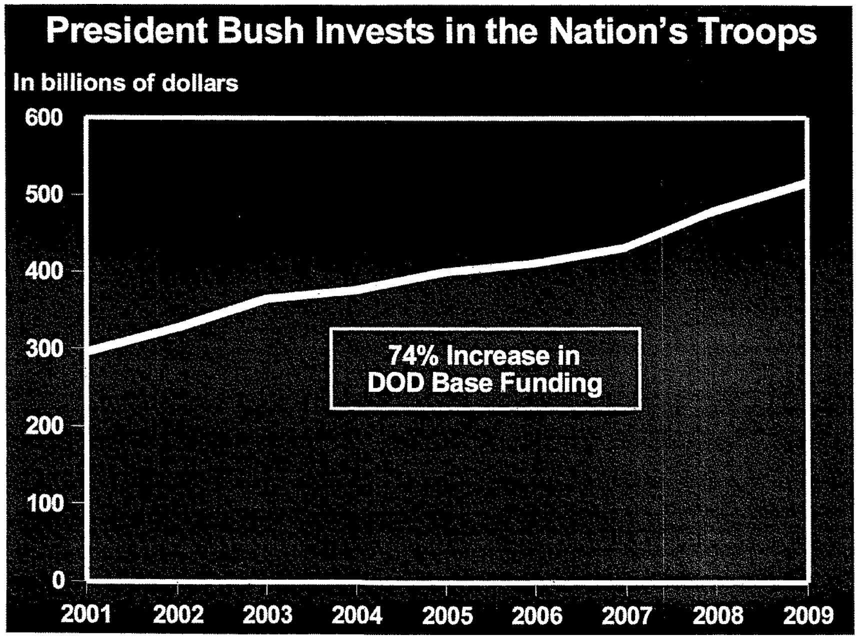

Health Care Spending Outpaces GDP Growth
Per capita spending (1960=100)
5,000
4,000
3,000
2,000
1,000
0
Per Capita Health Expenditures
Per Capita GDP
8.8 % Average Annual Growth
6.1% Average Annual Growth
1960
1970
1980
1990
2000


Growth in Population Age 65 & Over
Percentage of U.S. Population Over 65
25
20
15
10
5
0
1950 1960 1970 1980 1990 2000 2010 2020 2030 2040 2050


Must Keep Spending In Check to Achieve Balanced Budget by 2012
In billions of dollars
2000
1500
1000
500
0
2008 2009 2010 2011 2012 2013
Medicare/Medicaid Outlays (Current Law)
Medicare/Medicaid Outlays (Proposed)
Security Budget Authority
Non-Security Budget Authority

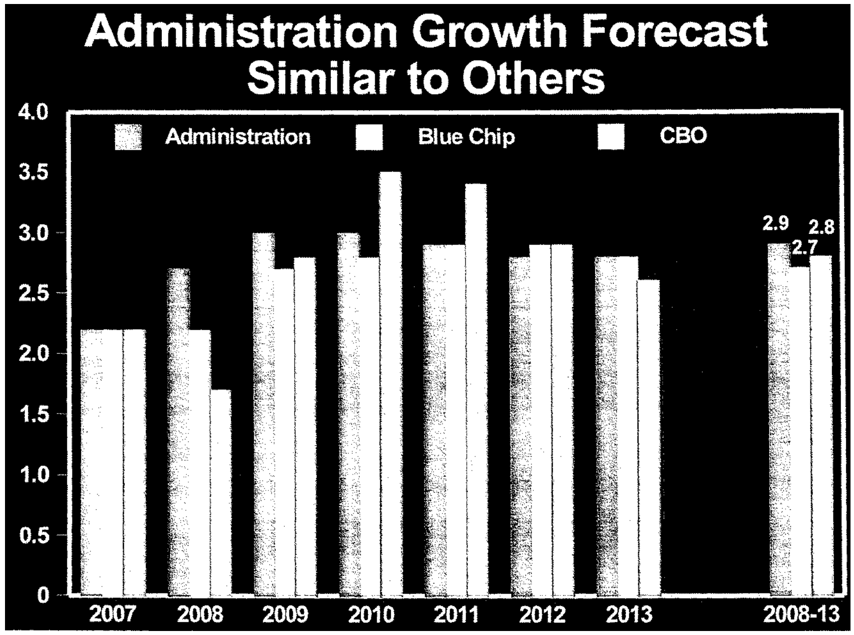

President Bush Invests in Protecting the Homeland
In billions of dollars
40
35
30
25
20
15
10
5
0
2001
2002
2003
2004
2005
2006
2007
2008
2009
283% Increase in Homeland Funding


Providing Increases in Health Care and Other Services for Veterans
Billions of dollars
50
45
40
35
30
25
20
15
Medical Care
Total VA
104% Increase for VA Funding
106% Increase In VA Medical Care
2001
2002
2003
2004
2005
2006
2007
2008
2009



Significantly Increased Funding for Key Low-Income Programs Since 2001

•Food Stamps	111%
•Pell Grants	92%
•Title 1	63%
•Supplemental Security Income	57%
•WIC Program	51%



Reasonable First Steps to Save Medicare

- **Bends the Growth Curve:**
  - Medicare still growing at a rate higher than inflation.
  - Slows Medicare's rate of growth from 7.2 percent to 5.0 percent.

- **Helps Address Long-Term Challenge:**
  - 75-year unfunded obligation in Medicare is $34 trillion.
  - This plan reduces it by nearly one-third.

Chairman CONRAD. Thank you, Director Nussle, for your opening statement.

Let me put up a chart that I used in my opening remarks that reflects what is happening to the debt. At the end of the President's first year, the debt of the United States was $5.8 trillion. We do not hold him responsible for the first year because he is working off the budget plan from the previous President. We are now at over $9 trillion of debt. At the end of the President's 8 years of his responsibility, we will be at over $10 trillion.

Is this a sustainable course?

Mr. NUSSLE. I believe that it is not a sustainable course, and, in fact, by my calculation about 50 percent of the debt that is added and that will continue to be added comes from our mandatory programs—not the programs that, unfortunately, we will talk about during the bulk of the appropriations process over the next 6 to 9 months but, rather, the programs that unless we actually take active effort on both our parts will continue to grow and grow out of control.

Chairman CONRAD. Director Nussle, this is what happens under the President's plan. Take the President's plan altogether, this is the result. You have testified it is not sustainable, and yet that is the President's proposal.

Mr. Nussle, it is to me not just irresponsible, it is wildly irresponsible to lay out this blueprint for the country's finances. It is just debt on top of debt.

What do you anticipate the debt will go up this year?

Mr. NUSSLE. Well, let me get that figure in front of me.

Chairman CONRAD. Gross debt, how much will that go up this year?

Mr. NUSSLE. Let me see if I have that here.

Gross Federal debt from 2008 to 2009 is $9.7 trillion to $10.4 trillion.

Chairman CONRAD. So that is $800 billion.

Mr. NUSSLE. From 2008 to 2009.

Chairman CONRAD. So, again, what is the increase then in the debt that you are forecasting under this plan? From 2008 to 2009 it is going to go up $800 billion?

Mr. NUSSLE. I think you have it about right. Yes, sir. But if I may, Mr. Chairman——

Chairman CONRAD. Well, let me just say this to you: $800 billion—how much has it gone up since this President took office?

Mr. NUSSLE. Well, what should we do about it? Let's do something about——

Chairman CONRAD. Well, this is your opportunity to have done something about it, sir. You have come——

Mr. NUSSLE. We do.

Chairman CONRAD. You do? You have increased it.

Mr. NUSSLE. No, sir.

Chairman CONRAD. The debt last—what did the debt go up last year?

Mr. NUSSLE. Let me tell you what the President——

Chairman CONRAD. How much did the debt go up last year?

Mr. NUSSLE. The President holds non-security discretionary spending at near a freeze, No. 1.

Chairman CONRAD. Yes, but that—let's talk about——

Mr. NUSSLE. No. 2——

Chairman CONRAD. That does not talk about the debt, sir. The debt. How much did the debt go up last year?

Mr. NUSSLE. Well, I am willing to consider proposals that will decrease discretionary spending and, for that matter, save much more money——

Chairman CONRAD. Well, that is good. Now you are working with one-sixth of the budget.

Mr. NUSSLE. OK——

Chairman CONRAD. One-sixth. I am talking about——

Mr. NUSSLE. Let's open up the mandatory spending——

Chairman CONRAD [continuing]. The final result. You want to focus on a sideshow.

Mr. NUSSLE. No, this——

Chairman CONRAD. I want to focus on the result. The result is the debt has done nothing under this President's watch but skyrocket, and the budget you bring before us today, sir, says let's increase it some more.

Mr. NUSSLE. All right. Let's open up mandatory spending.

Chairman CONRAD. And you say it is not—and it is not sustainable.

Mr. NUSSLE. Then let's open up mandatory spending.

Chairman CONRAD. Let's open up, sir, everything.

Mr. NUSSLE. OK.

Chairman CONRAD. Because you cannot just do it on one-sixth of the budget. You have to deal with all of it. You have to deal with the spending side. You have to deal with the revenue side. And what you all have done—you had your opportunity. This was the time to come forward with a plan. And your plan just explodes debt.

Now, let me go to the second point, if I can, which is on war cost. War cost in 2008 was roughly $200 billion. Do you agree with that?

Mr. NUSSLE. A hundred ninety—yes, ballpark, $196 billion requested.

Chairman CONRAD. It can be 196, 193, depending on what you include. In 2009, what has the President got in for war cost?

Mr. NUSSLE. $70 billion.

Chairman CONRAD. What does the President have for 2010?

Mr. NUSSLE. He has not proposed any additional spending for war cost in 2010.

Chairman CONRAD. So he has nothing. Let me just remind you of what you said when you were going through confirmation. You stated you had been the first Chairman to criticize the Administration on funding of the war. You further stated you believed the administration's last year had finally made greater progress on budgeting for the war and that you believe strongly that even though the estimate of multi-year war cost was uncertain, the correct answer was not zero. And yet as Budget Director, representing this administration—and I know you are here representing the President. This is not Jim Nussle's decision. But you bring before this Committee a budget that says the cost for the war in 2010 is going to be zero, when you said in the confirmation process if there is one thing that is clear, it is that the right answer is not zero.

Now, how can anybody take seriously this budget, which on one of the central costs before us is war cost, and you tell us the war cost is going to go down by two-thirds, how can anybody take that seriously?

Mr. NUSSLE. Well, I think part of the challenge here, Mr. Chairman, is that because it is not zero, we also know that it is currently——

Chairman CONRAD. But it is zero in your budget for 2010. There is a big zero.

Mr. NUSSLE. But, Mr. Chairman, Congress has still not delivered on the war funding for this current year. It is not zero for this year either.

Chairman CONRAD. No, no, but we are talking about the President's budget. You are here defending the President's budget. The President's budget says all of a sudden war cost is going to go down dramatically this year, and next year it is going to be zero.

Mr. NUSSLE. No, that is actually not what we are saying. What we are saying——

Chairman CONRAD. Well, that is what is in your budget.

Mr. NUSSLE. Well, let me—if I may explain.

Chairman CONRAD. Please.

Mr. NUSSLE. May I explain? The President proposes $70 billion for a couple of reasons. First of all, Congress has still not delivered on, I believe, their responsibility to fund the troops in the field who are there now. We know that money is necessary. We know that the remainder is not zero——

Chairman CONRAD. So is the President telling us, Director Nussle, that what Congress should approve is $70 billion for the war cost in 2009? Because that is what is in the budget.

Mr. NUSSLE. As a downpayment, that would be the important amount to——

Chairman CONRAD. But is that the full amount that the President believes would be the responsible thing for Congress to do in 2009, to budget $70 billion?

Mr. NUSSLE. If I may conclude, I would be happy to give you the rationale behind it.

Chairman CONRAD. There does not appear to be a rationale. I do not know how you can say there is a rationale when the war cost last year was almost $200 billion, and in the President's budget he is saying for this year it is $70 billion——

Mr. NUSSLE. If the war costs last year were $200 billion, how come we do not have the money yet?

Chairman CONRAD. Why don't you have the money yet?

Mr. NUSSLE. Yes. Why don't we have the money yet? When is Congress going to send us——

Chairman CONRAD. How much have you got?

Mr. NUSSLE [continuing]. The money?

Chairman CONRAD. How much have you got?

Mr. NUSSLE. When is Congress going to send us the rest of the——

Chairman CONRAD. How much money have you got——

Mr. NUSSLE [continuing]. Billion dollars?

Chairman CONRAD. How much money has been provided?

Mr. NUSSLE. Barely $87 billion. So when are we going to get the rest of the funding for the troops in the field?

Chairman CONRAD. Well, the President is asking this year——

Mr. NUSSLE. It is difficult to budget for next year or for 2 years down the line if you have not paid your bills for this year. How do you do that? You have to——

Chairman CONRAD. Well, I will tell you——

Mr. NUSSLE [continuing]. Pay your bills for this year.

Chairman CONRAD [continuing]. If you do not budget the——

Mr. NUSSLE. We know the bills are coming due, and it is not zero.

Chairman CONRAD. Yes, well, in the President's budget for 2010 it is zero.

Mr. NUSSLE. Well, we do not know——

Chairman CONRAD. And this year, the President is saying——

Mr. NUSSLE [continuing]. What it will be in 2010.

Chairman CONRAD. This is not Congress' document, sir. This is your document. Your document is telling this Congress that the amount of money you intend to spend on the war in this year, $70 billion.

Mr. NUSSLE. Well, in 2009——

Chairman CONRAD. That is not credible.

Mr. NUSSLE. Well, we believe that in——

Chairman CONRAD. And 2010, you are going to spend zero? That is what is in your budget, in your document. Not a congressional document, your document. And it is not credible. It is not credible. I do not know of anyone that would consider it credible.

I have used my time. We welcome Senator Gregg.

Senator GREGG. Well, I apologize to the Director. Unfortunately, I had some airplane problems getting in here. But since I was not here in the allotted time, and since it is our tradition to recognize people at their point of arrival, I would yield to whoever on my side was next.

Chairman CONRAD. Senator Allard?

Senator ALLARD. I think Senator Bunning was here before me, but do you want me to go?

Chairman CONRAD. Senator Bunning made an opening statement, but if you would like to defer, we are certainly glad to have Senator Bunning——

Senator BUNNING. I would like to followup on some of the questions that have been asked.

Director Nussle, because of the unsustainable growth in the entitlements, basically Medicare, Medicaid, Social Security, and the other entitlement programs that we have, we have been told time and time again that we cannot afford to make the 2001 and 2003 tax cuts permanent. The Chairman of the Ways and Means Committee also was so troubled by the looming deficit that he proposed an extraordinary 4-percent surtax on gross income on behalf of his party last year. Even so, in your budget you stubbornly cling to the idea—so out of tune with conventional wisdom here in Washington—that we should not increase taxes or allow the 2001 and 2003 tax cuts.

Can you explain to me why the conventional wisdom is so wrong?

Mr. NUSSLE. Well, I guess first of all I would say to the Senator that the President believes making these tax cuts permanent is important for the economy, No. 1, in order to promote economic growth, sustained for the future.

No. 2, that there are 116 million taxpayers across the country who would see their taxes go up an average of about $1,800 a person if, in fact, those tax cuts were not made permanent and would all of a sudden come back as a looming tax increase.

Third, I think you can see that the challenge over the course of the last number of years has not been because of lack of revenue in Washington. The revenue growth has been strong and sustained. It is a matter of not dealing with the spending challenges.

I doubt seriously that I will hear anyone go below the President's budget today. There may be a few who may propose one or two programs, but my bet or my guess is that there will not be a cry to go higher than $208 billion in mandatory spending savings or lower than the President's number with regard to discretionary spending. The spending is out of control, and we have to control spending. And, yes, the debt is a challenge, yes, the deficit is a challenge, yes, we have to deal with wars, yes, we have to deal with the current economic challenge. But I can tell you that it makes it harder to increase spending at that same time. It makes it more challenging if you increase and do not deal with the entitlement spending at that same time. And that is why the President has proposed as part of this budget an attempt to begin to tackle both the spending and the growth of entitlements.

Senator BUNNING. Let me get to one of the questions that the Chairman was hammering at. Last year, the President requested $196.4 billion for combat operations in Iraq and Afghanistan for fiscal year 2008. Congress approved less than half of that, about $70 billion for the general operation and $16.8 billion for mine-resistant, ambush protection vehicles.

What effect has Congress' piecemealing funding of the war had on this year's Department of Defense baseline budget? Thanks to increased politicalization of the Iraqi war by some of my colleagues, do you anticipate that the Department of Defense will become increasingly reluctant to streamline more of their anticipated costs in the baseline budget as opposed to emergency supplementals?

Mr. NUSSLE. Well, it does make it very difficult, Senator, for the Department of Defense to operate on a piecemeal approach. In fact, this year, it not only did not get the war funding on time for our troops in the field, but it also had to live within its base budget and supply not only the base services from the Department of Defense but also fund the war at the same time. It is the reason why I think the President has made a decision not to send a detailed supplemental. We sent a detailed supplemental last year. It did not work out so well, for a couple of reasons. First, Congress did not consider it, still has left about $108 billion left to consider. We know that the number is not zero. We know it is at least $108 billion, No. 1.

No. 2, even after we sent up the detailed request a year ago, it changed. It changed after the Petraeus testimony and report from the commanders in the field as to what was happening and what needed to happen. And so the strategy changed; therefore, the funding changed.

Third, it also responds to a need not to make a decision and tie the hands of our commanders until General Petraeus has an opportunity to come back and testify yet again this year, most likely in March or early April.

And then, finally, funding the war at $70 billion in 2009, yes, we know that is not the full amount, but we do not know the full amount. And rather than tying the hands of our next Commander-in-Chief who can make the decision about what that strategy ought to be, we decided to fund it to a reasonable time after this President has left office, to give that flexibility to the next Commander-in-Chief to make the decision about not only what the strategy should be but also what the funding level should be.

Senator BUNNING. I will get back—my time has expired, but I wanted to get back to the mandatory spending. Thank you.

Chairman CONRAD. Thank you, Senator.

Senator Sanders?

Senator SANDERS. Thank you very much, Mr. Chairman. Jim, thanks for being with us today.

I strongly concur with Senator Conrad's comments about what a disastrous budget this is and the very negative impact that it will have on the future of this country and our kids and our grandchildren. But I want to take this discussion a little bit away from the issue of the national debt, as important as that is, and the deficit to talk about what this budget means to ordinary human beings and to try to understand the moral values that have been placed in this budget, or I perhaps should say the lack of moral values. Senator Bunning a moment ago talked about tax burdens in this country, but let me talk about who pays the taxes, who earns the money in this country.

Mr. Director, as I am sure you are aware, the United States has by far the most unequal distribution of income and wealth of any major country on Earth, and increasingly we are looking more like Brazil and Mexico than we are like Europe and Scandinavia and other industrialized countries.

When Senator Conrad talks about legacy for this President, what we should be aware of, since President Bush has been in office, 5 million more people have slipped into poverty, the middle class has shrunk, median family income has declined by over $1,000. Eight million Americans have lost their health insurance. Three million Americans have lost their pensions. And, yes, some people have done very well, and those are the people on top. And of all of the statistics that we throw out around here, I want to throw out one statistic, and I want to get your comment on it, Director Nussle.

According to the latest reports from the IRS, the wealthiest one-tenth of 1 percent—one-tenth of 1 percent; 300,000 men, women, and children—now earn more income than do the bottom 150 million Americans. One-tenth of 1 percent, more income than 50 percent of the American people, and that gap is growing wider.

What is your sense about what it means to the future of this country and economic justice that we have such an unequal distribution of income and wealth?

Mr. NUSSLE. Well, first of all, Mr. Sanders, Senator, I have not thought about that question. I will——

Senator SANDERS. Don't you think it is a question that we should think about?

Mr. NUSSLE. I will give it some thought. I have given some thought to tax distribution and tax reform, and I would agree with you that our Tax Code needs to be reformed, and there are problems within our Tax Code that need to be rooted out. We have the top 1 percent of the Tax Code of the people paying taxes in this country pay 39 percent of all of the taxes. The top 5 percent pay 59 percent——

Senator SANDERS. But I have just given you——

Mr. NUSSLE [continuing]. Of all of the taxes.

Senator SANDERS [continuing]. An example of the fact that the wealthiest one-tenth of 1 percent earn more income than do the bottom 50 percent.

Mr. NUSSLE. But they also pay taxes, don't they?

Senator SANDERS. Of course they pay taxes, but not proportionate to what they earn.

Let me ask you another question, a moral question. Let's forget about being in the U.S. Senate. Let's get down to basic morality. In your budget, you propose over $700 billion in tax breaks for the wealthiest three-tenths of 1 percent—$700 billion in tax breaks for millionaires and billionaires at the same time as you want to eliminate, among other programs, the Low-Income Weatherization Assistance Program, as you want to make massive cuts in the LIHEAP program, which you are very familiar with. Well, in Vermont, and all over this country—in Iowa, I dare say—it is getting cold. Older people cannot afford to keep their homes warm.

What is the moral justification for giving over $700 billion in tax breaks to millionaires and billionaires and then cut back on programs which keep people warm, which provide health care for desperate people, and which provide many other basic necessities? Give me the moral justification for that.

Mr. NUSSLE. The tax cuts that the President proposed in 2001 and 2003 are distributed much further than the top one-tenth of——

Senator SANDERS. But I have given you an example of how it impacts the top three-tenths of 1 percent, $700 billion. Tell me why the richest people in this country need tax breaks when poverty is increasing.

Mr. NUSSLE. I would guess under that that you received a tax cut.

Senator SANDERS. I may have. But I am talking about millionaires and billionaires. And I do not need a tax break. You do not need a tax break. Tell me why should the richest people——

Mr. NUSSLE. Why don't I need a tax break?

Senator SANDERS. Because you are doing well and other people are going hungry in America, and people are—the middle class is shrinking.

Mr. NUSSLE. And so it is my responsibility——

Senator SANDERS. I am not talking about you. I am talking about millionaires and billionaires.

Mr. NUSSLE. Then take anyone as a taxpayer——

Senator SANDERS. I will give you an example. You want to repeal the estate tax. Is that correct? All of the benefits of the estate tax go to the richest three-tenths of 1 percent. If the estate tax is completely repealed, the Walton family, which is worth $80 billion, which owns Wal-Marts, will get over $30 billion in tax relief. Do you think the Walton family needs $30 billion in tax relief when you are cutting back on health care, when you are cutting back on programs that feed hungry people, hungry senior citizens? Let me hear the moral—your administration talks a lot about morality and family values. Now, tell me about the morality of giving tax breaks to the Walton family worth $80 billion and cutting back on the needs of the most desperate people. And throw in there a justification for raising the fees for our veterans for getting into the VA hospital, significantly increasing them, which will drive veterans off of the VA.

Mr. NUSSLE. Well, these are the veterans who have incomes that are higher than——

Senator SANDERS. Yes, $27,000 a year. In other words, I want to hear a simple—Jim, man to man, man to man, you tell me about tax breaks for billionaires and cutting back on the needs of veterans and low-income people.

Mr. NUSSLE. First of all, I do not know what the tax bill is for the Walton family. I do not know how much they pay. My——

Senator SANDERS. My estimate is they will save $30 billion through the repeal of the estate tax. Tell me why they need a $30 billion——

Mr. NUSSLE. What do they do with that $30 billion then?

Senator SANDERS. I have no idea, but I will tell you——

Mr. NUSSLE. But my bet is that they are quite philanthropic, as are many in that situation, and, again, I do not have personal knowledge about what they do with it, but they earned it——

Senator SANDERS. I am glad you are concerned about the Walton family. Some of us are concerned about——

Mr. NUSSLE. Well, no, you brought up the Walton family. I do not even know them. I have never met them.

Senator SANDERS. But you are worried, your Administration is protecting their——

Mr. NUSSLE. I am not worried—I do not think the Waltons would tell you that we ought to be worried about them either.

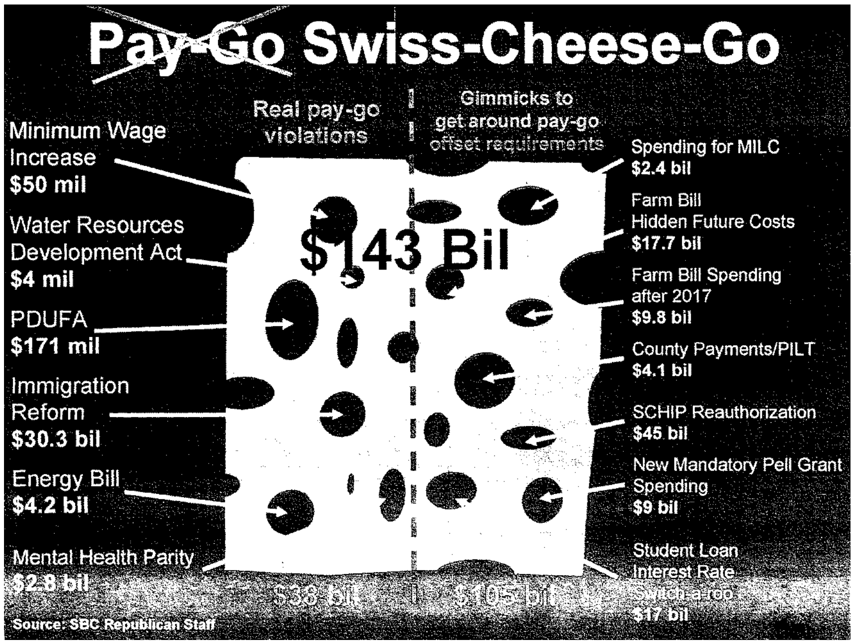
Senator SANDERS. Good. Probably not.

Chairman CONRAD. Senator Gregg.

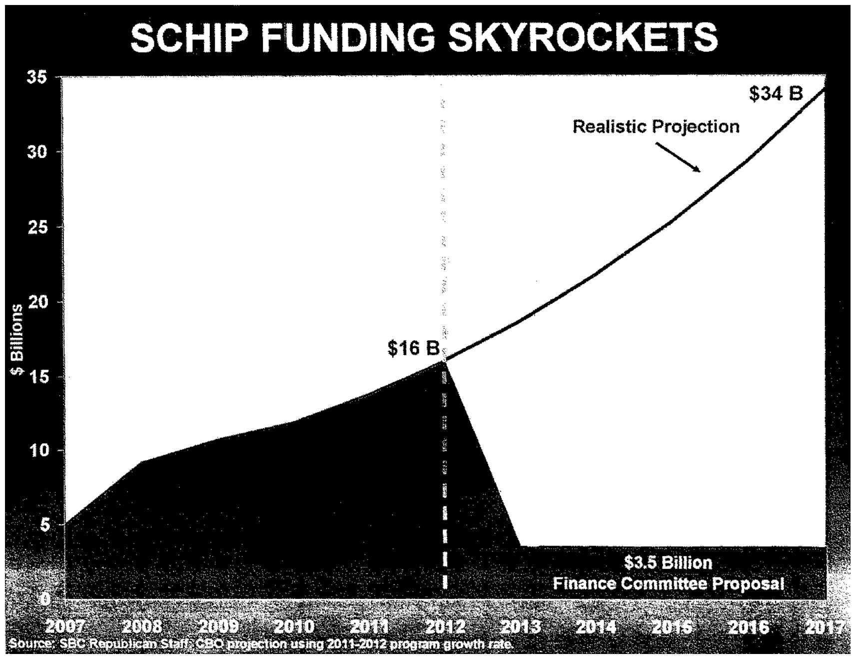
OPENING STATEMENT OF SENATOR JUDD GREGG

Senator GREGG. Mr. Chairman, if I might, just as a point of personal privilege, take a couple minutes here and then yield to Senator Allard and later I will come back and reclaim the balance of my time. But I do think it is important on this tax policy issue, because Senator Sanders in his usual eloquence has raised the issue, presenting the Vermont approach to it. Let me present the New Hampshire approach to it.

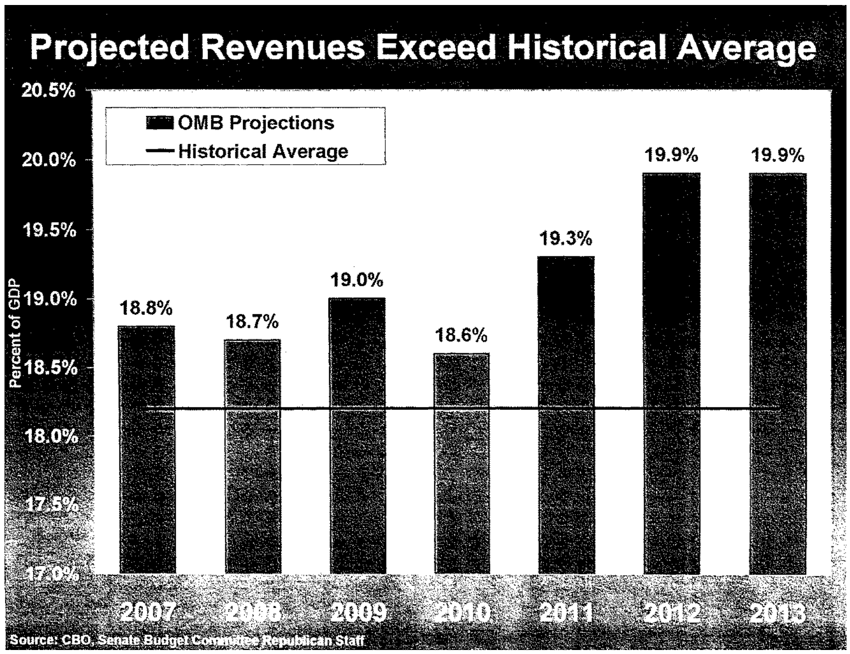
If you could put up the first chart, under the tax policy which we presently have today, we are generating more in revenues than we have historically generated. We are up to about 18.7 percent of gross national product is now coming in in revenues as compared to 18.2 percent of gross national product.



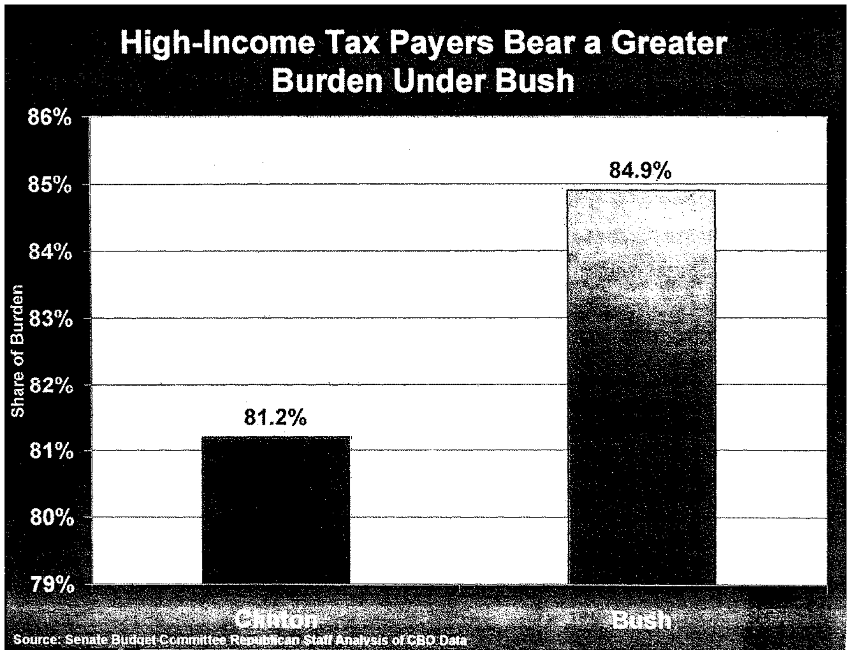
Please put up the second chart. And the highest 20 percent of taxpayers in this country, income taxpayers today are paying more in taxes as a percentage of the total burden than they were during the Clinton administration. In other words, the top end of American income people are paying more in taxes as a percentage of the total burden of our Federal tax burden than the lower—than they were under the Clinton time.

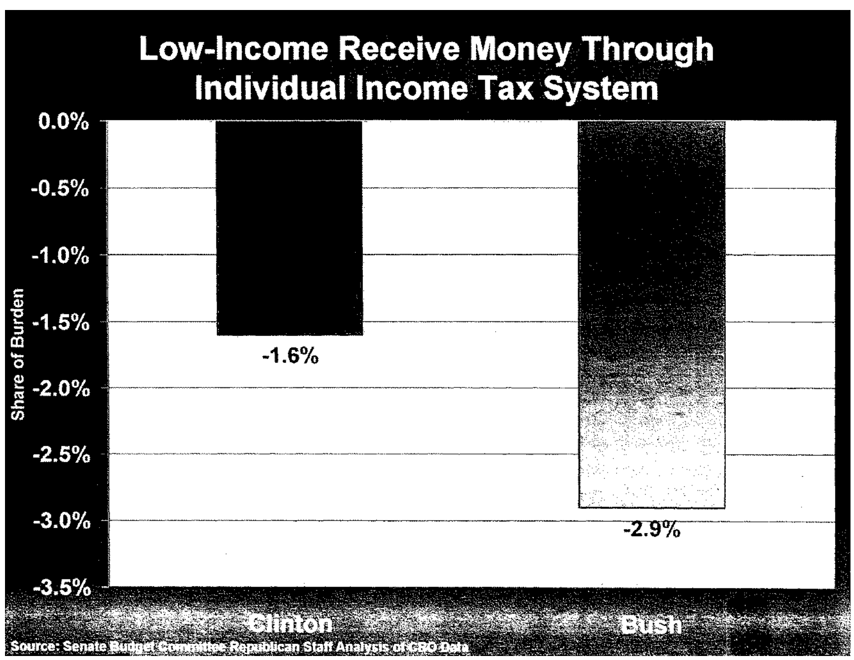


If you will go to the next chart? And presently today the bottom 40 percent of people who have earned income in this country are getting more back—most of them do not pay income taxes. They get an earned income tax credit. They are getting more back in tax benefit through the EITC, almost twice as much as they got under the Clinton period.



So we now have a tax law which, first, generates more revenue—more revenue—than has historically been generated for the Federal Government; second, taxes people at the high income and generates more revenue from high-income individuals; and, third, gives back more income to people in the lower-income brackets. That is called progressivity. It is also called a tax policy that works. Why does it work? Human nature. Human nature. You give people a reasonable tax rate, which is what we have done; you give people a reason to go out and be productive, to take that risk, to be the entrepreneur, to create that new job, they create economic activity. Economic activity does one very big thing. It creates jobs for Americans. It does a second very big thing. It creates a revenue for the Federal Government. And that is what our tax policy has done under this administration.


High-Income Tax Payers Bear a Greater Burden Under Bush
86%
85%
84%
83%
82%
81%
80%
79%
Share of Burden
84.9%
81.2%
Clinton
Bush
Source: Senate Budget Committee Republican Staff Analysis of CBO Data


Low-Income Receive Money Through Individual Income Tax System
0.0%
-0.5%
-1.0%
-1.5%
-2.0%
-2.5%
-3.0%
-3.5%
Share of Burden
-1.6%
-2.9%
Clinton
Bush
Source: Senate Budget Committee Republican Staff Analysis of CBO Data

So I happen to disagree with the Senator from Vermont. We do disagree. That is why he lives in Vermont and I live in New Hampshire. We have the lowest tax burden per capita in the country. They have one of the highest. That is just a fundamental difference.

Senator SANDERS. Will my friend from New Hampshire yield for a brief second?

Senator GREGG. Not on my time.

Senator ALLARD. I want to reclaim my time. I thank you very much.

Senator GREGG. Not on my time, but I am sure you will get another second. That was my interlude.

Senator ALLARD. And I also might note, you have a lot of people immigrating to New Hampshire, too. I assume that has to do with the lower tax burden.

Senator GREGG. Yes, and we have a few people who come over from Vermont occasionally to buy a bottle of liquor, and we appreciate that.

Senator ALLARD. Well, thank you for that point of interest because that is the point I wanted to make, Senator Gregg: we have seen revenues increase not only at the Federal level with the tax cuts of 2001 and 2003, but we have also seen revenues increase at the State level. And, of course, when you see that happening, there is money available to help to take care of the social needs that my friend from Vermont had talked about.

I have a couple questions I would like to discuss with you. Obviously, we have had a problem with the debt, total debt, no matter which administration has been in power. That is because we have to do some major reform as far as mandatory spending is concerned, and I think you agree with that. You explained that, Mr. Nussle.

I notice in balancing the budget that we see a decrease in spending under current law. Under current law, there is a 7.2-percent average increase, and then under the policy proposed in the budget, there is a 5-percent increase in budget policy on the Medicare spending section.

Can you explain to me what policies those were that were put in place that drove that spending down on Medicare?

Mr. NUSSLE. Well, there are a number of them that we are proposing. Many of them come from MedPAC, examples of policies that have been tried and true for many, many years, some of which were tried back in 1997 as well in a bipartisan way, and some are just a matter of allowing current law to continue.

For instance, with regard to the doctors, we allow current law to just continue, and there is a natural decline in the amount of reimbursement for physicians. We freeze providers for 3 years. We establish competitive bidding for lab work. We do a number of things with regard to Medicare, encouraging hospitals under Medicare to be more efficient and productive and continue to promote quality and information technology, to root out errors and mistakes. So there are a number of things that we have done to build to this $178 billion figure, but we stand ready to work with Congress, if Congress is ready to work in a bipartisan way similar to 1997, to look at other reforms and ways that we can curb the growth in Medicare.

We want Medicare to grow. Medicare will continue to grow even under the President's policy at 5 percent. It just will not grow at the current, what we believe is an unsustainable rate at 7.2 percent, and that is the basis for that.

Senator ALLARD. And then the challenge that we have now before the Congress is to either decide to support your suggestions as far as holding down spending or Medicare, or to come up with our own plan. And I commend you for coming up with a plan in order to reduce spending in Medicare. I think the burden on us now as Members of Congress is to look at your plan and, if we have a better idea, make it better—if we want to cut it more, look at those options.

Mr. NUSSLE. Yes, there is no question that the President has to be the first one out of the foxhole and show his cards on exactly what he wants to do. The question is: If, in fact, the—if debt is the threat, if the deficit is a concern, then we can control more spending. If the debt is a threat, we can go further with regard to our mandatory programs. You know, these are things that we can certainly consider, but, again, I have not heard anyone yet in any of the press statements suggest that we did not go far enough in cutting spending or we did not go far enough in reforming entitlements. In fact, most have said as much as—even today, we heard that the Majority Leader of the Senate suggested we are not even going to do appropriations this year. We are going to wait for a better deal under a President who might be willing to spend more. Or we are going to not worry about what happens with the entitlement spending this year because it is an election year.

Well, we all know, I mean, friends, it is always an election year in Washington. We know that. I mean, my goodness, I think we have come to realize that over the terms of our time and careers here.

So it is always difficult to make these changes, but we have to do it if we are going to bend the growth curve and get this growth under control.

Senator ALLARD. Mr. Chairman, I have one more question if I might.

If you look at the chart here on balancing the budget, it is deficits/surpluses as a percentage of gross domestic product. We see a jump in the deficit between 2007 and 2008. We see a decline in deficits 2004 to 2007, from 3.6 percent down to 1.2 percent. And then in the 2008 budget, we see a jump in the deficit to 2.9 percent. Can you explain that jump to us, please?

Mr. NUSSLE. From 2008 to 2009?

Senator ALLARD. 2007 to 2008.

Mr. NUSSLE. Oh, that is——

Senator ALLARD. You see a jump there in deficits, and then we see it is sustained at that level at 2.7. And then it takes a pretty dramatic drop down to 1 percent. You have a spike there for 2 years. I wonder if you might explain that.

Mr. NUSSLE. Well, the biggest challenge is what we have certainly been talking about. Obviously, we are funding a war during this period of time. We are also funding in a bipartisan way a growth or stimulus package. Both of those obviously have a dramatic impact on the budget. The downturn in the economy and the slowing of revenue growth, particularly from corporate receipts have added to that, and that is the reason why you see some of the large jump from 2007 to 2008. There is no question that those have been probably the three biggest drivers to that effect.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Chairman, I have a statement that I would like included for the record at the beginning of the hearing.

Chairman CONRAD. Without objection.

Senator MENENDEZ. Thank you.

[The prepared statement of Senator Menendez follows:]

Robert Menendez.

Statement
Budget Hearing with OMB Director Jim Nussle
February 5, 2008

Thank you, Mr. Chairman. Mr. Nussle, if I may say so, it is my pleasure to welcome you to your first hearing before this committee on the president's budget. I hope you don't take it the wrong way, but I'd be lying if I said I hope to see you before us next year. And by that I mean nothing personal, but I sincerely hope next year there is dramatically different budget before us.

The nation's budget is ripe with opportunity; every year we have a clean slate on which we can lay out the priorities we think will best serve the nation. Every year, we have a chance to shift millions in funding to support health care clinics or increase college aid. Every year we get to re-evaluate where our country stands, how we can improve the lives of the American people, and what we can do to make sound investments that will carry our nation forward. It is a responsibility that we cannot afford to take lightly.

And every year, for the last seven years, I have watched, hopeful that this year, maybe it would be different. Maybe the president would seize the opportunity and lay out a different set of priorities. But this president has had more than enough chances to build a legacy that this nation can be proud of. But instead he is leaving a legacy of lost opportunities, lost priorities, and lost values.

Where he could have built a legacy of hope, instead he is leaving working Americans to fend for themselves, and to deal with the consequences of misguided policies that have left them behind.

Robert Menendez.

Where he could have built a record of fiscal responsibility, instead, he squandered a surplus into the five highest deficits our nation has seen.

Where he could have left a legacy of record investment in education, instead we have schools clamoring for funding, and a law that is underfunded by more than $80 billion.

Where he could have waged a war on income inequality, and used fiscal policies to distribute tax cuts fairly, instead, he spent more than $2 trillion on tax cuts skewed towards the wealthiest 1 percent.

But worst of all, he has left future generations with the bill for his irresponsible war funding, and a debt that is rapidly rising.

On this last year, his last chance to leave a different legacy, I remained hopeful. But this president once again chose to follow the same mantra, and to recycle old missteps. Yet again, he proposed careless cuts to the programs that matter most to most Americans while leaving a mountain of debt to our children and grandchildren.

But this budget before us is not up for negotiation. It is dead on arrival. Instead, it only serves to point out the vast differences in choices and priorities between the American people and their President. I look forward to crafting a budget that accomplishes those things, and to building a different legacy, one that this nation will be proud of.

Senator MENENDEZ. I welcome the Director. I will say that it seems that you are as combative as the Director as you were as a Member of Congress. So it is interesting.

Let me just say I believe this budget is a continuing legacy of lost opportunities, lost priorities, and misplaced values. I think we could have seen a budget in this last year of this Presidency that would have provided and built on the legacy for hope. Instead, we leave working Americans to fend for themselves on a variety of these programs that are critical to their ability, particularly in a struggling economy, we leave them behind. We leave a record, if we were to adopt this budget, of fiscal irresponsibility, turning a surplus into the five highest deficits that the Nation has seen. And, you know, my colleague Senator Sanders I think put it aptly. We could have waged the war on income inequality. Instead, we used fiscal policies that spent more than $2 trillion on tax cuts skewered to the wealthiest 1 percent of the country, and all we hear about from the Director is why don't we cut further on the discretionary side that helps average working Americans.

But, most importantly, what is so alarming to me—and I think the Chairman pointed it out, and I want to pursue that a little bit more—is that the war funding—which is not paid for, by the way. It is not paid for. It is totally irresponsible and deceiving to put the amount in this budget that has been put in when, in fact, we are far away—know, all of us know, that there is far more to be asked for.

So as far as I am concerned personally, as one member of the Committee, this budget is not up for negotiation. It is dead on arrival. And so the question is: Where do we go from here?

I want to ask you, Director, to followup, you know, the President is asking for $70 billion for Iraq while at the same time stipulating that more requests are on the way. He boasts by, you know, projecting surpluses, but, on the other hand, he is concealing the true costs of the war. Isn't the real reason—isn't the real reason that you only got $70 billion when we spent $193 billion, you know, when you have put in $193 billion, when your experiential factor is clearly there—you know how many troops you have, you know how much cost it is to do this operation. This is now 5 years. To come before the American people and put $70 billion, isn't that dishonest?

Mr. NUSSLE. If it is, in fact, a fact that we know that it is going to cost $193 billion, then when will Congress be sending us the check to pay for that?

Senator MENENDEZ. You know, the beauty of the relationship we now have, Director, is that I get to ask the questions and you get to answer them. And the bottom line is I want to know. Is it dishonest to have 70—clearly, you believe——

Mr. NUSSLE. No, I do not believe it is.

Senator MENENDEZ. Can you—if we put you under oath——

Mr. NUSSLE. I do not believe it——

Senator MENENDEZ [continuing]. Could you tell this Committee that all we are going to need is $70 billion?

Mr. NUSSLE. And I acknowledged——

Senator MENENDEZ. Is that what you would testify to? Yes or no. Give me a yes or no.

Mr. NUSSLE. I acknowledged that earlier, yes, sir.

Senator MENENDEZ. That we would only need $70 billion?

Mr. NUSSLE. I acknowledged that earlier, that, of course, it is going to cost more than that, yes.

Senator MENENDEZ. Then why not put that in the budget and be honest?

Mr. NUSSLE. Because we don't know how much it is, and we rarely put supplementals into the budget. Last year was the first time it was done. We put it in specifically and——

Senator MENENDEZ. Isn't this exactly the problem?

Mr. NUSSLE. —Congress did not act.

Senator MENENDEZ. The exact problem we have is that by hiding the true cost of the war and adding it onto debt, the supplemental is—you put in supplementals knowing how many men and women are in the field and the costs, and you have a well-established experiential factor. So even with, you know, the reduction of the surge by mid-May or end of May, you know what it is going to cost to continue to operate them, clearly, beyond this administration. And so you do that purposely.

Let me ask you one other question. We talk about, you know, the realities of working families, health care. This budget does not have enough money in it to simply keep the children who are presently under the Children's Health Insurance Program funded moving forward. Isn't that true?

Mr. NUSSLE. No, that is actually not true, Senator. We fund $19.7 billion for SCHIP moving forward, which takes into consideration the population growth and not removing any of the children that are——

Senator MENENDEZ. In fact, States need at a minimum $21.5 billion over the next 5 years simply to maintain their current program. So who are you knocking off?

Mr. NUSSLE. Well, that is not—we do not calculate it quite that way, Senator. We believe that the program is for poor, uninsured children and——

Senator MENENDEZ. So, in other words, you are going to cutoff children over 200 percent.

Mr. NUSSLE. We believe that the program should be for poor, uninsured children.

Senator MENENDEZ. You are going to cutoff children over 200 percent. That is what you are telling me.

Mr. NUSSLE. This is not an entitlement. It is a program that——

Senator MENENDEZ. Can you just give me a simple, direct answer? You are going to cut children over 200 percent.

Mr. NUSSLE. We believe there are other options for families that are over the poverty level that have the ability to pay for insurance or that are already on insurance in many instances. So it is for poor, uninsured children.

Senator MENENDEZ. I agree, but the reality is that, you know, there is a wide swath of States across the country that, in fact, when you cut children over 200 percent—and I know what you are referring to is the Medicaid match. The reality is that what you do is shift the cost to the State. And that is what this budget is replete of. And the COPS program, you zero it out. Crime has gone up for the last 2 years in this country, and, in fact, you zero it out. That means shifting the cost to municipalities. You shift the costs on Leave No Child Behind. You shift the costs on the Children's Health Insurance Program, and that means the local taxpayers—a former mayor—pays more. That is what this entire budget is about: hide the war funding, shift the costs to the States, add to the debt, while we take care of the wealthiest people in the country. That is not, in my mind, the set of values that average working Americans have.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Gregg?

Senator GREGG. Thank you, Mr. Chairman. I understand my time is a little truncated because I took some of it earlier, but let me just make a couple points here.

First, I do not think the other side of the aisle necessarily comes at this with clean hands on the issue of fair and accurate budgeting. Last year, we saw a Democratic budget which claimed it was going to use PAYGO as the mechanism for disciplining spending. Put up the PAYGO chart. Well, they spent $146 billion by adjusting, abating, going around and basically playing games with the PAYGO rules, so that did not work.

Then put up the SCHIP chart. Then they brought forward an SCHIP proposal which basically had a drop-off which represented a $46 billion hold when you got outside the 5-year window. So that did not make any sense.

The budget also assumed a huge amount of revenues from just basically doing a better job collecting revenues. None of those revenues were realized. In the supplemental, you added $17 billion of domestic spending, which was basically earmarks. In the general budget, you increased spending by $22 billion, which, if the President had not insisted on maintaining some fiscal discipline on the discretionary side, would have been spent, and instead we ended up with about half of that being spent, if you factored out all the emergencies.

So I wish there was some realistic effort around here to control spending, but it certainly is not coming from the other side of the aisle. And I think, yes, you can point fingers at this budget. I have pointed a few fingers at this budget because this budget has some serious flaws from a standpoint of accuracy, and even more serious flaws from a standpoint of policy. But it is not just one side of the aisle that has been playing games around here.

The war cost issue is a legitimate issue. I was not here for the exchange. I understand it was enjoyable and good theater between the Chairman and the Director. But the simple fact is you cannot put a $70 billion figure in this budget and claim that you are funding the war—unless you are going to say that that is all it is going to cost, and we know that is not all it is going to cost. There should be full transparency on the war cost, and last year the administration sent up a real number, and I regret they did not do it this year.

There are also other issues in this budget which bother me, but let me go to the more philosophical question here. This budget is driving us toward—not necessarily this budget, but the economy, coupled with the stimulus package, coupled with the war cost, is driving us toward a $400 billion deficit in the year 2009 and a potentially bigger deficit in 2010.

I guess my question to you, Mr. Director, is: Here we are on the cusp of how we are going to deal with the tax policy question of maintaining capital gains and dividends rates. Is it in the better interest of the long-term strength of this economy that we maintain the present rates on capital gains and dividends, which the administration put into place at the beginning of this administration? Or is it better that we have the stimulus package?

Now, I recognize it is not in your view an either/or issue, but from a standpoint of just fiscal policy, which would have a stronger impact on the long-term structure of our economy?

Mr. NUSSLE. On the long term, I do not think it is even a question that it is making the tax cuts permanent. This is the short-term challenge with the economy, and that is why a short-term stimulus is necessary. But the President has said—and I certainly agree—that for the long-term strength of our economy, making the tax cuts permanent and not having an automatic tax increase in 2011 is exactly the right policy.

Senator GREGG. Well, here is the problem we have. The stimulus package is going to cost us $150 billion. When you compound it with its interest, it is around $200 billion over 5 years. That means we are going to be heading toward a deficit probably in the $400 billion range in the year 2010.

It will be very hard. that makes the argument for maintaining the cap gains and dividends rates much more difficult when you are dealing with those size deficits. I happen to think that they generate revenue, but there are not a lot of people around here who necessarily subscribe to that view. And I am perfectly willing to argue that until—you know, until I lose, which I will. But the point is if we do this stimulus package, what do we get for it other than putting ourselves into the whole $400 billion at—other than aggravating the deficit by $150 to $200 billion and creating a disincentive or an atmosphere where it is going to be much harder to maintain those good fiscal policies which are a lower rate on capital formation on dividends. I mean, what are we getting for this stimulus package? We are spending—most of this money is going to be sent out as individual rebates which are going to be spent on consumable items made in China. So we are going to stimulate the economy of China. And we will get the one-time accelerated depreciation, which will assist. But as a practical matter, it will probably all occur after we have moved into some transition on this slowdown, hopefully. And other than being a wonderful political statement that the Congress can join with the administration in a “Kumbaya” event and make everybody feel good, what substantively when we get to this that we put our—are going to be digging such a deeper hole on the deficit that it will make it so much harder for us to deal with the tax policy, which is really important to us, that is coming down the pike?

Mr. NUSSLE. Well, Senator, it is—and all of this, of course, is forecasting based on what economists will tell you, and they may disagree. But in the short term, by the third quarter, they estimate that it could and would bump GDP by six-tenths of a percent. That is enormous, particularly when you see what that does for job growth, which is also estimated at about 500,000 jobs.

Senator GREGG. Well, that works out to $300,000 per job. Divide 500,000 jobs into $150 billion, you get $300,000 per job.

Chairman CONRAD. They are really good jobs.

Senator GREGG. Right, they must be good jobs. Well, they are going to pay a lot in taxes, I will tell you that much.

[Laughter.]

Senator GREGG. But—well, anyway, I think I have made my point. It was almost rhetorical. So my time is up.

Chairman CONRAD. I just want to take a moment on the PAYGO because the Ranking Member likes to put up this Swiss-cheese-go chart, but let’s go back to reality. We had a positive balance on the PAYGO scorecard until the tax relief provided for in the alternative minimum tax. That meant the spending initiatives that we had were paid for. They did not increase the deficit or the debt. That is a fact.

The alternative minimum tax is the one place where we diverged from PAYGO rules. That was with respect to providing tens of millions of people tax relief in this country, and that was not paid for. I did not agree with that. The administration insisted on providing the alternative minimum tax relief without paying for it, and a significant majority of Congress went along. That is also provided for under PAYGO because if you get more than 60 votes, you can waive the PAYGO rules. The fact is until that moment we had a positive balance on the PAYGO scored.

Senator GREGG. Well——

Chairman CONRAD. Senator Murray?

Senator GREGG. Mr. Chairman?

Chairman CONRAD. Senator Murray is recognized.

Senator GREGG. You do not want to hear the other side of the argument?

Senator MURRAY. Thank you, Mr. Chairman.

Chairman CONRAD. I will, I am sure.

Senator MURRAY. Well, thank you, Mr. Chairman. And, Director Nussle. You know, a lot has been discussed this morning about the honesty of the budget proposal that has come before us, focused a lot on the war in Iraq, and I think we are all very disconcerted by that. But let me go to another point in this budget that I think is not very honest, and it is the Department of Energy's environmental management request.

You know, a budget has to be not only a statement of priorities and a budget blueprint, but it also has to share honestly with the American public the obligations that we have as a country. As you know, the Hanford site is in my home State of Washington. I wish it was somewhere else, but it is in my State. We have to deal with it. But it is not just my State. The entire country has to deal with this. We are cleaning up from the cold war and from the Manhattan Project, and it is an obligation of the entire country.

Now, I have to say I was stunned—stunned to see a significant cut from this administration to clean up these nuclear sites across the country. The total EM budget that you sent over is $166 million below fiscal year 2008 appropriated dollars. That is a budget that is going to ensure that this government will not live up to its obligation with regulators and with the States.

You know, this is going to cause our contractors to virtually stop working. I do not know how we can tell our contractors that we are not going to fund what we need to do under contracts that are out there. This is just, to me, poor management.

Tell us how the Government is expected to meet its legal obligation to clean up these sites when it does not provide adequate dollars to the contractors for the contracts that are out there.

Mr. NUSSLE. Well, we worked with the Energy Department on this issue, and they made their determination based on risk: what were the sites that posed the highest risk, what were the ones that needed the most attention. Hanford was one of those sites.

Senator MURRAY. Well, you cut the river corridor closure by $58 million. That is an extremely important project to clean up waste from the cold war that is going into the Columbia River, that will become an environmental and physical disaster for not just my region but the entire country if we do not stop it.

Mr. NUSSLE. Again, I can tell you that we worked with the Department of Energy. It was based on risk and their risk assessment of what——

Senator MURRAY. They do not think it is a risk to have nuclear waste going into the Columbia River because we have not cleaned up a site adequately that we have contracts with, tri-party agreements, agreements with the States? They do not think that is a risk?

Mr. NUSSLE. Well, I cannot speak for them.

Senator MURRAY. But you can speak for the Administration. Does the administration not think it is a risk to have nuclear waste seeping into the Columbia River?

Mr. NUSSLE. We do believe it is a——

Senator MURRAY. That we know is happening?

Mr. NUSSLE. We do believe that these sites are important. It is the reason why we do maintain it as a priority in the budget. But we base the determination across all of the sites that were available for cleanup based on risk.

Senator MURRAY. Well, I disagree. I think you know full well that Congress is going to keep its obligation and fulfill this. This is just a way for you to balance the budget. So I just think when I got to honesty, that one just sticks out clearly to me.

But let me go to another one, and Senator Sanders brought it up, and that is the budget for our veterans. Once again, the administration is proposing to double the drug copayments for our veterans and forcing our veterans to pay new user fees to access VA health care.

Now, you know that this Congress has not agreed to do that in the past, and it seems to me that at a time of war, when we are asking the world of these men and women who have fought valiantly and put their lives at risk, when we ask them to sign up, we do not say, "Gee, and, by the way, if you earn $27,000 or more, we are going to charge you for your health care." We say to them, "You sign up and fight for this country, and we will provide your health care."

So I find it very dishonest for this administration, who has worked very hard to recruit men and women to fight for this war, to then turn around and say to them, "By the way, we are going to tell Congress that you are going to have to pay user fees and copayments for the health care we promised you." And not only that, these copayments that you are collecting from them will not go to pay for VA health care. You put it back into the budget.

So what I see is that you are proposing these new user fees simply to balance the budget.

Mr. NUSSLE. Well, these are proposals that the Administration has carried in its budget—I believe every year it has proposed it, and certainly we understand that Congress may not take it out, but——

Senator MURRAY. Then I assume we should—this administration should be telling our recruits that if you earn more than $27,000 you are not going to get health care.

Mr. NUSSLE. No, that is not what we are telling them. We are telling them it is a very good health care plan and that if you earn more than actually $50,000, the copayments go up, as well as an enrollment fee. It is something that we believe is a responsible way to not only maintain the program but it is also for veterans——

Senator MURRAY. Well, I would just say it is balancing the budget——

Mr. NUSSLE [continuing]. That have higher income.

Senator MURRAY [continuing]. On the backs of her veterans, is how I see it. But I have a couple seconds. Let me quickly ask you about the VA construction program. We all saw what happened with Walter Reed. We looked across the country. We know these facilities are inadequate. We know that they have not met the standards for earthquakes or fires or patient privacy or so many other things. And it is really amazing to me that in this budget you short-fund the needs of veterans by hacking away at the construction account, which is clearly important for us to put money into, especially at a time when we have an increasing number of men and women who are coming into the VA. Can you tell me why you targeted the construction account?

Mr. NUSSLE. Well, first of all, the President since he came to office has proposed and the Congress has added to and together we have increased the veterans budget 100 percent just in the last 7 years alone.

Senator MURRAY. For health care.

Mr. NUSSLE. So we have not been——

Senator MURRAY. For health care.

Mr. NUSSLE. So we have not been shortchanging veterans——

Senator MURRAY. For health care.

Mr. NUSSLE [continuing]. And I think in a bipartisan and also between branches, we have done a good job of addressing those needs. We have also addressed the needs of Walter Reed, and those are met within this budget as well. So we believe we are meeting those obligations and priorities in this budget.

Senator MURRAY. Well, not when you have massive cuts to the construction program.

Chairman CONRAD. Senator Whitehouse?

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Director Nussle, the health care problem, the future liability of America for our health care obligations problem, has been estimated, depending on whose numbers you look at, in the $30 to $70 trillion range. Is that correct?

Mr. NUSSLE. It does depend on who you ask, but certainly there is a huge challenge, yes, sir.

Senator WHITEHOUSE. And with respect to the President's desire to reduce the earmarks by Congress by half, that would create an $8 billion savings, correct?

Mr. NUSSLE. I believe so, yes.

Senator WHITEHOUSE. Just to put that to scale, here are 8 pennies in a little stack in front of me, and let's say that each penny was $1 billion. In order to equate that to the liability that we face on health care, you would need to stack 30,000 to 70,000 pennies next to it, wouldn't you? Isn't that the math?

Mr. NUSSLE. Well, that is why the President has a proposal in here for Medicare in order to help bend the growth curve on Medicare, which drives a lot of the health care inflation and costs throughout the country as——

Senator WHITEHOUSE. But I am correct about the math, that if it was $8 billion, then it would be——

Mr. NUSSLE. I am sorry. I have not done the math, but I will take your word for it. That sounds——

Senator WHITEHOUSE. If you knock off a billion from each, you end up with 30,000 to 70,000 versus 8, right?

Mr. NUSSLE. OK.

Senator WHITEHOUSE. And a stack of 30,000 to 70,000 pennies would go well through the roof of this very high room, correct?

Mr. NUSSLE. Well, I do not know about you, but I grew up with a Dad that said if you worry about the pennies and the nickels and the dimes, the dollars will follow. And so I would worry about those 8 pennies that are sitting there just as much as——

Senator WHITEHOUSE. And the 30,000 to 70,000 would go through the roof of this room, would it not?

Mr. NUSSLE. I would worry about both, actually.

Senator WHITEHOUSE. And it would go through the roof of this room, would it not?

Mr. NUSSLE. I have not—I am sorry. I will take—I will have to take your word for it.

Senator WHITEHOUSE. What does it tell you about the culture of Washington when you consider this little pile of 8 pennies and the 30,000 to 70,000 stack of pennies that goes through the roof of this room to merit equal time in your testimony to the American people?

Mr. NUSSLE. Actually, my testimony I think focused on the need to deal with some of those long-term spending challenges.

Senator WHITEHOUSE. Two paragraphs each. It was equal.

Mr. NUSSLE. Well, the Chairman only gave me 5 minutes. I would have——

Senator WHITEHOUSE. In your prepared testimony.

Mr. NUSSLE. I can be——

Senator WHITEHOUSE. In your prepared testimony.

Mr. NUSSLE. I can be very eloquent and go off on a number of tangents if you want me to on this subject, but this has nothing——

Senator WHITEHOUSE. Well, let me ask you about one tangent——

Mr. NUSSLE [continuing]. Based on——

Senator WHITEHOUSE. Because you said earlier that——

Mr. NUSSLE [continuing]. The amount of paragraphs.

Senator WHITEHOUSE [continuing]. One of the ways to address this would be to promote quality and information technology. And let me start with by way of a framing section. I think there are two ways to address this problem. One way is to get into the health care system and repair it so that it is much more efficient in terms of delivering health care and save money that way. The other is to leave the existing broken health care system in place and simply stop putting money into it, cut people's benefits or raise taxes.

It seems to me that it is responsible for us to really embark on what we can do to reform the health care system so that the terrible choice between either massive tax hikes or massive benefit cuts is with any luck foregone, but at least reduced. So in that context, and given your reference to the importance of promoting quality and information technology, what is the President's budget for the Office of the National Comptroller for Health Information Technology, the ONCHIT office?

Mr. NUSSLE. I would have to check that for you. I do not have that off the cuff.

Senator WHITEHOUSE. Well, I will tell you. It is $66 million.

Mr. NUSSLE. OK.

Senator WHITEHOUSE. Which means if you took one of these pennies, you would have an infinitesimal piece, smaller than a half a grain of rice, that would reflect this administration's investment in trying to do something about the stack of pennies 30,000 high that goes through the roof. I really think that if you are going to be serious about this—and you say you are going to be serious. You have a serious record. You are a serious man. I am inclined to try to take you at your word on that. It would seem to me that some serious effort at reforming this health care system and building in appropriate health information infrastructure and really addressing the quality issue in a significant way would merit a lot more attention than it is getting from this administration.

Mr. NUSSLE. I would just say to the Senator, and this is just an example of where there sometimes is a disconnect: For the 2008 budget, the President requested $118 million for this office that you just described, and Congress only came up with $61 million. So I am not suggesting that—I mean, there is a disconnect. I do not disagree with you. I think certainly health information technology is an important priority.

But when the President makes it a priority and Congress obviously does not see that, and then we actually increase it, which is what that $66 million would be as an increase over what the Congress gave, I think it does show in a tight budget that we are making it a priority. But I think Secretary Leavitt, as you know, has this as a very enormous priority, one that he believes can help with the overall challenge that we face in health care——

Senator WHITEHOUSE. He talks a good game, but even at $118 million——

Mr. NUSSLE. Well, I was trying to be respectful——

Senator WHITEHOUSE [continuing]. The number is——

Mr. NUSSLE [continuing]. But how can you explain, if you will, why——

Senator WHITEHOUSE [continuing]. Terrible.

Mr. NUSSLE [continuing]. We propose $118 million and Congress cuts that in half, and then I am——

Senator WHITEHOUSE. I cannot. I think that was a terrible mistake to cut it in half.

Mr. NUSSLE. All right. Well, we——

Senator WHITEHOUSE. I think it should be way more than this, and I am trying to enlist——

Mr. NUSSLE. Well, we are willing to work with you——

Senator WHITEHOUSE [continuing]. Some interest on your part. It is your Health and Human Services Department. It is your budget in the first instance. It is the President's emphasis on this that matters. And I want to see the emphasis. Where is it?

Mr. NUSSLE. Well, we will be glad to work with the Congress on this office and in this area for this priority because it is very important, and the President did propose that in 2008. But based on Congress' reaction, we had to make a judgment and we did.

Senator WHITEHOUSE. My time has expired.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Whitehouse.

Senator CARDIN IS NEXT.

Senator CARDIN. Thank you, Mr. Chairman.

Mr. Nussle, first let me say I am disappointed by the budget but not surprised—disappointed because I think it does not reflect the priorities that are important for our country. I do not believe it is an honest budget. Not only are the costs of the war not reflected in the deficit that you advertise, but there are many other items. The Alternative Minimum Tax—when we fix that, it is going to add to the deficit if we do not offset the costs. I could go on and on about areas where the deficits are much greater.

But I want to spend my time dealing with the recommendations for Medicare cuts that are in your budget. I am really troubled by the way that you are trying to achieve Medicare savings. We need to have a much more cost-effective health care system. I agree with you on that. But the suggestions that you are making will have a major impact on the ability of seniors and disabled persons to find doctors who will treat them. More and more doctors are opting out of the Medicare system. The problem I find with your proposal to cut provider reimbursements is that you are cost shifting. You are cost shifting to the individuals who will pay for the hospitals and doctor bills and to companies that have to pay for their health insurance because Medicare will not be paying its fair share of the cost.

It is unrealistic to expect that Congress will not take up the pending ten percent physician reimbursement cuts. We have done that every year. You do not provide funds in your budget to prevent a significant cut in Medicare physician reimbursements.

But you are recommending that of the 2001 and 2003 tax cuts be made permanent. Your estimate is that over 10 years that costs $2.2 trillion. The Medicare savings are $603 billion. So from a fiscally responsible point of view, we could argue whether this makes sense.

But there are certain areas where we could save money in Medicare and in the entire health care system that you choose not to deal with: the cost of prescription medicines, which are far higher to American consumers than to any other industrial nation's consumers because we fail to organize the market and use market forces collectively to bring down the cost. Also, in Medicare Part C we continue to reimburse private insurance companies much more than it would cost the taxpayers of this country if the senior were enrolled in traditional Medicare. You know those numbers. And yet you are leaving the private insurance companies alone. You are leaving the pharmaceutical manufacturers alone. But yet you are making recommendations that could affect access to care for people in my State and around the Nation.

I want to work with you to bring down the cost of health care, but I do not see a good-faith effort here. Why don't you put on the table options that will save Government expense that affect the drug manufacturers and the insurance companies? Why should private insurance companies get 20, 30 percent more to cover seniors than it would cost the taxpayers to subsidize a senior in traditional Medicare?

Mr. NUSSLE. Well, first of all—and the Senator is an expert in these programs, and I greatly respect your knowledge and willingness to work with us on that, on many of these issues. And that is the reason why the President has at least opened the door yet again this year for Medicare reform—not suggesting that this proposal is the only proposal that would be considered. This is an opening opportunity to, again, as we did in 1997, bend the growth curve on health care and on Medicare and tackle some of that long-term challenge.

I am not saying anything is on the table or off the table. I am saying the President has opened the door for what we think is an appropriate and very important debate this year on Medicare if the Congress is willing to engage in that. And we believe the order of magnitude in this instance is one-third of that long-term liability, which is the reason why we picked the number of $178 billion. And some of the proposals, again, you have seen them before. These are proposals that we have debated many times over the years, and some have been accepted even in a bipartisan way. Many of them are put forward by MedPAC.

And the part about the drug benefit, as the Senator knows, the cost of the drug benefit, Part D, was not what it was advertised when it first passed. It was supposed to be 634, and it has come in at 390, as I understand it. So, yes, we certainly continue to have high costs, but the program is working——

Senator CARDIN. Let me stop you there because my time has expired, and I am going to quit while I am ahead.

I take that, Mr. Chairman, as an offer by the administration to deal with Medicare Advantage and negotiate prescription drug prices. And I will use that later in some of the arguments with our Committee. Thank you very much.

Mr. NUSSLE. Well, Medicare Advantage, if I may, just to finish, Medicare Advantage under this plan does have as a result—because, as you know, it is based on fee-for-service. I think it is like $40 billion that comes out of the Medicare Advantage plans as a result of the changes that we are proposing.

Senator CARDIN. But they still will be reimbursed at a level higher than if the individual were enrolled in traditional Medicare.

Mr. NUSSLE. Yes.

Senator CARDIN. Still a premium.

Chairman CONRAD. Senator Nelson?

Senator NELSON. Thank you, Mr. Chairman.

Good morning, Mr. Director.

Mr. NUSSLE. Good morning.

Senator NELSON. If you could explain the philosophy in a portion of the Medicare budget, I would appreciate it. Under the law a senior citizen who falls below a certain income level gets a subsidy in order to be able to pay his or her monthly premium for Medicare parts B and D. The President's proposal would eliminate inflationary updates to the qualifying income level, reducing the number of individuals eligible for this subsidy..

Please explain to the Committee why you would do that to poor senior citizens.

Mr. NUSSLE. What we do is we freeze it at—instead of allowing it to continue to grow at CPI. And it is one of the ways that we believe you not only have program integrity and you have the person involved in the program taking some responsibility for utilization, but it is also a way, again, to begin to grow—bend that growth curve that allows the program to continue to grow at 5 percent as opposed to over 7 percent.

Senator NELSON. Well, understandably, you are looking for areas in which to cut, and I just want to share with you that in my State, where we are fortunate to have a lot of senior citizens, that in the year 2008 there indeed are senior citizens that are having to make the choice between food or their medicine or cutting their medicine in two because they are at a certain level of income that they cannot afford both. And it just seems to me that as the Good Book says, when we come and reason together, we have an obligation to take care of the least privileged among us. And poor senior citizens would certainly be a part of those that we want to make sure are made whole. And I just did not understand the reasoning for that.

Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

Senator Feingold? And I just want to alert all Senators that the live quorum may commence in roughly 5 minutes or so.

Senator Feingold?

Senator FEINGOLD. Thank you, Mr. Chairman. This Committee and this country have benefited by your leadership and by the leadership of our Ranking Member, Senator Gregg. I know you have significant policy differences, but I think you both have an abiding concern for the Nation's fiscal position. And I cannot help but believe that, as bad as things are, we would be a lot worse off but for your service as budget guardians. But despite your efforts, Mr. Chairman, despite the efforts of Senator Gregg, we are in a huge fiscal mess. The contrast between where we are now and where we were when the current President first took office could not be greater. And the same is true of the attitude of Congress about budget matters, both now and then. I find the difference startling. I came here in 1992 when Senator Gregg and I were both elected, and the rallying cry really was, "Eliminate the deficit." And thanks to the deficit reduction package passed in 1993, to a continuing concern about the Government's bottom line and ultimately to an economy that was certainly helped by fiscally responsible policies, we actually balanced the books by the end of that decade. And when President Bush took office, he was handed a Government in surplus, and with projected surpluses coming into the decade.

Unfortunately, since then, the fiscal stewardship of our Government has been tragically lacking. But even though this has happened on our watch, we will not be the ones who will pay for this malpractice. The cost of this negligence will be borne by our children and grandchildren in the form of massively increased debt. This administration will add $4 trillion to the mountain of debt future generations will bear, and they will be the ones who will have to pay that debt in the form of either higher taxes or fewer Government services.

Mr. Chairman, there are a number of programmatic issues in this budget that I would want to pursue, including areas such as funding for local law enforcement and the Women, Infants, and Children program, but I will address those later.

Let me just finish by noting that the budget the President is sending Congress this year appears to be more of what we have seen in the past 7 years. The administration has again circumvented a basic principle that should govern the budget of any President, one that Chairman Conrad has enunciated on several occasions to this Committee: either provide the revenues necessary to pay for the spending you want, or limit your spending appetite sufficiently so that the taxes you are willing to levy can fully pay for it.

This budget just simply does not conform to that principle. Instead, it adheres to an unfortunate alternative view: Do all the spending you want, but only pay the bills you want to pay, and your kids will make up the difference.

Director, it may come as a surprise to some that on occasion I actually agree with the administration. For one, I strongly endorse your efforts to rein in unauthorized earmarks. I think it has been a little late in coming, but I certainly welcome those efforts. And along these lines I hope you will consider endorsing a bill I have introduced with my colleague from Wisconsin and a former colleague of yours, Congressman Paul Ryan—namely, a line-item veto measure that applies specifically to earmarks. It targets the abuse everyone says is the real reason a line-item veto is needed—namely, to go after earmarked spending.

Have you had a chance to look at the proposal at all?

Mr. NUSSLE. I have not, Senator, but I will, and the President obviously continues to support the legislative line-item veto and would probably look favorably on anything that would provide some control on not only earmarks but, in general, excessive spending.

Senator FEINGOLD. Well, I appreciate that. I hope you will give it a good look. I know it may not be everything that this President or any President would want. I voted for the previous line-item veto that was struck down by the Supreme Court. What we are trying to do here is find something that would pass muster with the Supreme Court and still give the President the ability to help us get rid of some of these unfortunate provisions.

Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

Senator Lautenberg?

Senator LAUTENBERG. Mr. Chairman, thank you, and, Director Nussle, I would appreciate it if we could keep the answers short. The reins are tight on time allotment, so I am going to get right to the subject of my interest, and I would appreciate the quickest response you can give.

Over the last 7 years, the President has tried to destroy our national passenger rail system, yet everybody knows how bad traffic is no matter where you go, whether it is the skyways or the highways. Why does the President continue to propose funding levels which would shut down Amtrak?

For your information, it is a $500 million cut from what we used in our appropriations last year—$500 million. How is that a conclusion that we can comfortably live with?

Mr. NUSSLE. Well, Senator, as you know, the Northeast corridor line is very profitable, or at least has a good economic track record, looks——

Senator LAUTENBERG. It covers its operating costs; it does not cover its capital costs.

Mr. NUSSLE. But that is not the same for some of the long lines, as the Senator knows, and it is for that reason that we continue to agitate on this issue. We need to——

Senator LAUTENBERG. Is there traffic congestion throughout this country of ours?

Mr. NUSSLE. On the rail lines?

Senator LAUTENBERG. On the highways and the skyways. Is there traffic congestion wherever you look here?

Mr. NUSSLE. There are many places where that is true.

Senator LAUTENBERG. OK. So is there any logic, in your view, your personal view, to making a cut like that in Amtrak which would effectively destroy its ability to function?

Mr. NUSSLE. Well, Amtrak just has not been managed well——

Senator LAUTENBERG. I do not want any of your opinions other than on the numbers.

Mr. NUSSLE. OK.

Senator LAUTENBERG. Does it make sense to you to project a $500 million cut?

Mr. NUSSLE. Yes.

Senator LAUTENBERG. It does. It is irresponsible, I must tell you, to say the least. For every $1 billion invested in transportation projects, 47,000 jobs are created. Given the state of our Nation's aging bridges, roads, airports, et cetera, and now the focus on the decline in jobs, why then should there not be more consideration for those investments in refurbishing our transportation system?

Mr. NUSSLE. Well, the President spends the final increment of SAFETEA-LU in this budget that was allocated under that Act and, in fact, has met the obligation. There will be a shortfall of about $3.2 billion in that fund because receipts will not meet the obligations that were put into SAFETEA-LU. And so a transfer has been proposed in order to fill that in, but there is no question that in the long term—and, actually, in the short term—there is a shortfall within the transportation account that the Congress and the President are going to have to work together on in order to resolve.

Senator LAUTENBERG. Thank you. In other words, you are suggesting that maybe the President would compromise a little bit on this, because if you are suggesting we work together, I can tell you the attitude here is certainly not for continuing to reduce the amount of spending that we need for our infrastructure.

The President claims he is concerned about reducing spending based on the effectiveness of programs. In that case, Director Nussle, how can he justify continued funding for abstinence-only education programs, which have been proven to be highly ineffective?

Mr. NUSSLE. I do not think they have proven to be highly ineffective. I think, again, there are differences of opinion when it comes to that.

Senator LAUTENBERG. Differences in opinion in the number of teen pregnancies and the exposure to sexually transmitted disease? Do you think that we have been gaining on that?

Mr. NUSSLE. I have not seen the statistics in the last number of days or months, but I can tell you the last time I checked, I believe that teen pregnancy was actually down.

Senator LAUTENBERG. Not in the abstinence-only programs, I can tell you, in school districts.

Hospitals across the country are in bad financial straits. In New Jersey, nearly 50 percent of hospitals are operating in significant financial difficulty. How can we keep those hospitals open and provide the service for patients when the budget reduces the amount of Medicare payments to hospitals by $12.4 billion? How can we do it?

Mr. NUSSLE. Well, Senator, the President has put forth a budget that tries to balance all of those priorities within a budget that realizes that there is a constraint based on the deficit. And what I hear from what you are telling me is that we need to spend more in all of these areas, which we certainly can look at, but that just drives the deficit higher, and the debt——

Senator LAUTENBERG. Well, there has been expert deficit driving in this administration already on a continuing basis.

Mr. Chairman, since there is—I do not see anybody else sitting here. Can I steal another minute.

Chairman CONRAD. Yes, sir.

Senator LAUTENBERG. Mr. Nussle, how much has the average weekly cost been for the war in Iraq in the past year?

Mr. NUSSLE. I am not sure I have that statistic in front of me.

Senator LAUTENBERG. Well, let me help you. It is $3 billion a week. It is $3 billion a week. Now, when the President proposes $70 billion for the war costs in the 2009 budget, I guess he thinks that the war stops with the day he leaves office because that is as much of the 2009 budget the President is taking responsibility for. Is that a proper conclusion on my part?

Mr. NUSSLE. I think it is only a proper conclusion if you also believe that Congress thinks the war stops here at about Memorial Day because they have not funded beyond Memorial——

Senator LAUTENBERG. No, but doesn't the President have the responsibility a Commander-in-Chief—he has taken the responsibility so far—for doing all of the financing——

Mr. NUSSLE. Well, my understanding is that Article I of the Constitution is where the power of the purse is and the responsibility to pay for this kind of a conflict.

Senator LAUTENBERG. Mr. Chairman, I hope you are listening to this explanation. What we are getting here are political analyses. You know, I once asked a political consultant, "How do you respond to questions?” He said, “Avoid answering it until you get your point across.” It is good politics. Thank you, Mr. Nussle.

Chairman CONRAD. I thank the Senator and the former Chairman of this Committee.

Let me just say—we have only got 6 minutes left on this vote, so you are saved by the bell, or at least relieved by the bell. I just want to tell you that some have said this budget is dead on arrival. I have never applied those terms to a President’s budget, but I was thinking, What does this represent in three words? And the President’s leaving. I think this represents “Debt on departure.” He is leaving a debt bomb on the steps of the next President. And the next President is going to inherit the worst fiscal mess that I have seen in my 21 years here. And if I look back historically, other than the time right after World War II, if you look at debt as a share of our economy, it will be at its highest level after this Presidency in 50 years. So this President has it going in precisely the wrong direction.

With that, we again thank you for your appearance here, Director Nussle. We apologize that we are interrupted by this vote, but I do not think it would be fair to ask you to stay for another round of questioning at this point, unless you were really eager to be here another hour.

Mr. NUSSLE. I am pleased to do so, Senator, Mr. Chairman, if you would like me to.

Chairman CONRAD. No. I think you have discharged your responsibility here, and we thank you again for your appearance. And, look, we have strenuous disagreements on policy, but we also admire your service and your willingness to take on a responsibility like this. I think it is one of the toughest ones in Government. Maybe it is the toughest one to be the Director of OMB.

So, again, thank you for your attendance and your answering the questions of the Committee.

Mr. NUSSLE. Thank you.

Chairman CONRAD. The Committee stands adjourned.

[Whereupon, at 11:49 a.m., the Committee was adjourned.]

Mike B. Enzi

Statement of Michael B. Enzi

OMB Director Jim Nussle
The President's FY09 Budget Proposal

February 5, 2008

I would like to thank Chairman Conrad for calling this hearing, as well as Director Nussle for testifying before the Committee today. Every year I look forward to reading the President's budget, because it is the best indicator of the President's priorities. Specifically, I am interested in the administration's proposals in areas where we can work together over the next several months to score meaningful accomplishments for the American people.

Today marks the first step in a long process that ends with the House and Senate setting a budget in mid-April. The Budget Resolution ultimately serves as a blueprint for broad categories of spending—as well as establishes the top-line discretionary funding level. Last year there was a significant gap in the funding level approved by Congress and what was proposed by the administration. This difference made for bumpy year-end negotiations that I think both parties would prefer to avoid this time around.

I hope that the Congress and administration can work together this year, and reach a responsible agreement on this top-line number. Otherwise, we are charging our expenses on a government credit card, and leaving the bill for our children and grandchildren.

I have had the privilege of serving on the Budget Committee since I was elected to the Senate 11 years ago, and I feel strongly that the budget process is an essential part of our institution. To that end, I'd like to acknowledge Senator Domenici's leadership in the budget process for more than 20 years. As my colleagues know, this is his last time through the cycle, and I will miss both his insight and service on this Committee. He's a genuine leader and good friend.

Finally, I'd like to conclude by reiterating my support for budget process reform. Already this year, the Committee has heard from expert witnesses that this country could be facing economic disasater unless we find a way to come together to reign in spending. Now that the baby boomers are reaching retirement age, our window to deal with these issues is closing. Congress must act. There are several process reform bills that have been introduced and are pending before this Committee. It's my hope that the Committee will act on these measures once the FY09 Budget Resolution is approved this Spring. I'll have more to say on budget process reform over the next few weeks.

I look forward to Chairman Nussle's testimony.

DEPARTMENT OF AGRICULTURE
ARS FACILTITY CLOSURE: GRAND FORKS/OBESITY RESEARCH

Question from Senator Conrad

Question: The President's budget proposes to close an important nutrition research lab in my state, the Grand Forks Human Nutrition Research Center. It is one of the three human nutrition labs in the country. This closure would mean the end of about 100 jobs in Grand Forks. And the proposed closure comes a year after the President's Budget proposed a $1.15 million increase for obesity research funding for the Center. Not only is it highly odd that the Administration would propose to close this lab one year after it wanted to significantly increase its funding, but we've also been told that the intent is not to eliminate positions, but rather just to close the lab and transfer employees to California and Maryland. This makes no earthly sense to me when we've been told relocation costs and new construction will be required to move the employees. In short, this could end up costing more to close the lab when you calculate in new construction and relocation costs. Could you please explain the rationale behind this move?

Answer: The FY 2008 President's Budget proposed a $7 million increase for ARS obesity prevention research. The proposed increased funding would have supported multi-center research at the six USDA Human Nutrition Research Centers. Thus, the intent was to have a coordinated multi-center obesity research program for which the proposed increase would have allowed the Grand Forks Center to participate. This proposal was not enacted by Congress.

Closing the Grand Forks Center, as proposed in the FY 2009 Budget, and transferring the employees to other ARS Centers in California and Maryland would incur one-time relocation costs but would provide substantial savings over the long-term for the ARS Human Nutrition Program. In an era of flat budgets, redirection of existing funds to high priority programs, such as obesity prevention, and facility consolidation are among the few opportunities ARS has to maintain its program and meet high priority research needs.

DEPARTMENT OF AGRICULTURE
ARS FACILTITY CLOSURE: GRAND FORKS/OBESITY RESEARCH

Question from Senator Conrad

Question: Obesity costs the US economy more than $117B each year. These costs fall disproportionately on rural America (the 10 states of lowest population density experience nearly 9 times the obesity attributable health costs of the 10 most densely populated states). That the underlying causes of this health disparity remain poorly understood should be of national concern. Therefore, why is the President proposing to transfer to urban areas the only USDA-ARS human nutrition research center (the Grand Forks Human Nutrition Research Center) actively addressing this issue in a rural region?

Answer: USDA-ARS obesity research program studies a broad cross-sample of the U.S. population, both those at high risk and low risk in order to understand the causes and solutions to obesity. Maintaining the Center at Grand Forks to sample a relatively small population would not benefit the overall strategy of collecting a broad based sample of the U.S. population.

DEPARTMENT OF AGRICULTURE
ARS FACILTITY CLOSURE: GRAND FORKS/OBESITY RESEARCH

Question from Senator Conrad

Question: Obesity-related illnesses, including type 2 diabetes, heart disease, osteoarthritis, depression and many cancers, are growing at alarming rates, particularly among Native American youths and seniors, both key recipients of federal food assistance programs. Reversing these trends demands the development of innovative approaches to affect health food choices and physical activity in these vulnerable groups, their families and communities. Why, then, is the President proposing to dismantle research of this type in Native American Communities which is now being done by the Grand Forks Human Nutrition Research Center?

Answer: The Administration agrees that innovative approaches will be needed to affect healthy food choices and physical activities in all at-risk populations in the United States. The mission at Grand Forks has been a national mission although the researchers there have paid special attention to Native American communities in recent years. ARS has proposed the redirection of the program at Grand Forks in order to use the resources available to meet the needs of all at-risk populations, including Native Americans.

Senator Gregg QFRs

Question:

1. Please break out this 19% border security increase by PPA and show in separate columns the comparable amounts enacted in FY08 regular appropriations and enacted in FY08 total of regular and supplemental appropriations.

Answer:

The increase cited by the Department of Homeland Security is representative of both border security and immigration enforcement funding. Funding for border security and immigration enforcement includes resources identified in multiple agencies at DHS – including CBP, ICE, USCIS, and US VISIT.

Border Security and Interior Enforcement Resources
(dollars in millions)

	2008 Regular	2008 Emergency	2009 Request
Customs and Border Protection			
Construction & Technology	$459	$1,114	$1,139
Inspections	$2,142	$323	$2,468
Border Patrol	$3,686	$0	$4,149
Air & Marine Interdiction, Operations, Maintenance, & Procurement	$476	$94	$528
Automation Modernization	$477	$0	$511
	$7,240	**$1,531**	**$8,795**
Immigration and Customs Enforcement			
Detention & Removal	$2,231	$262	$2,582
Office of Investigations	$208	$0	$220
Automation Modernization	$31	$0	$57
	$2,470	**$262**	**$2,859**
Citizenship and Immigration Services			
E-Verify	**$0**	**$60**	**$100**
US-VISIT	**$200**	**$275**	**$390**
Total DHS Resources	**$9,910**	**$2,128**	**$12,144**
Department of Justice			
Executive Office of Immigration Review	$245	$0	$238
Office of Immigration Litigation	$57	$0	$69
Total DOJ Resources	**$302**	**$0**	**$307**
Total Resources for Border Security and Interior Enforcement	**$10,212**	**$2,128**	**$12,451**

Included in the DHS total is a large portion of CBP's budget, including 100 percent of funding for the Border Patrol, a share of the inspections budget, Air & Marine activities, and the Border Security, Fencing, Infrastructure, and Technology account. For ICE, included is funding for Detention and Removal, worksite enforcement, 287(g), and compliance enforcement. Also included at DHS is funding for the E-Verify system and funding for the US VISIT program.

It is important to note that the increase compares President's FY 2009 non-emergency funding to the enacted FY 2008 non-emergency funding. In addition, $300 million was requested for the Department of Justice's border security and interior enforcement-related activities, resulting in the President's 2009 totaling approximately $12.5 billion.

Senator Gregg QFRs

2. Are additional resources necessary in the future to provide full operational control? If so, please describe.

Answer:

As the President has stated on many occasions, there are three pillars essential for successful immigration reform – improving border security, increasing interior enforcement, and establishing a Temporary Worker Program (TWP). Simultaneous pursuit of all three Presidential objectives is essential if we are to be successful in our attempts to gain control of the border. In keeping with this strategy, Secretary Chertoff created the Secure Border Initiative (SBI) to bring clarity of mission, effective coordination of DHS assets, and greater accountability to the work of DHS in securing the Nation's borders. SBI is a comprehensive multiyear, nationwide DHS program to secure America's borders and reduce illegal immigration. SBI is a key piece of the President's core objectives for comprehensive immigration reform.

To aid in securing the border, DHS requires an optimum mix of technology and infrastructure, as well as response assets and personnel, to provide the maximum tactical advantage in each unique border sector environment. U.S. Customs and Border Protection (CBP) is the lead agency in DHS for the development of SBInet. SBInet is the component of SBI charged with developing and installing a technology and tactical infrastructure solution for border control. For FY 2009, the President's Budget requests $775 million – bringing the two-year total to $2 billion -- to continue the deployment of border technology and infrastructure. SBI and the SBInet component are focused on providing additional personnel – (both Border Patrol agents and support staff), tactical infrastructure (including fencing and barriers), technological and surveillance packages – (including a "virtual" fence) to southwest border sectors over the next few years.

Additional resources, beyond the horizon of the President's FY 2009 budget, will be necessary to gain further control of the southwest border. In future years, work also will focus on deploying a tailored SBInet solution on the northern border as well as operating and maintaining the infrastructure and technology deployed in 2007 - 2009 and beyond.

As noted above, this effort requires more than just strong border security enhancements. We need vigorous interior enforcement of immigration laws that will encourage employers to hire legal workers; and an effective TWP that is well regulated, highly visible, and rests upon a secure form of identification. The FY 2009 Budget aims to accomplish this by continuing the Administration's commitment to interior enforcement by requesting resources for 1,000 additional detention beds, improving coordination with State and local law enforcement, and enhancing and expanding the use of technology to increase the effectiveness of interior enforcement initiatives.

Emergency Designation
Senator Gregg

Question:

You include several proposals to reform the budget process in the President's 2009 budget request, nearly all of which have been proposed in the previous seven budgets. One such perennial proposal is to enact a "stricter standard for the emergency designation." What is the definition of an emergency," according to your proposal?

Given that definition, I am puzzled by the budget request of$76 billion in emergency appropriations for 2009. Of that, $70 billion is to only partially fund the war. The other $6 billion is for "Hurricane Recovery/Gulf Coast," which I understand is for the Army Corps for levee repair. Since you are not requesting this money until next year, it is clear you do not need it or want it now, so it does not meet your definition as "urgent." Nor is it "sudden" or "unforeseen".

So why does your budget insist on calling either of these items an emergency?

Answer:

- Our definition of an emergency requirement is that it should be limited to spending proposals that are necessary expenditures meant to respond to sudden, urgent, unforeseen, and not permanent events. This definition is meant to encompass contingency operations that are national security related for both defense and international programs, as well as funding for disasters and reconstruction efforts that fall outside of a reasonable multi-year average of disaster relief funding that can be built into the base.

- We support applying this definition to preclude funds from being declared an emergency for events that occur on an annual or recurring basis because it is not unreasonable to assume a multi-year average amount of funding for disaster relief for any given year. We also support this definition to protect against the "bundling" of non-emergency items with true emergency spending.

- We are cognizant that an average amount of funding for certain disasters will not accommodate the level necessary to address large and relatively infrequent domestic disasters such as Hurricane Katrina or other extraordinary events such as a war or national security-related contingency operations.

- The $6 billion we are requesting for upgrading New Orleans storm protection, meets the definition on that basis. The funding for the Corps of Engineers to improve New Orleans storm protection by itself exceeds the annul funding for the entire agency, and is thus an anomaly.

- Our submission for war costs in the President's 2009 budget is also consistent with our definition of an emergency requirement. War costs are not permanent and outyear costs remain difficult to predict because it is impossible to predict the situation on the ground in Afghanistan and Iraq one to two years in advance. To provide such detail is at best false precision and at worst a signal to our adversaries.

- Separating war costs from the base budget facilitates sound decision-making about Defense resources by allowing us to adjust war-related spending as the pace of operations in Afghanistan and Iraq changes.

Question for the Record, Senator Bunning, Committee on the Budget

Our entitlement programs, specifically Medicare, Medicaid, and Social Security, are facing severe financial problems that cannot be ignored. In fact, these three programs currently account for 44% of total federal spending. By 2018, this number is expected to be 56% of total federal spending. This is clearly unsustainable over the long term. The Administration's budget takes steps to reduce the rate of growth for both Medicare and Medicaid. Medicare's growth rate would be reduced by 2.2% and Medicaid's would be reduced by 0.3%. However, I believe all three major programs need to be addressed simultaneously. The President's budget neglected Social Security, aside from a proposal to create personal savings accounts in 2013. Other possible reforms, such as increasing the retirement age to 70 at the same rate as the current age indexing, would provide significant savings to the program, and reforms like this deserve more serious consideration.

1) To truly get a handle on our entitlement spending, don't you think Social Security's unfunded liability needs to be addressed?
The President agrees that Social Security's finances are unsustainable and the program needs to be reformed. The President has presented his own ideas on Social Security, and welcomes a discussion with Congress on their ideas. The President's 2009 Budget re-proposes establishing voluntary personal accounts, which would, in addition to providing real retirement security, pre-fund some of the long-term Social Security obligations. The Budget also discusses progressive indexing, which would protect the benefits of lower-wage workers by indexing them to growth in average wages, while indexing the benefits of the highest-income workers to the rate of inflation. Middle-income workers would have benefits indexed to a ratio of the two. Progressive indexing would address approximately two-thirds of the Social Security shortfall.

While Medicare's unfunded liability is larger in real terms, Social Security's long-term fiscal imbalance will negatively affect both the federal budget and the overall economy if it is not addressed. One measure of this long-term imbalance is the relationship between the obligations that Social Security has incurred and the revenue available to pay those obligations. Using this measure, the program's costs exceed its income by $15.7 trillion over the infinite horizon. And it is a near-term issue: starting in 2017, the program is projected to pay out more in benefits than it receives in dedicated revenue. At that point, the cash deficits in the program will impact the rest of the federal budget, and will require increased borrowing, lower government spending, or higher taxes.

The President believes that bipartisan cooperation to make Social Security solvent is essential and urges members of both parties to put their specific ideas forward.

2) What changes, aside from personal accounts, should Congress consider?
There are a number of program reforms that would strengthen the program and place it on a more sustainable path. The Budget described one such proposal, progressive indexing, which would allow higher-income retirees to have benefits indexed to inflation while offering a higher rate of growth for low-income workers. In his framework for reform, the President laid out a series of principles for modernizing Social Security:

- Fix Social Security's finances permanently for our children and grandchildren.

- Ensure that future generations receive benefits at least as high as today's seniors.
- Protect those who rely on Social Security the most - America's low-income earners.
- Replace the unfunded promises being made to younger workers with real savings and real retirement security.

The Administration and Congress face choices in how to bring Social Security's finances into balance. Over the years, many people from both parties have offered suggestions such as limiting benefits for wealthy retirees, indexing benefits to prices, instead of wages; increasing the retirement age; or changing the benefit formula to create disincentives for early retirement. All of these options are on the table. Irrespective of the particular reform under discussion, the program needs to be modified so that it is permanently solvent and can provide real retirement security for future workers.

DEPARTMENT OF THE INTERIOR
Abandoned Mine Land Payments to States

Question from Senator Enzi

Question: Last year, at the direction of the Office of Management and Budget, the Department of the Interior agreed to release money owed to the state of Wyoming under the Abandoned Mine Land Trust fund in the form of a grant instead of in a direct payment as the legislation we passed and the President signed intended. The budget does nothing to rectify this misinterpretation of the law, and I am disappointed that the agencies continue to ignore the intentions of Congress at the harm of our states. Do you plan on re-examining this misinterpretation at any point in time?

Answer: The Administration recognizes the importance of promptly paying to states the amounts specified in the Surface Mining Control and Reclamation Act Amendments of 2006. In fact, the FY 2008 funds were made available for obligation to states and tribes on December 17, 2007 (less than three weeks after closing the books on fee collections on coal produced in FY 2007). The Solicitor for the Department of the Interior has concluded that, based upon applicable law, these funds must be provided through grants. The law distinguishes between payments made to "certified" states, like Wyoming, that have completed their high-priority Abandoned Mine Land (AML) coal reclamation, and uncertified states that have not. Using grants allows the Office of Surface Mining to meet the distinct statutory requirements for these two different situations. There should be no harm to states, since grants to certified states are available with no strings attached and the funds under the grants will be provided as soon as the state needs funds to cover obligations.

DEPARTMENT OF THE INTERIOR
Net Receipts Sharing for Energy Minerals

Question from Senator Enzi

Question: I am extremely disappointed that the Administration included a 2 percent net receipt sharing provision in the FY 2009 budget and proposed authorizing legislation that would make this deduction permanent. The federal government collects mineral royalties from states who allow for energy production on their lands. Under the law, the states are entitled to half of the royalties collected. To distribute the state share, the law intends for the Minerals Management Service to divide the amount of mineral royalties collected by two, write a check for that amount, and mail it to the states. That's all it entails. How can you justify this $40 million provision?

Answer: The Administration's net receipts sharing proposal simply shares the burden of managing mineral leasing programs on Federal lands between the Federal and State beneficiaries of mineral revenue. Under the Mineral Leasing Act, States share equally in the revenues generated from Federal mineral development within their boundaries, but no longer share in the costs of managing mineral leasing programs and ensuring the appropriate collection of revenue. The Administration's proposal would cost-effectively recoup a portion of these costs by deducting two percent from the payments made to States. This is equivalent to one-percent of the total Mineral Leasing Act revenues, so that the Federal-State split would be 51/49. This would return to a form of net receipts sharing similar to what was in place during the 1990s, and would be consistent with the approach Congress endorsed for FY 2008 under the FY 2008 Consolidated Appropriations Act.

Food and Drug Administration (FDA) "Follow-on Proteins"
Senator Enzi

QUESTION: **The 2008 President's budget proposes a new authority for the Food and Drug Administration to approve "follow-on proteins" through a new regulatory pathway and financing this activity through user fees. Does the Administration believe that a new licensure pathway can be created without legislative authority?**

The Administration supports Congressional action to create an abbreviated pathway for the approval of follow-on protein products. Such legislation must, as a first priority, ensure patient safety. Furthermore, it should promote innovation through adequate intellectual property protections that provide significant periods of market and/or data exclusivity, independent from any patent protections that might be applicable to the product. The review of follow-on applications will require additional FDA resources that should be covered by authorizing the collection of user fees. There were a number of legislative proposals considered by Congress in 2007, and I refer you to the letter sent in June 2007 to Chairman Kennedy for additional information on this issue. The Administration looks forward to working with the Health, Education, Labor and Pensions Committee and the Congress in general to enact legislation that will make high quality biologic products more affordable for all Americans.

FFEL (Student Loan)
Senator. Enzi

For years, many of us have believed that the FFEL program is less costly to operate than the Direct Loan program, but the budget scoring rules have made it difficult to make this point. However, this year the Administration has concluded that FFEL is now the less expensive student loan program. Can you please elaborate on the implications of this change?

Response: It is true that the federal government's costs in the FFEL program are much lower after the College Cost Reduction and Access Act reduced subsidies paid to lenders and guaranty agencies. As a result, for new loans the cost difference between FFEL and Direct Loans is smaller than in previous years. Going forward, some categories of loans will be cheaper under FFEL than under the Direct Loan program, and some categories of loans will be more costly under FFEL.

Notably, consolidation loans in the Direct Loan program are much more costly, in part because many troubled borrowers already in default on their student loans consolidate into the Direct Loan program. Roughly half of Direct Loan consolidation volume is from underlying defaulted loans, compared to two percent of FFEL consolidations.

Experience has shown that competition between the two programs has yielded significant benefits for taxpayers and students. The Direct Loan program created pressure to reduce unnecessary taxpayer subsidies in FFEL. The innovations and adoption of best practices in both programs has improved services and options for students, families and schools. The President is committed to maintaining two efficient loan programs.

No Child Left Behind
Senator Enzi

Mr. Nussle, given that the No Child Left Behind Act is up for reauthorization, can you describe how the resources identified in the budget will be targeted to those areas that need to be strengthened in order to ensure that all children regardless of background receive a quality education? Will the budget request reinforce the accountability systems that have put into place?

Yes. In anticipation of the reauthorization of the No Child Left Behind Act, the President proposed significant and targeted increases to key NCLB programs in the FY 2009 Budget, as well as in the FY 2008 Budget. These increases are focused particularly on areas of greatest need -- schools in need of improvement, disadvantaged populations, literacy, and math and science education – and support State accountability systems. Specifically, the 2009 Budget:

- Provides $14.3 billion for Title I, the cornerstone of NCLB accountability and school improvement, a $406 million increase. This increase builds on the $1.1 billion increase provided in 2008, for a total of $1.5 billion in new funds to support reauthorization. The Administration's Title I reauthorization proposal would help improve rigor and accountability in high schools and provide more choice to students and parents.

- Continues strong support for School Improvement Grants, maintaining funding at $491 million. Together with the Title I set-aside for school improvement, over $1 billion will be devoted to additional support for struggling schools.

- Restores funding for Reading First, providing $1 billion, an increase of $607 million, for this effective program to help ensure all students can read well by third grade.

- Provides $300 million for a new Pell Grants for Kids program, to expand choices for parents by providing scholarships for students in chronically low-performing schools to attend a better school.

- Increases funding for programs serving disadvantaged populations to improve the achievement of students most at-risk of academic failure, including Special Education Grants to States (+$337 million); English Language Acquisition (+$30 million); Migrant Education (+$20 million); and Neglected and Delinquent State programs (+$3 million).

- Requests $100 million for Statewide Data Systems, a $52 million increase, to help support State efforts to improve accountability and to increase their ability to use data effectively

The Administration believes these, and other, investments provide a strong foundation for improving No Child Left Behind and urges Congress to reauthorize this good law.

Access to Electronic Records
Senator Enzi

Can you explain OMB's role implementing the President's goal of most Americans having access to electronic health records by 2014? How do you envision the relationship between what technology standards are adopted or endorsed by the Secretary of Health and Human Services with what Federal information technology purchases are approved by OMB? Are any of the agencies currently using health IT products that have been certified by the Certification Commission for Healthcare Information technology?

As part of the President's health information technology (IT) initiative, OMB assists Federal agencies in the use of and contract requirements for health IT systems and products. For instance, OMB initiated a Health Information Scorecard as part of the President's Management Agenda quarterly reporting process to track agencies' progress in implementing Executive Order (EO) 13410 titled, "Promoting Quality and Efficient Health Care in Federal Administered or Sponsored Health Care."

This EO directs Federal agencies to utilize health IT systems and products meeting recognized interoperability standards as agencies implement, acquire, or upgrade their health IT systems. The scorecard, which is managed by both OMB and HHS' Office of the National Coordinator for Health IT, measures how agencies are: incorporating health data standards, as recognized by the Secretary of HHS, into health IT systems; implementing accepted standards and acceptable contracting language with regard to systems development, validating ambulatory care systems are compliant with product certification criteria; and, demonstrating price and quality transparency. These are key outcomes for health IT standards implementation and availability of price and quality information in Federal Health Care Programs. Current participating agencies include HHS, DoD, VA, and OPM. All four agencies are moving towards implementation and adoption of health IT and improved price and quality transparency in Federal programs. Scorecard progress can be located at http://www.whitehouse.gov/results/agenda/scorecard.html

PELL GRANTS
Senator Enzi

The President's Budget Request includes $19 billion in Pell Grants to nearly 5.8 million students-186,000 more recipients than the 2008 level. This would also increase the maximum Pell Grant Award to $4,800, and for the first time, increase the average grant award to over $3,000.

How are the changes made through the College Cost Reduction and Access Act reflected in the budget, especially with respect to the maximum Pell grant award level?

Response: As you are aware, the College Cost Reduction and Access Act (CCRAA) made significant changes to the Pell Grant program by providing mandatory funds to increase the maximum award level and expanding program eligibility by adjusting the needs analysis formula. The 2009 Budget discretionary request of $16.85 billion for Pell Grants provides for a $2.6 billion discretionary funding increase. Of that discretionary increase, $1.2 billion is requested to cover the cost of CCRAA changes that expanded Pell Grant eligibility, and $1.6 billion is requested to pay for a cumulative prior-year funding shortfall that is due to increased program demand.

The 2009 Budget also requests $300 million to raise the discretionary maximum award level from $4,241 to $4,310. In combination with the $2.09 billion in mandatory funds provided in the CCRAA, this would support a total Pell Grant maximum award level of $4,800 in 2009. The Budget also includes other important reforms to the Pell program, including year-round Pell Grants to allow students to complete their undergraduate education more quickly.

Title I of No Child Left Behind and student financial assistance
Senator Enzi

Mr. Nussle, the budget level funds the Department of Education overall. Would you give us some background of how this funding has increased over the past 8 years, with particular focus on Title I of No Child Left Behind and student financial assistance.

Since President Bush took office, funding for the Department of Education has increased significantly, as education remains one of the President's highest priorities. In particular, the President has achieved extraordinary funding increases for both Title I, the cornerstone of No Child Left Behind (NCLB), and Pell Grants, a crucial source of financial assistance for students seeking to afford college.

Specifically, the 2009 Budget would provide the following increases compared to 2001—

- Total Department of Education funding would increase by $17.0 billion or 40 percent.
- NCLB funding would increase by $7.2 billion or 41 percent, including a $5.5 billion or 63 percent increase for Title I.
- Pell Grants funding would increase by $10.1 billion or 116 percent. The Pell maximum award would increase by $1,050 or 28 percent and the number of additional Pell recipients would increase by 1.5 million, or 33 percent.

Employment Eligibility Verification Program
Senator Feingold

The President proposes a $100 million expansion of the existing Employment Eligibility Verification Program. This system has been plagued with problems, resulting largely from a high error rate in the government data that is used to verify work authorization. How much, if any, of the $100 million will be dedicated to fixing the errors in the government's data and improving system accuracy?

Answer:

In the past, the Basic Pilot program – which is now E-Verify – was not capable of quickly verifying eligibility of all individuals run through the system, resulting in time consuming manual checks. However over the past few years, and as a result of regular independent reviews initiated by the U.S. Citizenship and Immigration Services (USCIS), significant changes and enhancements have been made to remedy these deficiencies.

The results from the most recent independent review, published in September 2007, found that 92% of all queries are verified instantly. This is an improvement from five years ago when only 79% of all queries were instantly verified. One example of the type of enhancement USCIS is continuing to make to E-Verify includes addressing naturalized citizens. USCIS found that, of the eight percent of cases that are not instantly verifiable, a large portion were individuals who had become naturalized citizens. Since they were U.S. citizens, their information was not included in the immigration data base and not all individuals notify SSA when they naturalize – so electronic verification has not been possible. To reduce the number of tentative non-confirmations, USCIS modified the process to include an electronic check against their naturalization database which is expected to increase future instant verifications significantly. The findings of the independent review are available on USCIS' website at:

www.uscis.gov/files/article/WebBasicPilotRprtSept2007.pdf.

For 2009, most of the $100 million is targeted toward covering the operational costs of the program which is expected to grow significantly. However, nearly $15 million of this request will focus on continued enhancements to further reduce the need for secondary, manual confirmations and improve information sharing between USCIS and SSA.

Feingold QFR
Cuts to Women and Infant Children (WIC) Program

WIC, which provides nutritious foods among other important services for low income women and their small children, has experienced consistent increases in enrollment and need, but this is has not been reflected in recent budget proposals. Instead of recognizing the need, the Administration repeatedly proposes cuts to the program by capping state administrative funds. I am concerned that this will hamper the ability of states to provide assistance to those already enrolled or wishing to enroll in WIC. USDA's own reports have found the WIC program to be effective in increasing consumption of more nutritious foods that are vital to early childhood development. Why does the Administration continue to propose this administrative cap to WIC?

OMB Response

The Administration is committed to providing WIC services to all eligible individuals seeking benefits, and the Budget request reflects this commitment by increasing overall WIC funding. The Budget proposes to rein in WIC administrative funding because these expenditures have been growing at rates faster than food costs. Since 2001, the average monthly cost for administration and nutrition services has grown more rapidly than the monthly food cost for each participant (23% compared to 14%).

Administrative funding increases significantly each year because the current law requires this funding to increase at an annual rate equal to the State and Local Expenditure Index, which is typically 1-2 percentage points higher than other commonly used inflators like the CPI-U and Thrifty Food Plan. The Budget does not propose a permanent cap on administrative funding; rather our proposal attempts to slow down the rate of growth in administrative funding. This proposal is intended to encourage State agencies to seek ways to be more efficient without affecting core services. The reduced administrative funding levels would allow for a greater proportion of appropriated funds to be used for food benefits and participation increases.

Feingold QFR
Eligibility, Food Prices for the Women and Infant Children (WIC) Program

Another important issue is the issue of estimating the number of Americans eligible for WIC and the cost of the food. Even with an administrative cap, last year's budget proposal did not come close to providing enough funding to maintain caseload, much less account for new applicants especially when the rising price of food is taken into account. According to a letter sent by Senators Byrd and Kohl to acting Secretary Connors, the Committee's estimates for maintaining WIC were some $500 million higher than the amount proposed by the President. Moreover, the Administration refused to adjust their proposal given the increased caseload and higher food prices and insisted that the Agriculture Appropriations Committee meet the President's outdated proposal. The Center on Budget and Policy Priorities estimated that the President's proposal would have resulted in a cut of more than 500,000 from the previous year. What assumptions about food prices and the struggling economy's impact on the number of eligible women and young children are included in the President's budget? If these estimates change, do you plan to adjust your budget request to maintain or expand caseload?

OMB Response

Since 2001, the Administration has provided enough funds to serve all eligible women, infants and children seeking WIC services. The Budget continues that tradition with a request of $6.1 billion to serve 8.6 million participants per month. The 2009 request assumes that, on average, 8.6 million individuals will use WIC per month, a monthly increase of 80,000 individuals from the 2008 participation projection and an increase of almost 300,000 participants from 2007. While it is difficult to project the cost of food items in the WIC benefit, the budget estimate assumes the food benefit costs will increase by about $1 to $43.55 per person, per month from 2008 to 2009.

If these assumptions change, the Budget provides $150 million in contingency reserves. The Administration closely follows participation and food prices affecting the cost of the WIC benefit. When participation and food costs increased significantly this past fall, we released over $100 million in contingency funds to ensure that all individuals seeking benefits were served. Additionally, in a letter in response to Senators Byrd and Kohl we acknowledged that the program had experienced significant and unanticipated participation and cost increases. We indicated a willingness to work with Congress to find offsets within the overall federal budget which would enable the appropriators to fund WIC above our 2008 requested level in order to maintain the Administration's commitment to serving all individuals seeking benefits.

Community Oriented Policing Service (COPS) Program
Senators Feingold and Launtenberg

1) The President's budget proposes to eliminate entirely funding for the Community Oriented Policing Service (COPS) program and Byrne Justice Assistance Grants, two programs that are each authorized at over $1 billion, and replacing them with the Byrne Public Safety and Protection Program at $200 million and $4 million for community policing training and technical assistance. These eliminations come at a time when I am increasingly hearing from law enforcement officials in my state about violent crimes in their communities. Indeed, according to the 2006 FBI Uniform Crime Report, violent crime in Wisconsin increased by a staggering 18.1 % and, unfortunately, the recently released preliminary statistics for 2007 indicate that these rates have continued to rise in both Milwaukee and Green Bay. Considering the climate of increasing crime in these and countless other communities across this country, how does the Administration justify this significant cut in funding?

Response:

While the crime rate has fluctuated recently in selected cities, the overall violent crime rate remains well below historical levels. In fact, FBI data shows that, nationally, violent crime dropped by -1.8 percent in the first half of 2007 compared to a year ago. In the Midwest, violent crime fell by -2.6 percent. Within Wisconsin, violent crime increased in some communities (e.g., Milwaukee and Green Bay), while it was down in others (e.g., Madison). Nevertheless, the Administration remains concerned about violent crime and believes that the Federal government must be a reliable and effective partner for state and local law enforcement. Taxpayer dollars must be spent smarter to help meet that goal, however. Competition should be the guiding principle used to ensure that Department of Justice state and local law enforcement assistance flows to the areas of greatest need.

The Budget proposes a total of $1 billion in spending for state and local law enforcement assistance programs, and consolidates more than 70 different programs, many of which are heavily earmarked and have not demonstrated results, into just four flexible grants. Each of the new grants will permit States and localities to compete for funding based on local needs, as well as national priorities. The Justice Assistance Grants and COPS Grants programs are among those that are consolidated. In addition to the Byrne Public Safety and Protection Program, which you note, we are proposing the Violent Crime Reduction Partnership (VCRP) Initiative, which is intended specifically to help State and local law enforcement agencies form multi-jurisdictional partnerships with Federal law enforcement agencies to tackle the most serious and violent crime issues in their communities. The Budget requests $200 million for this program for FY 2009.

Juvenile Justice Delinquency Prevention Act

2) In the past few years, there's been a steady accumulation of evidence showing that the types of programs funded by the Juvenile Justice Delinquency Prevention Act are extremely effective at preventing and reducing crime. It appears that the President's FY

2009 budget basically gets rid of the JJDPA framework, which was originally funded at almost $600 million and had dropped to $338.7 million in FY 2007. In its place, the President proposes a single "child safety and juvenile justice" program to be funded at the sum of$185 million. What is the rationale for slashing JJDPA programs just when it's becoming clear how effective these programs are at reducing crime?

Response:

The Administration believes that competition should be the guiding principle used to ensure that assistance flows to the areas of greatest need. This is why the Budget proposes to consolidate the Juvenile Justice Grant programs, some of which are heavily earmarked and have not demonstrated results, into a single flexible and competitive Child Safety and Juvenile Justice Program. The new program will help to reduce incidents of child exploitation and abuse, improve juvenile justice outcomes, and address school safety needs in communities across the Nation. The new grant will permit States and localities to compete for funding based on local needs, as well as national priorities. The Budget requests $185 million for this program for FY 2009.

Lautenberg QFR

Community Oriented Policing Service (COPS) Program

The President's budget eliminates the successful Community Oriented Policing Services (COPS) program and cuts funding for local law enforcement by more than one billion dollars. With violent crime on the rise across the country, do you believe this is a good time to be slashing programs that help law enforcement?

Response:

While the crime rate has fluctuated recently in selected cities, the overall violent crime rate remains well below historical levels. In fact, FBI data shows that, nationally, violent crime dropped by -1.8 percent in the first half of 2007 compared to a year ago. Nevertheless, the Administration remains concerned about violent crime and believes that the Federal government must be a reliable and effective partner for state and local law enforcement. Taxpayer dollars must be spent smarter to help meet that goal, however. Competition should be the guiding principle used to ensure that Department of Justice state and local law enforcement assistance flows to the areas of greatest need.

The Budget proposes a total of $1 billion in spending for state and local law enforcement assistance programs, and consolidates more than 70 different programs, many of which are heavily earmarked and have not demonstrated results, into just four flexible and competitive grants. Each of the new grants will permit States and localities to compete for funding based on local needs, as well as national priorities. The COPS Grants are among those that are consolidated. One of the competitive programs we propose, the Violent Crime Reduction Partnership (VCRP) Initiative, is intended specifically to help State and local law enforcement agencies form multi-jurisdictional partnerships with Federal law enforcement agencies to tackle the most serious and violent crime issues in their communities. The Budget requests $200 million for this program for FY 2009.

DEPARTMENT OF AGRICULTURE
SECURE RURAL SCHOOLS

Questions from Senator Crapo

The President's Fiscal Year 2009 Budget Request includes a legislative proposal that provides $200 million above the current baseline for a 4-year extension of the Secure Rural Schools and Community Self-Determination Act of 2000 (P.L 106-393). I appreciate the Administration's recognition of the importance of a multi-year extension of the Secure Rural Schools and Community Self Determination Act and willingness to work with Congress to identify mutually agreeable offsets. Extending this important legislation is essential to ensure that rural communities across this nation have the ability to maintain necessary school and road services, and it takes all of our cooperative efforts to achieve this extension. However, I am concerned with the potentially inadequate level of funding proposed by the Administration for an extension of the Secure Rural Schools Act. This requested funding level is far lower than past Administration proposals to extend this program. Additionally, I would like to see more details regarding the Administration's legislative proposal.

Question #1: Please explain why the Administration is requesting only $200 million for the extension of the Secure Rural Schools and Community Self-Determination Act of 2000 (P.L. 106-393).

Answer: The Administration continues to support its previously proposed extension of the Secure Rural Schools program through 2011. The 2009 Budget includes the funding for the final three years of the Administration's phased-out, fully offset extension. The Administration is proposing payments of $100 million in FY 2009, $60 million in FY 2010, and $40 million in FY 2011. These are the same FY 2009 to 2011 funding levels proposed in the FY 2007 and FY 2008 Budgets. The Administration's previous proposals included $320 million for FY 2007 and $200 million for FY 2008. Congress did not enact the Administration's FY 2008 Budget proposal. For the FY 2008 payment, the Administration will continue to work with the Congress to find mutually agreeable offsets.

Question #2: Please provide further details regarding the Administration's proposal to extend the Secure Rural Schools Act. What are the "most affected areas" that would be targeted for county safety net payments under this legislative proposal?

Answer: The Secure Rural Schools legislation was intended to provide temporary assistance to local communities to allow their economies to make the transition resulting from lower timber harvests. When the original legislation expired, the Administration recognized that the localities needed additional time for transition but wanted to ensure that payments would end after a five year extension of the authorization. The Administration proposed phase-out schedule was designed to achieve that goal. The Administration also recognized that Oregon, Washington, and

California continue to remain the most affected areas. Under our proposal, payments would be made in a manner generally consistent with the formula under the expired Act, which provided approximately 70% of total payment to these states, while reflecting consideration of how local economies have adjusted to lower timber receipts as envisioned under the Act.

Question #3:_Please provide specifics regarding how the Administration proposes to cap the program, adjust the program downward and phase it out.

Answer: The Administration's proposal provides $200 million in payments above the current baseline, consisting of not to exceed $100 million in 2009, $60 million in 2010, and $40 million in 2011. No additional funding for payments is proposed. Authority for payments will expire after the final payment is made.

DEPARTMENT OF AGRICULTURE
POTATO CYST NEMATODE

Question from Senator Crapo

Necessary funding for Potato Cyst Nematode (PCN) eradication. Eradication of the Potato Cyst Nematode is essential to our domestic potato industry, and we must ensure that the eradication plan continues to receive the necessary funding and support to achieve success. I understand for FY 2009, the Administration is requesting $7.7 million for PCN eradication.

Question: Please provide more information regarding the justification for this particular level of funding. Do you feel this amount will be enough to fully conduct the necessary steps for eradication, including the nationwide survey?

Answer: The FY 2009 Budget, along with the appropriate level of cooperator funding, should be sufficient to continue the Potato Cyst Nematode eradication program on a path to achieve success. The program projects reductions of PCN populations in the soil by 40 percent each year. The $7.7 million level requested in the FY 2009 Budget includes sufficient funding to conduct the nationwide survey.

John Cornyn

OMB Director Jim Nussle
Senate Budget Committee Hearing
February 5, 2008
Senator John Cornyn
Question for the Record

The Open Government Act of 2007

Mr. Nussle, as you may know, Senator Pat Leahy and I have long advocated for greater openness in government.

President Bush recently signed into law our OPEN Government Act, a significant reform of the Freedom of Information Act (FOIA). A key component of our legislation is the creation of the Office of Government Information Services (OGIS). Among other things, OGIS will mediate disputes between agencies and FOIA requestors, review agency compliance with FOIA, and house the newly created FOIA ombudsman.

In its FY 2009 budget proposal, the Administration proposes transferring the responsibilities of OGIS to the Department of Justice. This violates both the explicit text of the OPEN Government Act and its legislative intent. The statute unequivocally places OGIS within the National Archives. This placement was intentional.

Senator Leahy and I and our fellow lawmakers, supported by the FOIA requestor community, sought to make the FOIA ombudsman independent of the Department of Justice, which represents agencies sued by FOIA requestors. A primary reason for this intentional separation was to avoid conflicts of interest. We did not want the same agency to both mediate FOIA disputes and defend against them in court. Senator Leahy and I have written a letter to you on this point. In addition, the Sunshine in Government Initiative, a coalition of ten media organization, has written a letter to Senators Byrd and Cochran opposing the Administration's proposal. I request that both letters be included in the record.

Mr. Nussle, what is the justification for the Administration's proposed change to this weeks-old law?

United States Senate

WASHINGTON, DC 20510

February 5, 2008

Hon. Jim Nussle
Director, Office of Management and Budget
725 17th Street, NW
Washington, D.C. 20503

Dear Director Nussle:

President Bush recently signed into law our OPEN Government Act of 2007, Public Law 110-175, which made the first significant reforms to the Freedom of Information Act (FOIA) in over a decade. As longtime advocates for greater openness in government, we believe that our legislation will help restore the promise of FOIA. A key component of our legislation is the creation of the Office of Government Information Services (OGIS). Among other things, OGIS will mediate disputes between agencies and FOIA requestors, review agency compliance with FOIA, and house the newly created FOIA ombudsman.

In its FY2009 budget proposal, the administration proposes transferring the responsibilities of OGIS to the Department of Justice. *Budget of the United States Government, Fiscal Year 2009*, tit. 5, § 519. This proposal violates both the explicit text of the OPEN Government Act and its legislative intent. The Act declares that "[t]here is established the Office of Government Information Services within the National Archives and Records Administration." 5 U.S.C. § 552(h). This placement was intentional. We and our fellow lawmakers, supported by the FOIA requestor community, sought to make the FOIA ombudsman independent of the Department of Justice, which represents agencies sued by FOIA requestors. A primary reason for this intentional separation was to enhance the office's independence, as well as to avoid real or perceived conflicts of interest. We did not want the same agency to both mediate FOIA disputes and defend against them in court, if litigation ensued. The administration's proposal alters the essential character of OGIS as an independent, disinterested office serving FOIA requestors.

For these reasons, we strongly oppose the administration's proposal to transfer the responsibilities of OGIS to the Department of Justice. Instead of moving OGIS, the administration should be working to stand up and adequately fund the office. We hope that you will be responsive to our concerns, and we look forward to working with you to bring this new office into existence for the benefit of the FOIA requestors it was designed to assist.

Sincerely,

PATRICK LEAHY
United States Senator

JOHN CORNYN
United States Senator

Sunshine in Government Initiative

1101 Wilson Boulevard, Suite 1100 · Arlington, Virginia 22209
Phone (703) 807-2100 · Fax (703) 807-2109
www.SunshineInGovernment.org · info@SunshineInGovernment.org

February 4, 2008

Senator Robert Byrd, Chairman
Senate Appropriations Committee
S-131 Capitol Building
Washington, DC 20510
Sent via fax (202) 224-2100

Senator Thad Cochran, Ranking Member
Senate Appropriations Committee
113 Dirksen Building
Washington, DC 20510
Sent via fax: (202) 224-9450

Dear Chairman Byrd and Ranking Member Cochran,

We are writing to express our strong opposition to the administration's proposal in the fiscal year 2009 budget to eliminate the newly created independent Freedom of Information Act (FOIA) ombudsman at the National Archives and Records Administration (NARA).

The Sunshine in Government Initiative is a coalition of ten media organizations including **American Society of Newspaper Editors, Associated Press, Association of Alternative Newsweeklies, Coalition of Journalists for Open Government, National Association of Broadcasters, National Newspaper Association, Newspaper Association of America, Radio-Television News Directors Association, Reporters Committee for Freedom of the Press,** and **Society of Professional Journalists**.

The language inserted in the President's budget seeks to reverse legislation signed into law barely a month ago. Included in page 239 of the appendix to the President's proposed budget for FY2009 is a paragraph that eliminates the Office of Government Information Services (OGIS) within NARA and instructs the Justice Department to carry out its functions.

In the OPEN Government Act of 2007 (Public Law 110-175), which President Bush signed into law on December 31, 2007, Congress established an independent ombudsman within the federal government. Section 10 of the Act, which the President now proposes repealing, created a potentially valuable and effective tool to help the public reduce long delays and avoid costly litigation by mediating disputes that can arise when the public seeks documents held by government. Envisioning a mediator between the Justice Department's lawyers (representing federal agencies) and public requesters, Congress recognized this entity needs independence from the Justice Department:

> (1) There is established the Office of Government Information Services within the National Archives and Records Administration.
>
> (2) The Office of Government Information Services shall –
>
> > (A) review policies and procedures of administrative agencies under this section;
> > (B) review compliance with this section by administrative agencies; and
> > (C) recommend policy changes to Congress and the President to improve the administration of this section.

(3) The Office of Government Information Services shall offer mediation services to resolve disputes between persons making requests under this section and administrative agencies as a non-exclusive alternative to litigation and, at the discretion of the Office, may issue advisory opinions if mediation has not resolved the dispute.

Asking the Justice Department to perform the responsibilities creates an inherent conflict of interest. We encourage the Congress to fully fund OGIS within the National Archives. This reflects the plain language of the statute and intent of Congress in passing the OPEN Government Act. The money should follow the law.

Sincerely,

Rick Blum

Rick Blum, Coordinator
The Sunshine in Government Initiative

cc: Senate Majority Leader Harry Reid
Senate Minority Leader Mitch McConnell
Chairman Patrick Leahy
Senator Arlen Specter
Senator John Cornyn

Mr. Nussle, as you may know, Senator Pat Leahy and I have long advocated for greater openness in government.

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In its FY 2009 budget proposal, the Administration proposes transferring the responsibilities of OGIS to the Department of Justice. This violates both the explicit text of the OPEN Government Act and its legislative intent. The statute unequivocally places OGIS within the National Archives. This placement was intentional.

Senator Leahy and I and our fellow lawmakers, supported by the FOIA requestor community, sought to make the FOIA ombudsman independent of the Department of Justice, which represents agencies sued by FOIA requestors. A primary reason for this intentional separation was to avoid conflicts of interest. We did not want the same agency to both mediate FOIA disputes and defend against them in court. Senator Leahy and I have written a letter to you on this point. In addition, the Sunshine in Government Initiative, a coalition of ten media organization, has written a letter to Senators Byrd and Cochran opposing the Administration's proposal. I request that both letters be included in the record.

Mr. Nussle, what is the justification for the Administration's proposed change to this weeks-old law?

The Administration strongly supports measures to ensure the timely and fair resolution of Freedom of Information Act (FOIA) requests. However, most of the proposed functions for the new Office of Government Information Services (OGIS) are duplicative of activities already being performed by the Department of Justice (DOJ). Also, only DOJ, as the Government's lead on FOIA issues and mediation in legal matters, is properly situated and empowered to successfully mediate issues between requestors and the Federal Government. The National Archives and Records Administration (NARA), in contrast, has limited experience dealing with intricate legal issues that surround FOIA requests. Also, mandating such a role could detract from NARA's core mission of storing and preserving Federal records.

The Administration's commitment to improving FOIA processes is demonstrated through Executive Order 13,392, which the President issued in December 2005. Among other things, the Order mandated that agencies develop improvement plans by June 2006 to respond more quickly to FOIA requests, designate public liaisons to the FOIA requestor community, and establish Requestor Service Centers. According to a report from the Attorney General, most agencies have made measurable progress implementing the Order and reaching their milestones. As agencies continue to improve their processes, the Administration will continue to look for ways to improve the FOIA process and to make it more responsive to the needs of the public.

THE PRESIDENT'S FISCAL YEAR 2009 BUDGET AND REVENUE PROPOSALS

WEDNESDAY, FEBRUARY 6, 2008

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

The Committee met, pursuant to notice, at 10:04 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Murray, Menendez, Cardin, Sanders, Whitehouse, Gregg, Allard, and Bunning.

Staff present: Mary Ann Naylor, Majority Staff Director; and Denzel McGuire, Minority Staff Director.

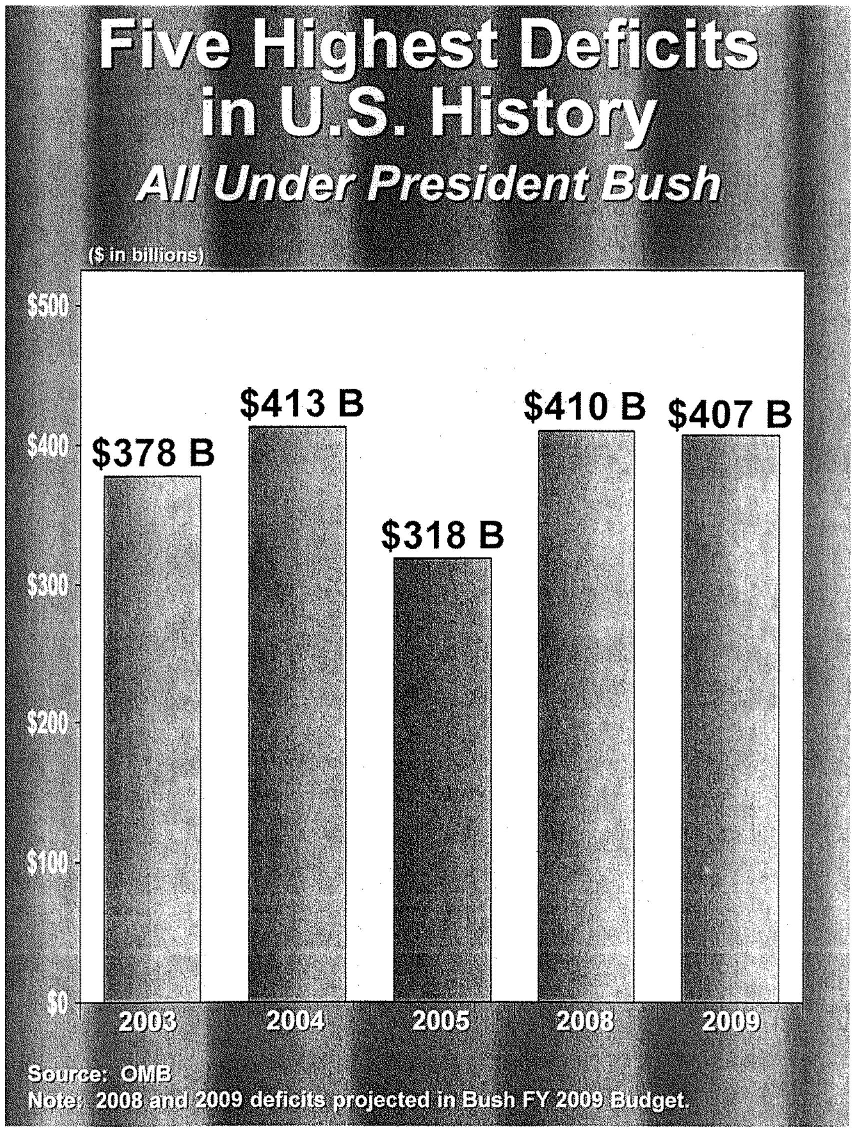
OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

The Senate Budget Committee wants to welcome the Secretary of the Treasury, Secretary Paulson. We are delighted to have you back before the Committee. We thank you for your service to the country in this incredibly important position and at this extraordinarily important time.

I think we all know the considerable risks that are out there to the economy and are eager to work together to prevent an economic downturn from turning into something steeper and longer-lasting than might otherwise be the case.

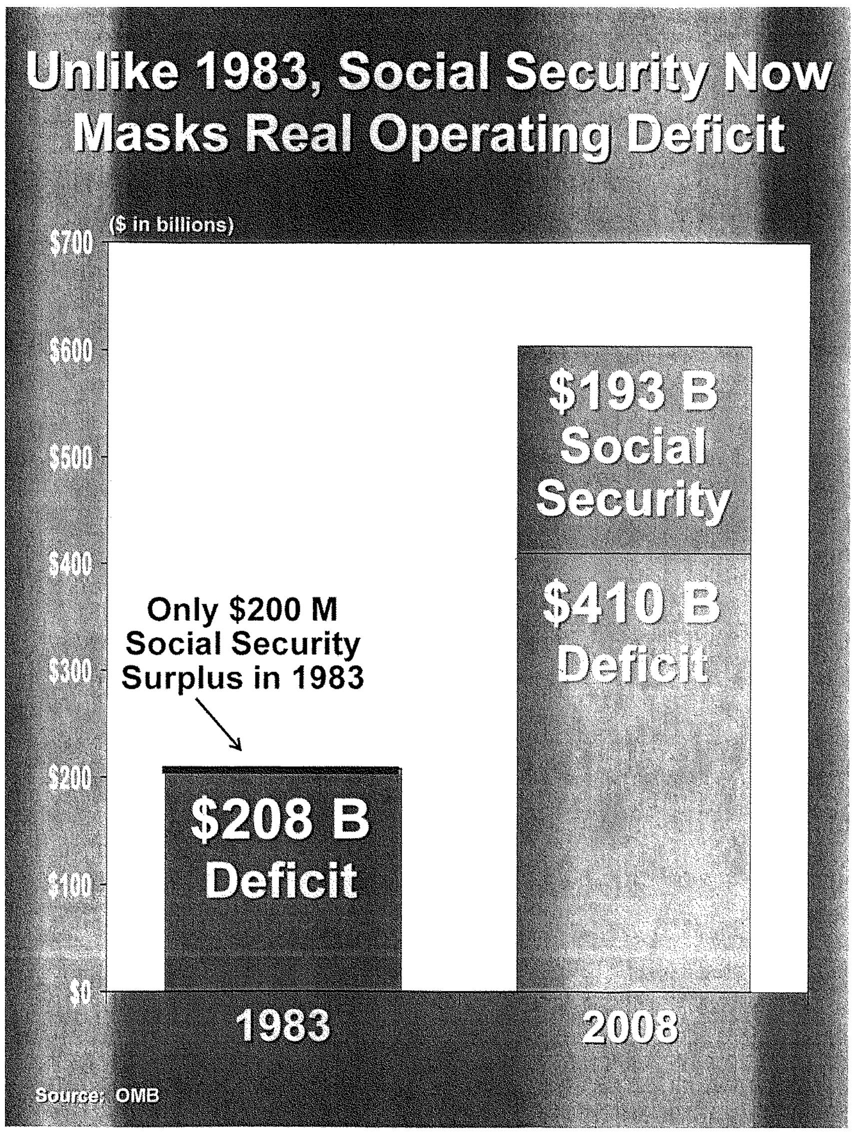
Let me just start by putting in perspective our budget deliberations as we look forward to this year. We now have under this administration five of the highest deficits in U.S. history.



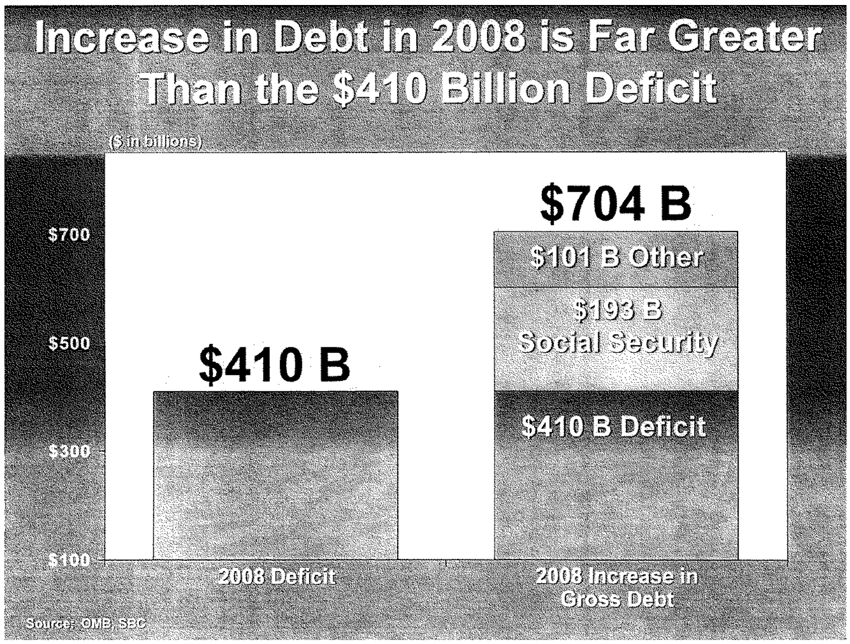
The administration is telling us we can expect a $410 billion deficit in 2008, and $407 billion in 2009. I hear often the pundits say, well, it is not so bad in terms of the share of gross domestic product. I just want to counter that by suggesting to those in the media that they are really missing the point, that the debt is going up much more rapidly than the deficit, and that while the deficit is forecast to be $410 billion for 2008, there is also almost $200 billion of Social Security money that is being used to pay other bills. And if you put those two together, it exceeds $600 billion. That is over 4 percent of GDP.

If you go back to the 1980's, which many people are eager to compare it with, we had a deficit then of $208 billion, but the Social Security surplus was only $200 million—$200 million. So when people were looking at deficits to GDP in those days and compared to now, it is apples and oranges. There is no comparison between what the real shortfalls are now as a share of GDP and what they were then.

Let's go to the next slide if we can.

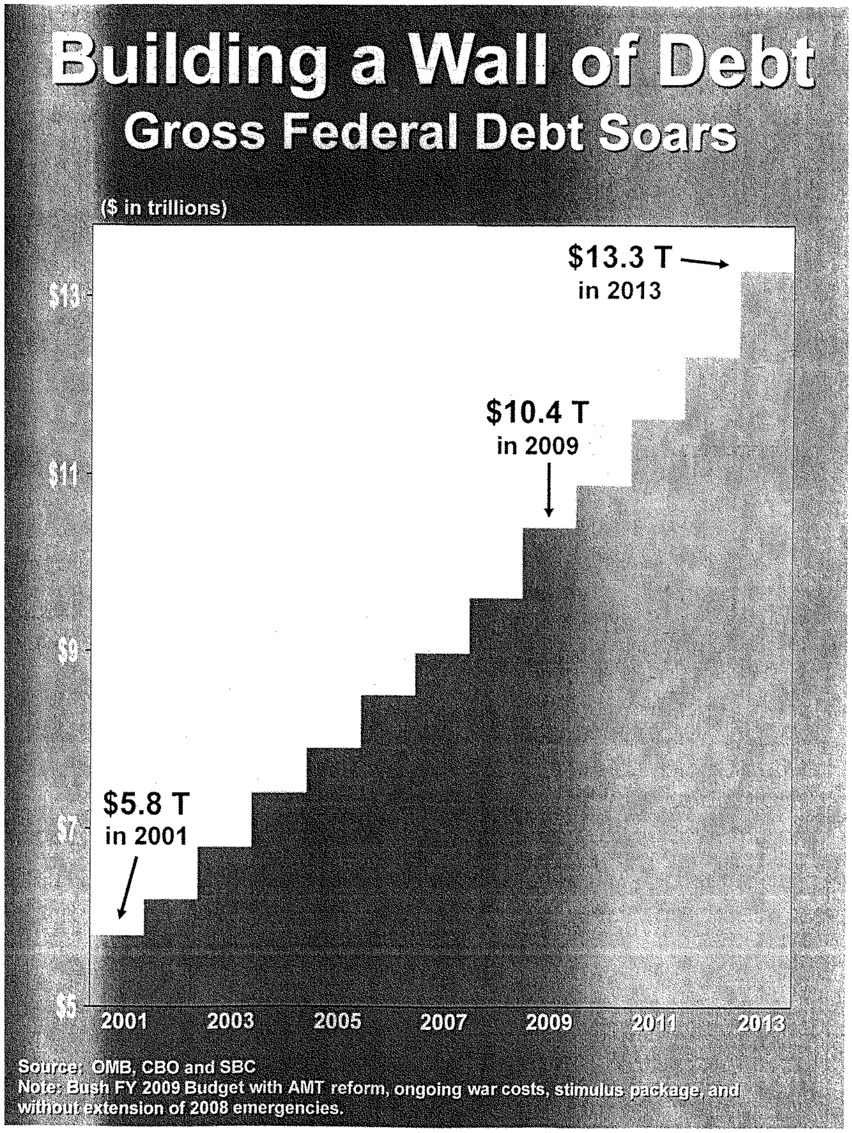


The total debt for this year is not going to go up by the deficit of $410 billion. The debt of the country is actually going to go up by over $700 billion.



Of course, the biggest difference is what I have already described, the Social Security money that is being taken to pay other bills, and other trust funds as well that are being tapped. So if you look at the gross debt of the United States, it is going up by $700 billion.

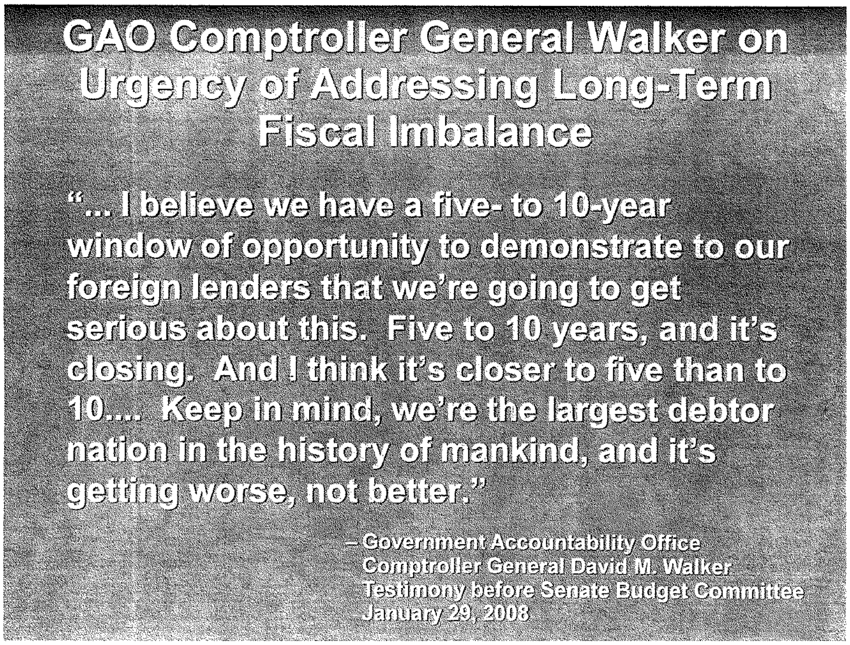
Let's go to the next slide.



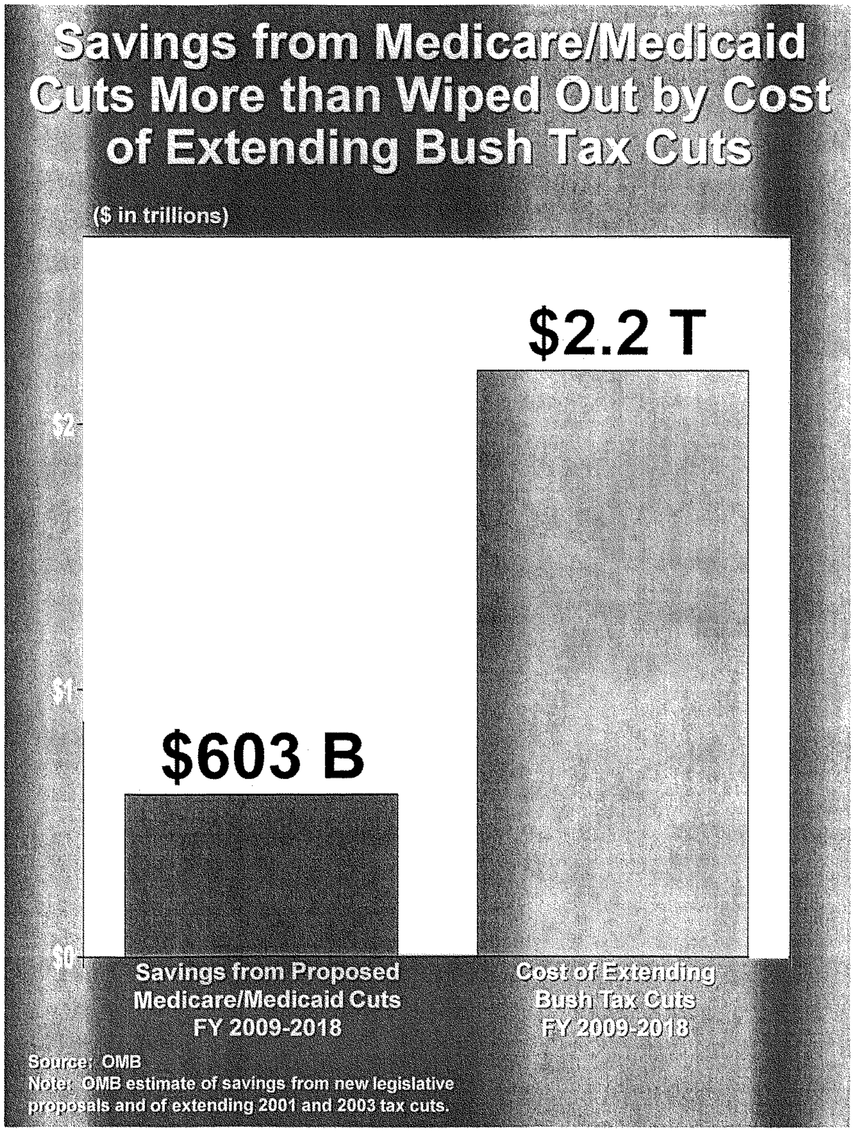
The result of all this is that we are building a wall of debt of stunning proportion, going from $5.8 trillion at the end of 2001 to $10.4 trillion by the end of 2009—the 8 years that the President will be responsible for—nearly a doubling of the national debt. And, increasingly, this is money that we are borrowing from abroad. We are increasingly dependent on the kindness of strangers.

If we look at the top ten foreign holders of our national debt, we see Japan at the top at nearly $600 billion; China, approaching $400 billion; the United Kingdom, $300 billion; the oil exporters, over $120 billion; and on it goes. We even owe Korea more than $40 billion.

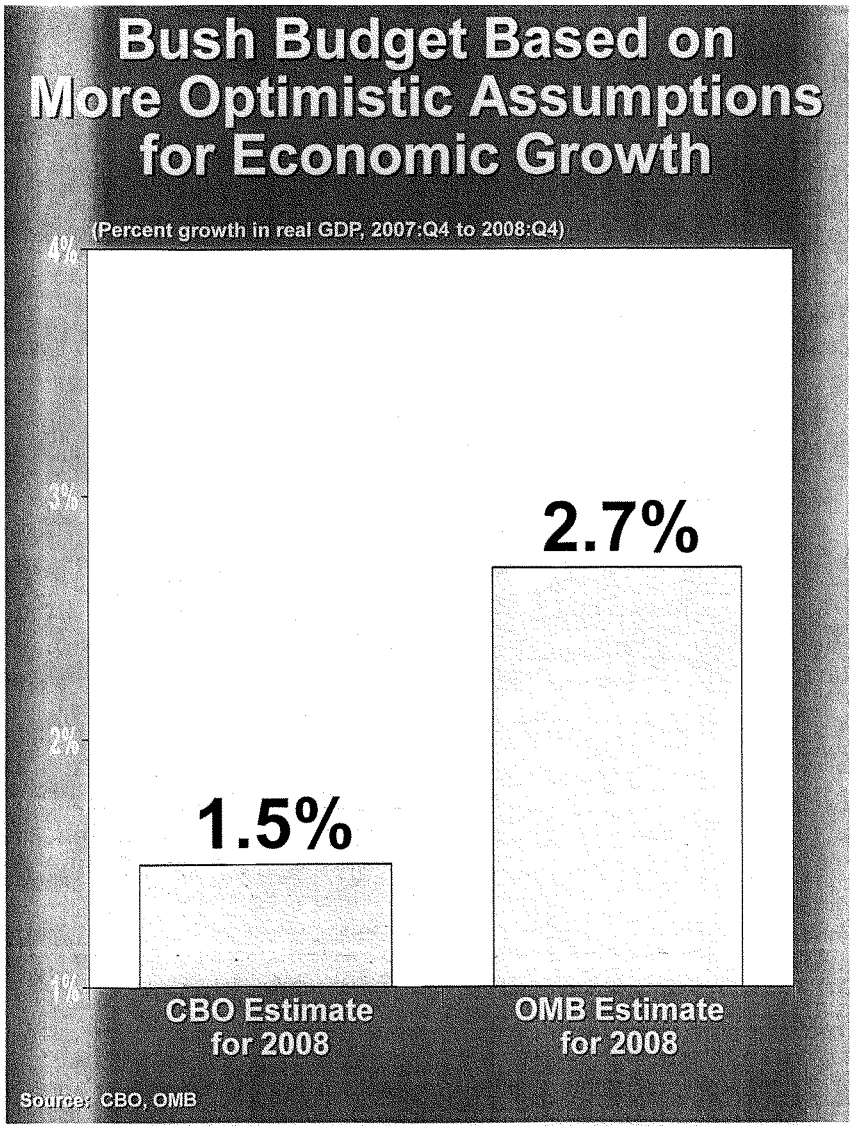
The Comptroller General in testimony before the Senate Budget Committee on January 29th said this: "I believe we have a 5- to 10-year window of opportunity to demonstrate to our foreign lenders that we are going to get serious about this—5 to 10 years, and it is closing. And I think it is closer to 5 than to 10. Keep in mind, we are the largest debtor nation in the history of mankind, and it is getting worse, not better."



That is the Comptroller General of the United States telling us, all of us—Congress, the administration—that time is a-wasting and we cannot continue to run up this massive debt.



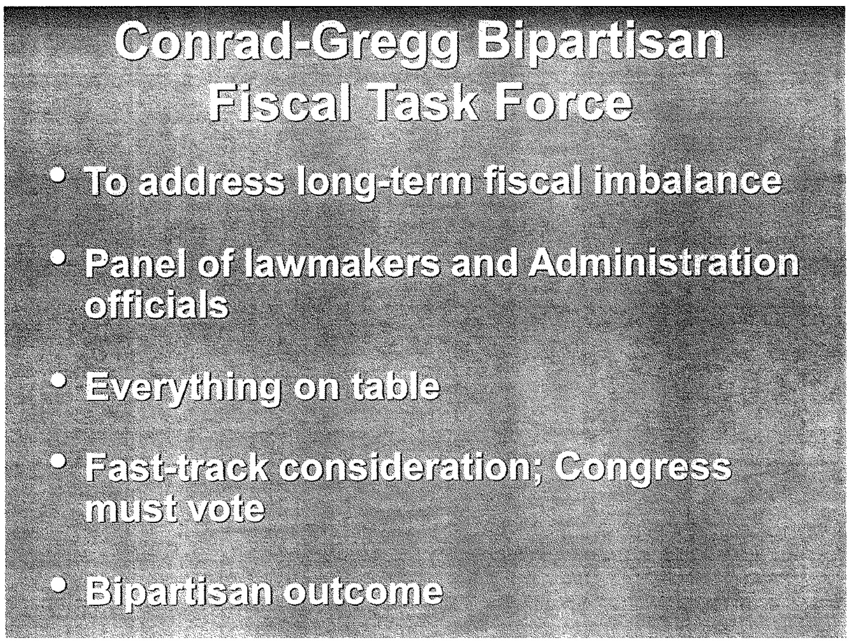
The administration comes forward with a proposal that says, well, we are going to start, we are going to lay down a proposal to save $600 billion in Medicare and Medicaid over 10 years. But in the same budget document, they are saying cut taxes another $2.2 trillion. That just digs the hole deeper, and somehow my own belief is together we have to come up with a comprehensive plan that deals with the imbalance between our revenue and our expenditures and these enormous shortfalls in our entitlement programs.



When I look at the assumptions behind this forecast, I see that OMB is estimating economic growth for this year of 2.7 percent. The Congressional Budget Office says it will be 1.5 percent. So as bad as these numbers are, they are buttressed by what looks like a rosy economic forecast.

I think we all understand the need for a stimulus package. I am not going to go through here the elements that are in the stimulus package that has passed the Senate. We will get to that in questions. But I do want to conclude on this note.

Senator Gregg and I have made a proposal for a task force—16 members, evenly divided—to address the long-term fiscal imbalance and to come up with a plan that would then come to Congress for a vote, everything on the table.



You know, when we started this earlier last year, I was convinced of its need then. Virtually every witness before this Committee has said it is imperative. It is imperative that we have some approach, either this one or something like it, to get at the extraordinary challenges that the next administration will face.

With that, I want to call on my colleague Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman, and again, I want to thank the Secretary of the Treasury for being here today. I want to thank him for his extraordinary service to the country and his leadership during what is a very critical period in our economic cycle. We thank him for that.

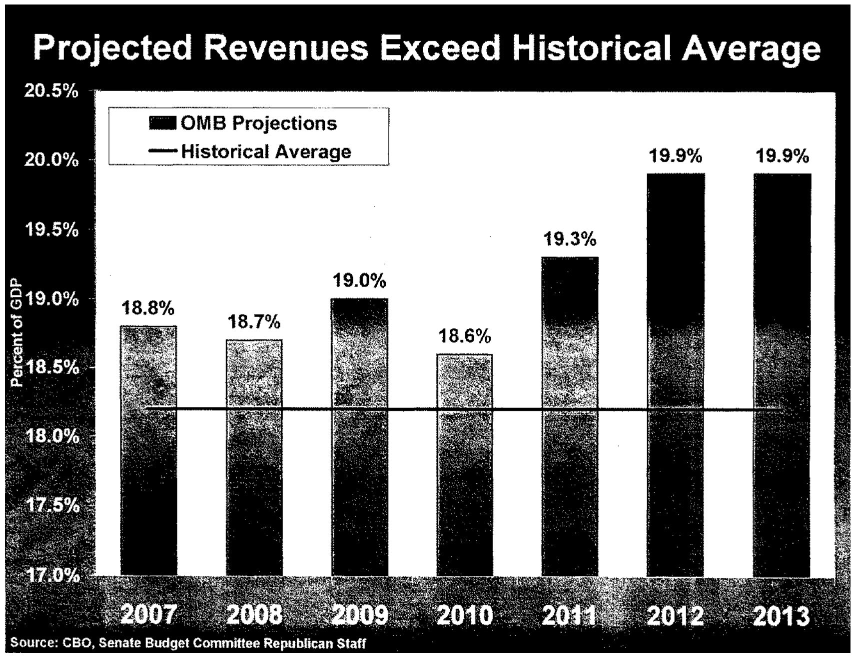
I wanted to respond to a couple of things that the Chairman said. First, I congratulate him, obviously, and appreciate the chance to cosponsor with him this initiative to try to address the fiscal out-year catastrophe which we face as a country. That is something that must be addressed, and we have proven beyond any doubt that as a Government we cannot address it item by item or policy by policy. Because of the nature of democracy, people tend to jump on policy proposals as they are put forward, depending on what their interest group is and what they desire to promote. And so sometimes you have to use procedure to drive policy, and that is why we have put this proposal forward.

I respect the Chairman's interest and focus on debt. But I think you have to also reflect the fact that if you look at the Democratic budget that we have been functioning under this year, it has significantly aggravated the debt situation. On 15 to 19 different occasions PAYGO, their rule of fiscal enforcement, was either waived, ignored, or basically gamed, causing about $145 billion of spending to escape PAYGO enforcement. Revenues which were projected under their budget through more enforcement and better enforcement of the Internal Revenue Service Code did not come forth. And then, in addition to that, on the discretionary side they proposed and put into the first supplemental $17 billion of new spending, which was essentially earmarks, and coupled that up with another $22 billion in the underlying budget, which, as a result of the President being aggressive, was cut back to approximately $10 to $12 billion, depending on how you account for emergencies.

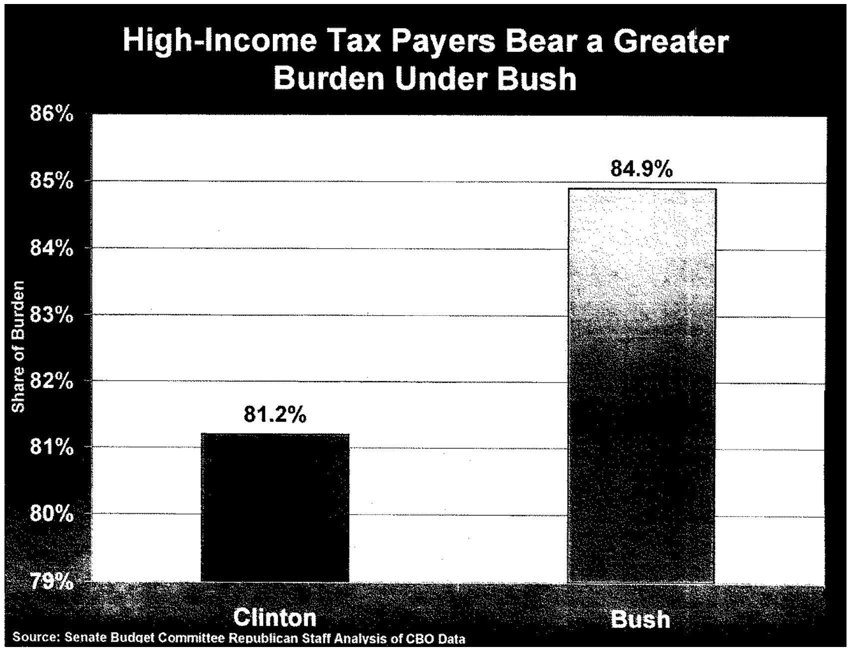
So there has been no significant contribution here. In fact, their budget made no effort in the area of entitlement reform, even though the President sent up two very reasonable proposals last year in entitlement reform—one of which was to simply ask that people like Warren Buffett actually pay a fair share of their cost of the Medicare Part D premium. Those reasonable proposals were rejected. So instead of controlling entitlement spending, we actually added to entitlement spending by increasing entitlement accounts last year and creating new entitlement accounts outside the PAYGO window, SCHIP being the classic example of that.

So, while I appreciate Senator Conrad's focus on debt, there is no action here coming from the other side of the aisle to substantively address that.

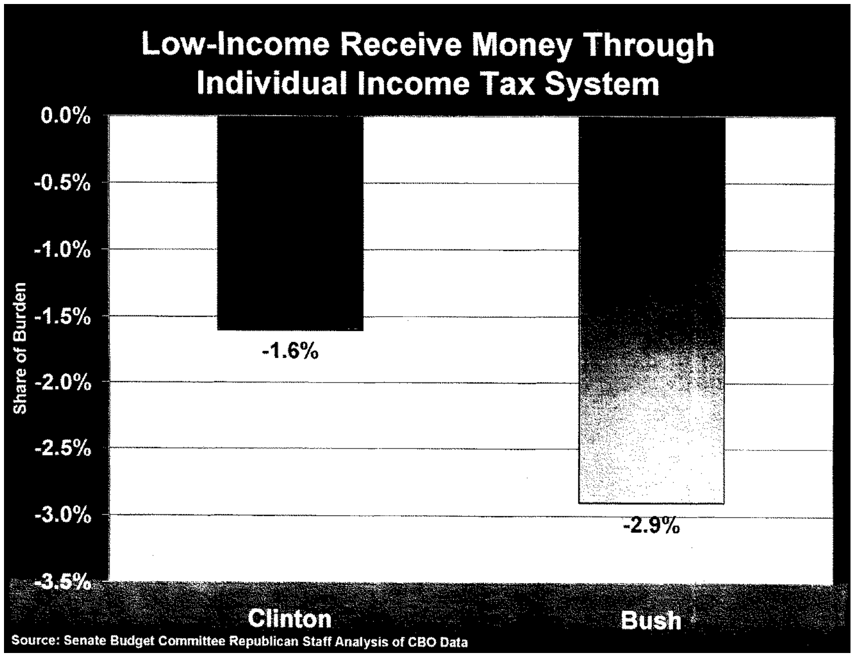
What I wanted to point out today, as the Chairman has already cited, there is $2 trillion of tax relief in the President's budget over 5 years, and that is not acceptable to the Democratic Party. I think it is important in the context of this economic slowdown that we are facing. I think it is important to point out what that means in real terms. And as we look at the present tax structure of our country, it is important to recognize that that tax structure which we have in place as a result of the tax cuts of the early part of this administration has generated more revenue than has historically been generated in this Government. We are up now in this year to approximately 18.7 percent of gross national product coming in in revenue. Historically, we have had about 18.25 percent of gross national product coming in in revenue. So under the present tax law as it exists today, we are actually generating more revenue than we have historically generated.



At the same time it is important to note that under the present tax law, people in the highest brackets of income are paying a higher share of the Federal income tax than they paid under the Clinton years. Eighty-five percent of Federal income tax is now paid by the top 20 percent of earners in this country as compared to 81 percent during the Clinton years.



And the people in the bottom 40 percent of the tax income brackets are actually getting money back. They do not pay income taxes in general, as an average rule. They obviously pay payroll taxes, but they do not pay income taxes. They are getting more back from the Federal Government—more—through the EITC than they did during the Clinton years; almost twice as much.



So the tax laws, while generating more revenue than has been the historic norm of this country, are actually more progressive. In other words, the high-income people are paying more of the burden; the lower-income people are bearing less of the burden and actually getting more back.

Why is that? Why is that happening? Well, it is called human nature. When you create a tax climate where people have an incentive to go out and work, to take a risk, to be productive, to be entrepreneurs, they do that and they create jobs and they create economic activity. We have had many quarters of job creation and economic activity here, and we are coming, unfortunately, to a slowdown. But for the last 4 years, 4–1/2 years, we have had dramatic expansion in jobs and economic activity in this country. And it has been a function of the fact that we have finally gotten to a tax law which says to the entrepreneur, Go out and invest, go out and take a risk, be a true American, take that risk, create that small business and create a job as a result. And as a result, we have generated more revenues. It is that simple. Whereas, if you dramatically increase taxes—and the proposal here from the other side, I guess, is going to be that we raise taxes by $2 trillion, not accept the President's budget in the area of tax policy. That is going to cause an economic slowdown. That is going to cause more than an economic slowdown. That is going to be hitting a great, big, huge cement wall if you raise taxes around here $2 trillion, especially on the productive side of our economy.

So I just think it is important to stress again the success of having a tax law which says to the entrepreneur, Go out and invest, go out and take a risk, go out and create jobs, because that is how you generate a strong economy. That is how we compete with the rest of the world, and that has been one of the things that we have done under this administration.

I appreciate the Committee's time.

Chairman CONRAD. Let me just take a moment to respond to the PAYGO assertion that the Ranking Member continues to make. The fact is we had a balance on the PAYGO scorecard last year, a positive balance, with one exception, and that was providing alternative minimum tax relief. I voted against extending that relief without paying for it, but our colleagues did not agree. The administration insisted on not paying for it. So the fact is on the PAYGO scorecard, we had a positive balance, with the exception of alternative minimum tax.

Senator GREGG. If the Chairman will allow——

Chairman CONRAD. No, wait a minute——

Senator GREGG. I would like to submit for the record my list of where——

Chairman CONRAD. Wait. The Senator is out of order. Wait. I am making a statement here. I did not interrupt you during your statement.

Senator GREGG. I thought you had completed your statement.

Chairman CONRAD. No, I had not.

Senator GREGG. OK. As soon as you complete it, I would like to have 2 minutes to respond.

Chairman CONRAD. No, no. We are not going to do that. You have had your chance. Then we are going to go to the witness. Then you can respond in your question period.

Look, we had a positive balance on the PAYGO scorecard, the only exception being the alternative minimum tax relief the administration insisted on not paying for. That is a fact. We will have a chance in the question period to go back and forth on this and any other issue anybody wants to do.

Secretary Paulson, again, welcome. Please proceed.

STATEMENT OF HON. HENRY M. PAULSON, JR., SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary PAULSON. Chairman Conrad, Senator Gregg, members of the Committee, I am pleased to be here today to discuss the President's budget for fiscal year 2009. As you know, my highest priority is a strong U.S. economy that will benefit our workers, our families, and our businesses through a measured approach that balances our Nation's needs with our Nation's resources. The President's budget supports that priority.

This is especially important now as, after years of unsustainable home price appreciation, the U.S. economy undergoes a significant and necessary housing correction. This correction, combined with high energy prices and capital market turmoil, caused economic growth to slow rather markedly at the end of 2007.

The U.S. economy is diverse and resilient, and our long-term fundamentals are healthy. I believe that our economy will continue to grow, although at a slower pace than we have seen in recent years. Yet the risks are clearly to the downside, and President Bush knows that economic security is of the utmost importance to the American people. In recent weeks, the potential benefits of quick action to support our economy became clear and the potential costs of doing nothing too great.

So we are gratified that Congress is advancing toward a growth package to support our economy as we weather the housing correction. We believe that a growth package must be enacted quickly; it must be robust, temporary, and broad based; and it must get money into our economy quickly. The Senate has begun to consider its version of this bill, and I am hopeful that you will complete your consideration very soon.

If we keep moving along a fast track and Congress sends the President a bill that meets our shared principles, rebate payments can start in May and be completed this summer. Together, the payments to individuals and the investment incentives for businesses will help create more than half a million jobs by the end of this year.

In addition to an economic growth plan to help us weather this housing correction, the administration will continue to focus on aggressive action to try to provide alternative options to foreclosures. This includes encouraging the Hope Now Alliance's outreach to struggling homeowners. Congress can do its part by finalizing the FHA modernization and GSE regulatory reform bills and by passing legislation that will allow States to issue tax-exempt bonds for innovative refinancing programs. We continue to monitor capital markets closely and to advocate strong market discipline and robust risk management.

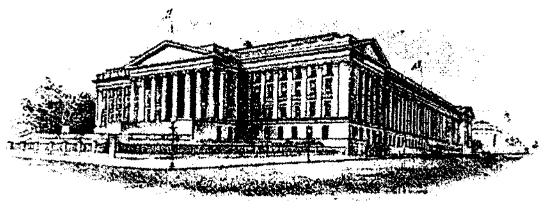
Working through the current stress is our first concern. Through the President's Working Group on Financial Markets, we are also reviewing underlying policy issues because it is just as important to get the long-term policy response right. While we are in a difficult transition period as markets reassess and re-price risk, I have great confidence in our markets. They have recovered from similar stressful periods in the past, and they will do so again.

The administration will also continue to press for long-term economic policies that are in our country's best interest: a pro-growth tax system, entitlement reform, and a balanced budget. To that end, the President's budget makes the 2001 and 2003 tax relief permanent and keeps the Federal budget on a track for surplus in 2002. In the future, as in the past, our long-term economic growth will also be enhanced by supporting international trade, by opening world markets to U.S. goods and services, and by keeping our markets open. Congress can help create economic opportunity by passing the pending free trade agreements with Colombia, Panama, and South Korea.

I appreciate the cooperative and bipartisan spirit that has brought the Congress and the administration together to support our economy and look forward to that spirit continuing as we work through this period.

Thank you.

[The prepared statement of Secretary Paulson follows:]



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10 a.m. (EDT), February 6, 2008
CONTACT Brookly McLaughlin, (202) 622-2920

OPENING STATEMENT BY SECRETARY HENRY M. PAULSON, JR. ON THE PRESIDENT'S FISCAL YEAR 2009 BUDGET BEFORE UNITED STATES SENATE BUDGET COMMITTEE

Washington, DC— Chairman Conrad, Senator Gregg, Members of the Committee: I am pleased to be here to discuss the President's budget for fiscal year 2009. As Treasury Secretary, my highest priority is a strong U.S. economy that will benefit our workers, our families and our businesses. Through a measured approach that balances our nation's needs with our nation's resources, the President's budget supports that priority.

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The Administration will also continue to press for long-term economic policies that are in our country's best interest – a pro-growth tax system, entitlement reform and a balanced budget. To that end, the President's budget makes the 2001 and 2003 tax relief permanent, and keeps the federal budget on track for a surplus in 2012.

In the future, as in the past, our long-term economic growth will also be enhanced by supporting international trade, by opening world markets to U.S. goods and services and by keeping our markets open. Congress can help create jobs and economic opportunity by passing the pending Free Trade Agreements with Colombia, Panama and South Korea.

I appreciate the cooperative and bipartisan spirit that has brought the Congress and the Administration together to support our economy, and look forward to that spirit continuing as we work through this period. Thank you.

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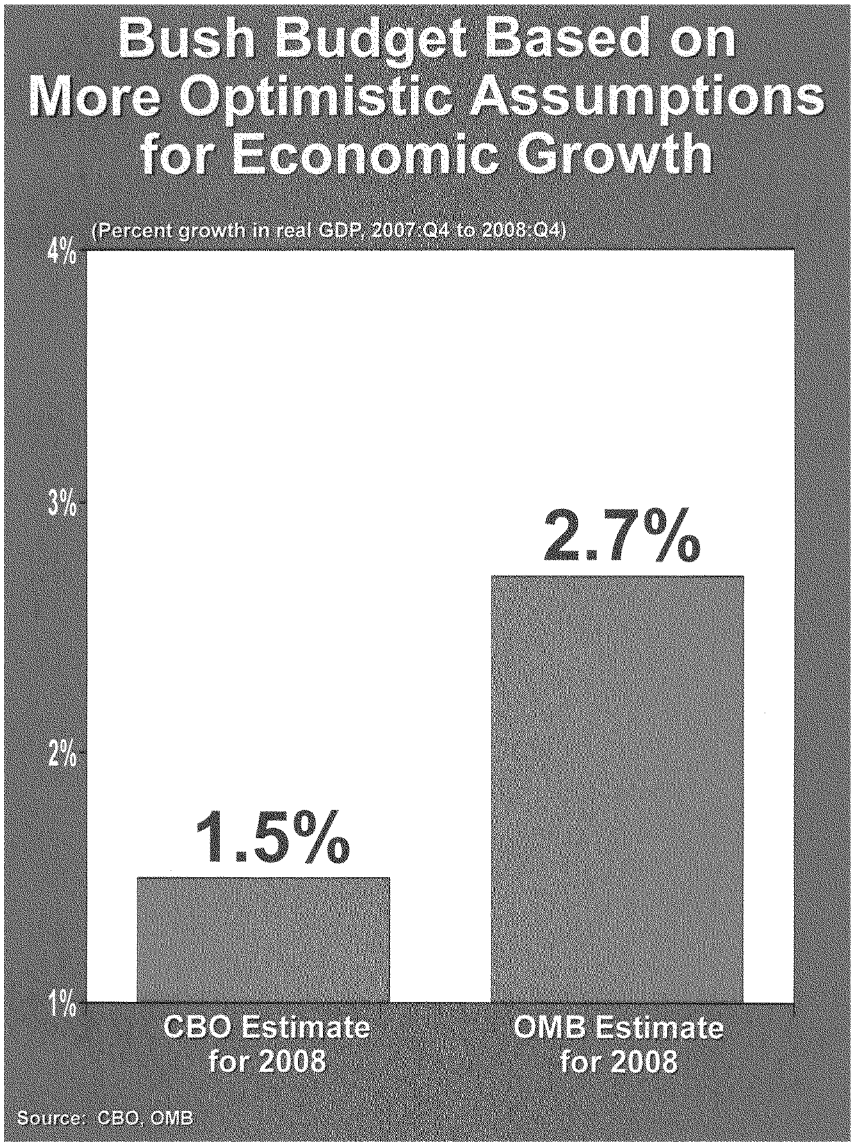
Chairman CONRAD. Thank you, Mr. Secretary.

Let me start with the economic assumptions that underlie this budget. Do we have that chart that we could put up?


Bush Budget Based on
More Optimistic Assumptions
for Economic Growth
(Percent growth in real GDP, 2007:Q4 to 2008:Q4)
4%
3%
2%
1%
2.7%
1.5%
CBO Estimate
for 2008
OMB Estimate
for 2008
Source: CBO, OMB

In the administration's forecast, they say economic growth will be 2.7 percent this year. What is your forecast for economic growth for this year?

Secretary PAULSON. Mr. Chairman, that administration forecast was made in November. The economy has slowed down significantly since that time. I think over the budget window, our forecast is very similar to CBO's forecast, but that forecast was made at a different time.

I would say to you, though, if CBO's forecast is right for this year, I think the difference, the added cost will be something in the neighborhood of $10, $15 billion. So it is real money, but when we look at the longer-term issues you and I have been talking about and you have been talking about, this is not the driver here.

Chairman CONRAD. All right. I want to get that on the record that your forecast is closer to the CBO forecast, but you do not see a material difference in outcomes with——

Secretary PAULSON. I did not change—I am not making a forecast. I am noting the fact that that forecast was made in November, that we have been pretty clear in saying the economy has slowed since that time, and I do not think that is a driver. And as far as I am concerned, I never place too much reliance on any economic forecast for 1 years. I look at it over a longer period of time.

Chairman CONRAD. All right. Let me turn to a chart that talks about what countries around the world are experiencing in GDP growth and their tax burdens. Can we put that up?

I do not know if you can see that, Mr. Secretary, from where you are, but it is——

Secretary PAULSON. I do not have great eyes. I see the United States there in the middle.

Chairman CONRAD. Have we got a handout, a smaller version of this that you could hand the Secretary so that he could have this? Maybe somebody can hold that up while he is getting a copy of the Secretary.

Tax Burdens and Growth of Real GDP per Capita

Ordered by Growth of Real GDP per Capita

	Real Per Capita GDP Average Growth Rate 1995 - 2005	Total Tax Revenue Percent of GDP 1995 - 2005*
Ireland	6.2	30.7
Poland	4.5	35.0
Slovak Republic	4.2	32.5
Hungary	4.1	38.9
Korea	4.1	22.8
Finland	3.4	45.8
Greece	3.3	35.7
Luxembourg	3.3	38.4
Spain	3.2	33.8
Czech Republic	3.0	37.0
Iceland	2.8	36.4
Sweden	2.6	50.8
United Kingdom	2.5	36.0
Australia	2.4	30.1
Norway	2.4	42.9
Canada	2.3	35.1
United States	**2.1**	**27.9**
New Zealand	2.1	34.6
Belgium	2.0	44.8
Netherlands	1.9	38.9
Austria	1.8	43.0
Portugal	1.8	33.5
Denmark	1.8	48.9
France	1.5	43.9
Italy	1.2	41.7
Germany	1.2	36.1
Switzerland	1.1	29.2
Japan	1.1	25.8

Source: OECD, IMF
*1995-2004 for Australia, Greece, Japan (social security contributions), Poland, Portugal and the OECD. 1998-2005 for the Slovak Republic.

What this chart shows is leading industrialized countries and what their economic growth rates are and what their tax burden is. You know, I hear all the time that the key to economic growth is the level of taxation in a country. So I decided let's go actually look around the world, let's look at what tax burdens are, and let's look at what economic growth is. And what jumps out at you as you look at this chart is there seems to be no connection. We have all kinds of countries that have much higher growth rates than we do—Ireland, Hungary, Korea, Finland, Spain, Iceland, Sweden, United Kingdom—that have higher growth than we do, but much higher tax burdens than we do. Similarly, we have a whole series of countries that have lower taxes than we do, and they do not have more economic growth.

So I am wondering, in your analysis what is the connection between GDP growth and tax burden?

Secretary PAULSON. Mr. Chairman, that is a very important question. I am looking at this chart for the first time, but let me make an observation.

I think there are two issues when you look at taxes. First is what is the level of revenues that is appropriate to raise, any economy to raise, you know, through taxes, and then what is the form of taxes. And what we are finding increasingly is that other nations are not emulating is in terms of the form of taxes. And if we looked at it just in terms of growth, we would be saying what form of taxes will give us the greatest growth, give us the most jobs. And that is—Treasury has started doing work on this because what we have found is I think in many ways the most expensive tax dollars we raise in terms of inhibiting competitiveness and jobs and growth are the way in which we tax our businesses that compete globally, because some of these countries at the top of the list—and most of them have now learned that the key is reducing corporate taxes and the way in which corporations are taxed.

So, again, I think this is a complicated question, and many of these countries make greater use than we do of consumption taxes. And various taxes on consumption I think have less of a drag on growth and jobs.

Chairman CONRAD. Have you looked at this fair tax proposal that is being advocated by some? They say with a consumption tax at 23 percent, with lower-income people being exempt, that that would raise the same amount of revenue as our current system. Have you done an analysis of that? And would a consumption tax at 23 percent, with low-income people being exempt, raise the same amount of revenue as our current system?

Secretary PAULSON. I would have to get back to you on that, but I would say the one thing we have done, which we have recently—Treasury has come out with a number of studies on the way we tax our businesses, small businesses that compete globally and corporations that compete globally. And we have documented the fact that we are out of step with the rest of the world, and we see grave danger there. And then we have put out a number of alternatives for addressing this, and one of these is replacing the corporate tax with a business activity tax, which is a form of consumption tax. And, again, there is no—every alternative has some issues. There is no perfection here. But I do think the kinds of questions you have been raising are the right ones, I very much agree with Senator Gregg when he said that we need to ask the questions: What portion of our economy should be taken up by taxes? What is the right level given the world we live in, given the entitlement issue we see coming? Then we need to ask, what is the right form of those taxes to maximize our competitiveness and maximize the jobs? That is what we should be asking ourselves, because taxes are necessary. They are necessary because we need revenues, and so now the question is how do we get the least drag on job production and continue creating good jobs for American workers and American people.

Chairman CONRAD. Yes, it really is quite striking. I mean, you look at this. You have a country like Finland that is taking much, much more in taxes, much higher tax burden, but much higher economic growth. Spain, much higher tax burden and much higher economic growth than we have. Sweden, Norway, all of them the same. On the other hand, Japan, has lower taxes than we have and economic growth at about half of our rate.

Secretary PAULSON. And Japan is the one country the world that has higher corporate taxes than the United States. So, they are also a case of having a form of taxation that is a big inhibitor to their economic growth.

Chairman CONRAD. Well, I hear all the time that we have the second highest corporate tax rate. But our effective rate is not the second highest, is it?

Secretary PAULSON. You are right. The headline rate is the highest. The effectiveness rate is above average.

Chairman CONRAD. Isn't it pretty close to average, our effective rate?

Secretary PAULSON. Our effective rate is pretty close to the average of the OECD countries, but the direction of change is what I find alarming. We went from being a high taxer of corporations in the 1970's to then in the 1980's becoming the lowest, and then others have all sort of copied, understood what we did and the benefits of lowering taxes. Now we have a higher corporate tax rate than the French and the Germans. Not only are we just about average, but that they are reducing taxes. And then our form of tax is not something that anyone is emulating anymore. I think most people recognize the way in which we tax is an inefficient way to do it.

Chairman CONRAD. If you could share with this Committee what analysis you have done along these lines, because many of us believe we are going to have to have thoroughgoing tax reform.

Secretary PAULSON. I will be able to send some analysis up to the Committee. Thank you.

Chairman CONRAD. Senator Gregg.

Senator GREGG. Well, before I pick up on that point, I would just add this whole issue of tax policy is critical. I am sorry we were not able to submit it for the record, but let me just review, therefore, orally the ways in which PAYGO has been gamed. I am sure the PAYGO scorecard was positive, but that is because gimmicks were used to get around PAYGO enforcement. These were specific PAYGO violations under the Democratic Congress: the revenue loss from minimum wage, the Water Resources Development Act, the Prescription Drug User Fee Act, the Mental Health Parity Act, the

Immigration Reform Act, and the Energy Act. Those were all very specific violations of PAYGO, and those bills were passed. And then PAYGO was gimmicked—gimmicked—so it would not show up on the scorecard.

The MILC program, that was one of the most outrageous, where they took the MILC program and put it in the supplemental and declared it an emergency, total gimmick on PAYGO.

Pell grant spending, that was a huge gimmicking of the process, using the reconciliation bill, creating a student loan interest rate, snapback. On the student loan interest rate, it drops to 3—I think it is 3.4 percent, but it goes back up to 6.8 percent in 2012. Why? To gimmick PAYGO so PAYGO does not look like it has been violated.

The PILT program, which is the county Payment in Lieu of Taxes program, again, another gimmick used in the Senate-passed bill to extend that program, declaring it an emergency.

The SCHIP program, which had this huge, huge gap—so we basically reduced SCHIP in 2012 back to a $3.5 billion per year program from a $14 billion per year program in order to declare that it had met PAYGO. So there is a $45 billion—billion—hole on the PAYGO side.

The farm bill, now that is a classic one. The farm bill is a $9.8 billion PAYGO gamesmanship, and then, of course, there are hidden costs in the farm bill which represent $17 billion, all of which adds up to $143 billion in PAYGO gimmicking around here.

I would like to return to the issue of tax policy, which I think is critical. I believe it is intuitively obvious that if you are dealing with something like our Internal Revenue Code, which has literally thousands of deductions, thousands of ways to basically invest or not invest, and you create different tax rates on you as an individual or on you as a business, those incentives for investing or not investing are driven by social policy or political policy, but not necessarily by efficient use of economic dollars policy. The most efficient use of economic dollars, would be to simply say to people, "Here is your money, here is your tax rate, you invest in the ways that you are going to get the best return." That is not what our tax law says. It says, "Here is your money, here is your tax rate, but you can change that tax rate if you invest in A, B, C, D, E, F," some of which is not efficient at all.

In that type of an atmosphere, where you have that type of a tax law, it is intuitively obvious that as you get rates higher and higher, people will take action, legal action, to avoid taxes by investing in a way which basically undermines productivity in the economy. Is that incorrect, Mr. Secretary?

Secretary PAULSON. That is correct. We had a conference at Treasury where we brought all kinds of experts from all over, and they clearly talked about all of the distortions and all of the policies—and the special benefits that are there for one industry or one company or another—that drive behavior in ways that are not always desirable. Complexity is an issue, and it is an issue very much with the individual income taxes and with business taxes. No doubt about it.

Senator GREGG. Actually, Senator Wyden and I are hoping later this year to introduce a bill which would go back to sort of the 1986

Tax Act reform approach, which takes a lot of this out and gets us to a much lower rate and allows the economy to be hopefully more efficient. But the second approach is, of course, this approach which, if you look at the Chairman's chart there, I suspect that most of the countries which are above us in terms of revenue as a percent of GDP, especially if they are European countries, are using a value-added tax as their basic source of revenue.

Secretary PAULSON. You are absolutely right, sir.

Senator GREGG. And I suspect, in fact, that their corporate rates are significantly less than ours and that their capital gains rates—for example, Ireland, I think, has a 15-percent corporate rate and a 0 capital gains rate, or something like that.

Secretary PAULSON. Absolutely. I remember spending a lot of time in my former job talking with Government leaders in many of these European countries. And at first they complained vociferously about what Ireland and England were doing, and they said it was unfair competition. Then they finally woke up and have started lowering their corporate rates and changing the form of taxation.

Senator GREGG. And isn't this actually affecting our ability to form capital in this country? One of the concerns many of us have is that London is sort of becoming a center—and you, of course, are the ultimate expert on this—a center of initial public offerings and capital formation versus New York. U.S. capital markets, obviously still the leading capital markets in the world, are being tested by the competition. And that competition is driven in large part by our tax policy here, as well as, obviously, our regulatory policy.

Secretary PAULSON. Well, first of all, you are not going to get me to say the U.S. isn't No. 1 in capital markets.

Senator GREGG. No, I am not saying it isn't. I am just saying that there is competition.

Secretary PAULSON. What I will say is that in today's world it is increasingly easy for major corporations, multinationals, to set up a headquarters wherever they choose to. And, the number of companies we have headquartered in the United States is a big benefit to us. I just think we need to be increasingly mindful of that and think about the impact on jobs and growth. To me the one thing to look at is which tax policy will help the American people the most, create the best jobs for our citizens.

Senator GREGG. In that context, the Chairman has complained about the $2.2 trillion, maybe it is $2.7 trillion, of what the Chairman and members on his side of the aisle view as tax cuts, which is basically the extension of present tax policy over the next 5 years, current tax policy being a 15-percent capital gains rate, a 15-percent dividend rate, lower estate tax rates, and lower marginal rates.

If we were to raise those rates in this weakening economy in order to raise the $2.2 trillion that the Chairman feels is inappropriately in the budget from the President's side, what would be the practical effect of that in this slowing economy?

Secretary PAULSON. I think very few people would recommend that. That is the last thing you would want to do right now, given what is going on in our economy. And on top of that, using capital gains as an example, I believe that it is intuitively obvious that when you tax something, you have less of it. And I believe capital is a key to capital investment and to good jobs. So there is plenty of room for reform and simplification of all aspects of the tax system.

Senator GREGG. Thank you. My time has expired.

Chairman CONRAD. I thank the Senator. I thank the Secretary. I just want to hopefully conclude on PAYGO.

Senator GREGG. I would like time to respond.

[Laughter.]

Chairman CONRAD. Well, you will have your chance.

Look, the simple fact is the PAYGO scorecard had a positive balance of $1.3 billion over 11 years. Every bill sent to the President—the Senator has a list here of things that never went to the President, never completed action. That is not how the PAYGO scorecard works, I would say to the Senator. The way the PAYGO scorecard works is what gets sent to the President, and the fact is we had a positive balance on the PAYGO scorecard of bills sent to the President, with one exception, and that was alternative minimum tax relief that the administration insisted not be paid for. That was done over this Senator's objection. But that is the fact. The Senator has all kinds of things his staff has put together. They criticize the College Cost Reduction Act. According to the Congressional Budget Office, which is the official scorekeeper, that contributed to a positive PAYGO balance, was not a violation of PAYGO. And if you look at——

Senator GREGG. Well, that is because it was gamed in by moving the interest rate back up to 6.8 percent. That is the only way you get to that number.

Chairman CONRAD. It was paid for, sir, by the scoring from the Congressional Budget Office. You do not agree with the means that were used to pay for these things. You do not agree with it. That is your business.

Senator GREGG. No, I do not——

Chairman CONRAD. I would just say to the Senator, you did not like the Democratic budget, but you never offered a budget. So, frankly, if you do not offer a budget, you know, it is hard to take very seriously your criticisms of a budget that is adopted and is passed and is put into place. If you are going to offer a budget, then I think you have something to say. But you did not offer a budget.

Now, this year, we will eagerly await your budget submission, and I would be——

Senator GREGG. Well, let me respond to that.

Chairman CONRAD. I would be happy to have you respond. Go ahead.

Senator GREGG. The point on PAYGO is that you offered—not you personally, because I know you believe very firmly in PAYGO. But your party offered up a budget which supposedly was going to be disciplined by PAYGO. And then on the Senate floor, either through gimmicks or through direct waiver, PAYGO was gamed to the tune of $145 billion. And the student loans is a perfect example of that. You set the rate at 3.4 percent, which was a very nice thing to do, and it was appropriate, and we recovered the funds from the lenders that were getting a windfall. But then in the fifth year, you jumped the rate back to 6.8 percent because you could not make the PAYGO numbers work under the lower interest rate that you had set. Now, that interest rate snapback is not going to happen. The same thing happened with SCHIP where basically you set a reasonable rate on SCHIP, a $14 annual billion program, and then in the fifth year you take the program down to $3.5 billion per year, in order to meet PAYGO. Obviously, that is not going to happen. These were all gimmicks.

Now, I understand the PAYGO scorecard, but the PAYGO scorecard only can be viable because these gimmicks were used—and some of these bills were stopped, obviously, but the gimmicks were used. So that is my point. Now, you have given your point, I have given my point. We disagree. That is the way we should——

Chairman CONRAD. We do disagree because what is your gimmick, two-thirds of what you have described as gimmicks have been scored by CBO as legitimate—

Senator GREGG. Well, they have no choice.

Chairman CONRAD. Well, they have no choice because they, in fact, are paid for. That is why they have no choice. These things—

Senator GREGG. But they are not realistic.

Chairman CONRAD. Well, in your mind they may not be realistic. Let's talk about SCHIP. Is anybody——

Senator GREGG. A $3.5 billion program——

Chairman CONRAD. Well, does anybody believe that we are not going to change the health care system of this country in the next 5 years? That is not your position. Your position is not that we can just stay with the current system.

Senator GREGG. Of course.

Chairman CONRAD. And it is not my position. And so talking about what is going to happen in the fifth, sixth, seventh year frankly is not terribly relevant to the real world——

Senator GREGG. Well, it is to——

Chairman CONRAD. And the fact is it was paid for under the PAYGO rules. Now, look, the larger——

Senator GREGG. It——

Chairman CONRAD. No. The larger—but you have raised this, and I am going to answer it.

Senator GREGG. No, no. You actually raised it.

Chairman CONRAD. No. You raised the PAYGO issue. I did not.

Senator GREGG. One of us did.

Chairman CONRAD. The reality here is that PAYGO has disciplined this process. No one knows that better than I do because I am the one who has to referee this, and I can tell you PAYGO has stopped tens of billions of dollars of spending around here. I deal with it every week. Anybody who says PAYGO has not contributed to the disciplining of the process is not being straight with the American people or colleagues on this Committee.

Senator Murray?

Senator MURRAY. Thank you, Mr. Chairman.

Mr. Secretary, thank you. Good to have you here. I wanted to talk with you about an issue that concerns me a lot, and that is one that I know you have spoken to as well. Early on in your tenure at the Treasury Department, you actually distinguished yourself from your two predecessors by highlighting the issue, and that is the one of the growing wage and wealth inequality in America. I know that during a speech at Columbia University, you spoke to that issue and talked about how the wage gap has grown, I think it is more than 60 percent since 1975. You said, “Amid this country's strong economic expansion, many Americans simply aren't feeling the benefits.” You cited rising energy and health care costs as part of the problem in that inequity, and I agree with you. I would also argue that globalization, with all the good that it brings, bring economic disparity as well, particularly with some of the weaker labor and environmental standards that we see overseas. And it is hard for American workers to compete with that, especially, I think, in the area of manufacturing.

But independent of all the causes, the erosion of the middle class is an issue that I am very concerned about, so I am somewhat confused by what you said in your testimony today. You said that the President's budget continues to press for long-term economic policies that are in the country's best interest, with specific reference to making permanent the 2001 and 2003 tax cuts.

Do you believe that extending the 2001 and 2003 tax cuts helped to reverse that growing income and wealth inequality that you talk about in our country?

Secretary PAULSON. Senator, I look at the purpose of the tax system as being to raise revenues and do it in a way that promotes growth, because I think promoting growth and jobs is going to help American workers and American citizens.

So I would agree with Senator Gregg in saying what we have seen happen under this President is that low-income earners, families of four right up to $42,000, no longer paying Federal income taxes. And when you look at the top 5 percent, the top 20 percent, they pay more than they ever paid.

We have also done analyses at Treasury that show that we have more economic mobility than I have seen in just about any other country. So the great thing about our system, as you look at the people who move out of the bottom the move up the ladder, some all the way to 20 percent, the top. So that is all good.

But to get to your point, I think the structural issue we are dealing with right now is an issue that has partly to do with globalization, and largely to do with automization and technological advancement. And I think the challenge that we are increasingly going to have, in the United States and other developed countries, is how to get the skills to the people, how to provide more skills, more training to the people that are going to need it to compete.

I think we have to be careful with some of the tax policy changes that some would like to make through the use of our tax system to further redistribute wealth, because what you may find is that it is going to slow down growth and slow down job creation.

So, again, my big focus is on tax policies that are going to create better jobs over time.

Senator MURRAY. Right. But you said the economic mobility of workers is there, but we have to have job training and skills training in order to give those people the ability to be mobile.

Secretary PAULSON. That is right.

Senator MURRAY. What concerns me is that the budget that President sent us, by extending those tax cuts, forces large cuts;

and where the President has chosen to do that is in the very education and training programs that that lower class needs in order to have that economic mobility that you just referenced.

Secretary PAULSON. When Margaret Spellings is here, she and others may talk more about what is in the education budget. But what I was talking about is that I do think that in the future we are going to have to rethink how we think about skill training to get the worker who is——

Senator MURRAY. Well, do you agree with the President's budget that cuts job training, low-income housing assistance, home heating assistance, food assistance for seniors, all those things that the lower economic strata needs to have that economic stability to move up?

Secretary PAULSON. I think when you are talking about some of the programs you are talking about being cut, again, I would note that putting together a budget is a very difficult thing given the——

Senator MURRAY. Well, especially when you do not have the revenue if you are giving tax cuts.

Secretary PAULSON. But I would say a lot of the programs you mentioned were not the kinds of skill training that——

Senator MURRAY. Well, but the President's budget actually cuts job training and skill training dollars. So would you agree that that is probably not a wise place to put your cuts?

Secretary PAULSON. Well, I will tell you, the programs that I have looked, and these programs in the middle of my plate here, but the ones that I have looked at most carefully, for instance, trade adjustment assistance and others, I view as very much structurally flawed. I think it is not going to be just a matter of throwing money at something called training. It——

Senator MURRAY. Well, but not having any resources, wouldn't you argue—OK. I hear you saying we need to give those people the skills.

Secretary PAULSON. Right.

Senator MURRAY. But you are here defending a budget that takes away our ability to give those people the skills.

Secretary PAULSON. Well, again, I wouldn't make it quite as simple as you do. In terms of the specific programs, I do not have the details on the specific programs, and, again——

Senator MURRAY. Well, then I would just argue——

Secretary PAULSON. Some of the programs that I have looked at I felt were structurally flawed and should be reformed before more money is put into. But to get to your basic point, I very much agree that there is a widening income gap, wealth distribution——

Senator MURRAY. And you would agree that we need to train workers in order to give them the economic ability to move forward?

Secretary PAULSON. I think that is increasingly going to be the challenge that we face in today's——

Senator MURRAY. And I would argue that the President's budget does not give us the flexibility to do that.

Secretary PAULSON. I hear your argument.

Senator MURRAY. All right. Thank you very much.

Chairman CONRAD. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman. I am sorry that you and the Ranking Member are having a bad day.

[Laughter.]

Chairman CONRAD. We are actually have—we are having a good day, other—just on this one area of disagreement. Other than that, we are having a very good day.

Senator BUNNING. Oh, good. I am very happy to hear that.

Secretary Paulson, I want to ask you a question about your policy on China currency. Last month, one of your colleagues, Chris Padilla, praised China for "brokering the most remarkable economic and social transformations in human history," and that is a quote. If you occasionally read Daily Report for Executives, I have it outlined in here.

Later, when he came back home, he said that legislation—I have sponsored it with 21 other Senators—that deal with China manipulating its currency "won't work". "I could throw armies of people at the problem," he said, "but I just don't know how we would do what we are being asked to do."

That is a very revealing statement, Mr. Secretary, and I am troubled by it, because employment in manufacturing is down, and this is one of the reasons for our economic weakness. I know where you stand on this.

I know you prefer to stick your head in the sand while China manipulates the WTO rules, denies us access to sell products there, counterfeits our goods, exports corrupted products, and exports prolonged unemployment here by manipulating its currency. But you must understand that the Administration does not control trade policy.

I am troubled by Mr. Padilla's statement because it is suggests that you will not carry out the law when we enact it. It also suggests to me that you are ignoring laws on the books. For years, you have failed to recognize that China is manipulating its currency, and this has made it impossible for the United States to seek changes through the IMF. Do we need to add civil penalties to our bill?

Secretary PAULSON. Senator, let me say I have been accused of many things; this is the first time of sticking my head in the sand.

Senator BUNNING. It will not be the last.

Secretary PAULSON. Although some people think that with my bald head, maybe it would be better under the sand. But let me respond very clearly to you.

I have engaged very actively with China, and I think with some results when you look at the currency. Do not be confused by the fact that I say I would like them to move quicker, because I would like them to move quicker. But the rate of appreciation of their currency roughly doubled last year to 6.7 percent. In the last 3 months, their currency appreciated 4 percent.

Senator BUNNING. If you add inflation to the fact, in the United States it almost is negated.

Secretary PAULSON. Do you want me to continue and answer——

Senator BUNNING. Well, sure. That is why you are here.

Secretary PAULSON. And answer your question, sir? Well, I will answer it.

So I said they are definitely moving quicker. I would like them to move even faster.

Now, to get to the question of legislation, I will just be direct since you are direct with me. I think it is bordering on the silly to say that one nation——

Senator BUNNING. Well, you are going to get it.

Secretary PAULSON. OK.

Senator BUNNING. Whether you like it, and you can have the President veto it, and we will override his veto.

Secretary PAULSON. Well, if I could just finish—for one nation to legislate another nation's currency policies or macroeconomic policies.

Now, the other thing I would say, with all due respect, is that we are in a market right now where we are benefiting greatly from the growth of our exports, we are benefiting from trade. That is one of the drivers we have right now——

Senator BUNNING. Yes, the dollar has a lot to do with that.

Secretary PAULSON [continuing]. Over our economy, and I would say again, with all due respect, that I think given what is going on in the capital markets, the last thing in the world we need is something like this. I believe that. And I also think——

Senator BUNNING. We have a major difference of agreement.

Secretary PAULSON. We do. And I also think the other place we have a difference of agreement is that some of those people who wish that China would have economic problems are wishing for the wrong things. That is what we do not want and what we do not need.

Now, I have to say, I think we are making real progress——

Senator BUNNING. Sir, you are using up all the time I get. I get 7 minutes, and you are using up all the time answering one question.

Secretary PAULSON. OK.

Senator BUNNING. I want to ask you about the economic stimulus package.

Secretary PAULSON. OK.

Senator BUNNING. I understand that in your negotiations with the House leaders, there was give and take. The final package represents some of Speaker Pelosi's priorities and some of the President's priorities. Each side put aside its differences in the interest of the American people, and I hope we will do the same thing when we vote on the economic stimulus package.

Yesterday, when you testified before the Finance Committee, you seemed to indicate that the President is willing to allow some changes to the bill. Can you tell us in general terms what changes the President is willing to accept and what changes he will not accept?

Secretary PAULSON. Senator, let me first of all say you are right, the House bill is a bipartisan bill. I very much would prefer the House bill and would like to see that enacted quickly. That is No. 1.

No. 2, I am increasingly concerned that in the Senate the bazaar is open, the special interests are coming to the trough. And when I am reading about and hearing about things like tax rebates for coal companies, benefits for oil well drilling and things like this, I am concerned that it is going to get bogged down. I am concerned that if we see things that are not stimulus and are not going to get money to the American people quickly, it will get bogged down.

So to me, the point I want to make is that time is of the essence. Some people have said timing does not make much difference, we cannot do anything until after April 15th. Nothing could be further from the truth. The day that a bill gets on the President's desk, the IRS can start working. More or less within 60 days, with a little timeout for a few weeks in April, we can start getting checks to the American people and make a difference in the economy.

So, first and foremost, I would say it has to be done quickly. If it is not, the American people are going to pay the price. The economy is going to pay the price. And complexity is our enemy here, and provisions that are not stimulus are our big enemy here. We are seeing some businesses saying that they would like some cash, give us some money. But if it is not stimulus, I do not think it is wise.

So that would be my answer.

Senator BUNNING. Thank you.

Chairman CONRAD. I thank the Senator.

Senator Sanders?

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

It is a strange morning. I almost find myself in agreement with something that Senator Bunning said. There you go. How is that?

Senator BUNNING. Well, isn't that amazing?

Senator SANDERS. Isn't that amazing?

Senator BUNNING. It is amazing.

Senator SANDERS. All right. And Mr. Paulson, Mr. Secretary, thank you very much for coming, and I think you deserve a special commendation for giving us one of the shortest introductory remarks that I have experienced. Thank you very much. And thank you for being—although it does not necessarily say a whole lot—one of the illuminating lights of the Bush administration. It does not say a whole lot, but thank you very much for being here. We appreciate it.

Now, I take a different look at economics, I think, than many of my colleagues. I share Chairman Conrad's deep concern about what this deficit and national debt is going to mean for our kids and our grandchildren and the future of this country. But I kind of look at economics as a question of winners and losers. You know, when we look at the Super Bowl, nobody goes around saying, well, they scored 31 points. Yes. Who got 17 and who got 14 is the issue. So we talk about economic growth, we talk about jobs, and all that stuff. That is great. But at the end of the day, what people want to know is who is winning, who is losing. And the reality is indisputable that the winners in this economy are not only the wealthy, but they are the super, super, super wealthy.

We are in a situation now—and I do not want to suggest that it just began when George Bush became President. It certainly has been a long-term trend. It has accelerated under George Bush. We have a situation today which to my mind is quite incredible for a major industrialized Nation, because it is unparalleled in the industrialized world, where the wealthiest one-tenth of 1 percent—

300,000 men, women, and children—earn more income than the bottom 50 percent of our population—150 million.

So when my friend from New Hampshire talks about economic growth and job expansion and all this stuff, the question is: Who gets what? And the reality is the people on top are making out like bandits while poverty is increasing, while millions of people—since Bush has been in office, 8 million people have lost their health insurance, 3 million people have lost their pensions, median family income for working families has gone down.

Now, in the middle of all that, I am not a believer in magic like my friend from New Hampshire, and he thinks all we have to do is give tax breaks to billionaires and, voila, every good thing happens. Now, he forgets to mention that when Clinton was in office, at the end of Clinton's administration, he raised taxes on the wealthiest people in this country. Guess what happened? More tax revenue developed.

Now, it is true tax revenue is coming in now. But I think most economists, probably including you, would not think that there is a magic formula that giving tax breaks to billionaires suddenly results in more revenue coming in.

My question is a simple one. If you look at the needs of ordinary people, as you know—you read the polls—massive dissatisfaction with the state of the economy, front-page story Washington Post just yesterday, and we understand why. Tell me why you think the repeal of the estate tax, $1 trillion which will go to the wealthiest three-tenths of 1 percent, $30 billion to one family, is more important than providing weatherization for low-income homes, a LIHEAP program, decent health care, decent education, not forcing our veterans to pay $250 or $750 more to get into the VA. Tell me why you think we should give $1 trillion over 20 years in tax breaks to the wealthiest three-tenths of 1 percent.

Secretary PAULSON. Senator, hopefully you will find this constructive. In the interest of doing something that brings people together, take a look at the estate tax, because I think what we have here is something that no one on your side would find very desirable. We have a situation where today, the exemption amount is 2 million. Next year it will be 3.5 million. Then you are going to have a situation in 2010 where the estate tax is totally repealed. And then in 2011, you are going to have a situation——

Senator SANDERS. Mr. Secretary, I do not have a lot of time. I am familiar with all that. We are all familiar with that.

Secretary PAULSON. So what I am saying is to me the President has been very up front, forward leaning in saying, let's get together and for the good of the American people, work something out.

Senator SANDERS. Well, but no, no, that is not quite accurate, sir.

Secretary PAULSON. And that——

Senator SANDERS. No, let me have it back.

Secretary PAULSON. And you would be against that?

Senator SANDERS. Let me have it back. I love working with everybody, but that is not what we are talking about. He wants—in 1 second, answer my question, please. You are a direct guy. Ninety-nine-point-seven percent of the people do not gain one penny by the complete repeal of the estate tax. All of the benefits go to the very wealthiest. One family—let me finish. One family, the owners of

Wal-Mart, the Walton family, gets $30 billion in tax relief over the period. Meanwhile, this budget is cutting back on food programs for low-income senior citizens. Tell me why you think it is more important for the Walton family to get a $30 billion tax break than low-income seniors get nutrition.

Secretary PAULSON. I do not think that is the right way to frame the issue. It is——

Senator SANDERS. I think it is exactly the right way to frame it.

Secretary PAULSON. The President has been very clear that he believes that the estate tax should be eliminated.

Senator SANDERS. Yes.

Secretary PAULSON. But he has also been very open to saying——

Senator SANDERS. But you are not answering my question. The President, as you just said, wants to eliminate it. You tell me why that is a good idea. Don't tell me that we may negotiate it. We are in the majority now. Of course we will negotiate.

Secretary PAULSON. I am saying that the question is: Why aren't you trying to negotiate something and reform this? Because I do not believe the American people want the exemption to be as low as $1 million——

Senator SANDERS. You did not answer my question. The President wants to give $1 trillion in tax breaks—does he or does he not? Am I inaccurate?

Secretary PAULSON. The President does not want tax rates to go up.

Senator SANDERS. The President wants to give—tell me if I am right or wrong. Three-tenths of 1 percent of the population, all millionaires and billionaires, will get $1 trillion in tax breaks if we do what the President wants. Is that true or not true?

Secretary PAULSON. I do not believe it is true.

Senator SANDERS. What do you disagree with?

Secretary PAULSON. I would simply say that the $2 trillion tax number is if the tax relief was not permanent: tax rates would go up and everyone would pay the cost. In terms of the——

Senator SANDERS. OK. I do not want—we do not have a lot of time.

Secretary PAULSON. OK.

Senator SANDERS. Here is what the story is, and the reason why I think people are very upset about what goes on in Government, and especially at the White House. Major cuts in programs that people desperately need at a time when poverty is increasing and the middle class is shrinking, and people look incredulous. You want to give tax breaks to billionaires when ordinary people are hurting, drive up the national debt, drive up the deficit, cause more pain. And you have no answer. You did not give me an answer. That we would negotiate, that is fine.

Secretary PAULSON. I would say the answer, which I just said, and the Chairman and I were talking about it earlier, is that we need to bring people together. There is no doubt that the President has made clear that he would like to reform the estate tax.

Senator SANDERS. Reform the—no. The President has said he wants to repeal the estate tax.

Secretary PAULSON. He has said he is willing to compromise. You all know that. And the American people would love to see a compromise and would love to have some certainty. And there are many, many Americans, hard-working Americans——

Senator SANDERS. All right. Last question——

Secretary PAULSON [continuing]. Who own farms, who——

Senator SANDERS. Last question—very hard to find a farmer, a small farmer, who benefits. Last question. Last question. As you know, oil prices are soaring. Correct? Our friends at Exxon Mobil are doing very well. The average person cannot hear their home. All right—let me finish. And yet in your wisdom—in your wisdom, oil prices are soaring, middle class is shrinking, poverty is increasing. You substantially cut back on the LIHEAP program. Please tell the American people the sense of that. The LIHEAP program, as you know, is fuel assistance for low-income people, 40 percent of whom are senior citizens. Tell me why it is a good idea with oil prices soaring to cut back on LIHEAP so that people go cold in America.

Secretary PAULSON. That is a little bit like asking me, when did you stop beating your wife? You know, that is a loaded question.

Senator SANDERS. Well, if you were beating your wife, I would ask you that question.

[Laughter.]

Senator SANDERS. But what you are doing is giving forth a budget which makes people go cold. Why do you do that?

Secretary PAULSON. I do not agree with your basic hypothesis that we are offering a budget that is making people go cold.

Senator SANDERS. Oil prices are going up, and you are cutting back on LIHEAP. What do you think the implications of that are?

Secretary PAULSON. Senator, I understand your point of view. Thank you for it.

Senator SANDERS. Well, I wish you would answer the question, sir.

Chairman CONRAD. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I want to go back to the chart that you had brought up at the start of our discussion here, where you implied that—well, it showed on your chart that if you have increased taxes, the economy was going to grow more. And I just want to be very specific in my question to the Secretary here. In relation to corporate taxes, that does or does not apply?

Secretary PAULSON. This chart?

Senator ALLARD. Yes, that we talked about earlier.

Secretary PAULSON. Yes, what I said is that when I looked at that chart, the countries at the top of the chart and the one at the very top had the lowest corporate taxes, OK?

Senator ALLARD. OK. So the point that you want to make is that the lower the corporate taxes, then the better the economy.

Secretary PAULSON. I would have to look at every one of those countries before I made that point quite as emphatically as you did. But the one thing I have looked at is not only the total amount of taxes but the form of those taxes. And I believe that our taxes on corporations are relatively high, and the form of the taxes we charge inhibits growth. And, that countries that rely to a greater extent on consumption taxes are able to raise more money with less of an impediment on growth and jobs and competitiveness than our tax system will allow.

Senator ALLARD. Well, how do we rate on capital gains tax with other countries?

Secretary PAULSON. I have not done a study with all other countries.

Senator ALLARD. Well, I think we are high.

Secretary PAULSON. Yes, I believe we are.

Senator ALLARD. I think we are very high. I do not know that we are at the highest—we may even be at the highest, but I know it is very high compared to other countries. Would that have an adverse impact on our economic growth?

Secretary PAULSON. Clearly, when you get to corporate capital gains, this is a concept that does not even apply in certain other countries. But we have corporate capital gains at a level above even individual capital gains. But, again, I am just a believer when it comes to taxing something, if you tax it, you have less of it. And I think capital is what we need for investment to drive jobs and growth.

Senator ALLARD. Do you want to explain to me why you think we have companies that leave the United States and move to other countries? I think Senator John Ensign had proposed a repatriation provision where that if we get certain companies a tax break, they would move back in. And as a result of that, even though it was scored negatively—this happened last session, last year or so, these companies responding—it actually had a very positive impact on our budget because they would have been moving back. Do you want to talk about that?

Secretary PAULSON. What I would say is when you look at corporate taxation, the rest of the world uses a system, by and large—and this is an oversimplification—under which their corporations pay the rate that the domestic companies pay in any particular country. We charge that rate, and then we gross it up for the U.S. rate. We charge a tax to bring money back.

That does not seem to make a lot of sense to me, because you would think it would be in our interest to have our companies bring money back to the United States. And, again, I think it benefits us if our companies are able to compete successfully outside of this country as opposed to ceding that ground to the competition. Their success globally helps drive jobs and growth in the United States, and that is just simply the way I look at it.

Senator ALLARD. What about the marginal tax rate on corporations? Is that beneficial to deal with marginal tax rates?

Secretary PAULSON. Well, there are three or four ways in which to approach this, and one would be to bring that rate down rather dramatically and simplify. There are a number of other ways, but I think that would one effective way of looking at it.

Senator ALLARD. Now, I am assuming when you are talking about simplifying, you are talking to a certain degree about regulatory relief, and there is a cost to it. So that kind of brings me into another question. You know, if we look at some of the regulatory costs in the economy, I think that has an impact. Do we have some unnecessary regulatory costs in our tax structure that we can deal with without going into complete tax reform, like a value-added tax?

Secretary PAULSON. There are many things we can do to simplify, and we at the Treasury Department have tried to simplify the regulations. But I would say that the whole momentum is going in the other direction, because when Congress and others want to drive a certain policy, they very often look to put something in the tax code. And so our tax code, as you know, is overly complex on the corporate side and on the individual side as well.

Senator ALLARD. I happen to be of a different persuasion than what you have heard around here. I do not have a problem with the differentiation between a low tax rate and a high tax rate because I think what happens, instead of shrinking the middle class, you have actually expanded the middle class. I think it also indicates that your economy is more mobile. In other words——

Senator SANDERS. Will the gentleman yield?

Senator ALLARD. I will not yield, sir.

Senator SANDERS. OK.

Senator ALLARD. You know, when you start out, out of college, like most of us did, you usually start out at a minimum salary, but then there is hope of being able to move up—and so that differentiation just indicates the upward mobility and the growth in our economy, and you have to have it there. Otherwise, what you begin to do is you begin to destroy the opportunity for new people entering into your economy to grow and someday gain the advantages that the previous generation enjoyed.

Secretary PAULSON. Senator, when I look at what positively differentiates us from a number of other countries, it is income mobility. And as troubling in some ways as is the widening income gap and wealth distribution gap, it is encouraging to see the mobility we have in our economy and among our workers and our people. As far as I am concerned, though, it does not take away the need to keep this economy growing, and I do believe that the biggest challenge we are going to have in the next 20 years, one of the biggest challenges, is finding ways to get skills to the people who are going to need them to compete in this economy. And I have had a lot of experience working with manufacturing companies, and I keep coming back to this is example. In 1950, we had 15 million manufacturing jobs in the United States. That was 30 percent of our work force. Today we have 15 million. That is 10 percent of our work force. And people say, where did the manufacturing jobs go? Well, the output is 7 times greater. Each worker produces 7 times the output. We are the largest manufacturing country in the world, 2–1/2 times bigger than China.

But to me, the issue is automation. When I walk through plants, I used to walk through a Caterpillar plant in my early days and see a lot of workers. Now I see automation.

We are creating a lot of other good jobs, but, again, this challenge we face is faced by other——

Senator ALLARD. Well, I just want to make a point. I would like to hear your explanation of how you encourage the economy to grow when you compress people's ability to grow in that economy by trying to compress the wealthy down with the poor.

Secretary PAULSON. We can look at the issue, which is the widening gap. To me, I would not look at the tax code as a way to address that issue. The tax code under this President hasten more progressive. You can just look at the numbers. It has become more progressive.

Senator ALLARD. I agree.

Secretary PAULSON. The challenge is to create jobs and to help people that need the help, and that is——

Senator ALLARD. Yes, but you are going to have to do some explaining to me how you are going to com6press people by not allowing them to grow income and reach higher levels, and yet expect your economy to grow. I just think it is very difficult, and I do not think you can do it.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Whitehouse?

Senator WHITEHOUSE. Thank you.

Secretary thank you for being here. I have a personal view that we have a White House that, in a fashion rather unique in recent history, really loathes and despises the American process of government, and that, you know, judicial review is anathema to them even though it is a core constitutional principle. They would like to do things without congressional oversight everywhere possible. And I cannot help but have that opinion in mind when I see the way the stimulus package is proceeding.

We have a bicameral legislature. We have always had a bicameral legislature. It should not be news to anyone that the United States of America has a bicameral legislature. So the idea that a stimulus package gets negotiated between the White House and the House of Representatives and that is supposed to end the process is just silly from a process point of view. I cannot express how basic the process question is here. And I really think that unless this administration in its last year wants to govern by veto and veto alone, then in order to be relevant, you also have to be reasonable. You cannot just use force and pressure to get your way.

And what I see right now as backdrop to this is the White House putting intense pressure on Republican Senators, heavily arm twisting to get them to vote against the Senate Finance stimulus package despite the fact that it will put them in real peril with 21 million seniors out there who will see a benefit that is now waiting for them stripped, despite the fact that it will cause intense damage to the wind and solar industry from the tax rebate not being granted to them, despite the fact that 250,000 veterans would lose—disabled veterans would lose a benefit.

It strikes me that the sensible thing to do, and consistent with the American process of Government, which is no mystery to anybody, would be to let the Senate do its work, since you have not negotiated with us, and then take the bill that emerges from the Senate, and then it goes back to conference. And in conference, with the input from the White House, the House and the Senate negotiate to a bill that then goes to the President for signature.

But the idea that you try to stop this in the Senate without the Senate having any voice in the process by putting pressure from the White House on us I think is a misuse of the American process of Government, and I would urge you to use your credibility and your authority in this administration to ask them to calm down, to take the pressure off the Republican Senators, to let this thing work its way through the legislative process, to take it up in conference, and to come up with a bill. Because I really do not think it is such a bad thing to give 21 million American seniors a break or to give 250,000 disabled veterans a break that is worth putting the White House into the legislative process and stopping this stimulus. Because what is stopping the stimulus is the White House pressure on Republicans Senators jamming it up.

Secretary PAULSON. Senator, let me respond to that.

Senator WHITEHOUSE. I wish you would. I would appreciate the opportunity to have you discuss this.

Secretary PAULSON. I would say, first of all, that what was done in the House was bipartisan and was simple.

Senator WHITEHOUSE. But not bicameral, and we are talking about the American process of Government.

Secretary PAULSON. I was going to get to that. And the reason it was able to be done was that your leaders said, in the interest of speeding up the process, why doesn't the house take the lead, work something out in the House, and then the Senate can take it up quickly.

Now, I recognize and the Administration recognizes—and I am leading the effort from the Administration, so if you are going to point the finger, point it at me—but we recognize that the Senate has an important role to play here. I recognize that. And what I said yesterday, when I was asked a question about low-income seniors and veterans, is that the starting point was the 2001 legislation where the rebates went to taxpayers. The House changed that and broadened it to include working families. And when the question was put to me about seniors, low-income seniors, and veterans, I said I cannot negotiate this here, I should not negotiate in a public hearing. But we are well aware of the difficulties faced by low-income seniors and veterans, and I am sure something can get something worked out.

Senator WHITEHOUSE. The problem is, though, that from a process point of view, the Republican Leader is stopping anything happening on this bill.

The Republican Leader is stopping anything happening on this bill in process so that those discussions, those debates, what we do in the Senate does not happen at all, and the information we have is that he is doing it on instructions from the White House. Since you are in the middle of this——

Secretary PAULSON. No, I would say——

Senator WHITEHOUSE. Why don't we get to vote on these things?

Secretary PAULSON. I would say this: I am not going to get into your legislative tactics and what is being done. The other thing I would take issue with—in all due respect because I understand what you are saying. But I think the American people are not going to be very patient if we are going to have two different bills, go to conference, get bogged down there, and you are going to delay getting the checks to the American people. So——

Senator WHITEHOUSE. But we could already be done if it had not been stopped by the Republicans in the Senate. It could be through conference now.

Secretary PAULSON. Again, all I am calling for is speed. I was hopeful that there would have been a vote last week. I was hopeful. I am looking forward to the vote. I am looking forward to a resolution. I am looking forward to getting checks to the American people. I certainly am not trying to rain on this bipartisan moment or cast a shadow on it, because I do think we have a bill that reflects Democrats' views, Republicans' views, and the primary driving factor is what is stimulus and what is going to benefit the American people. But——

Senator WHITEHOUSE. From the White House point of view——

Secretary PAULSON. Let me just say one other thing. When I made my comment, the things I singled out were things that were not necessarily Democratic provisions. They were things that were not stimulus, benefits for business that just were not stimulus.

I think we want something that is going to work quickly, is going to help, and is going to be stimulus. And I am for a fast process.

Senator GREGG. Mr. Chairman?

Senator WHITEHOUSE. OK. I just wanted to say that from the White House point of view, it is not enough to just say, look, I went and did the distasteful thing of negotiating with a Democrat, I did it with the House, and now I am done with it, I have done it and I am not going to do anymore, now it is bipartisan.

We have a process of Government here in the United States of America that has two Houses of Congress——

Secretary PAULSON. Absolutely.

Senator WHITEHOUSE [continuing]. And ours has a right to go through a process.

Secretary PAULSON. I could not agree more.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Secretary PAULSON. This started, as far as I am concerned, with Senators Reid and McConnell being gracious and saying to the House, move and then we will move quickly. The Senate is going to have its say. You are working. I do not think it is pressure to express a view that I think it would be good to pass the House bill. You do not have to do it. I have expressed the view I did as it relates to some of these other things. But the one thing I want to resist is any thought that we have extra time and that delaying a few days is not going to hurt the economy, because it will. We need to get the checks to the American people.

Chairman CONRAD. Senator Cardin?

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

Secretary Paulson, first, I genuinely want to thank you for your public service, and I thank you for the manner in which the negotiations took place in the House on the stimulus package. I think that was healthy for our economy, and I think it showed the right type of respect for negotiations.

I first need to respond to Senator Allard's exchange with you because I found it very misleading. And I must say, you have an impossible task to try to defend this budget submitted by the Bush administration given the objectives that you have so eloquently pointed out for our economy.

Senator Allard talked about the middle class growing. To let that go unchallenged is just intellectually dishonest, and it is not what is happening in America. We know that we have a widening disparity of wealth in this country, which you have acknowledged. And this budget does very little to correct that.

To suggest that our code is progressive and then take on Senator Sanders' point about the repeal of the estate tax to me, again, is not furthering the debate.

According to information that has been made available through our Committee, the budget provides $51 billion of tax relief for those making over $1 million in 2009. That is the gap that has to be filled because of the policies that you are recommending. And yet for just a fraction of that amount, we could deal with the problems that you are bringing up. We could develop a workforce able to compete in the future, put money into education, job training, and other programs that are well below any reasonable growth levels necessary to meet the challenges that you point out that we must meet for our economy to grow.

I point that out because it will be difficult for us to make that connection if we are not going to work in the same spirit as the short-term economic stimulus package.

I want to share with you some of the experiences I have had in Maryland regarding our economy and my disappointment with the budget that has been submitted. Marylanders are hurting today. They are having a hard time paying their health care bills, having a hard time paying their energy bills. They are worried about losing their homes. And I look at the Bush budget, and I do not see remedies for those deep problems. It might have been the housing market that triggered this economic problem, but there are also deep problems within our economy. And I would like to see us take action in 2008. I do not think we should wait until 2009 to deal with these problems.

So let me start with housing, first. Over 2 million homeowners in this country are in jeopardy of losing their homes through foreclosure because of the subprime mortgage crisi by the end of next year. The initial program recommended by President Bush would do very little for those that are in danger of delinquency or are in delinquency in their mortgages. Part of the Senate Finance stimulus package, a proposal that the administration supports, would add some revenue bonding authority to be able to help homeowners. I make a plug for that because I do not want to forget homeowners. We talk about low-income seniors, very important. We talk about disabled veterans, very important, but let's not leave out the housing issues, which we need to deal with now, and I hope that provision gets into the final package and becomes law.

My question is, I do not see much in this budget that is going to help someone who was victimized by the subprime crisis—and in my State, many homeowners were victimized. The majority of subprime borrowers awere eligible for a conventional mortgage. They were steered into subprime loans, and now they are in danger of losing their homes. The credit crunch is affecting them, and I think we have a responsibility to be more aggressive, not only to ensure that homeowners are treat fairly, but also for the sake of our economy.

In Baltimore, we just had layoffs announced from General Motors Transmission because light trucks are not being sold because of the building industry cutting back. So all of us are being affected by what is happening in housing. I would hope to have a more aggressive budget on this issue, and I welcome your thoughts.

Secretary PAULSON. Senator, let me talk about housing because that is the biggest drag on our economy, and it is the major risk, and it is a risk to the downside. First of all, the Hope Now Alliance is aimed at dealing with the 2 million subprime resets, and I am much more optimistic about that than you are. I think what you are going to find is that if you are a homeowner and you are able to make your initial mortgage payment—if you cannot make that, you are right, then it is going to take other alternatives—but if you can make the initial payment but have trouble making it under the higher rate, fast-track——

Senator CARDIN. Well, what are the other alternatives?

Secretary PAULSON. What?

Senator CARDIN. What are the other alternatives? You said it will take other alternatives.

Secretary PAULSON. I would say it will take one of the FHA products. We have FHA Secured, and if we can complete the legislation that has already passed the House and the Senate, this will give the FHA ability to help another couple hundred thousands homeowners. But I am saying that there are a large number—two-thirds of those resets—that we think will be homeowners who can make the initial payment.

But I want to get to your more basic question, which is what we are doing for the homeowners that have been victimized who have other issues. We have thought about this a lot, and we said that dealing directly with homeowners is, we think, the right way to go. And then, the fairest and the most effective way of dealing with thus more broadly, is by putting these stimulus checks in the hands of people, many of whom will be homeowners. With the House package, you would see rebates of $600 for individual, up to $1,200 for married couples, and, of course, the child credit on top of it.

So, again——

Senator CARDIN. I would just point out that these asre very limited, short-term protections. The problem is that these at-risk homeowners have loan structures that they could have avoided, but they were steered into it. And I think we have a responsibility not to bail out the lenders——

Secretary PAULSON. Right.

Senator CARDIN [continuing]. But to help these homeowners refinance. And I think the revenue bond package will help. I think it is a good proposal, and I hope it is part of the stimulus package.

Secretary PAULSON. The revenue bond proposal was something we proposed in the budget that would be very helpful. We are also going to work very hard with this Hope Now Alliance to expand it and strengthen it as we go forward. But the one thing that we have not been able to figure out is how to deal with a homeowner who bought assuming the price of the home was going to keep going up and it has not, and who no longer wants to own the home and no longer wants to make the initial payment. We are not able to deal with that. But I think we do have a program aimed at those that can make the initial payments, and we need to get this FHA modernization legislation done, which will help with those that are having added trouble——

Senator CARDIN. Let me just conclude. I agree with what you are saying, but I blieve we need to go further. And I do agree with the point that you are raising, but there is a group out there that has been victimized. I am not talking about those who made bad judgments but those who have been victimized, and I think we have a responsibility. When you take a look at the communities that are particularly affected by the crisis, you find a lot of minority communities where the practices were different than in non-minority communities. And we have a responsibility to respond to that.

Secretary PAULSON. I agree. Senator, I have visited a number of those communities. I have spent time on the road. I am well aware of it. You know, there are abusdes that took place. Another big part of my focus is to come up with policy responses to minimize the chance of that happening again and a repeat of those kinds of practices. So we are trying to get through this period with as little harm to the economy and to individuals as possible and then come up with a strong policy response to deal with that problem. Thank you.

Senator CARDIN. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Secretary, I am sorry that I did not get to hear your testimony, although I did read it, and the exchanges since I was on the Energy Committee, but I appreciate you being here.

Mr. Chairman, I have a statement that I would ask to be included at the beginning of the hearing.

Chairman CONRAD. Without objection.

Senator MENENDEZ. Thank you.

[The prepared statement of Senator Menendez follows:]

Robert Menendez

Statement
Budget Committee Hearing with Secretary Henry Paulson
February 6, 2008

Thank you, Mr. Chairman. Secretary Paulson, welcome to the committee to discuss the president's budget. Our nation's budget lays out our priorities for the coming year. It is more than just a document. The budget should be a reflection of our Nation's direction. However, our nation is at a crossroads: we are working to jump start a slowing economy; managing our way through a housing crisis; feeling record-breaking energy prices; and praying that our troops return home safely.

Secretary Paulson, the U.S. and world markets are looking for strong leadership to guide our economy. Just yesterday, the Dow Jones lost 370 points after the Institute for Supply Management reported that non-manufacturing business activity contracted for the first time since March 2003. And last month, our economy lost 17,000 jobs as reported by the Labor Department. Our country will need a responsive stimulus package that will provide immediate and effective assistance to our seniors, veterans and families who will need critical unemployment benefits. The Senate has crafted a package that recognizes the struggles of Americans who are out of work and the timely stimulant effect of extending their unemployment insurance. I am very encouraged that our package will extend to those hardest hit by this slow down in our economy.

Secretary Paulson, when I look at this budget, it becomes painfully obvious that the President is continuing on his trail of misplaced priorities. This budget asks some of our most vulnerable citizens to bear the burden of balancing the President's budget while extending tax cuts to the wealthiest Americans – those in the top 1 percent of incomes. Whether we're talking about Medicare, Medicaid, SCHIP or the Low Income Home Energy Assistance Program, this budget cuts critical resources for those who need them most and gives to those who need it least.

Instead of giving the American public an open and honest budget, we see that the President can increase the defense budget to $515.4 billion, a 7 percent increase, but cannot give us the costs of the war beyond the first half of FY09. He fails to give an accurate picture on balancing the budget when he omits the costs of the Alternative Minimum Tax. He cuts grants to state and local governments by $15.1 billion which will force local officials either to raise local taxes or eliminate programs completely.

For the last seven years, I have watched and hoped that the president would seize the opportunity and lay out a different set of priorities. But this president has had more than enough chances to build a legacy that this nation can be proud of. Instead he is leaving a legacy of lost opportunities, lost priorities, and lost values.

Senator MENENDEZ. I want to pick up where Senator Cardin finished. You know, at the Banking Committee, I raised this issue about your Hope Now program, and, you know, we hope it has hope. But the reality is that, you know, if we look at some of the percentages that have been extrapolated by independent entities, not very much has happened in percentage terms. As a matter of fact, the Center for Responsible Lending predicts that the plan only helps 3 percent of the subprime ARM borrowers, and that, in fact, the percentage of those who have actually been helped to date are incredibly small compared to the universe.

What do you say to that?

Secretary PAULSON. Well, what I would have to say that is wrong. You will see some information put out later this week on what happened through December.

Now, remember, the biggest issues we have are coming up this year, Senator. Over the next couple of years, we have the big wave of resets, and those are the mortgages that have the most lax underwriting standards, some of the abuses that Senator Cardin was talking about. So that is where the challenge is going to be. What

I am pushing for and what we will get are metrics. We are going to get numbers, and we are going to just see what the answers are to your question.

But what the——

Senator MENENDEZ. Well, for you to say it is wrong mean that you already have a different set of circumstances.

Secretary PAULSON. I would say what the latest numbers that were released near the end of the year show a real step-up into the third quarter in terms of the number of people that were helped, and so that has moved up dramatically. I am not going to make this out to be a silver bullet, but I am going to say that I will be unpleasantly surprised if we do not find that those people who are facing resets and have been able to afford the initial rate are helped. I believe that is what the facts are going to show, and we are going to drive that very hard. I think the numbers that have come out to date, the most recent numbers show there was a big step-up at the end of the year in terms of the number of people helped, 370,000.

So, you know that different organizations can put out different guesses as to what will happen, and what I am going to drive for is metrics and numbers and getting the numbers out there. And I have to tell you that, if the members this alliance are not doing what they have said they are going to do, I am going to be all over them. And they will have to do other——

Senator MENENDEZ. I am all for metrics. But I must say that when your house is being foreclosed on, metrics alone is not a solution.

Let me just say it is not just what they——

Secretary PAULSON. Metrics will prevent us from having——

Senator MENENDEZ. It is not what they just project will happen. They project that what has happened is very little.

Secretary PAULSON. The numbers that have come out for the fourth quarter—and we will send you those numbers—show that 370,000 people have been helped. But, again, the reason I say metrics are important, and I know metrics will not save your house, is that when we are having this discussion in the future, we will know what the facts are. And, again, I believe what we are going to see is that a good number of people are going to be helped because they are going to be fast-tracked and do a quick modification or refinancing.

Senator MENENDEZ. Well, I just simply hope, Mr. Secretary, that you and others will be as aggressive about this as we are about making sure that the marketplace and Wall Street are reinvigorated.

Secretary PAULSON. I could not be more aggressive.

Senator MENENDEZ. Well, let me ask you about a different question.

Secretary PAULSON. I got to tell you, if this group does not perform, I am going to say so publicly, and I am going to be all over them.

Senator MENENDEZ. And I am going to be there right with you. Let me ask you the following: Yesterday at the Finance Committee hearing, you said that you were open—and correct me if I am wrong—to including rebates for seniors and disabled veterans in the stimulus, but you disagreed with including unemployment benefits. Is that a correct statement?

Secretary PAULSON. Well, I think that is an oversimplification. I chose my words very carefully because I was not there to negotiate. But I did say, and I said here today, that we understand the difficulties that low-income seniors and veterans are facing, and I am optimistic we will work something out.

With unemployment, you have me right, because I oppose that very strongly for one major reason: the unemployment rate in this country is now 4.9 percent, and it would be unprecedented, it would be a huge break with precedent, to extent unemployment insurance at that rate. I have analyzed it. The lowest unemployment rate ever when we extended it was March of 2002. Then it was 5.7 percent. In November 1991, it was 7 percent; September 1982, it was 10.1 percent; January 1975, 8.1 percent; January of——

Senator MENENDEZ. So your opposition is simply based on that it is not high enough, the percent of unemployment?

Secretary PAULSON. I am saying that would send the wrong signal to the whole world. Again, I have been up front and very early out on the fact that the economy has been slowing down. I continue to believe growth is going to slow down, but we are going to keep growing.

My only point is, if the situation that some people on the other side are predicting is correct, if the economy slows further than expected, if the unemployment rate rises significantly, then let's have the discussion at that time.

Senator MENENDEZ. Well, even though the economy lost 17,000 jobs in the month of January, the first monthly loss of jobs in more than 4 years, which some say is an indicator of what forbears—you know, in March of last year, I said we are going to have a tsunami of foreclosures. Everybody pooh-poohed it. Unfortunately, we are facing a tsunami of foreclosures. This wave of unemployment I hope is not the reality, but I am really concerned about it. And the economists say that it is a quick and high bang for the buck that we get $1.64 for every $1 that we provide in this process, plus we help people who are trying to find a job but just cannot find one in this economy.

So with all of that considered, if the whole purpose is stimulus, isn't this a good way to stimulate quickly?

Secretary PAULSON. I have had a huge focus on stimulus. I believe the rebate checks in the House bill, which is broad based, and given what I think we are going to be able to do with the IRS in terms of getting checks out quickly, much more quickly than people had expected, and getting a big check out all at one, I think will have a significant stimulus effect.

And so, again, I understand your position; I have heard it. There were a lot of people in the House that felt the same way. The Speaker made the tough decision, let's do something that is stimulative and balanced and get support from both sides. Because I am for things that are stimulative, I gave you my objection and why.

Senator MENENDEZ. Well, I appreciate hearing your objection. Let me just say—and I know my time has run, but let me just say that if we are talking about timely, it is going to be far more timely than anyone who is going to get a rebate. That is for sure. It may not be as big as the rebate in the immediate—but timely, this will be far more timely. It will be in the hands of people far quicker, and probably by the time you get that rebate out, they will have had more money in unemployment benefits than they will get in a rebate. And the stimulus context as well as helping people stay on their feet, it seems to me that it is far better.

Secretary PAULSON. The numbers do not bear you out in terms of the amount of money, especially when you look at what it means to make a small increase in a monthly check, and when you look at the kinds of stimulus we are talking about with the benefits for children, and you look at the speed of getting the checks out. Again, that is why I am pressing so hard to get this on the President's desk, because we can then start programming immediately at the IRS, and I think we can start getting this money out in May. And so that is where we are.

Senator MENENDEZ. Well, hopefully you will talk to our colleagues, and we can get the Senate bill passed, and then we can have a conference.

Secretary PAULSON. The best of all worlds would be to get something passed and not need a conference. Then we would really get it out quickly.

Senator MENENDEZ. Well, it is not just doing it quick. It is getting it right. And, you know, there are two sides to the Congress, Mr. Secretary, having been here in both Houses for a while. You need to negotiate with both sides on behalf of the American people and its totality.

Thank you, Mr. Chairman.

Secretary PAULSON. I agree with you on that, but do you agree that it could be possible to get quick action in both the Senate and the House and still not need a conference where it could get bogged down?

Senator MENENDEZ. I think there is every desire to get it out quickly, and there is also every desire to get it out right so we really stimulate this economy. And I think both can be reconciled.

Secretary PAULSON. Thank you.

Chairman CONRAD. Thank you, Senator.

Mr. Secretary, there has been a lot of skepticism expressed about the stimulus package. I was on a talk radio show the other day, and the host posed the question to me in this way, and I would like your response. He said to me: "Senator, you are going to go out there and borrow, you, Congress, and the administration are going to go out there and put $150 billion, roughly, into this package. All of it is going to be borrowed. Much of it is going to be borrowed from China and Japan. You are going to send checks to people who are then going to go down to the store and they are going to buy goods from China and Japan. Whose economy are you really stimulating?"

What would your response be?

Secretary PAULSON. First of all, I also have had skepticism from a couple of groups of people. I have had skepticism from people who point to fundamental, long-term policy objectives that, if they could be enacted, would make a bigger difference in the intermediate and the long term. And so I have had skepticism from people there. I have heard skepticism from people that are concerned about the deficit, and I really respect your concerns there.

What my position has been has been is that there is a need, and we should do something quickly that will make a difference. We need to do something that is big enough to make a difference in terms of the size, but not so big that it is going to create a big impediment to what we are trying to do in balancing the budget and dealing with the deficit. That is why we came up with the size we did. I would just say very directly that I have no doubt that if we can keep this simple and we can keep it focused on stimulus—I do not want to spend money that really is not going to be stimulus—it will make a difference this year.

What I would say to the talk show host or anyone else is that if we get money out and put it in people's hands, not government programs, but people's hands and let people spend it, this will create jobs. It will create real jobs. It will create economic growth. It will make a difference this year.

Chairman CONRAD. And economic growth in this country?

Secretary PAULSON. In this country. Oh, absolutely economic growth in this country. That——

Chairman CONRAD. Is it true—I had an economist tell me 90 percent of the goods and services sold in this country are American. And so this idea that——

Secretary PAULSON. I do not have the number, but——

Chairman CONRAD [continuing]. To whatever extent you stimulate——

Secretary PAULSON. The vast majority. I would just simply say that the No. 1 bogeyman we are fighting, I believe, are all those people who somehow or other believe that trade or globalization is hurting the United States or that we should lose our self-confidence and think we cannot compete with others around the world, or that we should not open ourselves up to that. And I will tell you, with repect to the imports we do get, the low-cost imports, the same people who are concerned about low-income citizens, that are concerned about what is happening to the middle class, some of those people are the ones who are trying to prevent low-cost imports and increased options and choice for citizens of this country.

So, again, we benefit from our trading relationships around the world, and I think we can be self-confident. And, you know——

Chairman CONRAD. Can I just say, can I just give this word of advice?

Secretary PAULSON. Yes.

Chairman CONRAD. I think instead of getting off on a trade dispute, which gets off into a whole series of other issues, if we stayed focused on the question of stimulus, if you could get us what your analysis is of what the goods and services that would be bought by these checks, is it true—is it true that 90 percent of the goods and services are American?

Secretary PAULSON. The vast majority are going to be American, and I want to stay——

Chairman CONRAD. Could you get us an analysis that would tell us——

Secretary PAULSON. I will do my best, but the analysis——

Chairman CONRAD. Because I will tell you something, this is going around. This is going around the talk show world, this is going around the political world, this notion that we are going to borrow money from China and Japan and we are going to turn around and buy Chinese and Japanese goods, and that we are really stimulating their economies, not ours. We need some factual analysis that tells us whether or not that is true.

Secretary PAULSON. I am going to say two things to you here.

First of all, I believe that the talk show hosts are going to have a hard time convincing the American people that it is not good for them, that the American people are going to oppose getting checks. That is No. 1.

No. 2, I have been very clear in saying that with a stimulus package like the House bill we expect to get at least 500,000 jobs this year. We have looked at what it does to the GDP. It is seven-tenth of a percent, more or less, if we can get this out quickly and keep the package simple. I will do my best to get you an analysis that you have asked for.

But, again, I think the overriding analysis is that this will give a boost to the economy. This will——

Chairman CONRAD. And to our economy.

Secretary PAULSON. Help our GDP. That is all we are talking about, our GDP, our jobs. And the only reason I go off a little bit on a tangent, is that it is just amazing how people want to point the finger at globalization or trade to fight almost anything good you would like to do.

Chairman CONRAD. Let me go to one other point that we have discussed previously, and that is this long-term debt. This is not a projection, at least until 2008. We know the debt of this country is going up like a scalded cat, and the question is: What do we do about it?

Senator Gregg and I have made a proposal to empower, give the responsibility to 16 representatives, some from the administration—this would be done next year, now. We have changed the timing. It would be done next year. Some from the administration, some from the Congress, to come up with a plan; and if a significant majority of the members of that group would agree on the plan, that plan would come to Congress for a vote.

As I look at what the next President is inheriting and the next Secretary of the Treasury is inheriting, it is a mess. Do you think that kind of approach has merit? Do you have an alternative recommendation for us? What would you tell our colleagues? Because there is a tremendous debate going on behind the scenes right now on what we should do about this longer term?

Secretary PAULSON. First of all, I want to commend your leadership and Senator Gregg's leadership in this area, and this Committee, because this is one of the major structural issues that this country is facing. I listened carefully to what you said about debt, and I would characterize it a different way. But I agree with the overwhelming issue you have raised. The big issue is what is happening with the Social Security and Medicare and how to deal with this.

I think what you have suggested is a constructive approach, and I think it will take something like this to cut through all of the cross currents and the sentiment out there. This is an easy issue to demagogue if you do not want to get something done. And I have no doubt, Mr. Chairman, something will get done. It has to get done. But the longer we wait, the more costly it will be, and it is the younger generation that will pay the cost.

So I just commend your leadership, I commend Senator Gregg's leadership, and I hope as you work behind the scenes, you get some traction for an idea like this.

Chairman CONRAD. Thank you very much.

Senator Gregg?

Senator GREGG. Mr. Secretary, I just want to make a few points, and they are rhetorical in nature, and then I have to leave, regrettably.

First, I want to thank you for your service. The Nation is lucky to have you. And I think that the good fortune of our Nation is reflected through your leadership in this Hope Now program. I mean, you had this up and running last summer or early fall, and I guess Senator Menendez is not too impressed with it. But I am impressed with it. You got $150 billion, I think it was, in play for the purposes of addressing the rollover relative to the subprime issue on the adjustable rate mortgages, and it is going to relieve some of the problem here. And certainly for those people who got drawn into a subprime contract, who could not afford the step-up in the interest rates but could afford the underlying contract at the original rates, it is going to give them some options, which is very, very important for those individuals. And I congratulate you for setting it up, and I appreciate your leadership there.

Second, Senator Whitehouse said that Senator McConnell is holding up the economic stimulus package and will not tolerate the issue of the Senate add-ons. Actually, what Senator McConnell has suggested in order to expedite this process is that we add the senior language, we add the veterans language, we straighten out the immigration language, and we put those in the House bill and we pass it and sent it over to the House and have them pass it. The House is ready to do that, as I understand it. Senator McConnell has asked that in numerous unanimous consent requests, and it has been objected to by the Democratic Leader. Why? Because the Democratic Leader wants to bring to the floor a Senate package which throws in a lot of other stuff. I mean, this is a train leaving the station and everybody wants to put their baggage on. We have a coal tax break. We have a windmill tax break. We have some sort of other energy tax breaks thrown onto this train. Totally inappropriate to the effort because those items are not stimulative.

Obviously, there is some debate about the utility of extending unemployment insurance when you are at technically a full-employment economy, 4.9 percent unemployment. As you say, and you say accurately, to do an unemployment insurance extension when you are at 4.9 percent unemployment makes no sense in the historical context. You do an unemployment insurance extension when unemployment has jumped significantly and when people cannot find jobs. At a 4.9-percent unemployment rate, at least in some regions of this country, there are obviously jobs that are not being filled because that is a full employment number.

In New Hampshire, for example, we have 3.6 percent unemployment. Arguably, if you extend the unemployment benefit for another 6 months, you are basically saying to people, Do not go out and look for a job even though there may be jobs available. So any unemployment insurance extension should be tied to an unemployment rate which reflects the fact that there are not jobs, and that would be at around a 5.7 percent unemployment rate at the base. So it should be a trigger event. At the best it should be a trigger event. It just should not be a national extension of the unemployment insurance.

And that is a point I have been making. Sure, there may be regions in this country, like Michigan, where you should extend the unemployment insurance. But it should be done by a trigger based on actual unemployment numbers that show that there are no jobs available or the jobs are scarce versus undermining the productivity of the country by keeping people on unemployment insurance in regions where there are jobs available.

So those are the three points I wanted to make in response to your efforts, and, again, I appreciate all you are doing. And I certainly appreciate your strong endorsement of Senator Conrad's and my efforts to try to address the entitlement issue which is coming at us.

Secretary PAULSON. May I say just one thing?

Chairman CONRAD. Yes, sir.

Secretary PAULSON. Currently, imports are 17 percent of GDP. Of course, we have imports from many parts of the world. So the vast majority of the spending for stimulus will go to U.S. goods. And so when we came up with our estimates on jobs and GDP, we took all of that into effect.

Chairman CONRAD. Well, we thank you for that.

Let me just go back to this question of stimulus and what Senator Gregg was raising. There are other parts of this package that some of us think are important, the net operating loss provisions, and let's look at housing. Home builders employ about 3.5 million people in this economy. They are not in a recession. They are in a depression. And the package that was in the Senate was expanded to provide for 2008 losses to be carried back to profitable years, and the reason was we are being told by the home building industry that they are faced with a very serious problem. Not only are they facing operational losses and write-down on their book value from that, but in addition, their accountants are coming and telling them you cannot write off your losses, you cannot take them back to profitable years, and so you have to take another hit on your book value. That means they are under pressure to have a fire sale of assets to raise cash to continue operations.

Now, this is the case they have made to us very persuasively, that they need to be included here if they are going to buffer the downturn that has already hit them, and hit them sharply.

We had Mr. Zandi here of Moody's Economy.com last week for a hearing, very impressive economist, one of the most impressive witnesses that has come before this Committee. And he was sharing with us his forecast of where this is all headed, and I am sure, Mr. Secretary, you have seen it.

I think every member of this Committee found it very sobering because, as you have described, we have not hit bottom here. And so I think the need for stimulus is absolutely clear, and the need to do it quickly is clear. The need for us to resolve these differences is also clear.

I would say on unemployment, the one concern that I have about not including it is we are seeing long-term unemployed workers now comprise 18 percent of all unemployed workers. Those are people who have exhausted their 26 weeks. And, you know, in our conversation, the phone call that you made to me, which I welcomed, over last weekend, we talked about this issue. I did not know then that the percentage of unemployed workers who have exhausted their 26 weeks, remaining jobless for more than 26 weeks has now reached 18 percent of the unemployed. Does that give you any concern?

Secretary PAULSON. That is part of the structural issue we were talking about earlier when we were talking about income distribution. Of course, it is something I am concerned about, and I watch it carefully. But it does not change my view about extending unemployment benefits, extending the period across the board, when we have a 4.9 percent rate of unemployment. And I would——

Chairman CONRAD. Is it 4.9 or 5? I have been told——

Secretary PAULSON. It ticked down to 4.9. It was 5 percent. But whether it was 4.9 or 5, I would make the same point.

Chairman CONRAD. I think the message that should go forth—and I apologize. I have to end because I have another obligation. But I would just say this: We have a mutual responsibility to reach a conclusion. It is absolutely true the administration reached an agreement with the House of Representatives, a good-faith effort and a very good beginning. It is also true that there is another body. That is the U.S. Senate. They have weighed in through the Senate Finance Committee. And while there are elements there that you may not support, somehow we have to find a way to reach a conclusion here in a rational way.

Secretary PAULSON. I am optimistic. I believe we will do it, and we will do it quickly. So let's hope we are both right.

Chairman CONRAD. On that positive note, the hearing is adjourned.

Secretary PAULSON. Thank you.

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

Jim Bunning

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON THE BUDGET
THE PRESIDENT'S FISCAL YEAR 2009 BUDGET PROPOSAL

February 6, 2008

Thank you, Mr. Chairman.

I am pleased that we are here today to hear Secretary Hank Paulson answer questions about the President's Budget Request for Fiscal Year 2009. The budget we are preparing to review will affect every American today and far into the future, and we need to think carefully about the balance we strike between benefits we spend out today and our responsibility to future generations.

One area in which I would like to see more leadership by this Administration is in entitlement reform. I applaud the changes the President is proposing to Medicare, but I am disappointed that the Budget does not go further in seeking changes to Social Security and other entitlement programs. This is not an insignificant omission. These programs account for a staggering $1.6 trillion in this year's budget. The President does propose changes, but these changes still allow entitlements to grow at a rate much faster than the rate of the economy. In effect, the President is saying in his budget: let future generations fend for themselves.

Another area where I think the Administration should have gone further this year is in tax reform. It is universally acknowledged that our tax system is broken and needs to be modernized to allow businesses here to compete on a more even footing with their foreign competitors. The Treasury Department released a study calling for a major overhaul of our business tax rules, but, unfortunately, the President decided not to include a detailed business tax reform proposal in his budget request.

I hope that this oversight does not mean the President intends to neglect this important area, because I think the recent agreement on economic stimulus proves that Congress and the Administration can work together when there is a pressing need. There is clearly a pressing need for tax reform to boost our economic growth and align our tax system with the rules of the WTO, and I look forward to working with Secretary Paulson on this, as well as other matters, during the coming year.

Thank you.

THE PRESIDENT'S FISCAL YEAR 2009 DEFENSE BUDGET AND WAR COSTS

TUESDAY, FEBRUARY 12, 2008

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

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

Present: Senators Conrad, Wyden, Feingold, Nelson, Menendez, Sanders, Whitehouse, Domenici, and Allard.

Staff present: Mary Ann Naylor, Majority Staff Director; and Denzel McGuire, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order. I especially want to welcome everyone to today's Budget Committee hearing on the President's defense budget and war costs. Our witnesses are Gordon England, the Deputy Secretary of Defense; General James Cartwright, the Vice Chairman of the Joint Chiefs of Staff; and Tina Jonas, the Under Secretary and Comptroller of the Department of Defense.

Secretary England serves as the Chief Operating Officer of the Department of Defense and was previously the Secretary of the Navy, where he provided very distinguished service. Secretary England, we want to again thank you for taking on these chores. It is certainly not for the pay. It is certainly not for the cushy hours. It is terrific that people of your quality and character are willing to serve our country, and we appreciate it.

General Cartwright is our Nation's second highest ranking military officer, with primary responsibility for overseeing the defense acquisition and budgeting process. General Cartwright, it is good to have you before the Committee. We also deeply appreciate your public service. These are difficult, challenging times, and we are fortunate to have people with integrity and quality in our Nation's service.

And Under Secretary Jonas is the Chief Financial Officer of the Department of Defense. She is well regarded by this Committee, somebody who has done her homework, which we very much appreciate.

Let me make a quick presentation. As you can imagine, I am going to be saying things here that do not reflect on any of our witnesses here. These are matters, frankly, that are of concern to this Committee that are decisions by this administration with respect to providing transparency or failing to provide transparency to this Congress and this Committee with respect to ongoing costs.

Let me put up a recent headline from the New York Times to put the President's defense request in historical perspective. Its headline read, "Proposed Military Spending Is Highest Since World War II." In fact, if we look at defense outlays, we can see that under the President's request, defense spending will exceed the highest levels during the cold war. We will spend more than at the peak of the Vietnam War or the peak of the Korean War, even after adjusting for inflation. Keep in mind we had several times as many troops deployed overseas during those war years as we do today.

The New York Times

Proposed Military Spending Is Highest Since WWII

By THOM SHANKER

WASHINGTON — As Congress and the public focus on more than $600 billion already approved in supplemental budgets to pay for the wars in Iraq and Afghanistan and for counterterrorism operations, the Bush administration has with little notice approached a landmark in military spending.

The Pentagon on Monday will unveil its proposed 2009 budget of $515.4 billion. If it is approved in full, annual military spending, when adjusted for inflation, will have reached its highest level since World War II.

That new Defense Department budget proposal, which is to pay for the standard operations of the Pentagon and the military but does not include supplemental spending on the war efforts or on nuclear weapons, is an increase in real terms of about 5 percent over this year.

Overall since coming to office, the administration has increased baseline military spending by 30 percent, a figure sure to be noted in coming budget battles as the American economy seems headed downward and government social spending is strained, especially by health-care costs.

Still, the nation's economy has grown faster than the level of military spending, and even the current colossal Pentagon budgets for regular operations and the war efforts consume a smaller portion of gross domestic product than in previous conflicts.

About 14 percent of the national economy was spent on the military during the Korean War, and about 9 percent during the war in Vietnam. By comparison, when the current base Pentagon budget, nuclear weapons and supplemental war costs are combined, they total just over 4 percent of the current economy, according to budget experts. The base Pentagon spending alone is about 3.4 percent of gross domestic product.

"The Bush administration's 2009 defense request follows the continuously ascending path of military outlays the president embraced at the beginning of his tenure," said Loren Thompson, a budget and procurement expert at the Lexington Institute, a policy research center. "However, the 2009 request may be the peak for defense spending."

Pentagon and military officials acknowledge the considerable commitment of money that will be required for continuing the missions in Iraq and Afghanistan, as well as efforts to increase the size of the Army, Marine Corps and Special Operations forces, to replace weapons worn out in the desert and to assure "quality of life" for those in uniform so they will remain in the military.

Pentagon budgets grow, but not as much as the economy.

Yet those demands for money do not even include the price of refocusing the military's attention beyond the current wars to prepare for other challenges.

Senior Pentagon civilians and the top generals and admirals do not deny the challenge of sustaining military spending, and they acknowledge that Congress and the American people may turn inward after Iraq.

"I believe that we need to have a broad public discussion about what we should spend on defense," Adm. Mike Mullen, chairman of the Joint Chiefs of Staff, said Friday.

Defense Secretary Robert M. Gates and Admiral Mullen have said military spending should not drop below 4 percent of the national economy. "I really do believe this 4 percent floor is important," Admiral Mullen said. "It's really important, given the world we're living in, given the threats that we see out there, the risks that are, in fact, global, not just in the Middle East."

Geoff Morrell, the Pentagon press secretary, said Mr. Gates and the senior Pentagon leadership were well aware that the large emergency spending bills for the war, over and above the Pentagon base budget, would at some point come to an end.

"The secretary believes that whenever we transition away from war supplementals, the Congress should dedicate 4 percent of our G.D.P. to funding national security," Mr. Morrell said. "That is what he believes to be a reasonable price to stay free and protect our interests around the world."

No weapons programs are canceled in the new Pentagon budget, officials said; in fact, steadily increasing base defense budgets and the large war-fighting supplemental spending packages have made it easier for the Pentagon to avoid some tough calls on where to trim.

"But I think it's doubtful the nation will sustain this level of defense spending," said Steven Kosiak, vice president for budget studies at the Center for Strategic and Budgetary Assessments.

The 2009 military spending proposal will be the 11th year of continuous increases in the base military budget, he added.

War-fighting supplement spending measures are outside the base Pentagon budget, an issue that has angered some in Congress. Pentagon officials have proposed a $70 billion special war budget just to carry on operations from Oct. 1, the start of the fiscal year, into the early months of the next presidency.

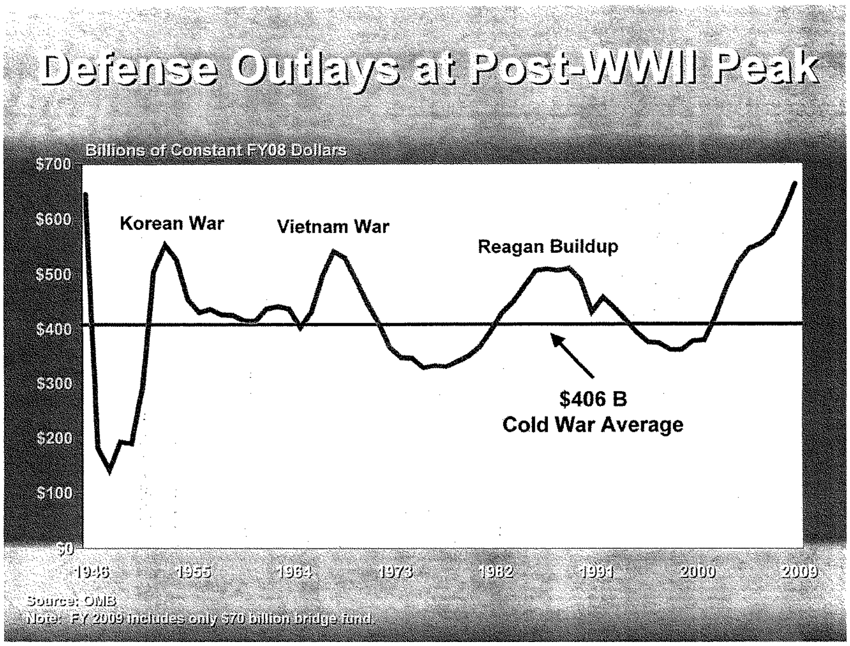
Another supplemental spending proposal is expected before October, but after Gen. David H. Petraeus, the senior commander in Iraq, reports to Congress on his recommendations for troop levels through the end of 2008.

Any budget proposal is more than just a list of personnel costs and weapons to be purchased, as it lays out the building blocks of military strategy. Democrats vow to scrutinize the budget, the last by this president.

Senator Jack Reed of Rhode Island, who visited Iraq again last month, said that expanding the ground force as proposed in the new budget was an important step to relieve pressure on the Army and Marine Corps — one he would support even though he said it came too late.

Mr. Reed, a Democrat and a senior member of the Armed Services Committee, said demands of the counterinsurgency wars in Iraq and Afghanistan raised questions on whether troops were receiving sufficient training, and were instead surrendering skills across a broader range of combat missions.

"It's going to require a rebalancing," he said. "It's going to require budget decisions that'll be very difficult."

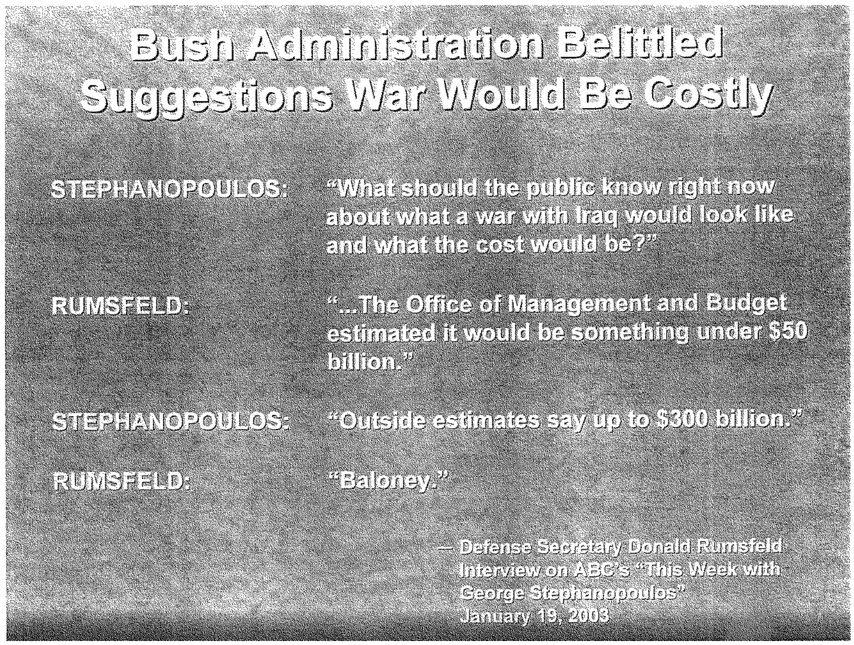


The costs of the war in Iraq are the major factor driving our defense expenditures. It is worth noting that before the Iraq War began, the Bush administration suggested that we would not see spending anywhere near this level. Here is the transcript of an interview in January of 2003 with Defense Secretary Rumsfeld on "This Week with George Stephanopoulos": "What should the public know right now about what the war in Iraq would look like and what the cost would be?"

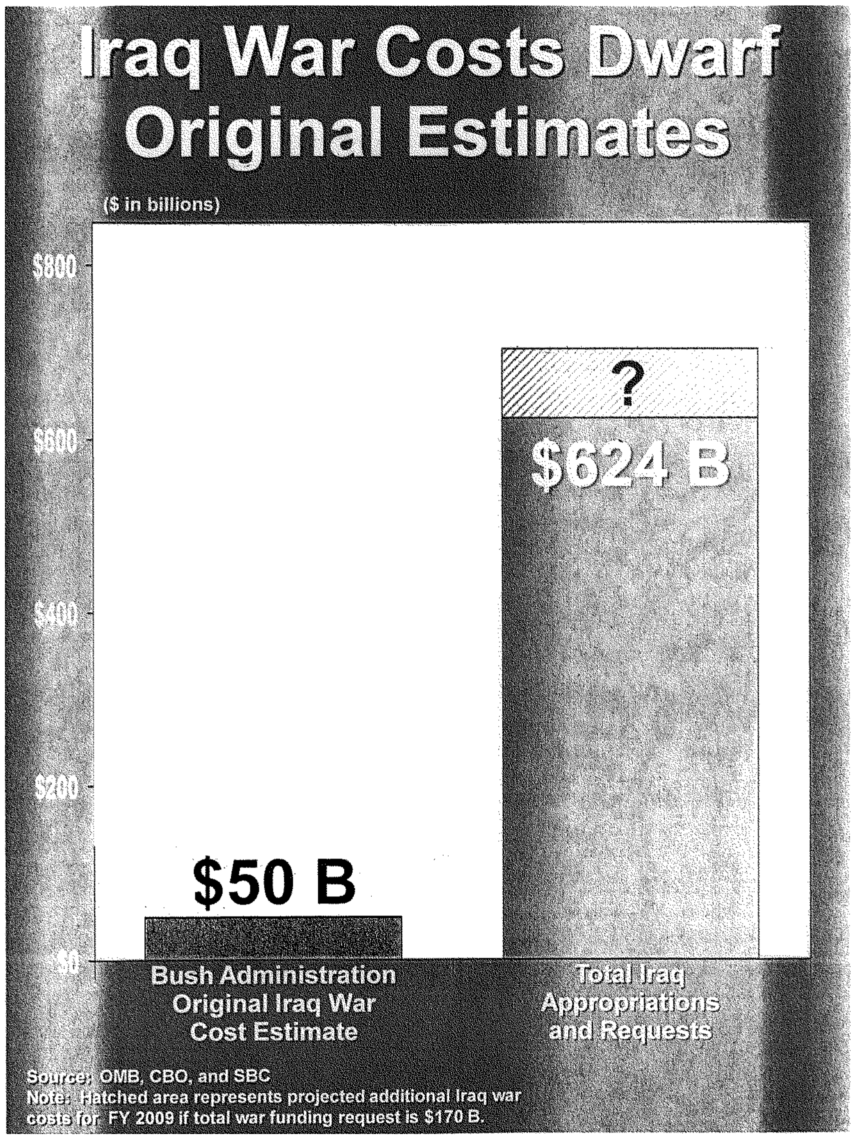
Rumsfeld: "The Office of Management and Budget estimated that it would be something under $50 billion."

Stephanopoulos: "Outside estimates say up to $300 billion."

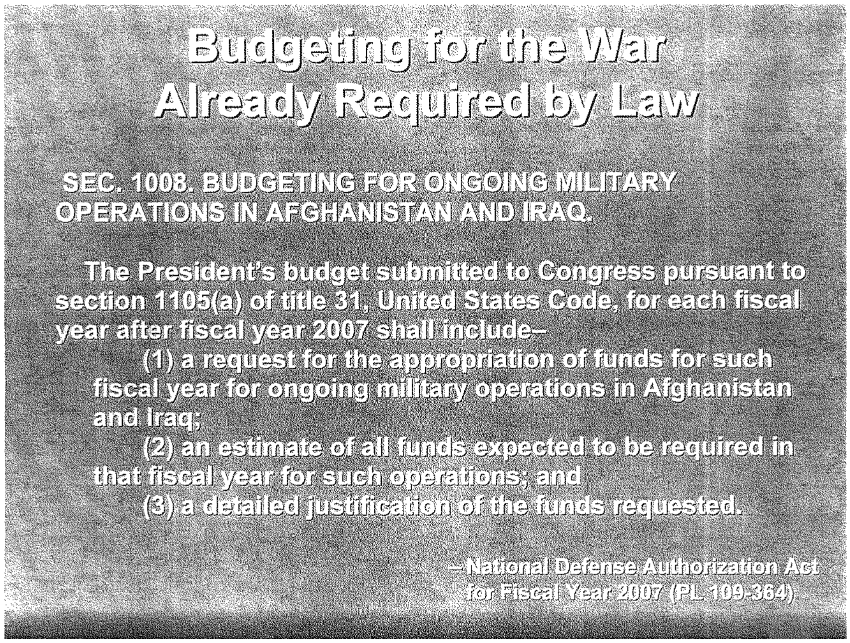
Rumsfeld: "Baloney."



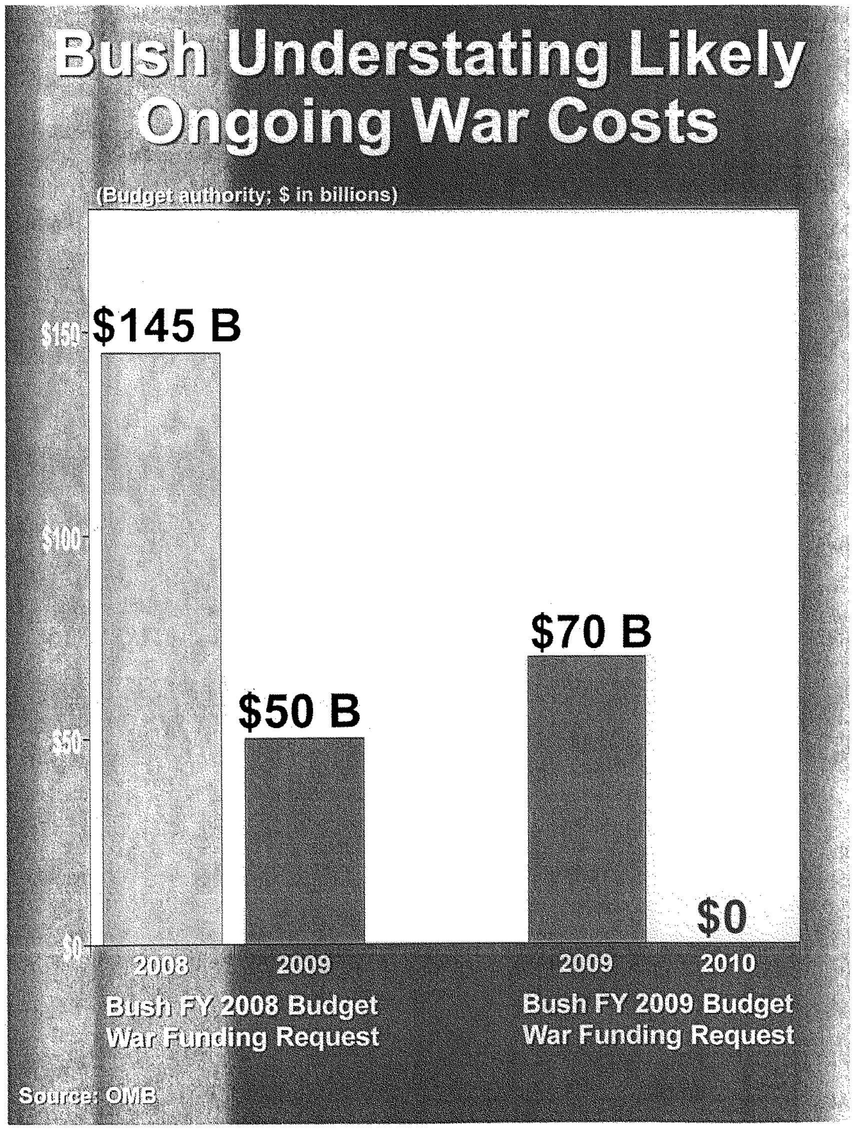
Well, if that was baloney, we have double baloney now because we are now over $600 billion, either received or requested by this President for the war in Iraq alone. In fact, our most recent calculation is $624 billion on top of the regular defense outlays. That is for the war in Iraq from 2002 through 2009. That is more than 12 times the administration's original war cost estimate. And that only includes the $70 billion of war funding requested for 2009 in the President's budget. We all know that the costs will be far higher in 2009 under the President's policies.



It is disappointing that the Bush administration has again left realistic war costs out of its budget. This is not just an issue of concealing war costs from the American people and underestimating deficits under the President's policy. It is also ignoring the law the President himself signed.



Last year's defense authorization bill, signed by President Bush, included a provision requiring the President to include war costs in his budget. I helped to get that provision adopted because having a good projection of war costs is essential to the work of this Committee as well as the Congress. In last year's budget, President Bush included $145 billion for 2008, a $50 billion plug for 2009, and nothing for the years after that.

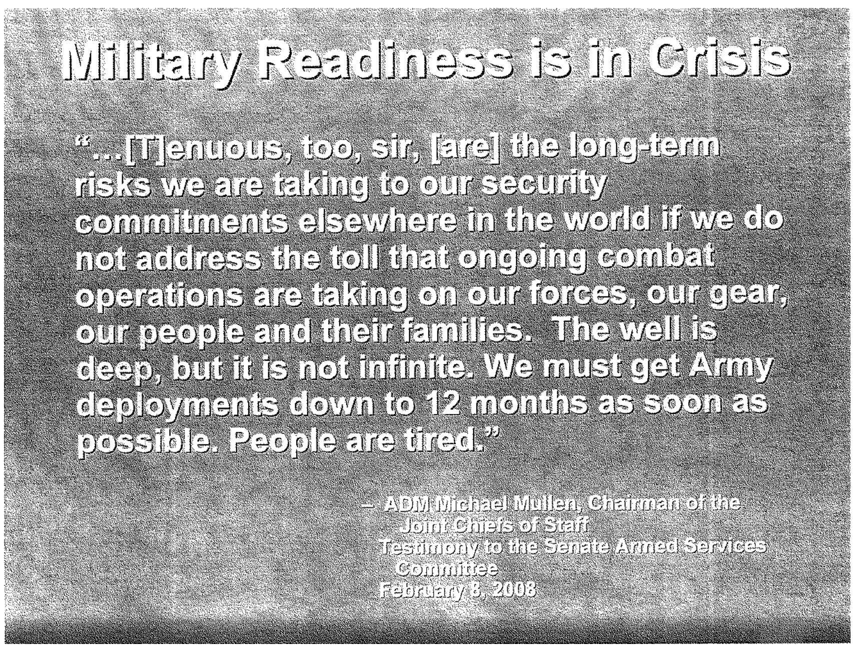


In this year's budget, he included $70 billion for 2009 and nothing for 2010 or any year after that. The President is clearly understating likely ongoing war costs under his stated policies. We know that more will be needed in 2009 and beyond no matter what happens next. In fact, Secretary Gates testified last week that the real 2009 war cost is likely to be closer to $170 billion, not the $70 billion that is in the President's budget.

Meanwhile, the Congressional Budget Office has estimated that ongoing military operations could cost $616 billion from 2009 through 2013 while the administration has included nothing after

2009. Even if the next President chooses to reduce troop deployments promptly, there are still foreseeable costs beyond 2009. The Army has said that they need reset funding for 2 years after the war in Iraq ends. None of that is in the budget.

Finally, I want to raise the issue of military readiness. It is clear the war in Iraq is severely undermining readiness. Here is what Admiral Mullen, the Chairman of the Joint Chiefs, said last week: "Tenuous, too, sir, [are] the long-term risks we are taking to our security commitments elsewhere in the world if we do not address the toll that ongoing combat operations are taking on our forces, our gear, our people, and their families. The well is deep, but it is not infinite. We must get army deployments down to 12 months as soon as possible. People are tired."



I would just say that ought to be an alarm bell to all of us. Military readiness is a critical component of deterrence. Instead of getting help, our troops have been overextended. Too many have been placed in harm's way without the proper equipment. Their deployments have been repeatedly extended, and when they leave the service, their veterans' care has been underfunded. They certainly deserve better than that.

This Committee has tried to provide better. I am especially proud of what we did last year in terms of increasing veterans' health care funding to match and even surpass the Independent Budget in virtually every area. That has now been adopted and has become the law of the land, and I am especially proud of this Committee that provided the leadership to accomplish that.

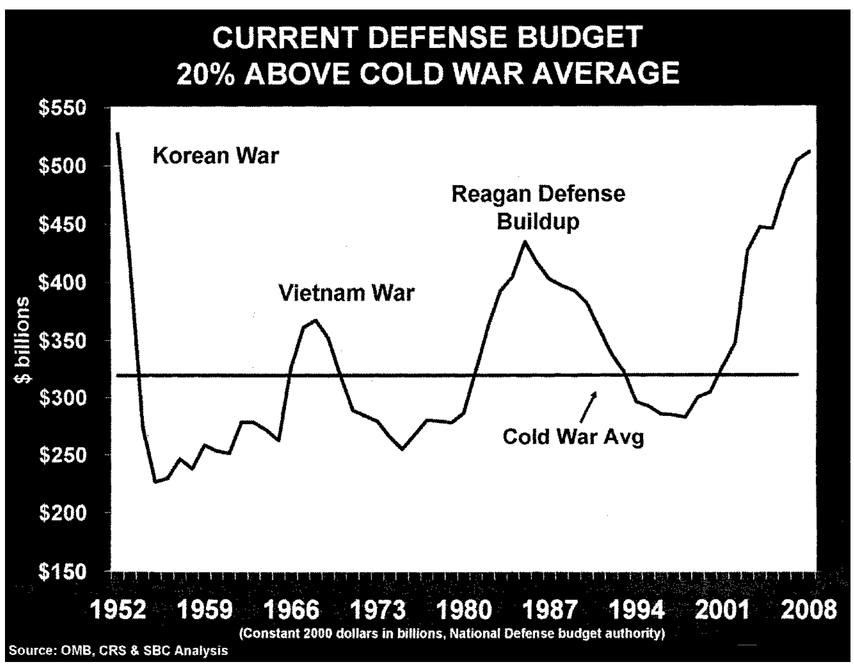
With that, I want to call on my colleague Senator Allard. I want to indicate that Senator Gregg, who is the Ranking Member of this

Committee, could not be with us this morning. That is a rarity. Senator Gregg is a faithful participant in the deliberations of this Committee. But he could not be with us this morning, and he is ably filled in for by Senator Allard of Colorado. Senator Allard.

OPENING STATEMENT OF SENATOR ALLARD

Senator ALLARD. Mr. Chairman, thank you for yielding, and I appreciate you making arrangements to hold this hearing today. We are going to have a tough schedule this morning with a bunch of votes scheduled, so I know that you are anxious to get going.

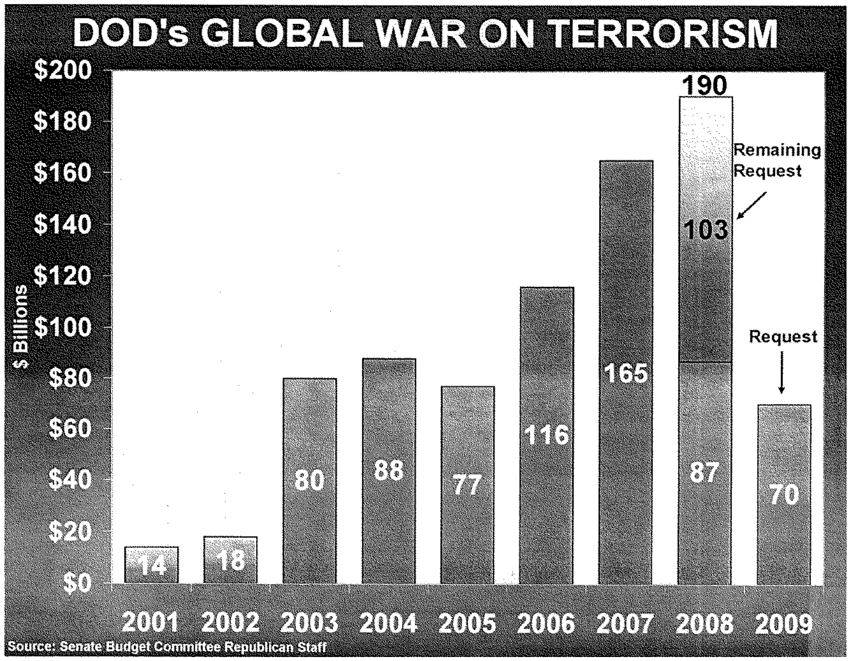
The subject matter of this hearing is, arguably, the most important function Congress will discharge this year: paying for the resources by which the Department of Defense fulfills the mission to defend the American people. The Department's requested core budget to carry out this mission is $515 billion. That is about 20 percent above the cold war average in real terms and more than $200 billion more than DOD received in the year 2000.



Yet some have doubted DOD's ability, even under these trends, to modernize its force within budget. The coming generation of weapons systems will be very expensive. For example, the Future Combat Systems may have a total program cost of up to $200 billion, and that is only one of our many modernization initiatives the military is planning.

At the same time, DOD's current weapons inventory is aging rapidly. One of the objectives of this hearing is to satisfy ourselves that DOD has a plan to reconcile its military requirements with the budgetary resources available.

Beyond DOD's core budget, we must also consider the supplemental budget. This country has been engaged in the global war on terrorism for more than 6 years. It has been paid for by a budgetary mechanism that is not a part of the Defense Department's regular budget. Last year, DOD for the first time took steps to budget for the war in advance and submitted a detailed supplemental budget request along with its regular 2008 request. This year, however, the DOD budget submission for 2009 arrived with a $70 billion plug for the war on terrorism.



There was no detailed justification, and the amount, $70 billion, was far below what will realistically be spent in 2009. The administration has offered varying rationales for this placeholder submission, and it is one of our goals today to obtain greater clarity on war funding.

Since our last hearing, the war in Iraq has reached a critical juncture. Over the past year, a surge has brought positive results as our troops have done everything asked of them. Through their brave and dedicated efforts, U.S. casualties are down, Iraqi civilian casualties have declined, and many indicators of progress—such as economic activity and delivery of public services—have started to improve.

I hope our witnesses can give us a more specific sense of the way forward in the war on terrorism as we continue to make progress in this particular war. I, too, would like to join the Chairman in welcoming Deputy Secretary England, General Cartwright, and Under Secretary Jonas.

I just might add that we do have our soldiers that are stressed, we have equipment that is getting old, is starting to show its wear and tear, particularly in the harsh environment in which our global war on terrorism has to be carried out. And yet last year, the Congress did not fully fund the dollars that were needed for our men to do the job.

So my hope is that we can show a stronger commitment to our men and women in the armed forces overseas and the tremendous job that they have and that Congress was willing to show in standing behind them last year.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Allard.

Now we will turn to our witnesses. Let me just indicate our appreciation, the Committee's appreciation of the witnesses for changing the time of this hearing because we had originally intended our typical hour of 10 a.m. But because a series of votes has been scheduled for roughly 10:15, eight or nine votes, there would have been no way to get the hearing in. So I very much appreciate the witnesses' agreement to move the hearing up, and with that, we will turn to Secretary England. Again, we welcome your testimony.

STATEMENT OF GORDON ENGLAND, DEPUTY SECRETARY, U.S. DEPARTMENT OF DEFENSE; ACCOMPANIED BY GENERAL JAMES CARTWRIGHT (USMC), VICE CHAIRMAN, JOINT CHIEFS OF STAFF, U.S. DEPARTMENT OF DEFENSE; AND TINA JONAS, UNDER SECRETARY OF DEFENSE (COMPTROLLER), U.S. DEPARTMENT OF DEFENSE

Mr. ENGLAND. Chairman Conrad, Senator Allard, first of all, I thank you for your very kind words. And, Chairman Conrad, you are right. These are difficult and challenging times. By the way, we are just pleased to be here today. I enjoy coming to this hearing with you. I do appreciate the interchange, and I appreciate the opportunity to be here. So I thank you. It is, I think, helpful for us and hopefully helpful for the Committee when we appear before you.

It is a pleasure to have really good friends and people I work with every single day, General Cartwright and the Comptroller, Tina Jonas. As you rightly observed earlier, you need to have people with you who are extraordinarily smart, and so I did follow that advice today and brought with me some extraordinary people to help in this.

A comment about the war and our respective roles. One thing we do share between us, between the legislative and the executive and the DOD for us, is we do have a common objective, and that common objective is to defend our Nation and defend our people, which is the first imperative of Government to do that. And so the budget that is before you is designed to do that. It is designed to defend the Nation in these very difficult and challenging times.

As you know, this is a complex security environment that we are in today, and perhaps more complex than we have had in the past, and it is distinguished by a variety of very prominent challenges. First, as we are all familiar with, there is terrorism, extremism, and jihadism. We have ethnic and tribal and sectarian conflict in various places in the world. We still, obviously, are concerned about the proliferation of weapons of mass destruction, failed and failing states, and eventually emerging powers whose intentions today are not totally clear, but we need to be prepared in case they move in the wrong directions.

Each of these threats possess and pose unique challenges and demands on the Department of Defense. Our security, however, relies on a comprehensive approach and is distinguished by a balanced set of capabilities for the entire spectrum of these challenges. So even while we are committed in Iraq and Afghanistan, we do have to be concerned about the other security challenges to our Nation. So we look at this in a much broader context.

The budget request, you are right, is $514 billion. It is a lot of money, but it does reflect the reality of the world we live in and, when appropriate, it will provide the necessary resources to execute the National Military Strategy.

Now, it is a lot of money, there is no question. We understand that at the Department of Defense. I guess, fortunately, our Nation's economy has grown, so, frankly, from the total macro point of view, it is an affordable amount of money. It is about 4 percent of GDP. So while we have indeed increased the total amount of money, it is affordable in terms of providing the defense of our Nation and our citizens. And that, by the way, is much less—even though in absolute terms it is high, it is much less than we have had in other periods of conflict.

The comment about our $70 billion, you are absolutely right, we only turned in this year $70 billion in our supplemental to cover the war costs into the next year. I will say that while that is a decision of OMB, nonetheless it partly reflected my own views on this matter, so I need to frankly tell you some of the rationale for that, because it will be larger—there is no question it will be larger than the $70 billion. However, a couple of the confusing elements were: In our view, it would not have been—it would have, frankly, been dishonest to give you a number that we couldn't support. And since we do not know when General Petraeus comes in, in late March or early April, what he will say in terms of going forward or what decisions will be made at that time, we did not feel that we could "guess ahead" for that period of time.

Also, as Senator Allard commented, in the 2008 budget, we have also only received $70 billion, and we know that is not the right number. And so that has been very disruptive, both, you know, the money being late, all the uncertainty in this budget time. So there are some very complicating issues in terms of trying to project our way ahead, and to do that with any degree of certainty.

I would urge the Congress to, frankly, do two things for us this year: One, try to get the 2008 supplemental squared away because that is very difficult for us. Also, this fall, I mean, we go with what I call a "planned disruption." To change administrations, whatever that administration is, there will be great disruption as we go across from this administration to the next administration. It will be extraordinarily difficult, in my judgment, to manage the Department and to maintain our security both for our people in combat and for our citizens if we are also at that time in a budget turmoil like we were last year.

So I would urge the Congress—I think this coming year it is vitally important that we have some consistency in terms of our funding and predictability in that funding; otherwise, it will be hugely disruptive, I think, for everyone come this fall.

Chairman CONRAD. Might I just interrupt you at that point and indicate that this Committee last year not only acted on time, but gave the President everything he asked for in terms of defense operations, both with respect to the war and with respect to the underlying budget. And the problem developed in the appropriations process and the negotiations between Congress—that is at a higher pay grade than ours, and a higher pay grade, I might say, than yours.

Mr. ENGLAND. Thank you.

[Laughter.]

Chairman CONRAD. I think we need to call on everyone with respect to that issue, and I am happy to have you complete your testimony, and then I want to address this question of what is in the budget, because that is the primary responsibility of this Committee.

Mr. ENGLAND. Absolutely. Thank you, sir.

So my last comments are while there is some confusion in all this, I do want to say that our security requirements remain. I mean, we do have a significant security threat that we need to address at this time, and we have these magnificent men and women who come forward to protect and defend our Nation. And it, therefore, is incumbent on us, frankly, to provide them the funding they need. They are deployed today, and it is incumbent on our Nation to support our men and women in uniform.

So, again, I appreciate the support of this Committee, and, Mr. Chairman, Mr. Allard, we do look forward to a discussion with you on these issues. Thank you very much.

[The prepared statement of Mr. England follows:]

Statement for the Record by the Honorable Gordon England
Deputy Secretary of Defense
Before the Senate Budget Committee
12 February 2008

Chairman Conrad, Senator Gregg, Members of the Senate Budget Committee,

I deeply appreciate your continued support of our military and thank you for the opportunity to meet today and discuss the President's Fiscal Year 2009 Defense Budget and war costs. We share a common, fundamental goal; the first obligation of any government: the defense of the nation. The budget request before you is carefully reasoned and designed to achieve that broad goal as well as specific goals set forth by the President: to prevail in the current conflict, to prepare for the entire range of irregular and conventional threats that will challenge the nation in years to come, and to improve the quality of life for our servicemembers and their families.

The Vice Chairman of the Joint Chiefs of Staff General Cartwright and the Under Secretary of Defense (Comptroller) Ms. Jonas are with me today, and the three of us look forward to your questions.

Before addressing the components of this budget in detail, I think it useful to describe again the strategic landscape and challenges confronting the nation: the essential context for any discussion of national security and defense spending. Additionally, I believe it worthwhile to describe briefly for you the rigorous process that generates the Department's submission. With an understanding of the strategic imperatives that inform our efforts and an appreciation of the actual process as a foundation, it's possible to better understand both the scope and the complexity of the Department's budget request.

Strategic Landscape

We live in a dangerous world; one in which the many security challenges confronting the nation can be expected to endure, and indeed, likely to grow in complexity and magnitude. Most would agree that we are now engaged in a long war. For the extended duration of this conflict, the demands levied upon us will ebb and flow, our successes will be leavened with occasional setbacks; ultimate victory will be long in coming, and our endurance and resolve will be tested.

The exceedingly complex security environment in which the nation is obliged to conduct its affairs is distinguished by a variety of prominent challenges, among them:

- Terrorism, extremism, and violent jihadism;
- Ethnic, tribal, and sectarian conflict;
- Potential weapons of mass destruction proliferation;
- Failed and failing states;
- Emerging powers whose intentions are either uncertain or unknown.

While terrorism will remain the dominant threat to our security for some time, each of the threats listed above is significant and poses its own unique challenges; together, they constitute a significant threat to our interests. While each demands a discrete set of capabilities, prudence demands that we pursue an altogether comprehensive approach distinguished by a balanced set of capabilities. As is often said, the one certainty of the future is its unpredictability. Thus, with that dictum in mind and history as our guide, the military is compelled to prepare for the entire spectrum of challenges.

The clear lesson of the post-9-11 era is that the protection of America's security, prosperity, and freedom demands unwavering commitment to an active, robust defense posture. The base budget request reflects that sensibility. It is also clear that while the defense of the nation and its interests, both at home and abroad, has never been the exclusive purview of the military; the challenges we confront today defy an exclusively military solution and demand an integrated approach. Secretary Gates has said that, in the future, "Success will be less a matter of imposing one's will and more a function of shaping behavior—of friends, adversaries, and most importantly, the people in between.... But these new threats also require our government to operate as a whole differently—to act with unity, agility, and creativity. And they will require considerably more resources devoted to America's non-military instruments of power." Surmounting the nation's challenges and those of our friends around the world will require the intelligent, integrated application of all instruments of the nation's power.

Defense Budget Process

Be assured that the Department fully understands, and takes absolutely seriously, its fiduciary responsibility. Every budgetary decision is made with the clear understanding that we are obliged to spend the money of the American people wisely. To that end, the

Department has, over the years, developed a rigorous and refined budget process. It is a fully inclusive, exhaustive methodology whose ultimate product reflects the collective wisdom of the Department's entire leadership. Emblematic of that approach, the Vice Chairman of the Joint Chiefs of Staff and I chair a group called the Deputy's Advisory Working Group (DAWG), one of a number of horizontal integrating mechanisms composed of the Department's senior military and civilian leaders. It is an open, collaborative body that relies on the unique experiences, expertise, and perspectives of its members to achieve informed resource decisions.

In 2006, the Department implemented "capability portfolios" as a means to better inform resource decisions. Each portfolio groups related capabilities together to promote visibility and facilitate objective resource decisions. This approach contributes to a more reasoned and practical trade-off within a given capability set as required. Likewise, the DAWG, functioning at a level above the portfolio managers, does the same across the entire gamut of capabilities.

The mechanisms described above are designed to account for relevant factors and to enable the soundest resource decisions possible.

FY 2009 Base Budget

The President's FY 2009 base budget request of $515.4 billion provides the essential resources necessary to execute the National Military Strategy. Although the budget is admittedly large, its size needs to be considered in the terms of both contemporary challenges and historical context. In 1945, as World War II drew to a close, the Department's budget as a percentage of Gross Domestic Product (GDP) was 34.5 percent. It has steadily fallen from that high ever since: During the Korean conflict it was 11.7 percent; in Vietnam 9 percent; and in Desert Storm 4.4 percent. The base budget request of $515.4 billion represents about 3.4 percent of GDP. While total defense spending has increased significantly since 9-11, at roughly 4 percent of GDP (when war funding is included) it remains the smallest percentage ever invested by the nation in its defense during wartime.

When appropriated, this budget will sustain an enterprise of immense scope and complexity: 2.9 million employees, a global footprint that includes 545,000 facilities at 5,300 locations in the U.S. and around the globe, 5.2 million inventory items and over $1.5 trillion in assets. The request is a $35.9 billion—or 7.5 percent—increase over last year's enacted level. When inflation is accounted for, the request represents an increase of about 5.4 percent. In summary, the base budget request:

- Supports the President's commitment to prevail in Iraq and Afghanistan and grows the U.S. ground forces required to do so;
- Maintains the high rate of military readiness commensurate with our nation's global responsibilities;
- Prepares for a wide range of dangers that may threaten the nation today and in the future; and

- Provides high quality health care for our all-volunteer force and their families.

While $515.4 billion is by any standard a lot of money—Secretary Gates has referred to the Defense Budget as "staggering" —and altogether sufficient, when combined with required supplemental funding, to support the nation's defense needs, it affords significantly less flexibility in spending than may, at first, be obvious. As is true in any budget, much of it is consumed by what can be considered fixed costs. Specifically, the President's Fiscal Year 2009 Defense Budget requests:

- $107.8 billion, an increase of $9.6 billion over the Fiscal Year 2008 enacted level of $98.2 billion, for pay and benefits to improve the quality of life of the 2.2 million active and reserve members. Notably, the Fiscal Year 2009 budget increases military pay by 3.4 percent and improves benefits for the all-volunteer force. It is instructive to note here that the requested funding for pay and benefits alone represents about 21 percent of the entire base budget.
- $41.6 billion of the base budget is requested to maintain high quality health care benefits for 9.2 million military members and their families, working-age retiree members and their families, and Medicare-eligible beneficiaries. When taken together, the funding requested for pay and benefits and health care constitutes nearly a third of the base budget. While these are vital, fundamental requirements reflecting our deep commitment to our people, their sheer size illustrate well the immense proportion of the defense enterprise. On the subject of health care, it's appropriate to note that the Department continues to believe

that increases to the TRICARE out-of-pocket costs for working-age military retirees are necessary to ensure that military health benefits remain affordable and sustainable. To that end, legislation providing an additional $1.2 billion in resources and recommending enactment of the recommendations of the Task Force on the Future of Military Health Care will be submitted.

- $158.3 billion, an increase of $14.9 billion over the Fiscal Year 2008 enacted level of $143.4 billion, is requested for operations, maintenance, training, and facility and base support at levels consistent with those of Fiscal Year 2008; of that figure, $68 billion is requested to maintain readiness and ensure that our soldiers, sailors, airmen, and Marines remain at the highest levels of proficiency; $33.1 billion is needed for support activities; $10.7 billion is needed for recruiting, training and retention; $11.8 billion is requested for equipment maintenance, repair and refurbishment; and $32.6 billion is requested for facility and base support.
- $183.8 billion, an increase of $8.3 billion over the Fiscal Year 2008 enacted level of $175.5 billion, is requested for modernization to meet future threats. This figure includes funding for procurement, as well as research and development. It includes $9.2 billion to modernize ground capabilities and to continue development of the Army's Future Combat System; $16.9 billion to enhance our maritime capabilities to preserve the Navy's capacity to exert global presence and influence; $45.6 billion is requested to improve our aviation capability; $10.7 billion is requested to strengthen joint space-based capabilities; and $68.5 billion is requested for an array of command, control, communications, computers and

intelligence equipment; procurement of advanced munitions and missiles; and a variety of mission support including ammunition. These investments are critical to ensuring that the Department remains capable of meeting the full spectrum of security challenges across every domain. The demands of sustained war coupled with the growing age of many major weapon systems necessitate determined efforts to ensure their timely replacement.

- $23.9 billion is requested for family housing and facilities; of that, $9.5 billion is requested to continue Base Realignment and Closure (BRAC); and $3.2 billion, an increase of $300 million over the Fiscal Year 2008 enacted level, is requested to construct new and to improve existing family housing. Included in this request are funds to reduce overseas housing and to increase military housing privatization.

Additional noteworthy requests, contained in the figures described above, include:

- $15.5 billion is requested to increase Army active duty end strength to 532,400 and $5 billion to increase Marine Corps end strength to 194,000 in order to increase our ground combat capability to meet current and projected needs while reducing stress on the force by increasing the average time between deployments. With the lessons of the last six years in mind, funding for the planned, phased growth of the Army and Marine Corps must be sustained.

- $750 million is requested to strengthen the military and security capabilities of global partners. Earlier I touched on the importance of an integrated, multi-faceted approach to the nation's security; the development of partner nation capability will become increasingly important in this regard and this request is central to our efforts.
- $389 million is requested to establish the U.S. Africa Command. The creation of AFRICOM reflects acknowledgement of the importance of a holistic approach to security and stability issues as well as the absolute necessity of building effective security partnerships around the globe.

War Funding

Regarding war funding, on February 6, Secretary Gates included the following comments in his opening statements to the SASC and HASC:

"In addition to the $515.4 billion base budget, our request includes $70 billion in emergency bridge funding that would cover war costs into the next calendar year. A more detailed request will be submitted later this year when the Department has a better picture of what level of funding will be needed.

The 2007 National Defense Authorization Act requires the Department of Defense to provide an estimate of costs for the Global War on Terror. We would like to be responsive to this need. Indeed, I was voluntarily responsive to a similar request last year. Some have alleged that the Administration has taken this position in order to somehow hide the true costs of the war. Nothing could be further from the truth. The Department has been very open about what we know about our costs, as well as what we don't know. So the challenge we face is that a realistic or meaningful estimate requires answers to questions that we don't know yet, such as:

- When and if the Department will receive the requested $102 billion balance of the FY 2008 Supplemental War Request, and for how much; and
- What, if any, adjustments to troop levels in Iraq will result from the upcoming recommendations of General Petraeus.

We should also keep in mind that nearly three quarters of the FY 2009 Supplemental Request will likely be spent in the next administration, thus making it even more difficult to make an accurate projection.

I have worked very hard during my time in this job to be responsive and transparent to this Committee and to the Congress. Nothing has changed. But, while I would like to be in a position to give you a realistic estimate of what the Department will need for FY 2009 supplemental funds, I simply cannot at this point. There are too many significant variables in play. I can give you a number, but that number would inevitably be wrong, perhaps significantly so—i.e., "precision without accuracy."

As I mentioned earlier, Congress has yet to appropriate the remaining balance of the FY 2008 War Funding Request, $102.5 billion. This delay is degrading our ability to operate and sustain the force at home and in theater, and is making it difficult to manage this Department in a way that is fiscally sound. The Department of Defense is like the world's biggest supertanker. It cannot turn on a dime and cannot be steered like a skiff. I urge approval of the FY 2008 GWOT request as quickly as possible."

Conclusion

As I noted at the beginning of this statement, the Department and the Committee share the same objective—to protect and defend America. While the global challenges confronting the nation are substantial and enduring we can all take comfort in the courage, commitment and example of those sworn to defend her. Their heroic efforts and sacrifices in the years since 9-11 and, particularly, the progress achieved in Iraq in the last year and ongoing efforts in Afghanistan, are ample evidence of the dedication and prowess of our men and women in uniform. The hard won progress they have earned must not be jeopardized. I again urge the Congress to expeditiously appropriate the outstanding balance of this year's war funding request to ensure our dedicated troops continue to receive the support they deserve.

Those of us charged with the stewardship of the Department of Defense are ever mindful of the great trust the nation has placed in us. The base budget submission reflects our acknowledgement of that trust and the obligation it connotes. As Secretary Gates has said, "the President's budget for FY 2009 provides the resources necessary to maintain an agile, highly trained, and lethal fighting force, increase Army and Marine Corps end strength, and sustain the United States' technological advantage over current and potential enemies."

Chairman Conrad, Senator Gregg and Members of the Committee, thank you for your steadfast support to the selfless men and women of our military. We look forward to your questions.

Chairman CONRAD. Thank you, Secretary England.

Let me just go to the question that I started with and that you addressed directly in your testimony, and that is, what is included in the budget. Let me just say for the purposes of this Committee, transparency is critically important because we have to act—our intention is to be on the floor the second week of March. The work week of March 10th we intend to be on the floor with the budget resolution. Senator Gregg has completely agreed with that timing. That puts considerable pressure on this Committee to do the work of building a budget. Secretary England, you know what that work is like, and all of the witnesses here do.

Let me just say this: Here is what is very troubling to us. In 2008, the President asked for $145 billion, and in that budget year, in 2009, he put in what we call a plug for 2009 of $50 billion. We considered that progress in the sense that he was beginning to tell us for the first time in the budget process what the war might cost. But I can say on a bipartisan basis on this Committee—I am at least speaking for Senator Gregg and myself—we are extremely disappointed with this year's budget telling us it is going to be $70 billion for 2009 and there is nothing, a big goose egg, for 2010.

Now, one thing we know for us, the right answer is not zero. Secretary, you said hard to guess ahead, but, you know, that is what budgeting is. Budgeting is trying to bring some predictability out of uncertainty. That is our obligation. That is this Committee's obligation to our colleagues. And that is your obligation to us, to try to give us your best estimate of what things are going to cost. And we know, I think with great certainty, $70 billion is not the right answer for 2009; zero is not the right answer for 2010.

With that, Secretary England, can you tell us—Secretary Gates indicated the other day, as I understand it, that the cost is more likely to be in the range of $170 billion for 2008. Can you give us your best estimate? Do you think Secretary Gates—after all, you report to him so I assume you are in pretty close harmony on this question—are we reading his statements correctly that the cost is likely to be $170 billion?

Mr. ENGLAND. Mr. Chairman, I would not say it quite that strong. I do not believe the Secretary believes it is likely to be $170 billion. I believe, under some duress to come out with a number, he said, listen, if you just want me to state a number, I will state a number, but it is more a guess than it is an estimate. Because earlier this year, when we were looking ahead in 2009, we realized that there were going to be significant changes taking place this year, unknown changes this year. In addition, we also know that this budget—most of this budget will be basically spent by the next administration. So there are a lot of decisions that will be made this year into next year, because this is 2009. So this is really the next administration's budget in terms of the war. Plus changes will be made this year when General Petraeus comes back to Washington. So there will be more debate and discussion at that time.

So the judgment was rather than just try to put numbers together and not understand the basis—because, on the other hand, the Congress asks us to support these numbers when we submit them to the Congress. We do provide you detailed justification for the numbers. So the decision was since we cannot provide you detailed justification, let us just delay providing you those numbers, and then we will provide you numbers with detailed justification when those decisions are made this spring. That was——

Chairman CONRAD. Mr. Secretary——

Mr. ENGLAND. That was the decision's rationale.

Chairman CONRAD. But, Mr. Secretary, isn't the truth of the matter that the expenditures are going to be much greater for 2009 than $70 billion under any scenario?

Mr. ENGLAND. Mr. Chairman, you are right, but I will tell you at least my thinking was, on the other hand, I mean, we know that this year the expenditures are more than $70 billion, but the Congress only appropriated $70 billion.

Chairman CONRAD. No, I think the right number now is, with everything, $86 billion.

Mr. ENGLAND. It is 86——

Chairman CONRAD. Our number is——

Mr. ENGLAND. No, you are right. It was 70 plus the MRAP vehicles, which was, I think, 86-plus. You are right. So it is more than—but it was the fundamental 70, and then we added the MRAP. The Congress agreed to that because of the protection of our troops.

So, I mean, we are sort of in the same position here. In 2008, the Congress decided to appropriate 70—or 86, knowing that it was——

Chairman CONRAD. But we know—we know that—we are just into 2008 now. This is February. We all know that much more money is going to be provided. We know that with a certainty. And we know with a certainty that 2009 is not going to be $70 billion. And so let me just say for the purposes of the Committee and the Congress, to be told by the administration it is going to be $70 billion and that 2010 is going to be zero, we know that is not so.

Senator ALLARD.

Senator ALLARD. Thank you, Mr. Chairman.

I sympathize with the Ranking Republican as well as the Chairman in that I am disappointed that we did not have a more precise figure that we could plug into the budget. And I think the Chairman has pretty well pursued that issue, so I will not, except I am just going to ask this question: Can you give us some idea of when there might be a supplemental request? Because, obviously, we are looking at a supplemental request. Maybe you cannot give us a specific date, but maybe are we looking at late spring, summer, this fall? Do you think we might be looking at two additional supplemental requests?

Mr. ENGLAND. Mr. Allard, I sort of hate to jump in for OMB here because, obviously, that is their responsibility. But I would say the Department, based on what I know about testimony and decisions, it would be late springtime. Yes, sir.

Senator ALLARD. OK. And so I think Secretary of Defense Gates mentioned $100 billion in a public comment he made about a week ago, and that is on top of the $70 billion that we have now, so a total expenditure might, if I understand his comments, would be somewhere around $170 billion. Is that correct?

Mr. ENGLAND. Again, I am not sure it is likely, and I am not sure it is an estimate, because we have not accomplished the work to do that. But I would say based on past expenditures, that is probably, you know, a rational number to look forward to. But, again, we do not have any detailed estimates to support that, Mr. Allard.

Senator ALLARD. So if this Committee was to look at plugging in a figure here, I do not think the Committee is going to accept $70 billion. But we want to plug in a figure. I may even have an amendment—I do not know what the Chairman thinks—if he does not. To try and realistically plug into our budget about what that would cost, $170 billion would not be out of line.

Mr. ENGLAND. I certainly would not disagree with the Secretary of Defense, so I would say that—if you are going to plug in a number, that is probably an appropriate number to plug in, sir.

Senator ALLARD. OK. Thank you.

I want to talk a little bit about the sustainability of our forces right now. As I mentioned in my opening comments, we have some real challenges, particularly when you look at the Selected Acquisition Report. It seems to be one of the best tools for future budget consequences of present and past decisions. And there has been a doubling of acquisition costs in only the last 4 years, and in previous history we have not seen that dramatic an increase. So I guess the question is: How are we going to sustain some of our developmental systems? It looks like we are facing some real challenges there such as the Future Combat System, the Joint Strike Fighter, and the DD–1000, when they hit full production a few years from now.

Mr. ENGLAND. Mr. Allard, I do not believe that is—I mean, while that projection is put together, it is sort of a straight line to where we are today. And that is not what happens. I do not expect we will have those kind of funds in the future to double those kind of programs. So we will make modifications as we go. I mean, we are certainly not going to double the cost of those programs. I mean, even though the Congress has been extraordinarily generous these past several years, I do not see that we can double those budgets. So we will take other measures to control the budget. We either change some of the requirements or change the rates or, you know, we will take other actions to control that cost growth.

So that is a projection of future costs, but we then manage our way, you know, into a more realistic dollar amount as we go forward. So my view is that it is not what we would expect in the future. We would rather manage our way to a more realistic number.

Senator ALLARD. The Secretary of the Air Force is saying there is a $20 billion shortfall. The Secretary of the Navy has a goal of 313 ships. Are those overly optimistic, or are they reasonable requests, do you think?

Mr. ENGLAND. So, Mr. Allard, I expect in the 2010 budget we will look more carefully at those numbers to see exactly what the basis for those numbers are. The Navy ships, right now operational ships are, I believe, like 280-some ships. The Littoral Combat Ship, which the Navy was planning to build 55—I think they still are, but they basically had a setback, a delay of some couple years on that program. So they do have a way forward to the 313. The way forward, however, in the out-years does require more money than we presently have programmed. So that is an issue in terms of achieving the 313.

The Air Force issue, they do have older airplanes, and, unfortunately, I mean, a lot of money was spent on a relatively small number of F–22s at a very high cost, and they do not begin to recover until the Joint Strike Fighter comes along, which is a more affordable, what we call fifth generation airplane.

So these are valid concerns. I will say they are concerns we face every year in terms of trying to get all the demands fit within the budget. But we will look at that more as we do the 2010 budget and better understand their requirements.

Senator ALLARD. Just one final question, if I may, Mr. Chairman.

Are the services now feeling any adverse effects from the failure to provide the $102.5 billion in the supplemental request this last year?

Mr. ENGLAND. Tina, perhaps you can help me here. I do know they are having some effect because we are not placing all the orders we would normally place. But I expect that will become a much more significant problem here in a couple months. But what would like to have is continuity of production, continuity in our facilities in terms of depots, et cetera. And when we have uncertainty of funding, you are not allowed to commit funds in advance. You know, it is anti—deficient you are not allowed to do that. So this does cause a lot of disruption.

If we look at a few programs here just recently, I know in just a couple months we are going to be at the point where we will be uneconomical in terms of some of our ongoing maintenance programs, and, Tina, perhaps you could elaborate.

Ms. JONAS. Sure. Mr. Chairman and Mr. Allard, some of the concerns that we have regarding the 102 that has not been passed by the Congress yet include the resetting of the force. There was about $32.6 billion that is still required by the military, and I think there are concerns there, as the Secretary has just discussed, that it becomes problematic when they are trying to plan and look forward as to how to plan production, et cetera, and inventories. So we want to make sure that the next-to-deploy forces have what they need and the inventories that we have are there.

Also in that piece of procurement is about $11 billion worth of force protection. We did get the full amount for the MRAPs, the 16.8 in the initial amount, but there are about 300,000 sets of body armor, a portion of which are still required in the second set of requirements. So that is important to us as well.

And one date that kind of looms with me is our Army military pay accounts will be exhausted in June, so that is one of the greater concerns I have about not receiving the funds in a more timely way.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Allard.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

In the written testimony that you have provided, you requested $41.6 billion to maintain high-quality health care benefits for 2.9 million military members and their families. I am interested in a particular piece of that. As you probably know, the American health care system lags terribly in the deployment of information technology. It is probably the worst industry in the country except the mining industry. And in that rather desolate landscape, the VA program is a relatively bright spot, and there have been difficulties between the Department of Defense medical programs and the VA medical programs in terms of each of them have set up various types of information technology support, but they did not organize it so that they could talk to each other. There is now a VA/DOD health information-sharing program going on. I consider that to be a matter of pretty significant priority, and I am wondering: Of the $41.6 billion, what in there goes toward reconciling and bringing together the VA and the DOD information systems under this sharing program? And what is the schedule for completing that task? And what do you need to get it done completely?

Mr. ENGLAND. Senator Whitehouse, first of all, I share your view. This is something vitally important to DOD and the VA. Last year, we put together a special group between myself and Gordon Mansfield, who is the Deputy at Veterans Affairs, a great American and a great friend. So we put together a group that met every week with all the senior leadership of both Departments. And we had, I believe, what we called "eight lines of actions." One of those was specifically devoted to this issue of electronic data sharing between DOD, VA, and both directions, but to make sure we had all this data readily available in both our organizations.

So I believe we are now on a path—we have made great progress. A lot of that data today can be transferred between DOD and VA. I mean, we have moved——

Senator WHITEHOUSE. Can be transferred or is accessible?

Mr. ENGLAND. No; can be transferred. We now——

Senator WHITEHOUSE. So not full accessibility but——

Mr. ENGLAND. Right. But we can now transfer medical records. We cannot transfer, say, high-resolution brain scans or something because that is much more difficult for us to do. But we can all the medical records, all the pharmaceuticals, and all that. So you can now receive a lot of that data. And I will need to get back with you in more specifics here, but I believe it is later this year that we will have a vast majority of this completed between DOD and VA. So I am not sure of the exact money that is in the budget, but I can tell you we are adequately funded to do this, and it is a priority of our two Departments.

And so if you will allow me, what I would like to do is get back with you on the very specifics, and we will come meet in your office and give you a lay-down of exactly this entire program with the milestones.

We do have people assigned. We have milestones. We have funding. We regularly look at this. So we will be happy to come and address this. And perhaps, General Cartwright, you may want to add your thoughts too, because I know you have been involved in this.

General CARTWRIGHT. I just would add one piece to this, which is the long term. It is not easy, but we can go out and buy for one time a program, an application that would allow us to trade this information. So we have taken it a step further with the services and the interagency to set standards so that as one application becomes worn and we find a better way of doing this as we move to the future, we will be on the same standards so that we are not depending on one agency buying at the same time that the budget is available for a second agency. So we also have gone to that step so that as we move to the future, we are going to have data standards for exchange and transfer of information that will be long-standing and allow people to improve these applications as the opportunity presents itself.

Senator WHITEHOUSE. OK. Thank you. Mr. Deputy Secretary, I accept your invitation.

Mr. ENGLAND. Yes, Mr. Whitehouse, we will call your office very quickly. We have that data immediately available, so we will do this very quickly and get back to your office.

Senator WHITEHOUSE. OK. My time has expired. I thank the Chair.

Chairman CONRAD. I thank the Senator.

Senator DOMENICI.

Senator DOMENICI. Thank you very much, Mr. Chairman. I know you are going to have another difficult year, and I compliment you for your work and efforts that I hear about this year's ideas that you have.

I want to ask the General a question based on some facts that I know. As you know, General, among the things that I am interested in, I am very involved in our future domestic nuclear power. We are now finding that the time between getting a permit from the Nuclear Regulatory Commission, which we used to hear stories about for many, many years—we think we have that all on the right path. But now we hear from the companies that plan to build these nuclear power plants—I will get to my point pretty soon. They get ready and their boards of directors, are passionately frightened because they do not know where they are going to get the manpower, the equipment, the technology, just, believe it or not, the 30,000 electricians and welders that are going to have to be out there when they build three nuclear power plants. You know, they are not—they do not exist in America anymore. Nobody wants to do that kind of work, and there is nobody trained for it. And $40 an hour is not enough to entice people to go be an electrician and go to vocational school.

Now, that is not an exaggeration. It is really happening, such that we had one very powerful company drop off the list of builders of nuclear power plants. I do not know if you read about it, but one big company said, "No dice." And the only reason was their board of directors could not be assured of manpower, of times of delivery, et cetera, for the things they needed to build this complicated $6.3 billion power plant.

Now, I ask you—and I have never heard anybody ask somebody in your position this question. As we attempt to maintain our military forces, are we having any problems with the delivery of parts and delivery of equipment in a timely manner and at bid price because we do not have the manpower and the ability to manufacture that as equipment we once had?

General CARTWRIGHT. Senator, are you speaking broader than the nuclear——

Senator DOMENICI. Yes. I am asking about you and the military. We are here talking about procurement, and that means all kinds of procurement. I assume it means equipment from General Motors. It means specially built things from Boeing. Right?

General CARTWRIGHT. Right.

Senator DOMENICI. I am asking the general question: Do we have the capacity to build for this war or not?

General CARTWRIGHT. The capacity is there. It is spread globally. It is challenged by restrictions that we have on trade, special materials, the assurance that the equipment, the workmanship, and the quality of the basic design is to the standards that for the military—and I will only speak to the military need—are necessary.

We have worked around in several cases issues with metals, issues with offshore suppliers, and so the answer to you is, in this global economy we do not—we are challenged in the United States to provide all of the technical expertise, equipment, and supplies necessary for all of the systems that the Department of Defense runs.

We have found work-arounds. In many cases we have had to train. A classic case is the MRAP where you will find the assembly work and you will find much of the manufacturing down in South Carolina, and one of the reasons is because we were able to take the welders that worked in the shipyards that used to be there, retrain them, bring them up to a level of skill so that they could contribute to the MRAP.

At the same time, at that same factory, you can walk out on the front lot, and the way that they get the transmissions and the way that they get the axles is to tear down existing, already built, new trucks because that is cheaper than finding the labor to build those economically in the United States.

Now, when that business case changes, that company will certainly change, but the company is going to find the best way they can to produce this. So we are filling in some of these voids in critical areas, but we do not have sufficient to fill in all of them for all of our materials.

Senator DOMENICI. Well, General, I am fully aware also that if we think the cold war has ended totally, we are big fools because Russia is back in the business across the board, especially when it comes to nuclear activity and to intercontinental ballistic missile work and the re-establishment of their great laboratories of old. And I just want to keep myself and the generals that I talk to publicly, I want to keep this on the front burner, that the United States of America has big problems—it is not just the problems of this war in Iraq. The confrontations that exist between us and Russia are real today, and their production of things of war are very powerful as of now. And we have to do our share, and I am very fearful that this war we are in in Iraq is taking too much of our energy and time, and we just have to hope that that war will not have these budgets for 15 or 20 years, like some think, because I am quite afraid we will not have enough left over to develop the military that we need for other threats.

I do not know what you think about that, but I know you have a lot of intelligence and you understand. Does this ever bother you, sir?

General CARTWRIGHT. It is one of the things that would keep me up at night. As the Chairman spoke to, the broad range of our threats out there today is what really challenges the military. We have to be ready to go against those threats that existed in the cold war, as ready as well as the counterinsurgency threats that we face today, and as we look to the future, issues like the cyber challenges that we are going to face in the future, and the intellectual capital in this Nation to provide us the soldiers, sailors, airmen, and marines that will be able to work across this broad range of threats. It is going to be challenging for the individual. It is going to be challenging for us as a Nation to grow those people. And it is going to be challenging for this Nation to compete in that world. And if we do not pay mind to that, we will be challenged.

Senator DOMENICI. Am I finished, Chairman?

Mr. ENGLAND. Could I make one comment, Mr. Domenici, if I could, though, on this? An issue that I think is important, because Mr. Allard and Mr. Conrad both commented earlier. We tend not to buy things at economic order of quantities, and we tend to buy them on a yearly basis. We have some programs that are multi-year. I think the industry view would be to maintain a base of workers and expertise. The very best thing we could do is long-term commitments at reasonable rates of production.

So we are always in this position, frankly, of low rates and not having long-term, predictable production. And if we could get to that point somehow—I do not know if that is achievable, but I believe that becomes the critical flaw in the system.

Senator DOMENICI. Sure it is. Right now we are talking at very high levels about doing 2-year budgets and 2-year appropriations. At least that is one jump away from where we are now. And that is a very serious issue. This Chairman has not decided where he is, but this old Chairman has decided where I am, and apparently within the next few days, there will be an effort to get before the public the starting of a momentum to change our process so we have everything 2 years, 2-year budgeting, and you do all your work on 2 year cycles. That would be helpful.

Mr. ENGLAND. Yes, it would.

Senator DOMENICI. You would like four, but, obviously, I have pushed to give you two, and we know why.

Mr. ENGLAND. But that would be a step in the right direction. Predictability for industry is very important for the investment both in assets and people.

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

Chairman CONRAD. Senator Sanders.

Senator SANDERS. Thank you, Mr. Chairman.

Thank you very much for being with us this morning on an issue of enormous consequence.

Mr. ENGLAND. Good morning.

Senator SANDERS. Mr. Chairman, I am going to take this discussion, if I might, in a slightly different direction. You will recall, gentlemen, Mr. Chairman, and other Senators, that in 1960 a very great Republican President, Dwight David Eisenhower, warned us about the power of the military-industrial complex. And he also told us at that point, a Republican President, that every dollar spent on the military in many ways is a dollar not spent on our children, not spent on the most vulnerable people in our society—

which makes it terribly important with this budget, as well as every other budget, that we scrutinize it carefully.

And, Mr. Chairman and members of the panel, I would remind you that this budget calls for a very significant increase in military spending, $515 billion; plus $15 billion, as I understand it, for nuclear weapons, which are not included in this budget; plus the war in Iraq; plus the war in Afghanistan. The bottom line, it is a lot of money. It is a huge amount of money.

Meanwhile, in this same budget, the President has said that we should cut back on Medicare and Medicaid. He wants to eliminate the weatherization program in this country, which means that people are going to spend a whole lot of money on fuel to keep warm. He wants to cut back on the low-income LIHEAP program. Oil prices are soaring. People in my State will go cold. LIHEAP does not have any money. He wants to cut back on that, cut back on programs for education, cut back on programs that impact tens of millions of people.

So it is terribly important that we take a hard look at what you are doing because, let's be clear, the money that the President is proposing, increases, huge increases for you, are resulting in massive cutbacks for millions of American people.

Now, I have some very simple questions that I want to ask you. All of us are aware that terrorism is a major, major problem. We are worried that al Qaeda is, in fact, growing around the world. I do not want anymore to get into the war in Iraq and whether that has stimulated the growth of al Qaeda, another issue for another time. And we all know that we have to spend money to fight international terrorism.

But let me ask you this question: In a budget this massive, I am curious to know actually how much of it is really being focused on international terrorism? When you build nuclear submarines, by and large that is not really targeted against Osama bin Laden. I know you can make the case that all $600 billion are focused on international terrorism, but it is not really.

Now, we all know—and Senator Domenici raised this issue. We went through a cold war. We had an enemy. It was called the Soviet Union. Conventional enemy, very powerful, huge army, nuclear weapons, and we spent hundreds of billions of dollars fighting them.

My concern is that within your budget, there are tens and tens and tens of billions of dollars fighting the old Soviet Union. And I am curious who the enemy is. We know it is al Qaeda, and we want to fight them. Is China the enemy? As Senator Domenici mentioned, is it Russia again? Who are we fighting above and beyond al Qaeda? Mr. Secretary?

Mr. ENGLAND. So I would say, Mr. Sanders, certainly you are right, all this money is not to go fight an adversary. That is part of our mission, but that is a mission hopefully that the Nation does not find itself fighting in. Our budget is to deter future aggression.

Senator SANDERS. Who are we deterring? Are we deterring China?

Mr. ENGLAND. So we deter whatever country may decide in the future, you know, that they find us in a weakened position.

Senator SANDERS. But let me be—we do not have a lot of time. I mean, we are not spending this money deterring Chile or Uruguay. Who are the countries we are deterring?

Mr. ENGLAND. I would say that I think it would be better if we had another discussion on this in a more classified area for you. But let me just say that we do spend funds to deter—I mean, we do track what other nations are doing. We see what they are doing in terms of their own development of armament. And so it is prudent—and, by the way, you are absolutely right. I believe this is something that should be debated. This is a national decision of how funds are spent. So the Nation historically has spent money to deter aggression——

Senator SANDERS. Right, but we need——

Mr. ENGLAND [continuing]. And to fight the Nation's wars.

Senator SANDERS. All right. Here is the point. If you come here and you tell us that our soldiers need armor in Iraq, everyone says that is right, we understand that, let's get them the armor. And we did. But your answer is a little bit vague, and I would love to go into it in a classified situation. But when you are asking for hundreds of billions of dollars above and beyond al Qaeda, I want to know who the enemy is. Is China the enemy?

Mr. ENGLAND. Well, we know that China has nuclear submarines. We know the Soviets have nuclear submarines. We know that they have, you know, significant arms and——

Senator SANDERS. We also know that China is buying up a significant part of America. We know that corporations like General Electric see their future in China. My question is: If you come in here and you say, look, we want to go classified, we are really worried about China, that has impact about our trade policies, impact about whether or not we think it is OK for Chinese companies to be buying up America, does it not?

Mr. ENGLAND. Senator, as all elements of national power come to bear for America's position in the world, one part of that is our military and DOD. So there are many elements of national power. It is economic, it is trade, it is military. And there is typically, I would say, in an administration and Congress a debate about the balance between all those in terms of deterring future aggression. Obviously, we always want everyone to be our friend and ally.

Senator SANDERS. Mr. Chairman, I think, frankly, we do not have enough of this discussion. This is a lot harder discussion than saying, look, I voted against the war, I do not think the war is a good idea. But you can make the case this is what you need for the war. We can understand that.

But we are talking about hundreds of billions of dollars, and I would love to go in classified discussion with you to get more information. I look forward to doing that.

I want to ask you one other question.

Mr. ENGLAND. Sure.

Senator SANDERS. We scrutinize waste and fraud all over this place. We do not do it enough in the Defense Department. I want to give you one example. The Air Force inventory system, the GAO—I do not know if you are familiar with it. A GAO report noted that $18.7 billion, or 65 percent, of the Air Force's secondary inventory was not needed to support required needs. And the truth is that the Air Force now has warehouses full of part supplies not needed. According to the latest data available, the Air Force has on order—on order—$235 million in inventory already identified as ready for disposal. In other words, it is coming in, it is going out. They do not need it.

Now, when we have kids in this country who do not have any health insurance, clearly we can spend money a little bit more wisely. Now, can you comment on the Air Force's spare parts program and what we are going to do to deal with that?

Mr. ENGLAND. Senator, I have not seen the report so I cannot comment, but I will, now that you have brought it to my attention—having not seen it——

Senator SANDERS. CBS Television did a little segment on it.

Mr. ENGLAND. Can I just comment? We do, I believe, Tina, what, over 3,000 audits each year?

Ms. JONAS. Yes, sir, the Defense Contract Audit Agency last year did 35,610 audits. They saved the taxpayers over $2.3 billion.

Mr. ENGLAND. So, I mean, we do regularly have audits, and we look at this, and so this particular case I am not familiar with. But, Mr. Sanders, I mean, perhaps that is right. I just cannot comment.

I can tell you that we do try to put systems in place to make sure that we do not have these kind of problems. Do they happen? Unfortunately, they do happen, but hopefully that is an exception, if that is a valid report. I just cannot comment.

Senator SANDERS. Well, two points. Mr. Secretary, I would like to take you up on meeting on that. And, second, the last question is: The number of auditors in the DOD——

Chairman CONRAD. Senator Sanders, we have to move on.

Senator SANDERS. OK. Thank you, Mr. Chairman.

Chairman CONRAD. We have just been advised that the first vote is going to start in 20 minutes.

Senator SANDERS. Thank you very much.

Mr. ENGLAND. Mr. Sanders, I will call you, though.

Senator SANDERS. Thank you.

Chairman CONRAD. Senator Wyden?

Senator WYDEN. Mr. Secretary, there are tens of thousands of brave men and women who have waited more than a year and a half for the Defense Finance and Accounting Service to approve the benefits that they earned when they were fighting for our country. Now, as of yesterday, the agency—the Defense Finance and Accounting Service—told us that they have over 39,000 cases to be processed of what are known as the CRDP or the CRSC claims. These are also known, of course, as Concurrent Retirement and Disability Pay claims or Combat-Related Special Compensation claims. And I know of one veteran in my State who died waiting for his claim to be processed. And my fear is, looking at your budget, that that constituent of mine isn't the only such veteran to be out there languishing waiting for a claim to be paid. These are some of the most courageous Americans we have ever known, and thousands of new claims are coming in.

So can you point specifically, to me and to the Committee, how under your budget you are going to turn this around and get at this huge backlog of claims?

Mr. ENGLAND. So, Tina, if you could address that, please?

Ms. JONAS. Senator, you are absolutely correct. I was made aware of this problem recently, and I asked the Director of the Defense Finance and Accounting Service, Zack Gaddy, to triple the number of people on this effort. And he is doing so. You are absolutely right, the backlog needs to be cleaned out. And so I wanted—I told him that we would like to have that done by April, and I accept what you are saying, sir.

Senator WYDEN. That sounds constructive, and I want to make sure that we are clear for the record, because there are thousands of these claims. You have now indicated to the Committee that you are setting in place a plan so that the backlog of these claims will be cleaned up by April——

Ms. JONAS. I have told them that I want the staff—the staff is supposed to be tripled, and that they need to get the claims, particularly the most—the oldest claims done by April. So they are on track to try to get that done.

Senator WYDEN. I like the first answer a little better than the second answer. Of the 39,000 claims in the backlog, how many are going to be addressed by April?

Ms. JONAS. I will have to get him to give you the exact number, but what I have directed him to do is get it cleaned out. So, obviously, they will—in fact, we will be happy to have them give you a weekly update on that, if you would like.

Senator WYDEN. That would be constructive.

Ms. JONAS. OK.

Senator WYDEN. And I appreciate the tripling of the people because that is the kind of commitment that is needed. And if you would update us a weekly basis, that would be helpful.

Ms. JONAS. Absolutely, Senator.

Senator WYDEN. One last question, if I could, Mr. Secretary, about the F–15s, and I know other Senators are concerned about this as well. You know, we have them in Oregon. The Fighter Wing in Portland and the one in Klamath Falls both fly the F–15. They have been grounded for structural problems. The President has requested money to repair them. Regrettably, the F–15s are so old and stressed that they are going to encounter more problems soon.

My question to you is: Does the Department have a plan for replacing the F–15 in the near future? And if yes, is the plan to go forward with the F–22? And my reason for linking these two is that together we have to come up with some way to get planes that are safe to fly. So if you put it in the context of both the relationship of the F–15 and the F–22, that is the purpose of my question.

Mr. ENGLAND. So, Senator, the F–15s, first of all, the Air Force, there is still an investigation on the F–15. A lot of them have returned to flight, there are still some that have not. I believe there are like 160—158 that have not yet returned to flight. And so there is still an investigation in terms of what they can do to those airplanes, if anything. So the first question is: Can we fix those airplanes? I believe is a long-term issue with the airplanes. So that investigation is going on, and they have, I think, NASA and everyone involved in a pretty comprehensive study, analysis of that problem.

So first we will hear the answer to that analysis. Depending on that outcome, then we will decide what to do on F–15s. But in answer to your question about the F–22, I do not believe the F–22s will be replacements for the F–15. The F–22 is a much more expensive, higher-end airplane, fifth generation. So I would expect that instead we would try to accelerate the Joint Strike Fighter, which is more the class of the F–15, so that the Air Force would move into Joint Strike Fighter, not into the much more expensive F–22 airplanes. So that would be my judgment, but, again, I need to temper that without having the specific data on the F–15s themselves until all that study and work is completed.

Senator WYDEN. I hope you will—and my time has expired—continue to make sure that you address the future of the F–15s as well. My constituents care a great deal about this. We feel that they have made an important contribution to the country's national security. And I am sure you will get questions from other Senators on this.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Wyden, and thank you for bringing up the F–15 issue, which has broad interest on the Committee on both sides.

Senator MENENDEZ.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Secretary, let me ask you, I have a difficulty understanding why the Department of Defense does not seem to be able to put in for budget purposes, now that we have 5-year experiential factor in Iraq, the resources necessary. You know, we have seen supplemental appropriations for this war have grown from $62.5 billion in fiscal year 2003 to $189.3 billion in 2008. Every year, we have had additional supplemental requests, and we have clearly some experiential factor here. And then we had the Director of OMB here who, under questioning that I had of him, said, yes, clearly we will need more than $70 billion, but we do not know the amount. And then we had Secretary Gates before the Armed Services Committee, and when Chairman Levin pressed him about give us some sense, he said $170 billion.

Why is it so hard for the administration to give the taxpayers a straight answer as to about what this war is going to cost?

Mr. ENGLAND. Well, so if I could answer maybe two. First, what is in the budget as opposed to the supplemental, that is really a decision by OMB. But the $70 billion is really a decision by ourselves and OMB. And there, Senator, the decision was made that we would go with the $70 billion until we had a better understanding of the 2009 requirement so that we could provide a higher precision number. So rather than just sort of guesstimate the number going forward, in our judgment it was better that we turned in basically a bridge number, which is similar to what we had been doing in the past, and then provide a more definitive number to the Congress that we could justify. So, I mean, that——

Senator MENENDEZ. But, Mr. Secretary, you know—you know—that $70 billion is clearly not enough.

Mr. ENGLAND. Senator, you are absolutely right. I mean, you are absolutely——

Senator MENENDEZ. So why aren't we closer to the truth?

Mr. ENGLAND. Because we have two requirements. One is when we provide numbers to the Congress, we also provide detailed justification for those numbers. So we provide you great justification for the numbers, so our dilemma is if we cannot provide what we believe is accurate and complete justification, that gives us a dilemma. And since we know the situations will change or that it is highly likely things will change come March or April——

Senator MENENDEZ. Well, you know, I do not understand, Mr. Secretary, when in the Vietnam War, war funding for Vietnam was in the regular budget from 1967 on. What has changed so dramatically that the Department of Defense could do it then and cannot do it now?

Mr. ENGLAND. Again, Senator, that part is not our decision as to how it is handled. That is an OMB decision.

Senator MENENDEZ. Mr. Secretary, yesterday the New York Times reported on a Rand study from the summer of 2004. The report, called "Rebuilding Iraq," was part of a seven-volume series on lessons learned from the war. It was very critical of the White House and the Department of Defense. The study found problems with "nearly every organization that had a role in planning the war." And it seems that this report has upset senior Army officials, and they have refused to allow the publication of the unclassified report.

When can we expect the Army to permit the publication of the unclassified sections of this report?

Mr. ENGLAND. Senator, that is the first I heard about the report yesterday. I read the same article. I have not had an opportunity to talk to the Army about this. We will do so, and we will get back with you on that, sir. I am just not familiar with the report.

Senator MENENDEZ. Well, I hope you get back to the Committee. You know, here is the problem. When I sit here, at least for myself—I cannot speak for my colleagues—I view my role as the fiduciary to the American taxpayers, and that means you have to have a judgment when you are being asked for more money for an engagement in which there are official reports that say that it is replete with errors, that cost maybe lives, but certainly cost the taxpayers money. And how does one make a judgment about whether the requests coming forward, which obviously are less than what, in fact, are necessary in the first place, clearly—clearly, Secretary Gates, OMB Director, clearly the experiential factor. And, second, how do you know that—how can the American people or those who have to act as fiduciaries on their behalf have an honest sense that your request is being used appropriately? I want to see the unclassified sections of that report published.

Mr. ENGLAND. So, first of all, I know nothing about the report. I do not know if that report is a valid report or not. I just know there is a report that was put out.

On the other hand, we do provide to the Congress, Senator——

Senator MENENDEZ. A valid report? This is a report that I understand was commissioned. That is why you are holding it. What do you mean it is an unvalid—this wasn't from some organization doing it on its own, they would have published it. This is a report that the Department actually authorized. What does it mean, an unvalid report?

Mr. ENGLAND. So I will pass no judgment on the report. I do not know the quality of the report. And when we look at the report, we will provide feedback to you, sir.

Senator MENENDEZ. This is why, with a track record such as this, this is why the American people have little faith in asking for billions more when you cannot tell us the right amount, when you come in with supplementals every year that far exceed it, even though you have 5 years' experience, when in Vietnam we could have it as part of the regular budget since 1967, and then when you keep reports, you know, secret when they should be clearly made public in terms of unclassified because they are critical, this is why you face the consequences of a reluctant Congress to give resources when we cannot make the judgments that in the first place the resources are being used appropriately.

Mr. Chairman, I urge you as the Chair of this Committee to join us in trying to make sure that the elements of this report that are unclassified become public, because we need to know what went wrong so we can decide, when we are being asked to make budget decisions here, whether we are making the right or wrong ones.

Thank you, Mr. Chairman.

Mr. ENGLAND. I do need to comment, though, Senator, in terms of your fiduciary responsibility. We do provide monthly Global War on Terrorism (GWOT) expenditure reports to the Government Accountability Office. Every month they come into the Congress, and they are here in detail. We provide summary reports quarterly to the Congress. We provide our coalition expenditures quarterly to the Congress. So we do provide——

Senator MENENDEZ. Mr. Secretary, those are after the fact——

Mr. ENGLAND [continuing]. Exceptionally detailed data to you.

Senator MENENDEZ. We are going to be marking up a budget in March. You know, those are after the fact. We need, after 5 years—we are going to into the sixth year of this. There is no reason why we cannot have greater accountability. There is no reason that we cannot have this report public so that we know what went wrong. There is no reason that, in fact, you know, even the reports you refer to, the GAO has a report that says DOD needs to take action to encourage fiscal discipline and optimize the use of tools intended to improve the global war on terror cost reporting. So these are not just my views. These are the views of people who have independently looked at it.

Thank you, Mr. Chairman.

Mr. ENGLAND. One last comment, if I can, because of the GAO report, and it is germane, I think, to this Committee. In 2001, when we came in office, there were 119 internal control deficiencies in terms of our financial systems. We now have that down to 19, and they will be completely taken care of by the end of this year. So I believe the reporting has improved considerably during this administration, and hopefully we will have all of our internal controls that we inherited, frankly, down to zero or very close to that by the end of this year.

So we are making progress, Senator, in terms of our reporting and our confidence in terms of the expenditures and the rationale for those expenditures.

Thank you.

Chairman CONRAD. I thank the Senator.

I want to go, in the moments we have left here, into something that is critically important for this Committee, and members on both sides have asked me to pursue these questions.

Last year, the press reported that the classified Chairman's Risk Assessment, which describes the risk that our military will not be able to win another war, showed significant risk. The Commission on the National Guard and Reserve found that the current Army plans for equipment will "not restore readiness and attain the goal of fully manning training and equipping its units until 2019."

In 2006, Lieutenant General Blum noted that readiness levels for non-deployed National Guard forces had plummeted because those units only had 26 percent of their authorized equipment.

I know, as you do, that the detailed reports are classified, so in an open hearing, I will only say what defense officials have said publicly: that the trends for the Army and Marines over the last few years raised serious concerns. Congressman Skelton said last month that readiness was declining at an alarming rate. That is of very serious concern to this Committee, as you can imagine.

Last year, there was press reporting suggesting that the Chairman of the Joint Chiefs raised his assessment of the level of risk that we face in executing the National Military Strategy. My understanding is that Congress has not yet received the Chairman's Risk Assessment for this year, although it is supposed to be transmitted along with the budget.

My first question is: Secretary England, do you know why the Chairman's Risk Assessment has not been forwarded with the budget, as has been the long-term practice?

Mr. ENGLAND. No, I do not know why it has not been. I know we were looking at—we are required to turn in a risk assessment and also the mitigation approaches by the Department to mitigate that risk identified by the Chairman. So I know we have had a number of discussions and meetings on this subject, Mr. Conrad. So perhaps that is still being put together. I am not exactly sure of the schedule or why it was not exactly on that date. But I do know that we have a mitigation measure to go along with the Chairman's Risk Assessment, and I will just have to get you a date when we will submit that.

Chairman CONRAD. Can I just say that that is critically important to the work of this Committee.

Mr. ENGLAND. OK.

Chairman CONRAD. We need to know, and I am sure you appreciate that it is absolutely critical to the work of this Committee. And I have announced we are going to mark up in this Committee on the week of March 3rd. We are going to be on the floor the week of March 10th. We need that as soon as we can get it.

General Cartwright, can you enlighten us with respect to this matter?

General CARTWRIGHT. We are working our way through the final phases—we call it "chops"—of the Mitigation Plan. The risk assessment is done. It has been—and this is the response to it. It has come to my level. I approved it yesterday. We should have it ready and to the Secretary within the next 48 hours.

Chairman CONRAD. Can I just emphasize the need to get that up here as rapidly as possible? Because it is really irresponsible of this Committee to go forward with a budget mark without having the latest risk assessment by the Chairman and to understand the mitigation measures that are necessary to address whatever that risk assessment might be. And I understand that is classified. I have only talked here in open session about things that have been publicly reported. And I do not want to go beyond that.

I do want to indicate the serious concern of the members of this Committee with respect to readiness issues. And we have seen that. All of us have National Guard and Reserve in our States. All of us hear frequently from those who command those forces and their growing concern reflected in the statement of General Blum for whom we have high regard.

Mr. ENGLAND. Mr. Chairman, I do have to say on the National Guard and Reserve, I believe the National Guard and Reserve at the national level is about 79 percent, I believe, the last I saw—and maybe somebody can correct me here—in terms of their “fill rates.” And that is well above historical averages for the National Guard, and it is also against new standards. That is, we have increased the amount of——

Chairman CONRAD. But that does not go to the question of readiness, I think you will agree. I mean, that is one component, but that does not go to the larger question of the Chairman’s Risk Assessment. And that is what is not before us, typically has been. At the time the budget comes up, we get the Chairman’s Risk Assessment. For whatever reason, we have not received that.

Mr. ENGLAND. No, we will definitely get that to you. I mean, there is no question we will get that. I was just addressing on more of this National Guard and Reserve issue about the fill rates. The fill rates of the National Guard and Reserve I believe are at an all-time high now, and not only at an all-time high, but——

Chairman CONRAD. But there is also a question of recruiting, and, of course, this is a larger issue, because we know that to meet those recruiting rates, they have issued a series of waivers in terms of kinds of people they are able to recruit. So that takes us down a whole other line of a question of what is the quality that we are able to attract, what else has to be done.

Let me just indicate that the first vote has now commenced, and I would be happy to give you, Secretary England, any final statement. Secretary England.

Mr. ENGLAND. Look, there are some issues we need to discuss and probably more so as followup to this meeting. First, Mr. Conrad, any questions you have, we would be pleased to respond to those questions by any member of the Committee. Obviously, if you will get them to us, we will. I do think some of these topics need to be addressed in more detail, and perhaps we will have an opportunity to do that.

In the meantime, I do thank you again for the opportunity to be here with you and to express some of the views of the Department and to hear the views of the Committee. And I thank you for those views. We do respect your input, and we do appreciate it, and I do thank you on behalf of the Secretary.

Chairman CONRAD. We thank you, Secretary England, General Cartwright, Tina Jonas. Thank you very much for being here. As always, we look forward to working with you. And, again, if you can get us those items that we have mentioned here today, the highest priority is obviously the Chairman's Risk Assessment and mitigation measures that are necessary.

Mr. ENGLAND. We will do that, Mr. Chairman. Thank you very much.

Chairman CONRAD. We will adjourn the Committee—oh, excuse me. Senator Nelson has come. We will give him a chance to ask questions.

Senator NELSON. And it will be quick. There is-#I21Mr. England. Hello, Senator.

Senator NELSON. Good morning.

Mr. ENGLAND. Good morning. My favorite Marine right there.

[Laughter.]

Senator NELSON. There is a Reuters story that a Russian bear bomber has buzzed one of our aircraft carriers. Can you tell us what is going on.

General CARTWRIGHT. Russian aviation, long-range aviation, has started to ramp up the number of sorties and the routes that they fly similar to the activity that they did during the cold war. One of those flights in the recent days came down the coast of northeastern Russia, Japan, to a carrier battle group that was doing training in the waters adjacent to Japan. They flew over the carrier. They were detected really more than 500 miles out, escorted, as is the normal procedure in international waters, to an overflight of the battle group, and then to a subsequent turn, then back home.

These are the standard practices from our standpoint of intercept, escort, follow them through, and then follow them until they are out of range of the battle group's normal operations, both for safety of flight in the area and for the potential protection that would be afforded by having an escort along.

We treat that as something that is unusual from the standpoint there has been a significant lapse in time since that last occurred, but not significant in that the practice was done safely, professionally, and they were escorted out of the area.

Senator NELSON. The Russian bomber flew over our aircraft carrier?

General CARTWRIGHT. It flew over the battle group, several of the ships in the group.

Senator NELSON. At what altitude?

General CARTWRIGHT. I understand that it came in at low altitude, but still within the normal air structure.

Senator NELSON. Is low altitude like 2,000 feet?

General CARTWRIGHT. Low altitude in this case is below 2,000—below 3,000 feet. But what we observed was nothing different and nothing unprofessional. Now what we are concerned about is what are the indications of this return to a cold war mind-set, what are the implications of that activity, and how do we best address that. It is free and international airspace, and we are just trying to now go back and look what message was intended by this overflight.

Senator NELSON. Well, that sounds pretty provocative to me, Mr. Chairman, that they would be flying over one of our aircraft carrier battle groups, and specifically if it were the aircraft carrier itself. We will followup on this in the Armed Services Committee.

Senator DOMENICI. Mr. Chairman?

Chairman CONRAD. Senator Domenici.

Senator DOMENICI. I told you privately after my questions, and I want to say publicly that it is incumbent upon any Senators that are in the business we are in that they ask to see the current CIA report on Russia's rebuilding of its armed forces, in particular the science involved. It is rather incredible what is happening. As you know, there are making billions of dollars, and the billions of dollars are going just as they did before: first, to build their military, and then to the citizens. And they are pretty modern in terms of what they are building compared to what we have thought over the last decade, and nobody ought to be fooled. They are not built just to be parked up there in the icelands. They are also drilling oil in the icelands up there, exactly like we are not. Where we think we cannot go, they are up in their icelands drilling great, great new oil production.

Chairman CONRAD. Let me just say to the Senator that will have to be the last word because we have been notified we have 7 minutes until this vote.

I thank the witnesses.

Mr. ENGLAND. Thank you very much, Senator.

Chairman CONRAD. The hearing is adjourned.

[Whereupon, at 10:25 a.m., the Committee was adjourned.]

Insert 6-1

CHAIRMAN CONRAD
QUESTION FOR THE RECORD FOR GENERAL CARTWRIGHT
RECAPITALIZING AGING AIRCRAFT

I have particularly followed the issue of tanker recapitalization in recent years. It is an absolutely critical program, because our Army, Navy, Marines, and Air Force all depend on aerial refueling to be able to reach their targets. And I think it exemplifies a real problem we face in defense acquisition. Instead of focusing on a few major investment programs at a time and getting them done at a reasonable cost, we invest in everything all at once and buy at completely uneconomic rates.

I have been tremendously impressed with how open and transparent the tanker procurement process has been this time around. The Air Force leadership has really learned from previous mistakes, where criminal behavior by one individual put a vital program at risk. Now, they are following a process that is completely by the book and is really setting a new standard for transparency with industry and Congress.

Right now, the Air Force is able to come up with only about 3 billion dollars a year for tanker procurement. That only will buy 12 to 18 aircraft a year, an incredibly inefficient rate. It will take over 30 years to replace the entire tanker fleet and by then, the KC-135 will be almost 80 years old.

What do you think can be done to address both the specific problem of aging tankers and the broader problem that we are buying aircraft at such a slow rate that their costs are astronomical, given that further topline increases seem highly unlikely?

CHAIRMAN CONRAD
QUESTION FOR THE RECORD FOR SECRETARY ENGLAND
INCREASING SIZE OF ARMY AND MARINE CORPS

In recent years, the Army has had considerable trouble maintaining the current size of their force. While most of the services have made their recruiting goals, the Army in particular has had to lower aptitude standards, grant more waivers to recruits with felony convictions and past drug problems, and increase the enlistment age. The administration has requested, and Congress has approved large new enlistment and retention bonuses. What is the cost, both monetary and on the caliber of our force, of the plan to make a large, permanent increase in the size of the Army and Marine Corps?

The President's budget appears to assume that all the new Army units created under the "Grow the Force" initiative will be light infantry brigades. Is that correct? If so, are those actually the forces we will need, or is that just an assumption to hold down the cost of the plan?

Kent Conrad

CHAIRMAN CONRAD
QUESTION FOR THE RECORD FOR SECRETARY ENGLAND
AND GENERAL CARTWRIGHT
AFGHANISTAN

How much of the $70 billion for war funding requested in fiscal year 2009 do you estimate will go to cover operations in Afghanistan?

Secretary Gates implied this week that he will recommend that we sustain elevated troop levels in Iraq rather than the gradual withdrawal General Petraeus recommended in September. Will this mean continuing to conducted the war in Afghanistan as an "economy of force" operation? The Afghanistan Study Group and others have recommended increased troop resources for Afghanistan. Does the Administration have any plans to send additional troops to Afghanistan? If so, how will this affect the current rotation in Iraq and length of deployments?

After 9/11, NATO invoked the collective defense clause and has supported the mission to root out al Qaeda and defeat the Taliban in Afghanistan. However, the NATO coalition is showing strains. The public perception in many NATO countries is in favor of withdrawing from Afghanistan. What is the administration's long-term strategy for success in Afghanistan? What role do you see for our NATO allies?

CHAIRMAN CONRAD
QUESTION FOR THE RECORD FOR UNDER SECRETARY JONAS
FUNCTIONAL ALLOCATION IN THE FYDP

Could you please provide the Committee with the planned allocation of Department funding by appropriations title (procurement, RDT&E, O&M, military personnel, etc.) for the five years from 2009 to 2013?

Questions of Senator Pete V. Domenici for a Hearing before the Senate Budget Committee, February 12, 2008

For: Deputy Secretary England

Subject: National Guard Equipment

Your budget requests $49 billion to recruit, train, and equip National Guard and Reserve forces.

As you know, a General Accountability Office report released last year studies National Guard Domestic Equipment Requirements and Readiness and indicates that as of November 2006, nondeployed Army National Guard forces in New Mexico ranked last in the nation regarding equipment readiness, with less than 40 percent of the total amount of dual-use equipment they are authorized to have for war-fighting missions.

Question 1: How will the Department's $49 billion funding request be used to address the serious equipment shortfalls needed in New Mexico and many other States?

Question 2: What other actions is the Department taking to ensure that our National Guard forces are equipped to do their jobs at home and abroad?

Ron Wyden

Budget Committee Hearing on DoD Budget
February 12, 2008

Questions for Deputy Secretary Gordon England

This past month, we recognized the 15th Anniversary of the "Don't Ask, Don't Tell" policy. Since 1994, the military has dismissed over 11,000 personnel as a result of this policy.

How much does the Department of Defense spend dismissing personnel for homosexual conduct, including the cost of replacing these men and women?

Is this cost accounted for in the President's budget request?

I realize this is public law, but if given a choice, do you believe it's reasonable to spend taxpayer money to keep patriotic Americans from serving their country?

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COMMITTEE ON FOREIGN RELATIONS
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SELECT COMMITTEE ON INTELLIGENCE
DEMOCRATIC POLICY COMMITTEE

United States Senate
WASHINGTON, DC 20510–4904

Questions for the Record

Senator Russell Feingold
Senate Budget Committee Hearing
Fiscal Year 2009 Defense Budget and War Costs

1. Gen. Cartwright, if we keep 15 combat brigades in Iraq through the end of 2008 and a contingency arose elsewhere that required the deployment of two or more brigades, could we do it without further extending deployments or cutting into dwell time?

2. General, the CBO has estimated that the President's plan to expand our ground forces will cost $100 billion over the next five years, a large investment even

3. by the Pentagon's standards. Clearly, this increase in troop strength is partly driven by a desire to reduce the stress on the current force of 250,000 troops deployed in Iraq, Afghanistan and the region. But the premise underlying the increase also appears to be that the United States will face the need to continue to deploy such high levels of troops in the future even after a drawdown in Iraq. What are the other circumstances where DOD would envision needing to deploy over 150,000 troops for ground warfare over long periods of time?

4. Sec. Gates has testified that there is a need for a dramatic increase in spending on the civilian instruments of national security. For example, he has noted that during the Cold War, USAID had 15,000 employees and expeditionary capabilities. It has now been reduced to 3,000 personnel. Secretary England, would you agree that rebuilding our civilian corps is essential to our national security? If we had a greater civilian capacity, would we need such a significant increase in the Army and Marine Corps?

5. Ms. Jonas, last year the Congress added $588 million to the Department's request for *Virginia*-class submarine procurement. How has this impacted the Navy's budget?

6. Sec. England, the Secretary of Defense testified last week that he is concerned that additional procurement of F-22s beyond the 183 aircraft already authorized could "come at the expense of" the Joint Strike Fighters. Could you please explain the trade-off?

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CHARRTS No.: SBC-01-001
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Wyden
Witness: Mr England
Question: #1

Don't Ask, Don't Tell Policy

Question: This past month, we recognized the 15th Anniversary of the "Don't Ask, Don't Tell" policy. Since 1994, the military has dismissed over 11,000 personnel as a result of this policy. How much does the Department of Defense spend dismissing personnel for homosexual conduct, including the cost of replacing these men and women? Is this cost accounted for in the President's budget request? I realize this is public law, but if given the choice, do you believe it's reasonable to spend taxpayer money to keep patriotic Americans from serving their country?

Answer: Thank you for recognizing that DoD's Homosexual Conduct Policy implements public law, title 10, United States Code (U.S.C.), Section 654, and that this provision requires the Department of Defense (DoD) to separate from the Armed Forces members who engage in or attempt to engage in homosexual acts; state they are homosexual or bisexual; or marry or attempt to marry a person of the same biological sex.

DoD simply implements statutory law in this matter. We are mandated to spend taxpayer money to separate from military service those who choose to violate public law.

Now for the questions about costs. As reported in the 2005 Government Accountability Office (GAO) report Financial Cost and Loss of Critical Skills Due to DoD's Homosexual Conduct Policy Cannot Be Completely Estimated, "the estimated cost of separating servicemembers cannot be determined. Separation procedures are handled by salaried employees who work in the personnel offices of various military installations and who have multiple responsibilities other than coordinating a servicemember's separation from the military. They too do not compute their time spent on the various activities they perform."

The same GAO report provided training cost estimates of the occupations performed by Service members who were separated under the homosexual conduct policy statute for fiscal years 1994-2003. With the exception of the Marine Corps, the Services were able to compute cost estimates to train members, by occupation. For the 10-year period, GAO reported those costs at $95.1 million. For the period 2004-2006, we have calculated the total costs at $32.2 million. This figure does not reflect training cost estimates of the occupations performed by Service members separated under the policy, but reflects the cost per recruit across DoD, including the Marines.

It is noteworthy that, as stated in the 2005 GAO report, the number of discharges for homosexual conduct was a small percentage (0.40%) of overall discharges since the implementation of the policy. For 2004-2006, the timeframe not covered in the report, that percentage has been stable and very small at 0.30%.

The explicit costs for replacement of military members separated for violations of title 10, U.S.C., Section 654 are not budgeted for in the President's budget. Neither are costs for replacements of those individual separated from duty due to pregnancy, failure to meet physical fitness standards, etc., explicitly budgeted. Rather, each Service budgets for its long-standing rate of attrition per year.

Military service is only one avenue of service for patriotic Americans. Every day, thousands of Americans serve our country in myriad ways and we are grateful for their contributions.

CHARRTS No.: SBC-01-002
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Conrad
Witness: General Cartwright, Mr England
Question: #2

Afghanistan

Question: How much of the $70 billion for war funding requested in fiscal year 2009 do you estimate will go to cover operations in Afghanistan?

Answer: The Department has not determined a specific allocation between Iraq and Afghanistan for these funds. Actual expenditures will vary based on force levels and conditions in the Joint Operating Area. Detailed justification material for the full year fiscal year 2009 Global War on Terror request is being developed and will be submitted in the spring.

CHARRTS No.: SBC-01-003
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Conrad
Witness: General Cartwright, Mr England
Question: #3

Afghanistan

Question: Secretary Gates implied this week that he will recommend that we sustain elevated troop levels in Iraq rather than the gradual withdrawal General Petraeus recommended in September. Will this mean continuing to conducted the war in Afghanistan as an "economy of force" operation? The Afghanistan Study Group and others have recommended increased troop resources for Afghanistan. Does the Administration have any plans to send additional troops to Afghanistan? If so, how will this affect the current rotation in Iraq and length of deployments?

Answer: Sustaining current troop levels [above 15 brigade combat teams (BCTs)] in Iraq will continue to impact force levels in Afghanistan. As long as Iraq is our country's main effort, our finite resources will be prioritized with Operation IRAQI FREEDOM remaining as the top priority and operations in Afghanistan remaining as an economy of force effort.

3,600 U.S. Marines are currently deploying to Afghanistan for a one-time, seven month deployment to fill two separate USCENTCOM requests for forces. 2nd Battalion, 7th Marines (2/7) will fill the first request for forces to serve in a training/security role as Police Mentor Teams for the Afghan national police. The 24th Marine Expeditionary Unit (24 MEU) will fill the second request for forces to support coalition objectives and to defeat insurgent forces in order to assist the Government of Afghanistan in extending security, stability, and governance. The deployments for both 2/7 and 24 MEU will end in the fall of 2008. Given mandated dwell times and a requirement for 15 BCTs in Iraq, additional U.S. Force deployments to Afghanistan are not sustainable beyond FY 08. Currently, there are not any plans to send additional troops to Afghanistan beyond the one-time Marine deployments.

CHARRTS No.: SBC-01-003
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Conrad
Witness: Mr England, General Cartwright
Question: #3

Afghanistan

Question: Secretary Gates implied this week that he will recommend that we sustain elevated troop levels in Iraq rather than the gradual withdrawal General Petraeus recommended in September. Will this mean continuing to conduct the war in Afghanistan as an "economy of force" operation? The Afghanistan Study Group and others have recommended increased troop resources for Afghanistan. Does the Administration have any plans to send additional troops to Afghanistan? If so, how will this affect the current rotation in Iraq and length of deployments?

Answer:

It is premature to comment on how changes in troop levels in Iraq might affect our troop levels in Afghanistan. Secretary Gates has approved the deployment to Afghanistan of some 3,200 U.S. Marines. About 2,200 of these Marines will be deployed to southern Afghanistan to engage in combat operations. The other 1,000 Marines will assist in the mission to train and mentor the Afghan National Security Forces (ANSF). This is a one-time, approximately seven-month deployment. These Marines were not intended to deploy to Iraq; their deployment to Afghanistan does not affect current troop rotations or deployment lengths of forces in Iraq.

Despite the impending deployment of Marines to Afghanistan, shortfalls remain in the minimum requirements identified by the commander of the NATO-led International Security Assistance Force (ISAF). These include maneuver forces, Provincial Reconstruction Teams (PRTs), aviation assets, and mentors for the Afghan National Security Forces. Some, including the United Kingdom, Australia, and Poland have stepped forward with additional pledges – others have not been forthcoming. Both the Departments of Defense and State continue to engage with our NATO Allies and other partners to ensure these requirements are filled.

CHARRTS No.: SBC-01-004
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Conrad
Witness: General Cartwright, Mr England
Question: #4

Afghanistan

Question: After 9/11, NATO invoked the collective defense clause and has supported the mission to root out al Qaeda and defeat the Taliban in Afghanistan. However, the NATO coalition is showing strains. The public perception in many NATO countries is in favor of withdrawing from Afghanistan. What is the administration's long-term strategy for success in Afghanistan? What role do you see for our NATO allies?

Answer: [DELETED]

CHARRTS No.: SBC-01-004
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Conrad
Witness: Mr England, General Cartwright
Question: #4

Afghanistan

Question: After 9/11, NATO invoked the collective defense clause and has supported the mission to root out al Qaeda and defeat the Taliban in Afghanistan. However, the NATO coalition is showing strains. The public perception in many NATO countries is in favor of withdrawing from Afghanistan. What is the administration's long-term strategy for success in Afghanistan? What role do you see for our NATO allies?

Answer:

Our strategy is to use U.S. and international forces, partnered with Afghan units, to counter the insurgency, while building up the capacity of the Afghan government to govern. As Afghan Minister of Defense Wardak told NATO Ministers in February 2008 in Vilnius, "The simple counter insurgency prescription is to Clear, Hold, and Build."

This is a task for the international community, our NATO ISAF partners, the United Nations, and above all the government and people of Afghanistan. Secretary Gates is working with his counterparts on an ISAF "vision statement" that lays out what we want to achieve collectively in Afghanistan, and how we intend to get there. We expect this statement will be approved by Heads of State and Government when they meet in Bucharest in April 2008.

NATO's ISAF mission currently includes some 48,000 troops from nearly 40 countries, in NATO's first deployment outside the European theater. These forces play a crucial role in executing, along with the Afghan National Security forces (ANSF), kinetic combat operations against the enemy – the "Clear" phase of our strategy.

Further development of the ANSF, which includes both the Army and Police, also is a critical element in our strategy, and is particularly important in the "Hold" phase. The Afghan National Army (ANA) is increasingly assuming a leading role in the planning and execution of operations, and is a highly respected national institution. 49,450 personnel are currently assigned to the ANA, with a projected increase of between 10,000 and 15,000 personnel per year. To date, the U.S. has invested about $8 billion on the Army's development. In contrast, the Police lag behind the Army in both capability and effectiveness. There are some 75,300 personnel assigned to the ANP, of a projected 82,000 end-strength. The Afghans, with considerable support from the U.S., are taking steps to turn the ANP into a more capable and effective organization. This includes: better weapons and equipment for the Police, leadership changes within the Ministry of Interior, pay and rank reform (including pay parity with the Army), integrating Police Mentoring Teams (PMTs) with ANP units, and executing the Focused District

Development (FDD) plan. The FDD is an initiative to concentrate resources on priority districts in order to increase the capabilities of the police by temporarily inserting teams of highly proficient Afghan National Civil Order Police (ANCOP) into selected districts while the regular ANP are immersed in 8 weeks of intensive refresher training before resuming their positions with intensive follow-on mentoring. So far, the U.S. has invested $5 billion in Police development.

A number of our partners in ISAF also play a significant role in the reconstruction activities – the "Build" phase – for instance, in Provincial Reconstruction Teams (PRTs). There currently are 25 PRTs, of which 12 are led by the U.S. Civilian expertise has to be integrated with the military's capabilities for our strategy to work. State, USAID, and Department of Agriculture personnel are partnered with U.S. military officers in most of our PRTs. This phase of our strategy is perhaps the most challenging and will take the longest to achieve.

The Alliance, however, has fallen short of meeting its stated commitments in several key areas. We need to make progress in meeting these needs for our strategy to succeed. Afghanistan needs more maneuver forces, Provincial Reconstruction Teams (PRTs), aviation assets, and mentors for the Afghan National Security Forces. Some Allies also need to remove restrictive "caveats" on their forces, which all too often preclude their troops from taking on certain missions or deploying to particular regions.

Both the Departments of Defense and State continue to engage with our NATO Allies and other partners to ensure that these requirements are filled.

CHARRTS No.: SBC-01-005
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Conrad
Witness: Mr England
Question: #5

Increasing the Size of the Army and Marine Corps

Question: In recent years, the Army has had considerable trouble maintaining the current size of their force. While most of the services have made their recruiting goals, the Army in particular has had to lower aptitude standards, grant more waivers to recruits with felony convictions and past drug problems, and increase the enlistment age. The administration has requested, and Congress has approved large new enlistment and retention bonuses. What is the cost, both monetary and on the caliber of our force, of the plan to make a large, permanent increase in the size of the Army and Marine Corps?

Answer: The Army has not changed its recruiting quality benchmarks. These marks, 90% High School Graduates (HSDG), 60% Test Score Category (TSC) I-IIIA, and no more than 4% TSC IV, are established by DoD for all Services and our goal is to attain them. Although law prescribes much lower standards <20% CAT IV and >65% HSDG, Army focuses on meeting DoD quality marks. In 2007, we met our recruiting goal of 80K, but fell short of attaining the quality mark for HSDG at 79%. We did meet the quality marks set for TSC I-IIIA at 60.83% and CAT IV at 3.97%. Every recruit must have a high school diploma or equivalent (e.g., GED, home schooled). Our focus for 2008 recruiting mission of 80K remains geared toward meeting or exceeding prescribed DoD quality marks. In FY07, the Army spent $1.12 billion in recruiting and retention bonuses. This figure is composed of reenlistment bonuses ($565.3 million), enlistment bonuses ($472.7 million), and education benefits ($84.3 million). The forecasted recruiting and retention bonuses for FY08 and FY09 are $1.41 billion and $1.57 billion respectively. The continued support of Congress is critical in our efforts to growing the Army. One of our greatest needs is positive influencers to encourage our Nation's youth to serve their country.

CHARRTS No.: SBC-01-005
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Conrad
Witness: Mr England
Question: #5

Increasing the Size of the Army and Marine Corps

Question: In recent years, the Army has had considerable trouble maintaining the current size of their force. While most of the services have made their recruiting goals, the Army in particular has had to lower aptitude standards, grant more waivers to recruits with felony convictions and past drug problems, and increase the enlistment age. The administration has requested, and Congress has approved large new enlistment and retention bonuses. What is the cost, both monetary and on the caliber of our force, of the plan to make a large, permanent increase in the size of the Army and Marine Corps?

Answer: The Marine Corps continues to attract and retain the best and brightest as we grow to 202K. Between FY06 and FY08 our accession mission has increased over 20% while our quality remains above DoD standards of 90% Tier I HS Grads (USMC 95.4%) and 60% Mental Category (I-IIIA) (USMC 66.2%). To date in FY08, we remain above these standards and have shipped and contracted over 100% of our planned requirement. To support this effort, we have increased our Enlistment Bonus to our new Marines. This year approximately 31% of new Marines enlisting in the Marine Corps will receive an average Enlistment Bonus of $6.6K. The proof of success of quality recruiting is that our recruit attrition at boot camp remains low (~10%) and our Non-EAS attrition remains low.

Between FY06 and FY08 our retention mission has also grown by 46% which means the Marine Corps must retain approximately 5,500 more Marines than in FY06. The average SRB is approximately $30K for a total cost of approximately $536M for FY08. We must continue to retain our best and brightest to support the 202K End Strength goal the growth necessitates we retain approximately 41% of our First Term Force and 75% of Career Force. We are competing with the civilian sector and government contracts for the same people and we need to be able to offer incentives to retain our high demand personnel. We anticipate that the funding requirements for both EB and SRB will remain at these levels for the foreseeable future.

In short, the plan to increase the size of the Marine Corps has significantly increased the cost of our incentive programs, but has not impacted the high quality of our force.

Related retention costs associated with that force growth are outlined below. The AIP amount noted in FY07 represents funds expended in that category as an added retention incentive and is unique to FY07 only. The below amounts are reflected in the Marine Corps' budget submissions.

U.S. Marine Corps GTF			(In Thousands)			
Category	FY07	FY08	FY09	FY10	FY11	Totals
Enlistment Bonus	$ 68,076	$ 133,414	$ 61,672	$ 64,154	$ 66,576	$ 393,892
Reenlistment Bonus	$ 424,452	$ 370,952	$ 563,905	$ 412,926	$ 424,914	$ 2,197,149
AIP (FY07 Only)	$ 157,191	$ -	$ -	$ -	$ -	$ 156,893
Grand Totals	$ 649,719	$ 504,366	$ 625,577	$ 477,080	$ 491,490	$ 2,747,934

CHARRTS No.: SBC-01-006
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Conrad
Witness: Mr England
Question: #6

Increasing the Size of the Army

Question: The President's budget appears to assume that all the new Army units created under the "Grow the Force" initiative will be light infantry brigades. Is that correct? If so, are those actually the forces we will need, or is that just an assumption to hold down the cost of the plan?

Answer: The new units created in the Grow the Army (GTA) plan include six Infantry Brigade Combat Teams (IBCTs) in the active component (AC). The growth also includes 15 multifunctional and functional support brigades and over 38K of enabling combat support (CS) and combat service support (CSS) personnel across all three components. The GTA initiative was based on increasing rotational depth and filling global operational demands as quickly as possible. The growth of six IBCTs was the optimal way to accomplish the rapid growth with a structure suitable to meeting global demands in an era of persistent conflict.

To ensure growth remains consistent with the demands of future operations, the Army, in coordination with Office of the Secretary of Defense and the Joint Staff, currently is conducting a review of its BCT force mix. This analysis will determine the optimal mix of BCTs, by type and component, to sustain the Army's support to Combatant Commanders within the current program of 76 BCTs and congressionally mandated end-strength caps. The results of this review will be presented to the Deputy Secretary of Defense by July 1, 2008. The Army will use the results of this review to inform the Total Army Analysis and the next Quadrennial Defense Review.

CHARRTS No.: SBC-01-007
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Conrad
Witness: General Cartwright
Question: #7

Recapitalizing Aging Aircraft

Question: I have particularly followed the issue of tanker recapitalization in recent years. It is an absolutely critical program, because our Army, Navy, Marines, and Air Force all depend on aerial refueling to be able to reach their targets. And I think it exemplifies a real problem we face in defense acquisition. Instead of focusing on a few major investment programs at a time and getting them done at a reasonable cost, we invest in everything all at once and buy at completely uneconomic rates.I have been tremendously impressed with how open and transparent the tanker procurement process has been this time around. The Air Force leadership has really learned from previous mistakes, where criminal behavior by one individual put a vital program at risk. Now, they are following a process that is completely by the book and is really setting a new standard for transparency with industry and Congress.Right now, the Air Force is able to come up with only about 3 billion dollars a year for tanker procurement. That only will buy 12 to 18 aircraft a year, an incredibly inefficient rate. It will take over 30 years to replace the entire tanker fleet and by then, the KC-135 will be almost 80 years old.What do you think can be done to address both the specific problem of aging tankers and the broader problem that we are buying aircraft at such a slow rate that their costs are astronomical, given that further topline increases seem highly unlikely?

Answer: The KC-X is the first phase of a multi-phased approach to recapitalizing our entire tanker fleet. The KC-X will provide as much as 1.9 times the capability of the KC-135s across all mission areas. As such, a procurement rate of 15 per year will replace about 28 KC-135s. The follow-on KC-Y and KC-Z programs may yield tankers with different capability. Based on this information, the Air Force will continue to evaluate and address aging aircraft issues for the legacy KC-135R and KC-10 fleets through depot support activities and future modification programs. We looked at economic order quantities and found that 15 aircraft per year is an economic build rate. While the process will take many years, the improved capability of the new tanker puts us in a better position than previously expected.

CHARRTS No.: SBC-01-008
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Conrad
Witness: HON Jonas
Question: #8

Functional Allocation in the FYDP

Question: Could you please provide the Committee with the planned allocation of Department funding by appropriations title (procurement, RDT&E, O&M, military personnel, etc.) for the five years from 2009 to 2013?

Answer: The FY 2009 figures (discretionary budget authority, $ billions) by appropriations title are:

Military Personnel	125.2
Operation & Maintenance	179.8
Procurement	104.2
RDT&E	79.6
Military Construction	21.2
Family Housing	3.2
Working Capital Funds	2.2
Total	515.4

The Department intends to deliver its detailed classified Future Years Defense Program (FYDP) by the end of March. Below are the DoD totals for FY 2010-2013:

($ billions)	FY 2010	FY 2011	FY 2012	FY 2013
DoD discretionary budget authority	523.9	530.3	539.1	548.8

CHARRTS No.: SBC-01-014
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Domenici
Witness: Mr England
Question: #14

National Guard Equipment

Question: As you know, a General Accountability Office report released last year studies National Guard Domestic Equipment Requirements and Readiness and indicates that as of November 2006, nondeployed Army National Guard forces in New Mexico ranked last in the nation regarding equipment readiness, with less than 40 percent of the total amount of dual-use equipment they are authorized to have for war-fighting missions. How will the Department's $49 billion finding request be used to address the serious equipment shortfalls needed in New Mexico and many other States? What other actions is the Department taking to ensure that our National Guard forces are equipped to do their jobs at home and abroad?

Answer: The Army plan is to bring all Army Brigade Combat Teams (Active Component (AC) and Army National Guard (ARNG)) to 100 percent Equipment on Hand (EOH) by FY15 and all Combat Support and Combat Service Support units (AC, ARNG, and U.S. Army Reserve (USAR)) to 100 percent EOH by FY19. As the ARNG transforms to the Army's modular design, its units improve in equipment quality, quantity, and operational capability.

- To accomplish this, the Army has increased ARNG equipment funding from ~$1 billion (B) per year prior to FY05 to an average of $5B per year from FY05 to FY13.
- Based on current assumptions and full funding of Base and Supplemental appropriations, the Army will distribute approximately 400,000 items of new equipment to the ARNG in FY08 and FY09 and over 240,000 items in FY10-13.
- This strategy provides modern equipment to the ARNG (e.g., helicopters, vehicles, radios, force protection equipment).
- With current funding, the remaining ARNG equipment shortage will be:
  - $3.6B to achieve 90 percent Critical Dual Use EOH at end FY11. This amount was submitted as the Army's FY09 Unfunded Requirement.

Overall, 66 percent of EOH is available to Governors. In regards to New Mexico, the ARNG reported 63 percent of New Mexico's equipment is currently available for State use. This represents 18,000 out of 29,000 pieces of equipment for the State of New Mexico. The New Mexico Army National Guard had 89 percent of its Critical Dual Use equipment at the end of FY07 with 77 percent available for State use. In the next 24 months, the New Mexico ARNG will receive 4,155 new pieces of equipment from the Army.

CHARRTS No.: SBC-01-009
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Feingold
Witness: General Cartwright
Question: #9

Possible Future Regional Contingency and Force Levels

Question: General Cartwright, if we keep 15 combat brigades in Iraq through the end of 2008 and a contingency arose elsewhere that required the deployment of two or more brigades, could we do it without further extending deployments or cutting into dwell time?

Answer: Senator Feingold, I appreciate your question and concern about our forces and their families. The short answer to your questions is – maybe. It depends upon the type of operation and location, the amount and type of forces required, and the length of the deployment.

As you know we always have ready forces available in the United States and afloat around the world to respond to a crisis. We have a brigade combat team as part of our Global Response Force and Marine expeditionary units afloat. If we utilize these forces, there will be minimal affect on our deployment schedules and dwell times.

If we encounter a contingency operation that is like Operation Katrina – a short duration domestic operation, we could do it without extending deployments, cutting dwell time or altering our deployment schedule. If the contingency was a major operation for an extended period with large amount of forces, we will have to alter our deployment schedule and dwell times.

Secretary Gates and Admiral Mullen have a goal of a 1:2 deployment-to-dwell ratio. We are working toward that goal with the reduction of forces in Iraq from 20 to 15 brigade combat teams/regimental combat teams. As we decrease forces in Iraq, it provides us greater flexibility and increased dwell times for our Army and USMC ground forces.

CHARRTS No.: SBC-01-010
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Feingold
Witness: General Cartwright
Question: #10

Cost to Expand the Force

Question: General, the CBO has estimated that the President's plan to expand our ground forces will cost $100 billion over the next five years, a large investment even by the Pentagon's standards. Clearly, this increase in troop strength is partly driven by a desire to reduce the stress on the current force of 250,000 troops deployed in Iraq, Afghanistan and the region. But the premise underlying the increase also appears to be that the United States will face the need to continue to deploy such high levels of troops in the future even after a drawdown in Iraq What are the other circumstances where DOD would envision needing to deploy over 150,000 troops for ground warfare overlong periods of time?

Answer: The currently requested and planned expansion of our ground forces enables DOD to cover the shortages in other areas of responsibility, as well as alleviate a permanent surge-like environment. The increase in personnel requirements allows forces to be deployed on a rotational basis for the long war and reduces stress on the force. Furthermore, this requires a more in-depth, strategic analysis and research effort.

CHARRTS No.: SBC-01-011
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Feingold
Witness: Mr England
Question: #11

Growing the Civilian Force

Question: Secretary Gates has testified that there is a need for a dramatic increase in spending on the civilian instruments of national security. For example, he has noted that during the Cold War, USAID had 15,000 employees and expeditionary capabilities. It has now been reduced to 3,000 personnel. Secretary England, would you agree that rebuilding our civilian corps is essential to our national security? If we had a greater civilian capacity, would we need such a significant increase in the Army and Marine Corps?

Answer: DoD senior leadership agrees that an increase the capacity of the civilian tools of our government is essential to addressing the security challenges our nation faces today. In many areas of the world, we are currently relying on our soldiers, sailors, airmen, and Marines to carry out duties that are best executed by civilian officials who have expertise in diplomacy and development, as well as skills in key sectors such as essential services, rule of law, and governance.

This distinction in proficiency is precisely the reason why one capability cannot effectively substitute for another. As today's national security challenges frequently blur the line between peace and war, the U.S. Government needs the ability to select and apply those capabilities that are best suited for the mission and not be constrained by limited capacity in critical areas.

DoD supports the Secretary of State's proposed increase in staffing at the Department of State and the U.S. Agency for International Development and the creation of the Active, Standby, and Reserve Corps, part of the Department of State's Civilian Stabilization Initiative.

Growing the civilian force to meet gaps in unique civilian expertise does not obviate the need to grow the end-strength of the Army and Marine Corps. Force structure increases in the Army and Marine Corps are in response to the current and expected military requirements of the Global War on Terrorism, to relieve stress on the force, and to ensure appropriate time is spent in critical training. These demands include the need for additional combat forces as well as increased capabilities for stability operations, counter-terrorism, and training and advising of key partners.

Overlap in some areas of civil-military capabilities does not imply redundancy, but rather calls for increased integration of those capabilities to ensure unity of effort in U.S. Government activities.

CHARRTS No.: SBC-01-012
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Feingold
Witness: HON Jonas
Question: #12

Virginia-Class Submarine Procurement

Question: Ms. Jonas, last year the Congress added $588 million to the Department's request for Virginia-class submarine procurement. How has this impacted the Navy's budget?

Answer: The additional funds have allowed the Navy to accelerate their plans to procure additional submarines, which will strengthen our naval forces. The Navy is investing the $588 million Congress added in FY 2008 to accelerate the procurement of two submarines per year starting in FY 2011, one year earlier than the PB08 plan. Specifically, $518 million is being used to fund advance procurement items, including a shipset of reactor components and non-nuclear long lead time items for a second *Virginia*-class submarine in FY 2011. The remaining funds, $70 million, will procure advance procurement items for the FY 2009 *Virginia*-class submarine.

To support the second *Virginia*-class submarine in FY 2011, the Navy added advance procurement funding in FY 2009 and FY 2010 and full funding in FY 2011. Additionally, the Navy reduced full funding in FY 2009 for the FY 2009 *Virginia*-class submarine to account for the advance procurement funding provided by Congress in FY 2008.

CHARRTS No.: SBC-01-013
Senate Budget Committee
Hearing Date: February 12, 2008
Subject: FY 2009 Budget and War Costs
Member: Senator Feingold
Witness: Mr England
Question: #13

Impact of Additional F-22 Procurement on JSF

Question: Secretary England, the Secretary of Defense testified last week that he is concerned that additional procurement of F-22s beyond the 183 aircraft already authorized could "come at the expense of" the Joint Strike Fighters. Could you please explain the trade-off?

Answer: The correct mix of 5th generation strike fighter aircraft is a trade-off in affordability, mission areas, capability, and commonality. The Air Force's F-22 is a very capable aircraft. The F-22 brings air dominance and the capability to access denied operational areas. However, it is also a very expensive aircraft. The F-35 Joint Strike Fighter (JSF) is designed to be a very capable strike fighter aircraft with affordability as a key component. The F-35 will bring additional air warfare capabilities, and has been designed from the ground up to perform as the most advanced tactical strike platform in the world. The F-35 will be flown by the Air Force, Navy, and Marine Corps, as well as eight international partners. Foreign Military Sales are also likely to add additional international customers. The F-35 is in the latter stages of development and entering the initial stages of production. To ensure that the F-35 achieves the affordability objectives the Department requires, it is important to complete the development phase and continue to increase the procurement quantities in advance of full rate production. Continued procurement of F-22 aircraft would impact the Department's ability to invest appropriately in the F-35 program. The Department has a limited budget with many competing priorities. Achieving the appropriate mix of tactical aircraft to meet the Combatant Commanders warfighting needs requires the Department to balance the necessary budget constraints with the capabilities inherent in each platform procured.

HEALTH CARE AND THE BUDGET: INFORMATION TECHNOLOGY AND HEALTH CARE REFORM

THURSDAY, FEBRUARY 14, 2008

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

The Committee met, pursuant to notice, at 10:03 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Wyden, Nelson, Stabenow, Whitehouse, Gregg, and Grassley.

Staff present: Mary Naylor, Majority Staff Director; and Denzel McGuire, Staff Director for the Minority.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. I want to bring the Committee to order and thank our witnesses. We have had a little traffic incident/accident on one of the bridges, apparently, but all of our witnesses are now here. We want to welcome them all.

Valerie Melvin, the Director of Human Capital and Management Information Systems at the GAO, good to see you. Thank you for being here.

Laura Adams, the President and CEO of the Rhode Island Quality Institute, we are glad that you are here as well, undeterred by the traffic conditions in the Washington Metro area.

And Mary Grealy, the President of the Healthcare Leadership Council. Thank you all for being here. What a distinguished group of witnesses we have.

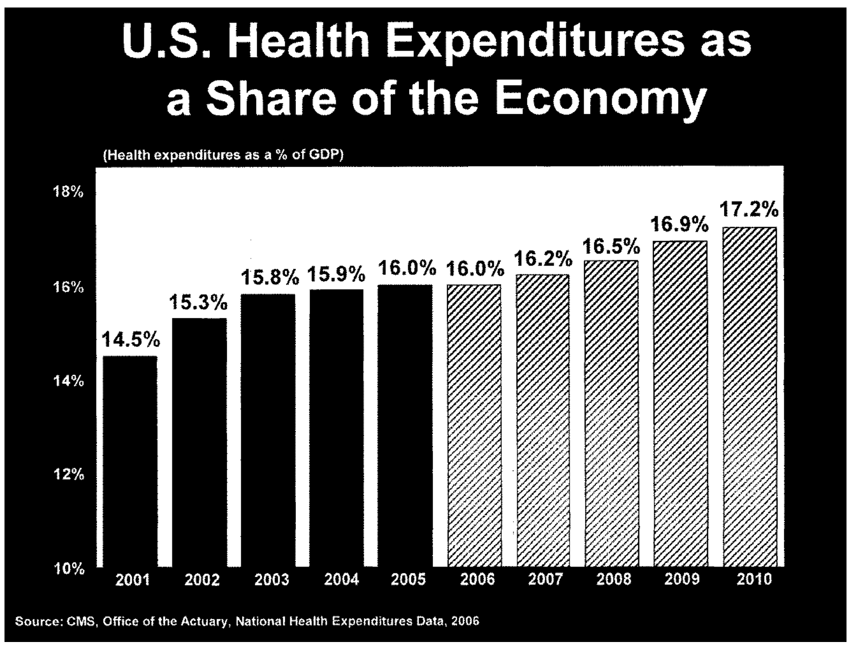
We want to thank, as well, members of this Committee who have been so active on this issue. I particularly want to thank Senator Whitehouse for his leadership. He has been a foremost advocate for health care information technology and we appreciate his really tireless efforts to address this issue. Thank you, Senator Whitehouse.

I also want to acknowledge the work of Senator Stabenow and her pushing of information technology in health care and what it can do to both reduce costs and improve outcomes.

We also should salute Senator Enzi on the other side, who is the Ranking Member of the HELP Committee and who has been actively engaged on this.

And I would be remiss if I did not thank our Ranking Member, Senator Gregg, who has helped push through legislation that if we can get it passed would really form a foundation of the information that is required to make dramatic improvements in health care. We really want to salute his leadership role. It has been very important and we thank him for it.

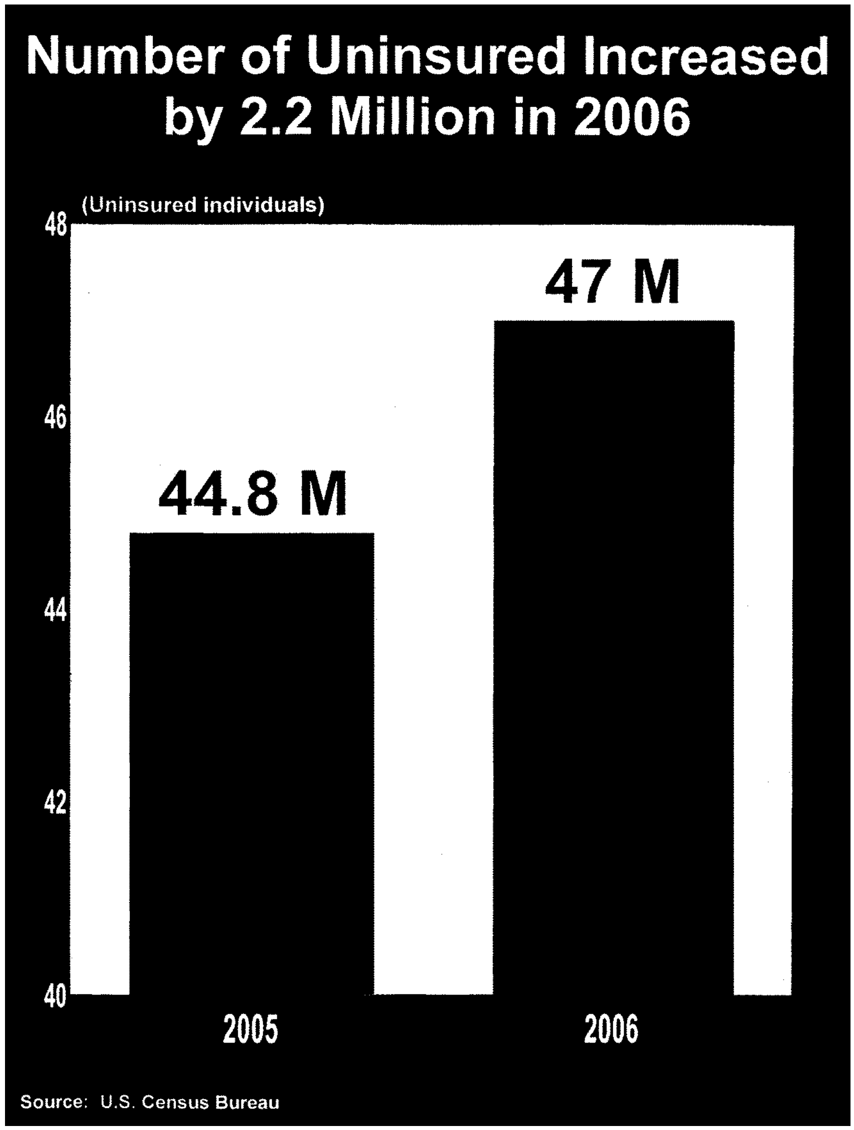
Let me just run through a couple of items to put this in perspective, or at least as I see it. Our health care system is simply not as efficient as we would all like it to be. We are spending far more on health expenditures as a percentage of gross domestic product than any other country in the OECD, and we spend more and more on health care as a percent of GDP each year. It is really quite startling that we are at 16 percent of our gross domestic product.



That means that one in every seven dollars in this economy is going for health care.

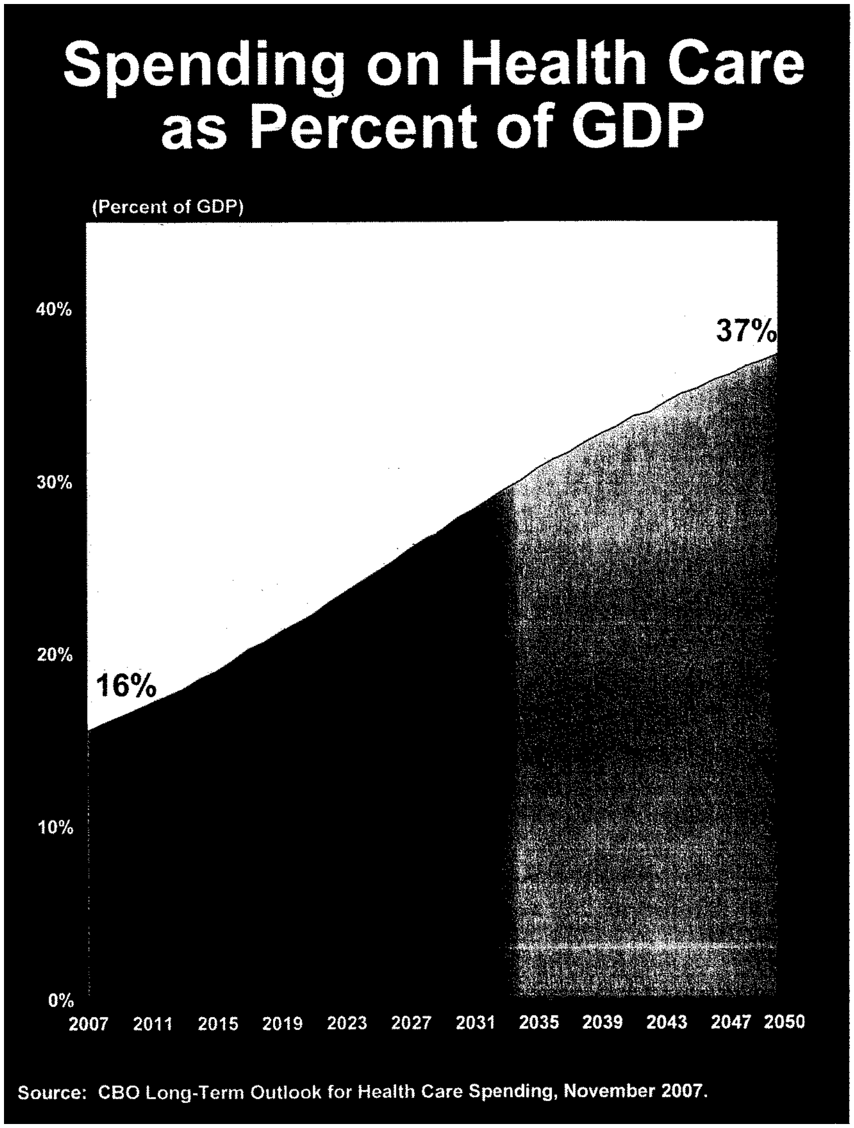
Despite this additional health care spending, health care outcomes in the United States are no better than health care outcomes in the other OECD countries. And OECD stands for the Organization for Economic Cooperation and Development. The OECD is really the international scorekeeper on these issues.

Despite this fact, the number of uninsured continues to grow. In fact, the number of uninsured increased by over 2 million in 2006 to now reach of 47 million people.



It turns out, however, that demographics are not the biggest issue driving our long-term budget outlook. Rising health care costs will have a far bigger impact, as the head of the GAO has testified before this Committee. This is not just an issue of Federal health spending, its impact on the Federal budget. We can see it in the private sector as well.

If we continue on the current trajectory, private sector will be overwhelmed by rising health care costs. In fact, if we look if we look at total health care spending if we stay on this trend line—I want to emphasize that, if we stay on this trend line—it will grow from 16 percent of gross domestic product, which is already high, to more than 37 percent by 2050.



Clearly, we must make changes. That would be one in every three dollars in this economy. No one is more acutely aware of that than the Ranking Member.

Here is what the CBO Director told this Committee earlier this year. "I think it's a mistake to look at containing costs just within the Federal programs themselves, Medicare and Medicaid. The underlying driver of that cost growth, of the costs in those programs, is the underlying rate of cost growth in the health care sector as a whole. And tackling that problem is the fundamental fiscal challenge and an important economic challenge facing the Nation."

Reform of Medicare and Medicaid Requires Overall Health Care Reform

> **"I think it's a mistake to look at containing costs just within the federal programs themselves, Medicare and Medicaid. The underlying driver of that cost growth, of the costs in those programs, is the underlying rate of cost growth in the health sector as a whole. And tackling that problem is perhaps the fundamental fiscal challenge and an important economic challenge facing the nation."**
>
> **– Congressional Budget Office Director Peter Orszag**
> **Testimony before Senate Budget Committee**
> **January 25, 2007**

There are a number of health care reforms that have potential to provide savings and improve health care outcomes. I think we should also acknowledge, if we are going to be honest with ourselves, that some of these reforms will have up front costs. We do not know yet how much they will ultimately save. But if we are going to address rising health care costs, we need to get started on some of these reforms.

Here are several of the options with potential for long-term savings.

Health Care Reforms with Potential for Long-Term Savings

May Have Upfront Costs

- **Expanding comparative effectiveness research**
- **Coordinating care for chronically ill**
- **Changing provider incentives and beneficiary cost-sharing**
- **Promoting healthy lifestyles and preventive care**
- **Widespread adoption of Health IT and e-prescribing**

One, expanding effectiveness research. Two, better coordinating care for the chronically ill. Three, changing provider incentives and beneficiary cos-sharing to encourage use of best practices. Four, promoting healthy lifestyles and preventive care. And finally, the widespread adoption of health care information technology.

I am going to stop there and turn to my ranking member for his opening observations and then we will go right to the witnesses.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman. Thank you for holding this hearing and I thank the witnesses. This is a very important issue from a budget issue but, more importantly, from a standpoint of where this country is going.

We know that health care is an extremely complex interwoven and overlaid matrix, that there is no one single answer to maintaining or producing a health care system that is affordable and delivers quality health care to all Americans. But we do know that one element of this matrix, and a fairly significant one, is how you communicate what is happening in the system and how you communicate within the system so that information is transparent and outcomes are known and costs are known, and we can use that information in order to effectively, hopefully, be better providers and purchasers of health care.

The Chairman was kind enough to refer to a bill which I have sponsored with Senator Clinton called the MQEA bill, which is the Medicare Quality Enhancement Act, the purpose of which is to make information more readily available that already exists, basically Medicare data and creates secure entities where people can request information along with the ability to combine it with existing data in private sector and then use it as purchasers, either as insurers, business people who have a large number of employees, or the general public. The idea is to make this taxpayer paid for information more transparent relative to outcomes and costs.

We also have the excellent work being done by Dartmouth Atlas Project in this area, the Dartmouth Atlas, which basically is the gold standard for assessing what is happening in outcomes and quality across the country. It is a work in programs due to the complex nature of this issue, but their initial findings are really rather important and can have a big impact on where we go here.

So I am looking forward from hearing from this panel because it is a continuation of the discussion of what I consider to be one of the essential issues in how we do start to get a handle on health care, which is the question of how we handle health care information and how we make it more readily available to consumers.

Chairman CONRAD. Thank you, Senator. Now we are going to turn to our witnesses and we will start with Dr. Melvin. Welcome, good to have you, representing the GAO.

STATEMENT OF VALERIE C. MELVIN, DIRECTOR, HUMAN CAPITAL AND MANAGEMENT INFORMATION SYSTEMS ISSUES, UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE

Ms. MELVIN. Thank you, Mr. Chairman, Ranking Member Gregg, and members of the Committee.

I am pleased to be here today to comment on Federal efforts to advance the use of information technology for health care delivery. The use of information technology has great potential to help improve the quality of health care and the performance of the U.S. health care system. Its benefits offer promise for making patients' health information more readily available to health care providers and for reducing medical errors and streamlining administrative functions, all of which can help improve quality of care and patient safety and reduce administrative costs.

In 2004, President Bush issued an Executive Order that call for widespread adoption of interoperable electronic health records by 2014. He then established a National Coordinator for Health IT within the Department of Health and Human Services to lead and foster public and private coordination of this initiative.

Since 2005, we have been reporting on the efforts of HHS and the National Coordinator's Office to develop and implement a national health IT strategy. Today, at your request, my testimony summarizes their efforts to complete key health IT-related activities based largely on our prior work.

Overall, HHS and the National Coordinator's office have been pursuing various initiatives in support of nationwide health IT. Among other actions, the Secretary formed the American Health Information Community in 2005 to help define the future direction of a national strategy and to advise the Department on developing interoperable health information exchange capabilities.

In this regard, initiatives have been undertaken in several areas, including advancing the certification and implementation of outpatient and inpatient electronic health records, identifying interoperability standards to be implemented in Federal health care programs, beginning trial implementations of a nationwide health information network to demonstrate real-time information exchange, and addressing health information, privacy, and security.

However, even though HHS has been pursing these important initiatives in an attempt to expand the nationwide implementation of health information technology, it has been doing so without a national strategy that integrates the outcomes of the various initiatives to help ensure that the President's goal is met. Given the many activities to be coordinated in an effort of this magnitude, such a national strategy is essential.

Thus, in May 2005, we recommended that HHS develop a strategy that includes the detailed plans, milestones, and performance measures needed to ensure that its goals are met and we reiterated this recommendation again in March and September 2006.

To his credit, the National Coordinator for Health IT has acknowledged that more detailed plans are needed to guide the various initiatives. And according to HHS's Fiscal Year 2009 performance plan, the Office has prepared a draft plan which it intends to release in the second quarter of 2008.

Overall, the National Coordinator's stated intent to act on such an approach is promising. However, Mr. Chairman, until HHS actually delivers an integrated national strategy, progress in pursuit of the President's goal for widespread adoption of interoperable electronic health records will be uncertain and the Department will be challenged to ensure that the outcomes of its various health IT initiatives will be successful.

This concludes my prepared statement. I would be pleased to respond to any questions that you may have.

[The prepared statement of Ms. Melvin follows:]

United States Government Accountability Office

GAO

Testimony

Before the Senate Committee on the Budget

For Release on Delivery
Expected at 10:00 a.m. EST
February 14, 2008

HEALTH INFORMATION TECHNOLOGY

HHS Is Pursuing Efforts to Advance Nationwide Implementation, but Has Not Yet Completed a National Strategy

Statement of Valerie C. Melvin, Director
Human Capital and Management
Information Systems Issues

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Highlights

Highlights of GAO-08-499T, a testimony before the Committee on the Budget, U.S. Senate

February 14, 2008

HEALTH INFORMATION TECHNOLOGY

HHS Is Pursuing Efforts to Advance Nationwide Implementation, but Has Not Yet Completed a National Strategy

Why GAO Did This Study

Health information technology (IT) offers promise for improving patient safety and reducing inefficiencies. Given its role in providing health care in the United States, the federal government has been urged to take a leadership role to improve the quality and effectiveness of health care, including the adoption of IT. In April 2004, President Bush called for widespread adoption of interoperable electronic health records within 10 years and issued an executive order that established the position of the National Coordinator for Health Information Technology within the Department of Health and Human Services (HHS). The National Coordinator, appointed in May 2004, released a framework for strategic action two months later. In late 2005, HHS also awarded several contracts to address key areas of health IT.

GAO has been reporting on the department's efforts toward nationwide implementation of health IT since 2005. In prior work, GAO recommended that HHS establish detailed plans and milestones for the development of a national health IT strategy and take steps to ensure that its plans are followed and milestones met. For this testimony, GAO was asked to describe HHS's efforts to advance the use of health IT. To do this, GAO reviewed prior reports and agency documents on the current status of relevant HHS activities.

To view the full product, including the scope and methodology, click on GAO-08-499T. For more information, contact Valerie Melvin at (202) 512-6304 or melvinv@gao.gov.

What GAO Found

HHS and the Office of the National Coordinator have been pursuing various activities in key areas associated with the President's goal for nationwide implementation of health IT. In 2005, the department established the American Health Information Community, a federal advisory committee, to help define the future direction of a national strategy for health IT and to make recommendations to the Secretary of Health and Human Services for implementing interoperable health IT. The community has made recommendations directed toward key areas of health IT, including the expansion of electronic health records, the identification of standards, the advancement of nationwide health information exchange, the protection of personal health information, and other related issues. The table shows recent HHS activities in these areas.

Key Areas of Nationwide Health IT Activities

Areas of health IT	Activities
Electronic health records	Defined initial certification criteria for outpatient and inpatient electronic health records and certified 100 products that offer electronic health records.
Standardization	Selected initial standards to address specific areas identified by the American Health Information Community; federal agencies that administer or sponsor federal health programs are to implement the standards, as required by President Bush's August 2006 Executive Order.
Networking and information exchange	Awarded contracts to nine regional and state health information exchanges to begin trial implementations of the Nationwide Health Information Network and to test their ability to work together and to demonstrate real-time information exchange.
Health information privacy and security	Reported the outcomes of a privacy and security solutions contract in a final summary report that described variations among organization-level business practices, policies, and laws for protecting health information that could affect organizations' abilities to exchange data. Developed and made available to the public a toolkit to guide health information exchange organizations in conducting assessments of business practices, policies, and state laws that govern the privacy and security of health information.

Source: GAO analysis of HHS data.

Even though HHS is undertaking these various activities, it has not yet developed a national strategy that defines plans, milestones, and performance measures for reaching the President's goal of interoperable electronic health records by 2014. In 2006, the National Coordinator for Health Information Technology agreed with GAO's recommendation that HHS define such a strategy; however, the department has not yet done so. Without an integrated national strategy, HHS will be challenged to ensure that the outcomes of its various health IT initiatives effectively support the President's goal for widespread adoption of interoperable electronic health records.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to comment on federal efforts to advance the use of information technology (IT) for health care delivery. As we and others have reported, the use of IT has great potential to help improve the quality of health care and is critical to improving the performance of the U.S. health care system.

Recognizing the potential value of IT in public and private health care systems, the federal government has, for several years, been working to promote the nationwide use of health IT.[1] In April 2004, President Bush called for widespread adoption of interoperable[2] electronic health records within 10 years and issued an executive order[3] that established the position of the National Coordinator for Health Information Technology within the Department of Health and Human Services (HHS). The National Coordinator's responsibilities include the development and implementation of a strategic plan to guide the nationwide implementation of interoperable health IT in both the public and private sectors.[4]

Since 2005, we have been reporting on the efforts of the Office of the National Coordinator to develop and implement a national health IT strategy. At your request, my testimony today will describe HHS's ongoing efforts to complete certain key health IT-related activities. We conducted our work in support of this testimony during February 2008. To prepare this statement, we reviewed our prior reports and analyzed agency documents on the current status of relevant HHS activities. All work on which this testimony is based

[1] Health IT is the use of technology to electronically collect, store, retrieve, and transfer clinical, administrative, and financial health information.

[2] Interoperable means that different information systems, software applications and networks are able to communicate and exchange information in an accurate, effective, useable, and consistent manner.

[3] Executive Order 13335, *Incentives for the Use of Health Information Technology and Establishing the Position of the National Health Information Technology Coordinator* (Washington, D.C.: Apr. 27, 2004).

[4] The Office of the National Coordinator for Health Information technology is under the Office of the Secretary.

was performed in accordance with generally accepted government auditing standards.

Results in Brief

HHS and the Office of the National Coordinator have been pursuing various actions in support of the President's goal for nationwide implementation of health IT. In 2005, the Secretary of Health and Human Services formed the American Health Information Community to help define the future direction of a national strategy for health IT and to make recommendations for key health IT areas, such as the advancement of electronic health records, the identification of health IT standards, the implementation of a nationwide health information exchange, and the protection of personal health information. As a result of these actions:

- The Office of the National Coordinator has taken steps to advance the implementation of both outpatient and inpatient electronic health records.
- The Secretary has recognized certain interoperability standards to be implemented in federal health care programs.
- The Office of the National Coordinator has begun trial implementations of a nationwide health information network at nine health information exchange organizations across the country.
- The Office of the National Coordinator has released a summary report and toolkit based on the results of its privacy and security solutions contractor's work.

However, HHS has not yet completed a national strategy for health IT that integrates the outcomes of these efforts and that includes key elements needed to ensure that its goals are met. Given the amount of work yet to be done and the complex task of integrating the outcomes of HHS's various initiatives, it is essential that a national strategy for health IT be defined that includes plans, milestones, and performance measures for ensuring progress toward the President's goals. Without such a strategy, it is difficult to effectively monitor progress toward achieving national goals for health IT.

Background

Studies published by the Institute of Medicine and others have indicated that fragmented, disorganized, and inaccessible clinical information adversely affects the quality of health care and compromises patient safety. In addition, long-standing problems with medical errors and inefficiencies increase costs for health care delivery in the United States. With health care spending in 2006 reaching almost $2.1 trillion, or 16 percent of the gross domestic product, concerns about the costs of health care continue, and many policy makers, industry experts, and medical practitioners contend that the U.S. health care system is in a crisis.[5]

Health IT offers promise for improving patient safety and reducing inefficiencies. The expanded use of health IT has great potential to improve the quality of care, bolster the preparedness of our public health infrastructure, and save money on administrative costs. For example, as we reported in 2003, a 1,951-bed teaching hospital reported that it had realized about $8.6 million in annual savings by replacing outpatient paper medical charts with electronic medical records. This hospital also reported saving more than $2.8 million annually by replacing its manual process for managing medical records with an electronic process to provide access to laboratory results and reports. Technologies such as electronic health records and bar coding of certain human drug and biological product labels have been shown to save money and reduce medical errors.[6] Health care organizations also reported that IT contributed other benefits, such as shorter hospital stays, faster communication of test results, improved management of chronic diseases, and improved accuracy

[5] GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005).

[6] GAO, *Information Technology: Benefits Realized for Selected Health Care Functions*, GAO-04-224 (Washington, D.C.: Oct. 31, 2003).

in capturing charges associated with diagnostic and procedure codes. However, according to HHS, only a small number of U.S. health care providers have fully adopted health IT due to significant financial, technical, cultural, and legal barriers, such as a lack of access to capital, a lack of data standards, and resistance from health care providers.

Federal Government's Role in Health Care

According to the Institute of Medicine, the federal government, as a regulator, purchaser, health care provider, and sponsor of research, education, and training, has a central role in shaping nearly all aspects of the health care industry. According to the Centers for Medicare and Medicaid Services, several federal health care programs, such as Medicare and Medicaid, spent almost $450 billion on health services in 2006, accounting for 23 percent of the nation's health care expenditures that year. Given the level of the federal government's participation in providing health care, it has been urged to take a leadership role in driving change to improve the quality and effectiveness of medical care in the United States, including an expanded adoption of IT.

In an effort to leverage the federal government's role in health care, the President called for the Secretary of Health and Human Services to appoint a National Coordinator for Health Information Technology. The Secretary appointed the first National Coordinator in May 2004.[7] Two months later, HHS released a framework document as the first step toward the development of a national strategy;[8] the framework described goals for achieving nationwide interoperability of health IT and actions to be taken by both the

[7] This position was vacated by the first national coordinator in May 2006. This position was filled by an interim coordinator until the Secretary appointed a new coordinator in April 2007.

[8] HHS, *The Decade of Health Information Technology: Delivering Consumer-centric and Information-rich Health Care—Framework for Strategic Action* (July 2004).

public and private sectors to implement a strategy for reaching these goals.[9]

In 2005, the Secretary formed the American Health Information Community, a federally chartered commission,[10] to advise the department on achieving its goals in this area: in particular, developing interoperable health information exchange through a future Nationwide Health Information Network and providing most Americans with access to secure electronic health records by 2014. The community is made up of representatives from both the public and private health care sectors. In 2005, it identified components of health care that could potentially achieve measurable results in two to three years, including electronic health records.[11] The community makes recommendations to the Secretary for advancing interoperability in these areas, along with recommendations directed toward the identification of health IT standards, the advancement of nationwide health information exchange, the protection of personal health information, and other related issues. Additionally, in furtherance of the federal government's initiative to achieve expanded health IT adoption, in August 2006 President Bush issued an executive order calling for federal health care programs and their providers, plans, and insurers to use IT interoperability standards recognized by HHS.[12]

From its establishment in 2004 through 2008, the Office of the National Coordinator has received about $200 million in funding to support new efforts to ensure the adoption of health IT nationwide through the development of data standards and the implementation of projects on priority areas identified by the American Health Information Community. For the first 2 years of its operation (fiscal years 2004 and 2005), funding was provided from departmental

[9] Interoperability is important because it allows patients' electronic health information to move with them from provider to provider, regardless of where the information originated.

[10] The Community was formed in September 2005.

[11] Other components are consumer empowerment, chronic care, and biosurveillance.

[12] *Executive Order: Promoting Quality and Efficient Health Care in Federal Government Administered or Sponsored Health Care Programs* (Washington, D.C.: Aug. 22, 2006).

discretionary funds allocated by the Secretary of Health and Human Services, and in fiscal year 2005 the office received $20 million. In fiscal year 2006, the department began submitting budget requests for the office. Table 1 shows the department's requested and actual budget for the office for fiscal years 2006 through 2008 and the amount requested for fiscal year 2009.

Table 1: Requested and Actual Budget for the Office of the National Coordinator (Fiscal Years 2006 through 2009)

(Dollars in millions)

Fiscal year 2006		Fiscal year 2007		Fiscal year 2008		Fiscal year 2009
Request	Actual	Request	Actual	Request	Actual	Request
$78	$61	$118	$61	$118	$61	$66

Source: HHS budget documents.

HHS's overall departmental budget request for health IT for fiscal year 2009 is almost $115 million for various new and continuing initiatives within multiple HHS divisions. Besides the $66 million for the initiatives of the Office of the National Coordinator, this amount includes

- $3.8 million to fund the second year of a project at the Centers for Medicare and Medicaid Services that provides financial incentives to physician practices to adopt certified electronic health record systems, and
- $45 million for the Agency for Healthcare Research and Quality to fund health IT investments aimed at enhancing patient safety.

The budget request also supports the continuation of an electronic health record system for all direct health care sites of the Indian Health Service.

Since the Office of the National Coordinator has been funded, congressional interest in the expansion of health IT has increased. According to the Healthcare Information Management Systems

Society,[13] 41 pieces of legislation related to health IT were introduced by the 109th Congress, and, so far, the 110th Congress has introduced about 12 bills, reports, and resolutions; subjects addressed include grants and financial assistance to help support the implementation of health IT, provisions for incentives to health care providers for IT implementation, standards for exchanging health information, and protection of privacy and security of electronic health information. Additionally, in his 2008 State of the Union address, President Bush called for the 110th Congress to expand the use of health IT.

Our Past Work Has Reviewed HHS's Efforts to Define a National Strategy and Expand the Implementation of Health IT

Since 2005, we have reported and testified on HHS's efforts to define a national strategy for achieving widespread implementation of health IT, including an approach for ensuring the protection of electronic personal health information. We reported that through the Office of the National Coordinator for Health IT, HHS has taken a number of actions to promote the acceleration of the use of IT in the health care industry.[14] For example, in late 2005 the National Coordinator's Office awarded several contracts to address a range of activities important for expanding the implementation of health IT; these activities include

- defining criteria and a process for certifying the interoperability of electronic health records to help increase the number of health care providers adopting electronic health records,
- defining health information standards needed to ensure the interoperability of electronic health records and health IT systems,

[13] The Healthcare Information Management Systems Society is the health care industry's membership organization exclusively focused on providing leadership for the optimal use of health IT and management systems to improve health care. Each year it maintains a list of health IT legislation introduced in Congress, including the status of the legislation.

[14] GAO, *Health Information Technology: HHS Is Taking Steps to Develop a National Strategy*, GAO-05-628 (Washington, D.C.: May 27, 2005); *Health Information Technology: HHS Is Continuing Efforts to Define a National Strategy*, GAO-06-346T (Washington, D.C.: Mar. 15, 2006); *Health Information Technology: HHS Is Continuing Efforts to Define its National Strategy*, GAO-06-1071T (Washington, D.C.: Sept. 1, 2006).

- defining requirements for exchanging health information throughout a nationwide health information network, and
- defining privacy and security policies to ensure the protection of electronic personal health information.

In our previous work, we reported that although HHS had made progress in these areas, it still lacked an overall implementation strategy, including the detailed plans, milestones, and performance measures needed to ensure that the outcomes of its efforts are integrated and that the President's goals for the implementation of nationwide health IT are met. In May 2005, we recommended that HHS establish detailed plans and milestones for the development of a national health IT strategy and take steps to ensure that its plans are followed and milestones are met. We reiterated this recommendation in March 2006 and again in September 2006.

We have also reported on HHS's efforts to ensure the privacy of personal health information exchanged within health information exchange networks.[15] According to our work, although HHS had initiated several activities to help ensure the protection of health information, it had not defined an overall approach for health information privacy or an implementation strategy that included key elements such as timelines and milestones for completing its privacy-related initiatives. We recommended that HHS define and implement an overall privacy approach that identifies milestones for integrating the outcomes of its initiatives, ensures that key privacy principles are fully addressed, and addresses challenges associated with the nationwide exchange of health information.

[15] GAO, *Health Information Technology: Early Efforts Initiated, but Comprehensive Privacy Approach Needed for National Strategy*, GAO-07-238 (Washington, D.C.: Jan. 10, 2007); *Health Information Technology: Early Efforts Initiated, but Comprehensive Privacy Approach Needed for National Strategy*, GAO-07-400T (Washington, D.C.: Feb. 1, 2007); *Health Information Technology: Efforts Continue, but Comprehensive Privacy Approach Needed for National Strategy*, GAO-07-988T (Washington, D.C.: June 19, 2007).

HHS Is Pursuing Efforts to Advance the Nationwide Implementation of Health IT, but It Has Not Yet Completed a National Strategy

HHS and the Office of the National Coordinator have been pursuing various efforts to implement health IT solutions. Among other activities, the department has been relying on recommendations of the American Health Information Community to assist the office's health IT initiatives in several key areas aimed at the expansion of electronic health records, identification of health IT standards, advancement of nationwide health information exchange, protection of personal health information, and other related issues. In this regard, HHS and the Office of the National Coordinator have taken actions in the areas of electronic health records, standardization, networking and information exchange, and health information privacy and security:

Electronic health records. To help expand the implementation of electronic health records, among other actions, HHS issued a contract for the Compliance Certification Process for Health IT. This contract, awarded to the Certification Commission for Health IT, is to define criteria and a certification process to ensure that various electronic health records products can be exchanged among different systems in health information exchange networks. In May 2006, HHS finalized a process and criteria for certifying the interoperability of outpatient electronic health records and described criteria for future certification requirements. Certification criteria for inpatient electronic health records were finalized in June 2007. To date, the Certification Commission has certified about 100 products offering electronic health records. The results of this effort are intended to help encourage health care providers to implement electronic health records by providing assurance that they will be able to use electronic records effectively and exchange them with other health IT systems.

Standardization. Through a contract for the Standards Harmonization Process for Health IT, HHS is promoting the implementation of standards required to enable the exchange of electronic health information in federal health care programs, as well as ensure the interoperability of electronic health records and

IT systems. Such standards are essential for the development of a nationwide health information network.

The contractor, in collaboration with the National Institute for Standards and Technology, selected initial standards to address specific areas identified by the American Health Information Community. These standards address, among other things, requirements for message and document formats, along with technical network requirements. According to the contractor, the Secretary announced the recognition of these standards in January 2008 after a year-long period of review and testing by healthcare providers, government agencies, consumers and other stakeholders. Federal agencies that administer or sponsor federal health programs are now required to implement these standards, in accordance with President Bush's August 2006 Executive Order.

Networking and information exchange. The Office of the National Coordinator has taken steps to enable health care entities—such as providers, hospitals, and clinical labs—to exchange electronic health information on a nationwide basis. HHS has awarded Nationwide Health Information Network contracts that were designed to provide prototypes of national networks of health information exchanges. These exchanges are intended to connect providers and patients from different regions of the country and enable the sharing of electronic health information, such as health records and laboratory results. Together, these connections are intended to form the "network of networks" that is envisioned to be the Nationwide Health Information Network.

According to HHS, in early 2007 its contractors delivered final prototypes that could form the foundation of a nationwide network for health information exchange. In October 2007, the Secretary of Health and Human Services announced the award of contracts totaling $22.3 million to nine regional and state health information exchanges to begin trial implementations of the Nationwide Health

Information Network.[16] At the end of the first contract year—September 2008—HHS intends for the nine organizations and the federal agencies that provide health care services to test their ability to work together and to demonstrate real-time information exchange based upon nationwide health information exchange specifications that they define. HHS plans to place these specifications and related testing materials in the public domain, so that they can be used by other health information exchange organizations to guide their efforts to adopt interoperable health IT.

Health information privacy and security. HHS has taken steps to further address privacy and security issues associated with the nationwide exchange of personal health information. In June 2007, HHS reported the outcomes of its privacy and security solutions contract based on the work of 34 states and territories that participated in the contract.[17] A final summary report described variations among organization-level business practices, policies, and laws for protecting health information that could affect organizations' abilities to exchange data. As a result of this work, HHS developed and made available to the public a toolkit to guide health information exchange organizations in conducting assessments of business practices, policies, and state laws that govern the privacy and security of health information exchange.

Additionally, in discussions with us in June 2007, the National Coordinator for Health IT agreed with the need for an overall approach to protect health information and stated that the department was initiating steps to address our recommendation that HHS define and implement an overall privacy approach. Such an approach should be part of a comprehensive national strategy for

[16] The nine health information exchanges are CareSpark, covering the Tricities region of Eastern Tennessee and Southwestern Virginia; Delaware Health Information Network, covering Delaware; Indiana University, covering the Indianapolis metroplex; Long Beach Network for Health, covering Long Beach and Los Angeles, California; Lovelace Clinic Foundation, covering New Mexico; MedVirginia, covering Central Virginia; New York eHealth Collaborative, covering New York; North Carolina Healthcare Information and Communications Alliance, Inc., covering North Carolina; and West Virginia Health Information Network, covering West Virginia.

[17] According to HHS, this project has now expanded to involve 45 states and territories.

health IT and should include milestones for integrating the outcomes of HHS's various privacy-related initiatives, ensure that key privacy principles are fully addressed, and address challenges associated with the nationwide exchange of health information. However, our recommendation for protecting health information has not yet been implemented.

Further, although HHS has initiated specific activities intended to meet the goals of its framework for strategic action, and it is continuing efforts to expand the nationwide implementation of health IT, it is undertaking these activities without a comprehensive national strategy that includes the detailed plans, milestones, and performance measures needed to ensure that the outcomes of its various initiatives are integrated and its goals are met. Given the many activities to be coordinated, such a national strategy is essential.

The National Coordinator acknowledged in March 2006 that more detailed plans were needed for the office's various initiatives and told us that HHS intended to release a strategic plan with detailed plans and milestones in late 2006. Nonetheless, today the office still lacks the detailed plans, milestones, and performance measures that are needed. According to its fiscal year 2009 performance plans, the Office of the National Coordinator has prepared a draft health IT strategic plan, which it intends to release in the second quarter of 2008. If properly developed and implemented, this strategy should help ensure that HHS's various health IT initiatives are integrated and effectively support the goal of widespread adoption of interoperable electronic health records.

In summary, Mr. Chairman, our work shows that the Office of the National Coordinator for Health Information Technology has been undertaking important work on specific activities supporting the goals of its framework for strategic action. However, HHS has not yet defined detailed plans and milestones for integrating the various initiatives, nor has it developed performance measures for tracking progress toward the President's goal for widespread adoption of interoperable electronic health records by 2014. To its credit, the office has taken steps to advance electronic health record adoption, identify interoperability standards, enable nationwide health information exchange, and protect personal health information. However, given the amount of work yet to be done and the complex task of integrating the outcomes of HHS's various initiatives, it is essential that a national strategy for health IT be defined that includes plans, milestones, and performance measures for ensuring progress toward the President's goals. Without such a strategy, it is difficult to gauge the amount of progress being made by HHS toward achieving widespread adoption of interoperable electronic health records by 2014.

Mr. Chairman, this concludes my statement. I would be pleased to answer any questions that you or other Members of the Committee may have.

Contacts and Acknowledgments

If you should have any questions about this statement, please contact me at (202) 512-6304 or by e-mail at melvinv@gao.gov. Other individuals who made key contributions to this statement are Barbara S. Collier, Amanda C. Gill, Nancy E. Glover, M. Saad Khan, and Teresa F. Tucker.

Chairman CONRAD. Thank you very much.

Now we will turn to Ms. Adams, Laura Adams, the President and CEO of the Rhode Island Quality Institute, who is here on the recommendation of our own Senator Whitehouse. Welcome.

STATEMENT OF LAURA ADAMS, PRESIDENT AND CEO, RHODE ISLAND QUALITY INSTITUTE

Ms. ADAMS. Thank you. Chairman Conrad and members of the Committee, thank you so much for this opportunity to appear before you today to testify on this issue of great importance to health care in our country.

My name is Laura Adams and I am the President and CEO of the Rhode Island Quality Institute, an organization founded 6 years ago by then Rhode Island Attorney General, now U.S. Senator, Sheldon Whitehouse. This multi-stakeholder organization comprised of hospitals, physicians, nurses, consumers, insurers, Government and employers has the singular mission of significantly improving quality, safety and value of health care in Rhode Island.

We are not-for-profit. We are beholden to no one but the people of the State of Rhode Island and to the Nation insofar as we develop models of innovation worth replicating.

My remarks today will reflect the perspective of our broad-based coalition working together to transform the health care system in the State.

The Quality Institute serves as Rhode Island's Regional Health Information Organization and we strongly believe in the value of health IT as an essential element in literally any viable proposal for the problems that plague our health care system. It is our goal to bring the delivery of health care out of the paper-based system which we recognize as a root cause of significant waste and harm.

But we are under no illusions. We fully recognize that health IT alone adds little to no value and if developed in isolation from other critical reforms is likely to be—to borrow a phrase from Don Berwick—the next festival of waste. We have a clear understanding that health IT undergirds virtually every major health care reform initiative being advanced today.

Whatever you support in terms of health care reforms, whether it's primary care's medical home model, emphasizing patient-centered primary care and prevention, consumer-driven health care, quality improvement and reduction of medical errors, pay for performance, population health and disease management, access for all, fraud and abuse detection, transparency and public reporting on quality and costs, none of these can succeed without a constant flow of reliable and timely clinical and administrative information, the kind that is only produced electronically.

Therefore, it would be a mistake to regard health IT as merely one good idea in a sea of good ideas for reform. Those that are pioneering efforts to promote adoption and full use of health IT deserve our attention and strong support as a Nation. So much is riding on the failure orR success of these grass roots initiatives.

I applaud the efforts of HHS, the Office of the National Coordinator on Health Information Technology, and especially the Agency for Healthcare Research and Quality, which has been particularly effective in grasping what is needed to prioritize and fund critically important initiatives in the field. However, our collective approach to funding and supporting these initiatives almost guarantees failure.

To illuminate the point, let us assume for a moment that our goal is to make toast. One idea advanced by bread producing vendors is to put bread in the toaster. Yet a credible scientific studies suggests that toast-making benefits from efforts to push the lever down to lower bread into the toaster. Another prominent industry group insists that plugging the toaster in is the key and everyone should work on getting electricity to the toaster.

Fund the testing of each of these ideas separately and we will conclude that there is simply no way to make toast or that reliable toast-making is still decades away. It is only when we combine all three of these in the same setting that we realize the potential.

Achieving the significant and sustained improvement we need in health care requires the testing of multiple concepts in the field simultaneously. We believe that health IT adoption, work on quality improvement and prevention, and reforming the toxic payment system must be tested in aggregate in what is an essential, yet virtually non-existent, research and development role for health care.

Efforts to test these concepts in real-world settings in which they must prove their worth are crippled by the necessity for local collaborators to cobble together funding and support, almost always with huge gaps for key elements necessary for informing the Nation of what truly works and what does not. As a result, we are learning at an achingly slow pace as a Nation.

We have some initiatives focused on implementing health IT, others advancing improvement projects, and a brave few testing the new payment structures, each struggling independently against the gale force winds of status quo. Yet after literally years and years of toil, we have come nowhere near what the architects of these initiatives have envisioned. We are testing these as isolated concepts and, not surprisingly, we are having difficulty making toast.

Rhode Island is no exception, even as some consider us as a candidate for most likely to succeed. For 6 years, we have had the CEO level leadership of every major health care stakeholder required to remake this system at the table and actively participating. We were the birthplace of SureScripts electronic prescribing system and currently ranked No. 2 nationally behind Massachusetts in e-prescribing. We are implementing a State-wide health information exchange with the help of a $5 million AHRQ contract which ignited our State's progress unlike anything else.

We have spawned unprecedented in the work of EMR adoption, an initiative co-led by our State government and our QIO. The Rhode Island organization is testing a medical home model that includes payment reform.

Our Governor championed the work that led to the Wellness Councils of America naming Rhode Island as the first well State in the Nation, as measured by the percentage of the work force employed in award-winning well workplaces.

We have every single ICU in every single hospital in the State participating in an improvement collaborative that has lowered deadly and costly central line infections by 47 percent in 18 months.

Our insurers, most notably BlueCross and BlueShield of Rhode Island, have stepped up, and so have our doctors, hospitals, and pharmacies, our consumer advocacy groups, our State government and, most certainly our Congressional delegation, all of whom are working nonstop to advance our work.

So yes, we are progressing but at a far slower pace than the crisis warrants. All of our initiatives are funded on a shoestring and depend heavily on the in-kind contributions of local participants and we are wearing them out. The funding sources are fragmented, each with their own set of deliverables and timelines which, while well-intentioned, can draw focus and energy away from critical business at hand.

We are respectfully urging Congress to place more trust and higher levels of aggregated resources in our organizations like the Rhode Island Quality Institute and a number of similar organizations across the Nation, many of whom would challenge us for the designation of most likely to succeed. We would like you to join us in our model of shared responsibility and contribution and then hold us accountable for the results, just as our other stakeholders do. We will deliver.

It is not a question of whether we can afford to spend the money to do this. We are already spending the money. The question is what we will buy with it. Unless we act, the money will be spent on more duplicate tests, avoidable hospitalizations, and the care required to mop up after the physical and emotional damage caused by medical errors and the consequences of uncoordinated care when we could be rapidly advancing toward a way out.

On behalf of my colleagues in Rhode Island and across the Nation, I would like to thank you for devoting your time and attention to exploring the value of health IT and its role in reform. We stand ready as an energized, committed, and capable partners in maximizing its worth for all of our citizens.

Thank you.

[The prepared statement of Ms. Adams follows:]

Senate Budget Committee Hearing: *Health Care and the Budget: Information Technology and Health Care Reform*

Testimony of Laura L. Adams, President and CEO, Rhode Island Quality Institute

February 14, 2008

Chairman Conrad and Members of the Committee, thank you for the opportunity to appear before you today to testify on this issue of great importance to the future of health care in this country.

My name is Laura Adams and I'm the President and CEO of the Rhode Island Quality Institute, an organization founded six years ago by then RI Attorney General, now US Senator, Sheldon Whitehouse. This multi-stakeholder organization, comprised of hospitals, physicians, nurses, consumers, insurers, government and employers has the singular mission of significantly improving the quality, safety and value of health care in RI. We're not-for-profit and beholden to no one but the people of the State of RI and, to the nation, in so far as we develop models of innovation worth replicating.

My remarks today will reflect the perspective of our broad-based coalition working together to transform the health care system in the state. The Quality Institute serves as Rhode Island's Regional Health Information Organization and we strongly believe in the value of health IT as an essential element in any viable proposal for addressing the problems that plague our health care system. It's our goal to bring the delivery of health care out of the paper-based system, which we recognize as a root cause of significant waste and harm.

But we're under no illusions. We fully recognize that health IT ***alone*** adds little to no value and if developed in isolation from other critical reform initiatives, is likely to be, to borrow a phrase from Don Berwick, the next festival of waste. But we have a clear understanding that health IT undergirds virtually every major health care reform initiative being advanced today.

Whatever you support in terms of health care reforms, whether it's Primary Care's Medical Home model emphasizing patient-centered primary care and prevention, consumer-driven health care, quality improvement and reduction of medical errors, pay-for-performance, population health and disease management, access for all, fraud and abuse detection, transparency and public reporting on quality and costs—none of these can succeed without a constant flow of reliable and timely clinical and administrative information—the kind that is only produced electronically. Therefore, it would be a mistake to regard health IT as merely one idea in a sea of good ideas for reform.

Those that are pioneering efforts to promote adoption and full use of health IT deserve our attention and strong support as a nation. So much is riding on their success or failure of grassroots initiatives. I applaud the efforts of HHS, the Office of the National Coordinator for Health Information Technology and especially the Agency for Health Care Research and Quality, which has been particularly effective in grasping what's needed to prioritize and fund critically important initiatives in the field. However, our collective approach to funding and supporting these initiatives almost guarantees failure.

To illuminate the point, let's assume for a moment that our goal is to make toast. One idea advanced by bread producing vendors is to put bread in the toaster. Yet credible scientific study suggests that toast-making benefits from efforts to push the lever down to lower the bread into the toaster. Another prominent industry group insists that plugging in the toaster is the key and everyone should work on getting electricity to the toaster. Fund the testing of each of these ideas separately and we'll conclude that there is simply no way to make toast or that reliable toast-making is still decades away. It's only when we combine all three in the same setting that we realize the potential.

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Efforts to test these concepts in real-world settings in which they must prove their worth are crippled by the necessity for local collaborators to cobble together funding and support, almost always with huge gaps for key elements necessary for informing the nation of what truly works and what doesn't. As a result we're learning at an achingly slow pace as a nation. We have some initiatives focused on implementing health IT, others advancing improvement projects and a brave few testing new payment structures—each struggling independently against the gale-force winds of the status-quo. Yet after literally years and years of toil, we have come nowhere near what the architects of these initiatives had envisioned. We're testing these as isolated concepts and not surprisingly, we're having trouble making toast.

Rhode Island is no exception--even as some consider us a candidate for "most likely to succeed". For six years, we've have the CEO-level leadership of every major health care stakeholder required to remake this system at the table and actively participating. We were the birthplace of SureScripts' e-prescribing system and currently rank #2 nationally behind Massachusetts in e-prescribing. We're implementing a statewide health information exchange with the help of a $5 million dollar AHRQ contract, which ignited our state's progress unlike anything else. We've spawned unprecedented collaboration in the work of EMR adoption. In an initiative co-led by our state government and our QIO, Rhode Island is testing a Medical Home model that includes payment reform.

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So yes, we're progressing, but at a far slower pace than the crisis warrants. All of our initiatives are funded on a shoestring and depend heavily on the in-kind contributions of the local participants—and we're wearing them out. The funding sources are fragmented, each with their own set of deliverables and timelines which, while well intentioned, can draw focus and energy away from the critical business at hand.

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It isn't a question of whether we can afford to spend the money to do this. We're already spending the money --the question is what we want to buy with it. Unless we act, the money will be spent on more duplicate tests, avoidable hospitalizations, the care required to mop up after the physical and emotional damage caused by medical errors and the consequences of uncoordinated care when we could be rapidly advancing toward a way out.

On behalf of my colleagues in Rhode Island and across the nation, I'd like to thank you for devoting your time and attention to exploring the value of health IT and its role in reform. We stand ready as energized, committed and capable partners in maximizing its worth for all of our citizens.

Chairman CONRAD. Thank you.

And now, Ms. Grealy, the President of the Healthcare Leadership Council. Welcome. Good to have you here as well.

STATEMENT OF MARY GREALY, PRESIDENT, HEALTHCARE LEADERSHIP COUNCIL

Ms. GREALY. Good morning, Chairman Conrad, Senator Gregg, members of the Committee. I want to thank you very much for this opportunity to testify on a subject that is so critical to the future of American health care.

For the members of the Healthcare Leadership Council, the issues being discussed today are neither abstract nor theoretical. The hospitals, health plans, pharmaceutical companies, medical device manufacturers, health product distributors, retail pharmacies and the other sectors that make up the HLC membership are among the early adopters of health information technology. They are witnessing firsthand what health information technology can mean for patients and for the effectiveness of our health care system as a whole.

The experiences of these companies and organizations form the impetus for the three points I would like to make this morning, points that are discussed in much greater detail in my full written statement.

First, the closer we get to nationwide information connectivity between health care providers, the more we will improve both the quality and the efficiency of patient care. We are not saying that health information technology in and of itself is health care reform. What we are saying is that you cannot have optimal health care reform without the expansion of health information technology.

The benefits of an interoperable information network, of having an electronic health record for every patient, are almost too numerous to mention. We know we can significantly reduce the medication errors that cost the health care system $76 billion each year. We can have a dramatic impact on the overutilization and misutilization of health care services. We can improve the ability of health care professionals to make informed decisions by placing critical data at their fingertips in real time.

We can also make it possible for physicians to have ready access to the most current practice guidelines and achieve the full promise of evidence-based medicine while eliminating things like geographic disparities in care.

We can take bold steps forward in making the concept of personalized health care through the use of genomic information a true reality.

Mr. Chairman, the future is exciting and it is already happening, as exemplified by the specific HIT achievements of Healthcare Leadership Council member organizations detailed in my written statement.

But that leads me to my second point, having to do with the obstacles standing between our status quo and this achievable future. Today, according to a RAND study, at best 25 percent of hospitals and 20 percent of physician offices in this country have transitioned from paper to electronic medical records. The primary reason for the slow evolution is not a mystery. At a time when health provider budgets feel the pressure from uncompensated care, disaster preparedness, staffing shortages, medical liability costs, and other factors, many hospitals—particularly smaller community and rural hospitals—do not have the capital to make HIT infrastructure investments.

We are not calling on Congress or the administration to write a blank check to overcome this obstacle, particularly in these challenging fiscal times. But we know that there are creative options that should be discussed such as revolving low-interest loan funds, matching grants, reimbursement incentives that are based on improved patient outcomes, and exceptions to the physician self-referral and anti-kickback rules that are preventing some hospitals from sharing their HIT investment with physicians.

The fact is that the benefits of HIT should be available to every American patient and health care consumer. And that requires that every health care provider have the ability to be part of a nationwide information network.

My final point, Mr. Chairman, goes to the issue of standards for such a network. Developing a multistate interoperable system depends on national technical standards, as well as national uniform standards for confidentiality and security. We have some work to do in this regard.

With the existing HIPAA privacy rules, they do provide effective patient privacy protections but they currently stand alongside volumes of sometimes conflicting State laws, rules and guidelines. This is problematic as we try to ensure that a patient's health records can follow them wherever they go in our increasingly mobile society. We believe that Congressional action to establish a uniform privacy standard is vital in order to achieve this national health information network.

Mr. Chairman, members of the Committee, over the last 2 years, Congress has taken some very important steps and moved in a welcome bipartisan manner to achieve progress on this important issue of health information technology adoption. We believe that this momentum must continue if we are to realize health information technology's full potential in improving health care quality, lowering costs, and generating greater value and efficiency.

Again, thank you for this opportunity and I will be pleased to answer any questions.

[The prepared statement of Ms. Grealy follows:]

HEALTHCARE
LEADERSHIP
COUNCIL

Testimony of
Mary R. Grealy
President
Healthcare Leadership Council

Hearing on
Healthcare and the Budget:
Information Technology and Health Care Reform

United States Senate
Committee on the Budget

Thursday, February 14, 2008
10:00 a.m.
608 Dirksen Building

Testimony of Mary R. Grealy, President, Healthcare Leadership Council at Senate Budget Committee Hearing on Healthcare and the Budget: Information Technology and Health Care Reform

Chairman Conrad, Ranking Member Gregg and Members of the Committee, I want to thank you on behalf of the members of the Healthcare Leadership Council (HLC) for the opportunity to testify on health information technology and its role in health care reform.

My name is Mary Grealy and I am president of the Healthcare Leadership Council (HLC), a not-for-profit membership organization comprised of executives of the nation's leading health care companies and organizations. Fostering innovation and constantly improving the affordability and quality of American health care are the goals uniting HLC members.

HLC supports rapid adoption of healthcare information technology (HIT) to improve quality of care, reduce medical errors, and lower health care costs. Members of HLC – hospitals, health plans, pharmaceutical companies, medical device manufacturers, biotech firms, health product distributors, pharmacies and academic medical centers – have seen firsthand what widespread adoption of HIT can mean to patients and health care providers.

Several HLC member organizations have been among the pioneers of health information technology. The collective experiences and achievements of these early adopters leads us to believe that HIT has the capability to transform our health care system by providing increased efficiencies in delivering health care; contributing to greater patient safety and better patient care; and achieving clinical and business process improvements.

The important task before us is to make sure that the promise of electronic medical records and interoperable HIT is available to all patients in the United States. We believe that Congress can significantly reduce or eliminate barriers to HIT adoption and that, in the interest of patients' well-being and greater cost-efficiency throughout American health care, it is important that Congress *act this year* to address this issue.

In my testimony I will discuss the ways in which HIT brings greater quality and value to our health care system. I've included as part of my written statement an attachment (see Attachment 1) that describes how various HLC member companies and organizations have already achieved significant success utilizing information technology. I will then outline the need for Congressional action to remove barriers to nationwide adoption of HIT by creating funding mechanisms to assist health care providers with the sizable IT infrastructure investments that are necessary if they – and their patients – are to be part of this technological revolution. Lastly, I will address the need for Congress to oversee the development of national, uniform standards to facilitate an interoperable health information network.

The Benefits of HIT

HLC believes that the establishment of nationwide health information connectivity between health care providers will dramatically improve both the quality and effectiveness of care. That is not to say that we believe HIT is the single "silver bullet" that will address all of the health care challenges we face. We believe, though, that combined with comprehensive health system reform, HIT is a critical component in lowering health care costs over the long-term and providing safe, effective, efficient and equitable patient care.

One of the ways that HIT would lower costs and increase quality is by reducing or eliminating duplicative medical care and overutilization. William Yasnoff, former Senior Advisor on the National Health Information Infrastructure for the U.S. Department of Health and Human Services (DHHS), posits that 20 percent of all laboratory tests and radiology studies are redundant, performed because the results of previous tests are not available at the point of care. DHHS estimates that nationally, savings could reach more than $400 billion through the implementation of a national health information network.

Three studies at the Regenstrief Institute also illustrated this point by providing additional information to physicians in the process of ordering diagnostic tests. Physicians were provided with the costs of diagnostic tests, statistical models regarding the likelihood of abnormal test results, and patients' past diagnostic tests and results. In all three cases, the electronic health record (EHR)-based intervention decreased the number of diagnostic tests ordered by physicians. This suggests that HIT is an effective tool for decreasing the costly overuse of health care services.

Perhaps the greatest benefit of HIT is its potential to reduce medical errors. As is the case in other industries, technology in medicine will help to prevent the incidence of human error. A recent article in *USA Today* notes that pharmacy chains say they have spent billions of dollars on safety technology and other improvements that have cut their prescription-error rates to a fraction of one percent. The article also notes an Auburn University study showing that as Americans age, the projected odds of getting a prescription that results in a serious, health-threatening error is about 1 in 1,000. That could amount to 3.7 million such errors a year, based on 2006 national prescription volume. (*USA Today*. "Five-year-old Took Wrong Medication for Two Months." Brady, E. and McCoy, K., 2/12/08)

The Department of Health and Human Services projects that medication errors alone cost the healthcare system $76 billion per year (Yasnoff). For example, the most common error in the medication use history occurs when a patient or other caregiver omits reporting a medication that is taken at home; a computerized physician order entry system cannot detect such an error without linkage to a community pharmacy database. This points to the need for a unified

EHR to serve as a single source of clinical information so that a complete record of medications a patient is currently taking is available to providers and the patient's pharmacist.

By having patient data, including laboratory and radiographic results, instantly available to the patient and any provider of the patient's choice via an interconnected network, HIT improves the ability of health care professionals and patients to make more informed decisions and avoid providing duplicative and redundant services. Furthermore, reconciliation of medications will decrease the likelihood of omission errors when medications are not carried over in a unified EHR. Thus, errors of omission and commission can be prevented; both resulting in savings and, even more importantly, enhanced patient safety.

HLC member companies have already demonstrated that medical errors can be reduced by deploying proven technologies, including bedside bar-coded medication administration systems, widespread e-prescribing, and secure online, "anytime, anywhere" access for physicians to critical patient medication information.

Additionally, HIT tools such as Clinical Decision Support, which help providers gain use the most current practice guidelines during patient encounters, and better post-marketing surveillance, such as the initiative created by the FDA Amendment Act of 2007, will do even more to increase patient safety and create better health outcomes.

HIT also greatly improves coordination of care for patients by allowing providers to work as a virtual team, even when stationed in various venues. Numerous studies support this conclusion.

For example, innovative organizations are utilizing HIT to provide patients, who are diagnosed with serious conditions, with second opinions from health care providers who operate within specified system protocols. Following a thorough review of patients' medical records and diagnostic tests, physician specialists can render a second medical opinion that includes treatment options or alternatives, as well as recommendations regarding future therapeutic considerations. All of this can be coordinated through a registered nurse who stays in personal contact with the patient throughout the process.

HIT may also help to accelerate the promise of personalized healthcare through use of genomic information to improve healthcare by transforming clinical practice and reducing health disparities. There is also vast potential for HIT and genomic information to aid clinical research organizations in improving the way diseases are diagnosed and treated by advancing research and development of innovative therapeutics. Clinical data collected from electronic health records (EHRs) can help speed delivery of novel products to market and monitor their efficacy and continual safety.

HIT is also an important tool to assist in the implementation of other proposals to lower health costs and increase health quality. Pressure is mounting for reform of current payment policy to encourage quality improvement, transparency and efficiency. Consequently, there is a growing need to measure the efficacy and efficiency of health care delivery. HLC believes the health care delivery system needs rapid adoption of HIT interoperability standards that not only facilitate the clinical management of an individual patient but that also support the ready aggregation of data for quality and safety measurement and reporting. In short, HIT will help to ensure that patients are getting the right care at the right time in the most appropriate setting.

There is growing interest in comparative effectiveness research and evidence-based medicine to assist providers in evaluating the best care for patients. Chronic disease management to manage high-cost illnesses such as asthma, congestive heart failure, and diabetes is another potential cost saver. These important initiatives, with untold possibility to improve patient outcomes and produce greater efficiencies, are much more easily facilitated by an automated health care system.

Federal Funding to Spur Adoption of HIT

Given the benefits of HIT to the health care system, HLC believes that it is critical that Congress and the Administration invest funds to encourage the widespread implementation of health information technology. HLC also recognizes that any source of funding must be fiscally responsible and sustainable and we, therefore, would support a variety of possible mechanisms to do so.

Though some providers have begun the transition to electronic medical records (EMR), most medical records are still stored on paper. The U.S. lags behind many other countries in its use of standardized EMRs. Only 15 to 20 percent of U.S. physician offices and 20 to 25 percent of hospitals have adopted some version of an EMR system, and the majority of these systems can't effectively interconnect through networks to coordinate care with other health care providers. (RAND)

HLC's interest in this issue is long-standing. In the summer of 2003, HLC established a Technical Advisory Board, comprised of clinicians and others with information technology expertise within HLC's member companies and organizations, to provide insights regarding their HIT implementation experiences.

Attached to this statement is a copy of the consensus recommendations that resulted from this effort (see Attachment 2). The paper attempted to quantify key benefits of HIT along with existing barriers to HIT implementation. The paper concluded that the following components are central to achieving effective HIT expansion:

- Financial incentives and funding mechanisms;
- Standards to assure interoperability;
- Liability protections to facilitate sharing of safety and quality data; and
- Stakeholder collaboration on best practices.

The lack of funding or adequate resources – combined with the high costs of HIT systems – was repeatedly cited in our member study as barriers to effective implementation of HIT systems. There are significant front-end and ongoing maintenance and operational costs for HIT, including software, hardware, training, upgrades, and maintenance. Systems are virtually unaffordable for those providers who do not have ready access to the operating capital needed for such an investment.

In an age in which health care providers must deal with rising costs associated with uncompensated care, medical liability rates, public health disaster preparedness and addressing staffing shortages, it is a simple fact that many providers do not have the financial wherewithal to invest in these new systems. This reality is especially prevalent among rural providers, who are most likely to need help overcoming the financial and workforce-based barriers to connecting their practices to a nationwide system. Our larger health system members have made it clear that although many of them have adopted HIT systems, they want to make sure that smaller community providers have ample capital, namely time and money, to do the same.

HLC believes that the federal government should provide impetus to the nation's implementation of HIT through financial incentives and funding mechanisms to help providers defray the huge costs of acquiring and operating HIT. Rapid implementation of interoperable HIT is also a critical component in achieving nationwide emergency preparedness.

While the Agency for Healthcare Research and Quality (AHRQ) and Office of the National Coordinator for Health Information Technology (ONCHIT) contracts and grants will support the development of a national information network and interoperability standards, we need to do more to get every provider using electronic health records now.

HLC advocates the implementation of multiple HIT funding mechanisms. We, of course, recognize that current fiscal deficits and budget constraints limit the ability of Congress to directly fund any expansive new program or initiative. There are creative options, however, that can help us achieve our health care goals without undermining the nation's fiscal future. Financing mechanisms could include: payment "rewards" or "add-ons;" a revolving low-interest loan fund with debt forgiveness in accordance with specified criteria such as savings to the

Medicare trust fund; tax incentives; reimbursement incentives based on improved patient outcomes; matching private funds with public funds through grants from the Department of Health and Human Services; and exceptions to the physician self-referral (Stark) and anti-kickback rules to allow hospitals to share their HIT investment with physicians. We look forward to working with the Committee to determine how Congress might best be able to assist providers in this regard.

National Standards to Insure Interoperability

In the area of standards, several public and private sector initiatives are making great strides in identifying or developing health information interoperability standards that will enable disparate systems to "speak the same language." And the work of the Certification Commission for Health Information Technology will complement these efforts by certifying that products are compliant with criteria for functionality, interoperability and security. This will help reduce provider investment risks and improve user satisfaction.

HLC believes, first and foremost, that in setting national standards to ensure interoperability, we must protect freedom for innovation. We firmly believe that the private sector should work collectively to develop a roadmap for effective health information exchange that specifies the priorities and the standards necessary to make such an exchange possible. Such standards will foster smooth and efficient communications and cooperation, regardless of individual system structure or architecture. Among other things, this work should address the increasing need for data, connectivity, interface, and communications standards. The health care industry also needs standards for commonly accepted clinical definitions, vocabulary, and terminology. Currently, a great deal of data goes into systems, but little automatically comes out in a way that readily supports health care providers and researchers.

However, HLC also believes there is an important and necessary role for the federal government in facilitating the effective expansion of health information technology. One of these areas is the standard for patient confidentiality and security.

Developing a multi-state, interoperable system depends on national technical standards as well as national uniform standards for confidentiality and security. We have some significant challenges ahead of us in this regard.

While the current Health Insurance Portability and Accountability Act (HIPAA) privacy and security rules provide effective protections, a multi-state data network requires the creation of a national patient privacy standard to replace differing and sometimes conflicting state laws, rules, and guidelines. Such a standard must protect patient confidentiality without imposing unnecessary and harmful restrictions that would impede the essential flow of patient information to health care professionals and medical researchers.

We believe congressional action to establish a uniform federal privacy standard is vital in order to ensure the viability of a national health information network.

Because the HIPAA Privacy Rule's preemption standard permits significant state variation, providers, clearinghouses and health plans are required to comply with the federal law as well as many state privacy restrictions that differ to some degree from the federal HIPAA Privacy Rule.

State health privacy protections vary widely and are found in thousands of statutes, regulations, common law principles and advisories. Health information privacy protections can be found in a state's health code as well as its laws and regulations governing criminal procedure, social welfare, domestic relations, evidence, public health, revenue and taxation, human resources, consumer affairs, probate and many others. Virtually no state requirement is identical to the federal rule.

In June of 2007, the Research Triangle Institute (RTI), under a contract with the AHRQ, issued its final findings on its project to identify state privacy laws and practices and determine whether they pose barriers to health information exchange. The report concludes that *variation in the interpretation and application of HIPAA poses a problem for health information exchange (HIE)*, along with varying levels of trust for security, and many other varied regulatory and business practice issues.

HLC is not alone in calling for action in this area. The eleven-member Commission on Systemic Interoperability, authorized by the Medicare Prescription Drug, Modernization, and Improvement Act to develop recommendations on HIT implementation and adoption, recommended that Congress authorize the Secretary of HHS to develop a uniform federal health information privacy standard for the nation, based on HIPAA and preempting state privacy laws, in order to enable data interoperability throughout the country.

Addressing this issue appropriately will be essential to achieving the interoperability necessary to improve the quality and cost effectiveness of the health care system – while still assuring patients' confidence that their information will be kept private.

To further underscore the importance of this issue to HIT development, attached is a map developed by the Indiana Network for Patient Care (see Attachment 3). Each dot represents a patient seen at an Indianapolis hospital during a six month period. While the dots are stacked very deep around Indianapolis as you would expect, patients served by the Indiana health providers during this period were also located in 48 of the 50 states. Today's health care providers, meeting the needs of a mobile society, serve patients from multiple and far-flung jurisdictions. Looking at this map, it is easy to see why regional agreements will not be adequate to address the myriad regulations with which providers and others will need to comply to achieve "interoperability."

Conclusion

In looking at the original recommendations that HLC developed and issued in 2004, it is clear that there has been significant progress since that time.

HLC commends Congress on the enactment of the "Patient Safety and Quality Improvement Act," in June of 2005. We advocated for this legislation as an important step toward fostering a culture of safety – through liability protections to allow voluntary information-sharing and reporting.

Legislation to facilitate greater adoption of HIT enjoys bipartisan support and continues to gain momentum. Senate action in 2007, along with continued support for HIT initiatives, suggests that 2008 will be an important year for progress on this issue.

In conclusion, we believe that legislation to facilitate the adoption of HIT offers Congress a clear opportunity to improve health quality and lower health costs. Such legislation should especially focus on areas in which Congress and the President *must act* to remove barriers and facilitate successful implementation of HIT. Therefore, legislation should accelerate the adoption of HIT and interoperable EHRs by providing funding to assist providers who need it in adopting HIT and ensuring uniform standards including privacy and security standards.

HIT expansion alone will not enable us to close the gap between the health care system we have today and the one we are capable of achieving. As this committee knows very well, we need reforms that will enable us to deliver greater quality and value to patients and health care consumers. We need to make health coverage more accessible. We need to link health care spending with quality of outcomes, not simply volume of services. We need a greater focus on wellness and chronic disease management.

But, there is no denying that health information technology is a vital, critical component in the future of American health care. The United States is already known for its medical innovations, the development of new cures, practices, treatments and devices that improve and lengthen lives. Taking the right and essential steps on HIT will enable us to be known for the technological innovations that will make health care more efficient and more effective in improving the health care of every man, woman and child in this country.

The Healthcare Leadership Council appreciates the opportunity to testify on the development of health care information technology. Any questions about my testimony or these issues can be addressed to me or to Ms. Tina Grande, Senior Vice President for Policy, Healthcare Leadership Council (telephone 202-452-8700, e-mail tgrande@hlc.org).

Attachment 1 – Examples of HLC Member Organizations' Successes with Health Information Technology

Aetna is one of the nation's leaders in health care, dental, pharmacy, group life, and disability insurance, and employee benefits. They are one of the nation's leading diversified health care benefits companies, serving approximately 35.9 million people with information and resources to help them make better informed decisions about their health care.

Aetna's CareEngine®-powered personal health record (PHR) helps over 4.4 million members manage and organize their health data so that they can work with their providers to make informed decisions. Aetna will make this tool available to seven million additional members by the end of 2008. Aetna has also partnered with RxHub and the National e-Prescribing Patient Safety Initiative (NEPSI) to improve physician access to decision-support information and e-prescribing technology.

Aetna was also the first health insurer and one of the first employers to sign the statement of support for the Department of Health and Human Services' "Four Cornerstones of Value-Driven Health Care," which calls for the development and use of HIT, as well as tools that provide quality and pricing information to consumers. To that end, Aetna has developed an innovative price and clinical quality transparency program to provide members with doctor and facility specific information.

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Amerinet is a group purchasing organization that promotes quality health care delivery and helps all types of providers more effectively manage expenses. They specialize in solutions related to technology, clinical operations, data management, executive-level decisions, and supply chain management.

An Amerinet member, the Virginia Mason (VM) Medical Center, is a private, non-profit organization that offers a system of integrated health services made possible through its large, multispecialty group practice of more than 480 physicians. Virginia Mason has been testing telemedicine services in rural areas throughout Washington state and Alaska for over ten years, including a live, interactive video feed between VM and other remote clinics in the Pacific

Northwest. This capability allows them to provide real-time information and store-and-forward communications related to a variety of medical fields, including radiology, dermatology, cardiology, and others, to a region that has been identified as lacking a sufficient health professional work force. VM is able to use this service to transmit radiological studies, consult on diagnosis and referral, and conduct pre- and post-surgical examinations.

* * *

Ascension Health is the nation's largest Catholic and largest nonprofit health system, serving patients through a network of hospitals and related health facilities providing acute care services, long-term care, community health services, psychiatric, rehabilitation and residential care.

Spearheaded by Ascension Health, the Austin, Texas-based, Indigent Care Collaboration (ICC) has demonstrated the effectiveness of HIT in improving health care for the uninsured and underinsured. Drawing from funding through federal and foundation grants, this community collaborative built I-Care, an integrating information structure providing for a shared patient record. This HIT system enables the area safety net providers, including hospitals and outpatient clinics and health centers, to obtain on a real-time basis a record for each patient's previous health care encounter. It also permits the ICC to map patients and diagnoses for health care planning and research; document, monitor, and manage diseases in the population, and measures the effects of policy changes on populations in the local region. In addition to improving the health and lives of vulnerable patients, ICC has become a self-sustaining business model upon which other communities can draw for expertise and inspiration.

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BlueCross BlueShield of Tennessee is an independent, not-for-profit, locally governed health plan company that provides health insurance benefits to Tennessee business customers and plan members.

SharedHealth, an independent subsidiary of BlueCross BlueShield of Tennessee, is the largest public-private electronic health information exchange in the United States and has made TennCare the only Medicaid program in the country to convert all its beneficiaries to an electronic health record application at the point of care.

By replacing paper-based systems with advanced technologies, TennCare effectively links authorized clinicians and patients with secure, up-to-date information at the point of care via an encrypted web-based system, including previous medical visits, service utilization, lab results, medications, allergies, and immunizations. The system also allows physicians to e-prescribe and will soon have additional functionality related to chronic care management.

Recent third-party studies have indicated that consistent utilization of SharedHealth increases clinician efficiency by 17%, resulting in savings of approximately $59 per episode of care and $9 per medication prescribed electronically.

* * *

Hospira is a global specialty pharmaceutical and medication delivery company dedicated to Advancing Wellness™ by developing, manufacturing and marketing products that help improve the productivity, safety and efficacy of patient care. To meet the needs of hospitals working to minimize errors, adhere to the best clinical practices, maintain continuity of care standards and fully utilize infusion devices, Hospira developed Hospira MedNet Software. Hospira MedNet Software is a server-based suite of applications designed to connect data from a hospital's drug information library to infusion devices throughout the hospital to monitor, control and provide reports at the device, group or system-wide levels.

The adoption by hospitals of "smart pumps," infusion pumps with safety software, helps to prevent medication errors at the patient's bedside. The system helps hospitals define medication dose limits and track intravenous drug delivery to help prevent errors. It involves hospital pharmacists with the rest of the hospital team to develop and program best-practice dose recommendations for the infusion of drugs into a database that can then be transferred to the pump. HLC members, **Cardinal Health** and **Baxter International**, also manufacture similar devices.

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The **Marshfield Clinic** is one of the largest private, multispecialty group practices in the United States today and includes over 750 physicians in 84 medical specialties and subspecialties located in over 40 centers throughout northern, central and western Wisconsin. Although Marshfield Clinic has become synonymous with the city of Marshfield, Wisconsin, the Clinic's "community" goes well beyond the immediate area, embracing nearly all of Wisconsin and much of Michigan's Upper Peninsula. Patients from every state in the nation and 25 foreign countries were seen in the Clinic system during fiscal year 2006.

As part of its participation in the three-year CMS Physician Group Practice (PGP) Demonstration, Marshfield Clinic has relied on substantial investments made in tools such as their long-established telemedicine initiative and an EHR. Using the data in the EHR at the point of care ultimately allowed clinicians to deliver higher quality care at a more efficient rate. CMS recently announced that Marshfield was successful over the first-year of the project in improving quality of care while controlling costs to Medicare.

Marshfield Clinic has been pioneering integrated computer technology for patient care for nearly 20 years. The Clinic is chartless as of 2007. Wireless tablet computers allow access to EMRs and prescription writing through an advanced electronic prescribing program called Medications Manager. Marshfield also employs an application called iList that allows providers to quickly identify and reach out to patients that have one of three chronic illnesses – diabetes, heart failure, or hypertension – yet do not meet all of their recommended health goals.

* * *

Mayo Clinic is a non-profit medical practice dedicated to the diagnosis and treatment of virtually every type of complex illness. Mayo provides clinic and hospital services at its locations in Rochester, MN; Jacksonville, FL; and Phoenix and Scottsdale, AZ.

The Automation of the Clinical Practice (ACP) at Mayo Clinic in Jacksonville, Florida is a project undertaken in 1993 to encompass the computer-based patient record with the addition of the mechanisms for automated charging and order creation by physicians. This vision was crystallized and communicated as the "paperless" practice of medicine that would increase patient safety and improve physician effectiveness while at the same time driving down expenses. The last paper-based record was circulated in January 1996 and the integrated outpatient practice continues to the present day.

The Automated Clinical Practice program involves all clinical users. The areas that are automated now include most aspects of the practice and examples include:

- An electronic medical record (EMR) including all clinical documents, orders, scheduling, and laboratory.
- A fully electronic filmless radiology department with speech recognition for radiologist documentation.
- An automated Intensive Care Unit with EMR integration and bedside medical device interfaces directly to the EMR.
- Inpatient and outpatient surgery areas consisting of surgical scheduling, material management, and nursing documentation.

From this level of automation patient safety initiatives have been possible. For example:

- Orders automatically generate task lists for nursing, respiratory, etc., in the hospital.
- Automated fall risk assessment and Braden skin scale assessment are generated in the hospital.
- A medical data warehouse allows free text searching against the entire repository of millions of documents in the EMR for patient care and research.
- An infectious disease application allows bioterrorism surveillance and automated infection control monitoring.

Dictating notes shifted work from the physician and improved both legibility and medical record turnaround time. The system allowed for real time availability of clinical information (notes, Lab, X-ray, and other results), automatic checking for duplicate redundant orders, simultaneous access to the same patient chart, improved ability to answer ad hoc questions for patient calls, more timely response from physicians when patients have questions, and improved flow of information to the physician enabling him or her to have a more "complete" picture of what is known about the patient's condition at the time of the appointment. Savings to the organization have been significant.

* * *

McKesson and their subsidiary, McKesson Provider Technologies, deliver vital pharmaceuticals, medical supplies, and HIT solutions that touch the lives of more than 100 million patients each day. McKesson is the world's largest healthcare services company and a leader in wholesale delivery of medicines and healthcare products.

Customers of McKesson Provider Technologies, a leader in the distribution and deployment of HIT solutions, have demonstrated the benefits of implementing HIT firsthand. One hospital that introduced bedside bar-code scanning of medications reduced its already-low medication error rate by 80 percent and sustained that rate for over ten years. Additionally, a clinic in the process of deploying an ambulatory EHR and e-prescribing system reduced nurse time spent on charts by 24 percent and increased time spent with patients by 16 percent. Similarly, transitioning to electronic charts at a rural medical center cut the average nurse daily paperwork by 1.5 hours. Examples like these and many more demonstrate the potential for HIT to improve the quality and efficiency of care, allowing clinicians to spend more time and resources on providing better care to patients and less time on burdensome paperwork.

* * *

Pfizer is the world's largest research-based biomedical and pharmaceutical company, with corporate headquarters located in New York and major research and development locations in the United States and England.

Since March 2006, Pfizer has been working with a small group of other pharmaceutical companies, including other HLC member organizations, to evaluate and explore how clinical research could be improved by leveraging the National Health Information Network (NHIN) and other Health Information Exchanges through an effort called the NHIN Slipstream Project. This group explored many important ways that the exchange of health information could improve patient health through the research, development, and commercialization of new therapies, and determined that the three most important areas of initial focus in the ONC NHIN process are: post-marketing drug safety surveillance, connecting patients to clinical trials, and establishing appropriate care standards through outcomes, pharmacoeconomic, and personalized medicine research. The group has spent the past few months developing documentation for these use cases and will continue by determining the data elements necessary to support them and the value propositions and business cases for each set of stakeholders.

Pfizer also participates in the Cancer Biomedical Informatics Grid (caBIG), a voluntary network individuals and institutions to enable the sharing of data and tools related to cancer research. caBIG is a partnership between the National Cancer Institute (NCI) and the private sector to facilitate integration of clinical information and the growing volume of genomic and proteomic data for the purpose of advancing development of new therapies. In conjunction with 80 companies as well as NCI, NIH, and FDA, Pfizer is working on the CRIX (Clinical Research Information eXchange) initiative to expand the caBIG vision from cancer to other therapeutic areas. caBIG is being built on open source, open access, open development, and federation principles.

ATTACHMENT 2

Healthcare Leadership Council

Chief Executive Task Force on Quality and Patient Safety
Technical Advisory Board on Health Information Technology

Recommendations to Congress to Advance Implementation of Health Information Technology

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EXECUTIVE SUMMARY

The Healthcare Leadership Council (HLC) has a long-standing commitment to improved quality of care and patient safety. HLC envisions a 21st century health care system that is integrated and linked by information technology, that is consumer-centered, and that utilizes new drugs, technologies, and medical procedures to perform the highest quality health care. Achieving this vision is dependent upon health care delivery that is effective and cost efficient. For this reason, HLC has maintained a strong interest in facilitating health information technology (HIT) and supports its accelerated adoption and deployment.

HLC members have a unique understanding and successful history in implementing HIT. In summer 2003, HLC established a Technical Advisory Board comprised of clinicians and others with information technology expertise within HLC's member companies to provide information about their HIT implementation experiences. In total, 17 teleconferences were conducted with individuals representing multiple perspectives, including providers, managed care organizations, payers, pharmaceutical companies, and health care delivery systems.

This report summarizes the views and observations of participants in those teleconferences. No comments are attributed to individuals or to organizations.

Key Findings and Themes

Health information technology solutions have long been and continue to be offered as a key factor in improving health care quality and efficiency. HIT has been around for decades, but the industry is still a long way from achieving full implementation. It is becoming increasingly apparent, however, that investments in HIT provide significant returns across a variety of metrics. ***HIT provides increased delivery system efficiencies and cost savings, contributes to greater patient safety and better patient care, and achieves clinical and business process improvements.*** Patients benefit from the comprehensive adoption of HIT and the ability to share data within and across sites of care and among clinicians. Ultimately, other stakeholders such as employers, payers, policy makers, public health officials, and regulators will benefit from the ability to share and exchange data. In short, the return on investment in HIT is significant for all parties involved.

HIT Benefits

Several HLC member organizations were among the earliest adopters and pioneers of HIT. For HLC members, specific benefits (and lessons learned) typically vary by several factors, such as delivery system, organization or entity, data network, and organizational culture and staff mix (i.e., on-staff or employed physicians versus community-based physicians).

HLC members have and continue to implement a wide range of clinical, financial and administrative applications and use diverse methods to develop systems. The following table summarizes the diverse benefits of HIT.

CLINICAL	ADMINISTRATIVE AND ORGANIZATIONAL	FINANCIAL
Reduced medication and other medical errors	Increased staff productivity	More accurate capture of codes and charges
Fewer and avoided adverse events	Increased access to data	Fewer rejected claims
Better communication between patients and clinicians	Increased job satisfaction	More efficient recruitment of qualified clinicians
Better communication with referring physicians	Enhanced recruitment of qualified nurses and other clinicians	Fewer duplicative tests
More timely and comprehensive infection control processes	Easier and more efficient data collection	Decreased operating costs
Increased time for hands-on patient care	Improved work flow	Reduced storage and transcription costs
Improved patient confidence in care	More efficient data flow to payers	Reduced per claim processing costs
Better information for clinical decisions and treatment options	More accurate, legible, and timely clinical documentation	Reduced supply costs
Fewer inpatient hospitalizations	Better compliance with regulatory requirements	
Reduced practice variation	Significant skill enhancement for nurses	
Improved patient satisfaction	Less redundant data entry	
Decreased patient waiting times	More timely public health reporting	
Better patient compliance with treatment plans	Improved data quality for research and clinical trials	
Streamlined disease and case management	Streamlined administrative processes	
	Improved data capture for use in national quality of care, clinical outcomes, and benchmarking efforts	
	Enhanced physician recruiting via EHR	

HIT Barriers

HLC participants highlighted a number of significant barriers, among them costs, standards, and interoperability. For example, in their quest to improve the quality of patient care, many health care providers, payers, and manufacturers continue to take advantage of information and communications technology. Unfortunately, their growing difficulty in investing scarce resources into increasingly expensive HIT, as well as the current lack of standards for HIT systems, have hampered the widespread adoption and implementation of these technologies.

Several participants cited an important yet often overlooked reality that must be taken into account regarding the costs and benefits of HIT systems. Providers that invest in or implement HIT absorb the full cost of system acquisition and implementation, but the benefits accrue to many others, including insurers, benefit managers, employers, regulators, patients, and the community as a whole.

Recommendations

In order to accomplish the widespread adoption of HIT, the Healthcare Leadership Council calls on the federal government to provide leadership, direction, and the capital necessary to spur the rate of diffusion through the entire health care system. Based on its members' successful track record, research, and "real world" experience, HLC offers the following recommendations, which can be organized into four broad categories:

- Standards to assure interoperability.
- Financial incentives and funding mechanisms.
- Liability protections to facilitate sharing of safety and quality data.
- Stakeholder collaboration on best practices.

Recommendation 1. ***The federal government should continue to oversee a comprehensive program of health data and information standards development that will facilitate exchange and sharing of data and information.***

Such standards will foster smooth and efficient communications and cooperation, regardless of individual system structure or architecture. Among other things, this work should address the increasing need for data, connectivity, interface, and communications standards. The health care industry also needs standards for commonly accepted clinical definitions, vocabulary, and terminology. Finally, this effort must also address concerns about patient privacy and confidentiality.

Recommendation 2. ***The federal government should implement financing mechanisms to spur private-sector HIT investment and accelerate the widespread adoption of HIT.***

This is designed to ease the financing crisis facing those attempting to adopt and implement often high-cost, highly complex HIT. Such financing mechanisms could include: payment "rewards" or "add-ons", creation of an HIT revolving loan fund to invest public dollars in HIT projects and programs (e.g., modeled after the

"Hill Burton" program); a revolving loan fund with debt forgiveness in accordance with specified criteria such as savings to the Medicare trust fund, tax incentives, reimbursement incentives based on improved patient outcomes, and matching private funds with public funds through grants from the Department of Health and Human Services and the Department of Homeland Security.

<u>Recommendation 3.</u> Congress and the Administration should pass legislation to encourage open sharing of patient safety data by providing liability protections for certain disclosures of such data.

A voluntary reporting system with strong legal protections for patient safety data is critical for improving the safety of the health care system. An environment where providers can share information for purposes of patient safety without fear of being sued will promote open disclosures of information about adverse events to designated patient safety organizations. Analysis of such disclosures can lead to system safety improvements. Legislation to accomplish this has been considered (but not passed) by Congress for the past three years. This legislation strikes a fair balance between protecting disclosures for patient safety purposes, while still protecting patient's legal rights by permitting use and disclosure of information that exists separately from the patient safety data. Electronic exchange and interoperability of health care information systems plays a critical role in an error reporting system described above.

<u>Recommendation 4.</u> Stakeholders should collaborate in the dissemination of best practices and lessons learned to further the successful implementation of HIT systems with proven functionality.

HLC supports both industry-initiated and federally led dissemination of information about HIT implementation, including best practices and lessons learned. Such dissemination would allow and encourage additional collaboration among stakeholders, facilitate knowledge and experience sharing, and ultimately help providers and organizations utilize HIT to improve patient safety and quality of care.

A federal investment in private sector HIT will go a long way toward improving the quality, safety, cost, and effectiveness of health care.

Introduction and Background

The Healthcare Leadership Council (HLC) has a long-standing commitment to improved quality of care and patient safety. HLC envisions a 21st century health care system that is integrated and linked by information technology, that is consumer-centered, and that utilizes new drugs, technologies, and medical procedures to perform the highest quality health care. Achieving this vision is dependent upon health care delivery that is efficient and cost effective. For this reason, HLC has maintained a strong interest in facilitating health information technology (HIT) and supports its accelerated adoption and deployment.

HLC members have a unique understanding and successful history in implementing HIT. Several HLC member organizations were among the earliest adopters and pioneers of HIT. Some are involved in the National Library of Medicine's (NLM) program providing grant support to health-related institutions and organizations for projects to plan, design, test, and deploy systems and techniques for integrating data, information, and knowledge resources into a comprehensive networked information management system.[1] Additionally, some participated in various Institute of Medicine (IOM), General Accounting Office (GAO), and Agency for Healthcare Research and Quality (AHRQ) studies and committees. Others are actively involved in national standards-setting organizations and related projects (i.e., Health Level 7 (HL7)).

After examining members' in-depth and diverse hands-on experience in HIT research and implementation, this paper discusses the many applications of HIT, the challenges and benefits of implementing HIT, and some key factors for successful implementation of HIT. We also offer three recommendations for furthering the adoption of HIT.

Methodology

In summer 2003, HLC established a Technical Advisory Board comprised of clinicians and others with information technology expertise within HLC's member companies to provide information about their HIT implementation experiences. In total, 17 teleconferences were conducted with individuals representing multiple perspectives, including providers, managed care organizations, payers, pharmaceutical companies, and health care delivery systems.

This report summarizes the views and observations of participants in those teleconferences. No comments are attributed to individuals or to organizations.

Key Findings and Themes

Participants shared their success stories and expressed diverse viewpoints reflecting their far-reaching experiences with HIT implementation. HLC members have implemented and continue to implement a wide range of clinical, financial, and administrative applications and use diverse methods to develop systems. Participants uniformly noted that the ability to exchange accurate information quickly within and across systems is essential in order to achieve a positive impact on health care delivery and related services. This section summarizes the major themes and participant recommendations.

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[1] NLM has supported such efforts to build integrated advanced information management systems (IAIMS). IAIMS are computer networks that link and relate the published biomedical knowledge base with individual and institutional databases and information files, within and external to an institution.

I. Members' HIT Applications

Clinical Applications of HIT. HLC members—providers, pharmaceutical companies, medical device manufacturers, payers, and group purchasing organizations—are very involved in HIT projects and described various successful applications and IT-enabled processes across the entire continuum of health care. While clinical applications of IT, such as electronic prescribing, electronic health records (EHR), and digital imaging are most pervasively used in hospital settings, it is notable that a broad spectrum of health care industry sectors plays a role in clinical HIT applications that, combined, have great potential to increase the quality and safety of the health care system.

For example, several HLC pharmaceutical manufacturer members have been instrumental in facilitating patient bedside bar code verification during drug administration by voluntarily producing unit dose packages printed with standardized bar codes. Some pharmaceutical companies have developed on-line disease management programs using sophisticated data systems. Insurers also have implemented on-line disease management programs using automatic alerts for both patients and clinicians. And one insurer participant discussed the company's sophisticated claims data mining system that helps classify providers according to the quality of care they provide. The insurer makes this information available on line to help its enrollee's select high-quality providers.

Hospital group purchasing organization participants discussed their innovative programs to collect data from their hospital members and use it to perform benchmarking to help develop and disperse best practices for diabetes and other diseases. This data is also being used in a demonstration project to reward providers for providing a higher level of care quality. Comments were made during this particular discussion that standardized clinical nomenclature would greatly improve the value of this quality improvement tool.

A medical device manufacturer participant described one of the latest clinical applications of HIT that allows human implanted medical devices automatically to report health data to an online electronic health record. The success of this technology is, of course, dependent upon widespread use of electronic health records.

The table below summarizes clinical uses of HIT and the types of organizations most likely to use these applications.

Clinical Uses of HIT

	Hospital Inpatient	*Hospital Out-patient*	*Office Practice*	*Insurer /MCO*	*Medical Device Manuf.*	*Group Purchas. Org.*	*Pharma Manuf.*
Computerized physician order entry (CPOE)	✔	✔	✔				
Bedside bar coding	✔	✔					✔
Electronic health record (EHR)	✔	✔	✔				
Health record data mining	✔	✔		✔		✔	
Automated clinical guidelines and protocols	✔	✔	✔	✔		✔	✔
Digital imaging	✔	✔					
Provider and patient web-based communication	✔	✔	✔				
HEDIS data collection	✔	✔		✔		✔	
On-line disease management programs	✔	✔		✔		✔	✔
Prevention outreach	✔	✔		✔			
Data collection for assessing quality of care	✔	✔		✔	✔	✔	✔
Physician alerts	✔	✔	✔	✔			✔
Knowledge management applications	✔	✔		✔			
Patient reminders	✔	✔	✔	✔			✔
Decision support systems	✔	✔		✔		✔	✔
Clinical data warehousing	✔	✔		✔			
Assisting patients in provider selection	✔	✔		✔		✔	
Telemedicine	✔	✔					
Picture archiving and communications systems (PACs)	✔	✔					
Implanted medical device automatic data reporting and transmission to EHR	✔	✔	✔		✔		

Administrative Applications of HIT. In addition to the clinical application of information technology, participants discussed administrative applications such as patient registration, appointment scheduling, claims submission, eligibility verification, and billing. Comments were made that highly automated administrative systems linked with the organization's clinical systems not only free resources for more hands-on patient care, but also greatly increase patient and provider satisfaction as a result of less paperwork.

II. HIT Benefits

HLC member discussions revealed that HIT has had, and will continue to have, an enormously positive impact on health care practice and delivery within their organizations, enhancing patient safety and quality, and ultimately lowering costs. For HLC members, specific benefits (and lessons learned) typically vary by several factors, such as delivery system, type of organization or entity, data network, and organizational culture and staff mix (i.e., on-staff or employed physicians versus community-based physicians).

Increased patient safety is a highly desirable benefit of HIT systems, although a difficult benefit to quantify. However, one vendor participant noted that a university hospital system using bedside bar code technology has realized an 89 percent reduction in medication administration errors. The same university has realized an 85 percent improvement in documentation accuracy in the emergency room and 71 percent reduction in overall discrepancies utilizing an automated drug dispensing system.

In addition to increased quality of care and patient safety and reduced costs, ***increased satisfaction for patients and providers*** was overwhelmingly cited as a highly valued benefit of HIT systems. Satisfaction was often attributed to easier and quicker access to clinical information which decreases waiting times, repeat appointments and laboratory tests, paperwork, and redundant data collection for both clinicians and patients.

Well-functioning HIT systems contribute to ***increased satisfaction among physicians and nurses*** for other reasons as well, according to several participants. Increased enthusiasm for HIT systems was noticeable once clinicians were convinced that it was an important factor in better patient care. One organization that had implemented a computerized physician order entry (CPOE) system, for example, determined through internal surveys that physician satisfaction had noticeably increased in large part because the physicians believed patients were receiving better care as a result of the new system.

At a time of severe health care workforce shortages, HLC member organizations have found their HIT systems to be ***beneficial for recruiting and retaining health care workers***, especially nurses. Improving nurses' job satisfaction by transforming the way nurses practice nursing was raised frequently as a benefit of HIT. HIT has made tangible improvements in nurses' work processes such as infection control review and case management. One hospital system participant with a very advanced HIT system said that, before implementing its electronic health record (EHR) system, nurses spent 30 percent of their time "hunting and gathering" scattered patient information; with the EHR system, time spent collecting data has been reduced to a fraction of the previous amount. Participants also cited HIT systems as valuable attractions for recruiting younger nursing graduates who see information technology as an integral part of their skill development as nursing professionals.

Collecting accurate data more efficiently to help consumers make better choices about their care was also frequently noted as an important HIT benefit for HLC's member organizations. Electronic data used in EHRs, electronic prescribing systems, digital imaging, or other HIT applications facilitate the assemby of more complete and accurate data across multiple sources. This contributes to better case and disease management, more accurate treatment options, and the ability to direct patients to higher quality and lower cost care.

In addition, HIT applications that combine administrative, financial, and clinical information systems benefit health care organizations, participants said, by allowing more accurate, timely, and complete data for data mining, predictive modeling, and financial analyses.

The following table summarizes benefits of HIT cited during our interviews:

Summary of Cited HIT Benefits

CLINICAL	ADMINISTRATIVE AND ORGANIZATIONAL	FINANCIAL
Reduced medication and other medical errors	Increased staff productivity	More accurate capture of codes and charges
Fewer and avoided adverse events	Increased access to data	Fewer rejected claims
Better communication between patients and clinicians	Increased job satisfaction	More efficient recruitment of qualified clinicians
Better communication with referring physicians	Enhanced recruitment of qualified nurses and other clinicians	Fewer duplicative tests
More timely and comprehensive infection control processes	Easier and more efficient data collection	Decreased operating costs
Increased time for hands-on patient care	Improved work flow	Reduced storage and transcription costs
Improved patient confidence in care	More efficient data flow to payers	Reduced per claim processing costs
Better information for clinical decisions and treatment options	More accurate, legible, and timely clinical documentation	Reduced supply costs
Fewer inpatient hospitalizations	Better compliance with regulatory requirements	
Reduced practice variation	Significant skill enhancement for nurses	
Improved patient satisfaction	Less redundant data entry	
Decreased patient waiting times	More timely public health reporting	
Better patient compliance with treatment plans	Improved data quality for research and clinical trials	
Streamlined disease and case management	Streamlined administrative processes	
	Improved data capture for use in national quality of care, clinical outcomes, and benchmarking efforts	
	Enhanced physician recruiting via EHR	

III. Measuring Return on Investment

Discussions among the HLC participants and examples of quantifiable benefits from their institutions indicate that methods to measure HIT benefits vary widely, although measures generally include both formal and informal analyses of financial impacts.

Some institutions use a return on investment (ROI) methodology to assess the financial impact of service-related operating expenses compared to revenue gains from improved service delivery. In some instances, the measurable financial improvements attributed to or facilitated by an information system have included the ability to control or reduce operating expenses (such as those related to personnel, printing, transcribing or storage costs), or to expand the types and range of services offered by the health care organization. Several participants described measuring positive financial outcomes in terms of quantifiable improvements in operating expenses or as new revenue for their health systems.

To fully calculate quantifiable benefits or ROI measurements, participants reported that they ***first determine the baseline measures of specific metrics*** and then perform formal *projected* return on investment or cost benefit analyses before investing in HIT systems. Several organizations reported the difficulty of making such assessments, however, because of the long length of time HIT implementation often requires before the old system can be integrated or dismantled. For example, one hospital system began implementing HIT systems in 1991, and it was not until 1999 that they had enough infrastructure in place to be able to begin taking costs out of the combined old and new systems. In contrast, one system cited that, in just two months after getting its EHR system off the ground, it collected the same revenue with fewer patients, and after four months it was taking in more revenue with the same number of patients. Clearly, factors such as the size of an organization, the patient population, the intensity of the HIT application as well as many others make it difficult to compare costs versus benefits across sites.

Another participating organization pointed out that formal evaluations of returns on investment are seldom conducted because they are an expensive, added cost. This system felt confident that it was receiving a return, without the official analysis. It was noted that cost savings from personnel reductions and transcription costs were evidence that the organization was receiving financial returns, and that the increased ability to deliver better quality and safer health care overshadowed the need to prove a financial return.

Other HLC members also measured benefits in ***more qualitative and perhaps intangible terms***. For instance, participants indicated that benefits resulting from implementing patient access to personal health records, patient-physician electronic messaging, and automated appointment scheduling include better communication, less hassle, and improved patient satisfaction. Maintaining critical staff and enhancing continuity of patient care were also raised as "returns on investment." These and other benefits of HIT mentioned previously in this paper might be difficult to measure, but as many participants pointed out, they intuitively translate into indirect cost savings for an organization.

There was general agreement that successful HIT implementation requires significant investments of time and therefore a system's financial return should also be measured over time because benefits are not always immediate.

IV. HIT Challenges and Barriers

Along with the benefits, HLC participants described several challenges in implementing HIT. One obvious challenge is that health care is fragmented and delivered by various providers across multiple settings. Clinical information is complex and there are logistical difficulties in information sharing across settings. Additionally, clinicians need access to larger amounts and increasingly more complicated kinds of information in order to provide adequate care. Health care organizations themselves are complex, presenting added challenges for information sharing. Legislative and regulatory requirements governing patient privacy and confidentiality add yet another layer of challenge. Finally, the health care industry continues to face increasingly technical and dynamic regulatory pressures and requirements.

HLC participants highlighted a number of other significant barriers, among them costs, standards, and interoperability.

HIT Costs. A lack of funding or adequate resources—combined with the high costs of HIT systems—was repeatedly cited as a barrier to effective implementation of HIT systems. There are ***significant front-end and ongoing maintenance and operational costs*** for HIT, including software, hardware, training, upgrades, and maintenance. Systems and products are virtually unaffordable for those providers who do not have ready access to the needed operating capital. In addition, health care organizations often view systems implementation as very time-consuming, which translates into another layer of costs.

Transitioning from existing paper-based or long-standing IT legacy systems is an expensive proposition. Systems that were implemented in earlier decades, many of which still exist, were often installed as stand-alone systems. Costs to replace or to integrate these systems are significant, as are costs for ongoing systems maintenance and upkeep.

In addition to capital costs, ***ongoing operational costs*** in any institution require careful consideration. One participant noted that health care providers typically commit to increased spending of about 3 percent for operational costs when planning IT projects. Other information-intensive industries–banking, insurance, investment houses–commit more than double or triple that number for operating

IT systems. This participant believes that an EHR system requires at least a 4 or 5 percent increase in spending for ongoing operational costs.

Several participants cited an important yet often overlooked reality regarding the costs and benefits of HIT systems that must be taken into account. Providers that invest in or implement HIT ***absorb the full cost of system acquisition and implementation***, but the benefits accrue to many others, including insurers, benefit managers, employers, regulators, patients, and the community as a whole.

Given these challenges, there are concerns that the pace and pattern of HIT adoption will not be uniform and will be too prolonged to have a significant impact on quality and safety in the foreseeable future.

HIT System Implementation Issues. Some participants discussed the difficulties of finding the "right" systems solutions among many HIT systems options. Major hospital system mergers have presented the challenge of integrating multi-vendor systems that have historically been incompatible. One participant described how his organization had to consolidate more than 70 products from 35 vendors across hundreds of provider sites to create a comprehensive HIT infrastructure leveraging the organization's existing investments and legacy systems.

Regardless of mergers, as mentioned above, many HIT systems have been implemented over an extended period of time, beginning before the availability of many of today's commercial vendor products. These homegrown legacy systems must frequently be factored into the design of an organization's new HIT infrastructure; however, incorporating them into a new system design usually requires costly trade-offs in terms of speed of implementation and the ability to share data between organizations. Consolidation of multiple vendor products and legacy systems can be extremely challenging and costly. Developing tailored or customized systems in conjunction with vendors and implementing various commercial off-the-shelf (COTS) vendor products are among the daunting array of choices for HIT systems that organizations must investigate when trying to implement or integrate an HIT system.

Several participants were encouraged by a very recent evolution taking place among HIT vendors that seems to be resulting in more versatile HIT systems with greater user satisfaction and interoperability. This may be largely a result of vendors working more closely with their customers to develop commercial systems. One teaching institution participant, for example, worked over a period of several years with a major HIT vendor to develop a commercial CPOE system that was fine tuned through years of physician trial and feedback about content and usability.

One participant of a very large hospital system stated that she did not perceive a lack of quality HIT products and vendors, but is instead challenged by the short supply of knowledgeable, high-quality IT personnel to maintain HIT systems in the long term.

Inadequate Standards and Lack of Interoperability. To achieve system-wide health care benefits of HIT, there is an increasing need for data, connectivity, interface, and communications standards allowing the sharing of data nationwide. For example, the EHR, as envisioned by many, implies total consolidation of all patient data from before birth through death, accessible by those who need to know, and available at all points of care. This will require full interoperability within and across all health care settings. Additionally, uniform interoperability would eliminate the issues many health care systems now face as a result of mergers of several smaller systems.

While participants acknowledged the importance of this "next step" of macro-interoperability, most are moving forward with implementation of HIT systems even in the absence of standards that would allow their systems to interface with other health organizations nationwide. There are still standards, however, that some stated as being necessary to help their individual HIT systems function better. One standard that was repeatedly cited as necessary to improve internal systems was ***a commonly accepted clinical vocabulary***. Lack of such a standard has contributed to costly, cumbersome, and inefficient retrospective data mining. Hope was expressed by several participants that the Department of Health and Human Services' recent action to publicly license SNOMED—a comprehensive set of clinical reference terminology that the health industry can use to improve the comparability of data—would prove an important step to resolving this particular problem.

Contributing to the interoperability challenge is the fact that health care is complex and no two providers, settings, or institutions are identical. ***A successful solution in one setting is not necessarily transferable to another.*** As discussed previously, in many instances, providers have merged into or have formed larger (integrated) delivery systems often resulting in numerous disparate and sometimes duplicative systems. In some cases we learned that even existing systems within organizations cannot communicate with each other.

All of these issues contribute to a fragmented use of technology with minimal interoperability. Federally driven standards (with appropriate testing and implementation considerations) could potentially go a long way toward resolving technical and technological constraints due to variations (and incompatibilities) among system configurations, architectures, and platforms.

V. HLC Members' Successful HIT Implementations: Key Factors

Participants provided keen insight into successful HIT implementations based on their firsthand knowledge and long-standing experiences. They described several key factors influencing HIT implementations, including organizational culture, access to capital, and long-term commitments in terms of time and people.

Organizational Culture and "Buy-In". An organization with a pervasive philosophy of continuous quality improvement and error reduction is bound to be more successful at HIT implementation. This foundation is laid through strong dedication and involvement of top executive leadership in process innovation and improvement well before commencing HIT systems implementation. Conversely, several participants stated the underlying danger of implementing expensive HIT systems on top of existing inefficient and poorly managed disparate processes. Detailed preparation and involvement of clinical, technical, and other staff were also mentioned by many participants as being necessary factors in HIT systems success. Anticipating and overcoming staff resistance or unwillingness to use the HIT system were critical.

Making sure that clinicians are proponents of the system was raised by all participants. ***It is essential, they said, that clinicians, especially physicians and nurses, actively participate in and support the development and implementation of any HIT solution from the very early stages.*** Several examples for gaining clinician "buy-in" for HIT implementation were cited. These included using team processes and staff-driven decision-making criteria and ensuring that computer technicians and clinicians engage in ongoing dialogues throughout design and implementation. Not only does this involvement help increase acceptance among clinicians, it also allows for incorporation of specific features and functions specifically designed to support the clinicians' unique work processes and needs.

One organization, for example, used a team of physicians to help design its EHR. The participant from that organization described the organization's willingness to compromise between an "engineering marvel" and a system that was acceptable and would be usable by the organization's physician staff.

The extent to which the use of HIT systems is "mandated" versus voluntary for clinicians (especially attending physicians) varied with the specific type of organization and HIT application. One hospital system definitively mandates that if physicians want to work in that hospital system, they must use the hospital's EHR. Another participant reported that, while the use of its EHR system was voluntary, more than 70 percent of clinicians were doing direct data entry using the automated systems. Interestingly, in cases where using the hospital's HIT systems is voluntary, there was little variance in physician user acceptance between staff models where the physicians are employees of the hospital versus models where the physicians are independent practitioners at the hospital.

Several participants said a key factor in influencing an "HIT culture" is to provide evidence to clinicians of improvement in safety and quality of care. One example offered involved improved outcomes data from fetal monitoring. In this case, there was enough evidence of improvement to compel an immediate practice change, which no physician resisted once shown the data. Similar results were demonstrated with nursing personnel. One respondent discussed the greatly increased level of commitment to IT by nurses who were presented with case studies of increased safety that resulted from automated systems.

Staffing and Training. The importance of up-front and ongoing staff training cannot be overstated, according to the participants. It is critical to make certain that staff is well trained and proficient in its use of HIT in order to assure acceptance and adoption of the system. One participant mentioned that each physician is required to complete 16 hours of electronic health record training in order to work at the hospital, in many cases required training hours exceeding that. Other participants remarked that taking the system and the training to the clinicians on the floors and at the bedside—not in the classroom—was also critical.

Organizational Expectations. Repeatedly, participants stressed the need to establish clear expectations of HIT implementation projects. Organizations implementing HIT systems need to identify expected accomplishments and benefits and link what will be invested with what will be achieved. Expectations can include better communication between patients and clinicians, increased job satisfaction among clinicians, improved workflow, more efficient data sharing and communication, lower operating costs, and better information to make clinical decisions.

One participant stated the importance of recognizing differences across organizations in terms of cultures, patient bases, environments, attitudes, priorities, size, complexity, and scope of services provided. This means that a successful system in one location will not necessarily meet the requirements or expectations at another.

Another important point made was that institutions must recognize that HIT systems implementation is an ongoing evolutionary process. HLC members noted that their personal and organizational involvement in specific systems implementation often spanned decades. One participant described her health system's HIT plan in particularly far-sighted terms. The health system, which was once three smaller systems, is focused on trying to ensure that each hospital has a minimum foundation of IT integration that can eventually lead to CPOE, digital imaging, and an electronic health record. Just installing this minimal foundation, however, is expected to take several years.

Organizational Business Processes. Success depends, in part, upon factors related to how the institution conducts its business plan for HIT implementation, according to the participants. This includes methods of management and project design, selected aspects of service redesign and consolidation, integration of services across sites, and their effects on staff and productivity. Related to this is the need to coordinate HIT planning and investment management techniques across the enterprise. Consolidating common HIT functions, processes, and applications are also critical to successful implementation.

Recommendations

Based on its members' successful track record, research, and "real world" experience, HLC offers the following recommendations, which can be organized into four broad categories:

- Standards to assure interoperability.
- Financial incentives and funding mechanisms
- Liability protections to facilitate sharing of safety and quality data.
- Stakeholder collaboration on best practices.

***Recommendation 1.** The federal government should continue to oversee a comprehensive program of health data and information standards development that will facilitate exchange and sharing of data and information.*

The federal government, working with private industry, should continue to establish agreement on basic rules for open, nonproprietary, and scalable system connectivity rules, operating protocols, data definitions, and data element specifications. The government should strongly encourage the use of these standards so that the same (versions of) standards are implemented and updated simultaneously across the industry. In order to overcome the continued lack of interoperability, HIT vendors need to implement systems in accordance with universally accepted standards so that different systems will work with each other. Obviously, such standards must address concerns about patient privacy and confidentiality.

The Department of Health and Human Services (HHS) is already playing a leadership role in fostering the development of data standards and encouraging investments to identify and speed the adoption of new technologies throughout the health care system. HHS efforts to date include the Consolidated Health Informatics Initiative (CHI) and support for the National Health Information Infrastructure (NHII). Both activities have contributed to the adoption of standards for federal health programs. There are many public-private activities underway to build the NHII, an idea noted in an Institute of Medicine (IOM) report on computer-based patient records in 1991 and then elaborated upon in a 2001

National Committee on Vital and Health Statistics Report.[2] The concept has since been endorsed by a variety of public and private sector organizations. The broad goal of the NHII is to deliver reliable data in a secure and private format to patients, clinicians, and providers when and where they need it, so they can use this information to make informed decisions about health and health care services.

In July 2003, HHS asked the IOM and Health Level 7 (HL7),[3] to design a functional model and standard for the electronic health record; their efforts are ongoing.[4] In July 2003, HHS also announced that the department had signed an agreement with the College of American Pathologists to license the college's standardized medical vocabulary system and make it available without charge throughout the United States.

In April 2003, the Food and Drug Administration issued a proposed rule requiring the use of standardized bar codes on all levels of drug packaging, including unit-of-use packages.

While these are impressive efforts toward developing nationwide standards for HIT, a coordinated and accelerated initiative must take place to ensure that these and other standards and their related technologies are available for mainstream use in the near future.

<u>Recommendation 2.</u> Congress and the Departments of Health and Human Services and Homeland Security should implement financing mechanisms to spur private-sector HIT investment and accelerate the widespread adoption of HIT.

The federal government should drive the nation's implementation of HIT by offering federally supported financing for capital and operations costs to help providers defray the huge costs of acquiring and operating HIT. The Department of Health and Human Services (HHS) should accelerate the development and disbursement of these financial incentives in order to encourage widespread HIT adoption. How soon the government ultimately supports such financing will be

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[2] National Committee on Vital and Health Statistics. "Information for Health: A Strategy for Building the National Health Information Infrastructure." Washington, D.C. November 15, 2001.

[3] HL7 is an accredited ANSI standard organization that produces the HL7 messaging standard. It is the accepted *messaging standard* for communicating clinical data. It is supported by every major medical informatics system vendor in the US. The HL7 mission is to provide a comprehensive framework and related standards for the exchange, integration, sharing, and retrieval of electronic health information that supports clinical practice and the management, delivery, and evaluation of health services.

[4] CHI is a collaborative effort between the Department of Health and Human Services, the Veterans Affairs/Veterans Health Administration, the Department of Defense, and other federal agencies to adopt government-wide health information standards. The first set of CHI standards were announced on March 21, 2003 and include: Health Level 7 (HL7) messaging standards; Logical Observation Identifier Name Codes (LOINC) to standardize the electronic exchange of clinical laboratory results; National Council on Prescription Drug Programs (NCDCP) standards for retail pharmacy transactions; Institute of Electrical and Electronics Engineers 1073 (IEEE1073) standards that allow for health care providers to plug medical devices into information and computer systems; Digital Imaging Communications in Medicine (DICOM) standards that enable retrieval and transfer of images and associated diagnostic information.

critical to the ultimate levels and patterns of HIT adoption across all segments of the industry.

Discussions revealed that, in the absence of federal financing mechanisms, it would be years before most providers adopt HIT. Generally, few believe that natural market conditions or private sector market competition will be enough to propel the needed level and pace of HIT adoption. On the other hand, incentives related to HIT implementation and operation would have a far-reaching and positive impact on the entire health care community, ranging from large enterprises to individual practices. Benefits of greater efficiency, productivity, and quality would diffuse to individuals and institutions throughout the health care system.

Rapid implementation of interoperable HIT is also considered a critical component of the nation's emergency preparedness. In a May, 2003, report, the General Accounting Office (GAO) states "Many of the activities underway to prepare for and respond to public health emergencies–including bioterrorism–are supported by information technology, which can better enable public health agencies to identify naturally occurring or intentionally caused disease outbreaks and can support communications related to public health." The report also states that "automated medical information systems can play an important role for clinicians during their response to a medical emergency, in documenting the treatment of illness and its outcome, and in collecting and sharing diagnostic test results." Additionally the report states, "The use of electronic medical records could reduce the burdensome and costly use of paper-based processes, facilitating rapid access to data critical for near real-time public health surveillance."[5]

HLC advocates the consideration and implementation of multiple HIT funding mechanisms. Regardless of the option or options chosen, participants noted that the federal government should assume a leadership role and create a financial catalyst for widespread HIT adoption, particularly among providers. As mentioned previously, the beneficiaries of IT-driven quality and safety improvements extend far beyond the providers—a strong argument for public funding. Instituting new or expanded funding mechanisms to reward those who successfully implement HIT—to include initial system installation as well as system upgrades or maintenance and operations costs—is one of the more compelling strategies to accomplish widespread adoption of HIT.

Potential financing models or options include:

- ***Payment "rewards" or "add-ons" based on HIT implementation and operating costs.*** This could include direct payments for using specific HIT applications (such as CPOE), offering higher payments to providers who use HIT, or offering discounts on medical liability insurance for HIT implementers.

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[5] *Bioterrorism: Information Technology Strategy Could Strengthen Federal Agencies' Abilities to Respond to Public Health Emergencies,* General Accounting Office (GAO), May, 2003, GAO-03-139.

- ***A loan program with debt forgiveness in accordance with specified criteria***, such as demonstrating a savings to the Medicare trust fund by achieving specific patient safety or quality of care improvements.

- ***Creation of a HIT revolving loan fund to invest public dollars in HIT projects and programs***. For instance, as some have proposed, these could be administered through community-level nonprofit lending agencies.[6] This could be a self-perpetuating fund as borrowers repay their loans and could be modeled after the "Hill Burton" program.[7] It could also include funding formulas and federal conditions of participation.

- ***Direct grants to designated organizations and providers*** based on established criteria and needs.[8] In addition to ongoing grant programs from the Department of Health and Human Services, the **Department of Homeland Security** could consider a grant program for facilitating the implementation and interoperability of HIT that can aid in health care delivery during an act of bioterrorism or other public health emergency.

- ***Tax incentives*** to stimulate private sector (especially provider) investment in HIT.

- ***Reimbursement incentives*** based on demonstrating designated levels of improved patient care outcomes or other established criteria. This could include an investment program based on federally developed standards of performance and tied to provider compliance with such standards or their ability to demonstrate performance in accordance with the criteria.

- ***Adjustment of payment policies*** to recognize designated HIT applications as a reimbursable service.

- ***Initiatives to match private funds with public funds*** via a grant and/or revolving loan program.

Recommendation 3. ***Congress and the Administration should pass legislation to encourage open sharing of patient safety data by providing liability protections for certain disclosures of such data.***

A voluntary reporting system with strong legal protections for patient safety data is critical for improving the safety of the health care system. An environment where providers can share information for purposes of patient safety without fear of being sued will promote open disclosures of information about adverse events to designated patient safety organizations. Analysis of such disclosures can lead to system safety improvements. Legislation to accomplish this has been

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[6] Coye, Molly Joel, Bernstein, William S., "Perspective: Improving America's Health Care System by Investing In Information Technology", Health Affairs. Vol. 22/No.4.

[7] The Hill Burton program was created by Congress in 1946 to give hospitals and other health facilities money for construction and improvement in exchange for providing a reasonable volume of services to those unable to pay and for making services available for all persons residing in the facilities area.

[8] For example, the Agency for Healthcare Research and Quality recently announced the availability of research grants to assess the value derived from the adoption, diffusion, and utilization of health information technology (HIT) to improve patient safety and quality of care. The HHS Office for the Advancement of Telehealth recently granted a total of $3.74 million to 15 existing telehealth programs. The awardees support clinical telemedicine, distance learning, and patient education/disease management programs.

considered (but not passed) by Congress for the past three years. This legislation strikes a fair balance between protecting disclosures for patient safety purposes, while still protecting patient's legal rights by permitting use and disclosure of information that exists separately from the patient safety data. Electronic exchange and interoperability of health care information systems plays a critical role in an error reporting system described above.

<u>Recommendation 4.</u> Stakeholders should collaborate in the dissemination of best practices and lessons learned to further the successful implementation of HIT systems with proven functionality.

Commencing an HIT implementation project requires a daunting amount of research to evaluate constantly evolving commercial off-the-shelf products versus other options appropriate for an institution's unique environment and desired applications. Further complicating implementation plans it that some or all of an institution's legacy systems must be taken into consideration in the overall design. In some cases, institutions may form relationships with vendors to help them develop a "semi-custom" and effective system solution. In these cases, the provider organization often provides the clinical and organizational expertise for product development. In any case, researching and designing such systems contribute to the already high cost of implementation. Of even greater concern is the potential to waste limited funding by choosing applications or systems that may not maximize potential for increased safety and quality, or by failing to consider adequately possible long-term complications. Given the expertise gained by many premier health care institutions pioneering HIT implementation, an industry-initiated effort to share best practices could potentially speed the adoption of HIT throughout the health care industry.

HLC also supports federally led (sponsored) dissemination of information about HIT implementation, including best practices and lessons learned. Such dissemination would allow and encourage additional collaboration among stakeholders, facilitate knowledge and experience sharing, and ultimately help providers and organizations utilize HIT to improve patient safety and quality of care.

Conclusions

From this work, HLC arrives at two overarching conclusions. First, that HIT holds enormous potential, but second, that it remains stymied by challenges and barriers—and that full implementation is still far off. With regard to the opportunities presented by HIT, it is becoming increasingly apparent that HIT will provide savings, contribute to greater patient safety, enhance patient care, allow for increased delivery systems efficiencies, and achieve clinical and business process improvements. [9] [10] HIT can drive across-the-board positive changes and

[9] General Accounting Office (GAO) Information Technology. Benefits Realized for Selected Health Care Functions. October 2003. GAO-04-224.

enhance value in care delivery. In particular, applications such as electronic health records, electronic prescribing, and bedside bar coding have been identified and promoted as necessary to facilitate a safer and more efficient health care system. Patients will benefit from the comprehensive adoption of HIT and the ability to share data within and across sites of care and among clinicians. Ultimately, other stakeholders such as employers, payers, and regulators will benefit from the ability to share and exchange data.

However, as this report points out, the reality is that there has been limited adoption and implementation of HIT. Ultimately, more widespread adoption of HIT will eliminate or diminish duplicative information gathering and will help assure delivery of health care based on timely, relevant, and complete information. The federal government should develop and implement a comprehensive HIT-financing program to meet the wide variety of providers' needs and to be responsive to many stakeholders.

In the absence of federal leadership and specific initiatives, HIT implementation will continue in a piecemeal and fragmented fashion. HHS should facilitiate ongoing collaboration between the public and private sectors to establish consensus enabling interoperability within and across health care organizations. A federal investment in private sector HIT will go a long way toward improving the quality, safety, cost, and efficiency of health care.

[10] Patient Safety: Achieving a New Standard for Care. Institute of Medicine of the National Academies, November, 2003.

Appendix A: Discussion Questions to Guide HLC Conference Call on Health Care IT

Please describe the clinical HIT (health information technology) systems or applications that you have implemented. For each, please note whether the system is "home grown" or a COTS product:

Admission/discharge/transfer
Computerized physician order entry (CPOE)
Bar coding
E-prescribing
Pharmacy/medication management
Other?
Patient registration
Electronic health record
Laboratory results
Clinical decision support

What were/are the compelling reasons to implement HIT systems? What were/are the benefits of implementing HIT systems?

What were/are the (strategic, tactical, operational, financial, cultural) challenges regarding HIT implementation?

What do you perceive as the most common barriers and obstacles to implementing HIT systems?

What were/are potential solutions to overcoming these barriers?

What strategies did you use/do you recommend to (successfully) implement HIT systems?

What role did/does HIT have regarding patient safety? Organizational productivity? Efficiency?

What role did/does organizational culture have in your implementation?

What do we need to do to help assure the continued future implementation/deployment of HIT systems?

How have you measured the success of your efforts?

Could you describe your techniques for conducting cost-benefit analyses of HIT implementations? For calculating your ROI (return on investment)?

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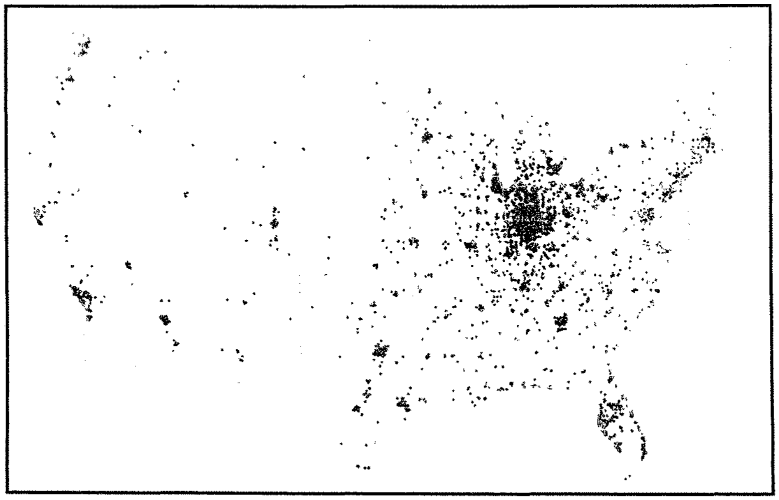

ATTACHMENT 3

Attachment 3: Map prepared by the Indiana Network for Patient Care, 2004. Dots represent home addresses of patients treated at an Indianapolis, IN hospital over a six-month period.

Chairman CONRAD. I thank all of the witnesses.

I am going to defer today to Senator Whitehouse. And then on the second round I will defer to Senator Stabenow, as well, because they have really led the effort on this Committee. And so, in fairness, I would ask them to do the first rounds of questioning.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

And first let me welcome Laura Adams to the Senate Budget Committee. I think my colleagues can see from her testimony why it is that the Rhode Island Quality Institute has been such an extraordinarily successful experiment. And I want to particularly thank the Chairman for allowing us to go forward with this hearing.

The Chairman is an extraordinary dedicated and articulate proponent of the need for addressing our health care problems before they get out of hand. He has described them as a tsunami of costs washing down on our country. I think that today's hearing helps illustrate that there are really two ways we can address this problem. We can wait until the tsunami is really on the shore and then we can apply fiscal adjustments to the problem, which are tax hikes and benefit cuts. And we are going to have one of the bloodiest and most ugly fights that this institution has ever seen when that day comes.

Or we can get ahead of it and work on system reforms. But they do not enjoy the benefit of immediacy that a fiscal adjustment has. You really have to build an awful lot of infrastructure before they take hold. It could be really a decade until the full value of something we started today began to be realized, which means that the time really is now to start on this.

I would like to ask Laura to comment on two things. We have been at this now for so long together, we kind of channel each other. So it is going to be a little redundant.

But the observation that we share, I think, is that one of the big handicaps of getting through to system reform is the siloization of the present health care system and the tendency for participants in the system to try to defect to their own economic interests within that silo which do not coincide with the interests of the health care system as a whole.

And so the trick, in many respects, is simply to find a forum where people can step out of their silo roles and move into a reform role, a leadership role, and start to think about ways to improve the health care system.

Part of what the Rhode Island Quality Institute has done is simply to be that forum where all those CEOs can come together and have that plan. So I would like to ask Laura to comment, first of all on the forum function that she has experienced with the Rhode Island Quality Institute.

And then also describe a little bit the resources that she has had to work with over 6 years. I would make the proposition that the Rhode Island Quality Institute and other agencies like it around the country are the R&D function for this critical problem that we have. And yet, they are essentially non-resourced.

So with respect to the forum and with respect to the resources, tell us what your experience is with the forum question and what you have been able to find to work with from an infrastructure point of view.

Ms. ADAMS. When Senator Whitehouse convened the organization in 2001, I think that one of the most effective things he did was to convince this group that they are responsible for the performance of the health care system in that State. I mean, if not them, who else? When you look at every major leader from every major sector sitting around that table, we knew that if we did not like the performance of that health care system—and we did not—who did we expect to come and change it?

Now one of the elements of magic of the Quality Institute is that everybody's behavior is public. So when you start laying out these issues publicly with each other and we start talking about and calling on others to take action, to change the system, it is very hard to decide to act in your own interests when you have the community watching you. All of our board meetings are open. Our committee meetings are open. Anyone can attend the Institute neetings. If you want to see who has contributed to the Institute, you check the website. Every dime we have ever gotten from anybody is listed on that website. We do not sign anybody contracts. We do not make laws. We do not direct business one way or the other.

The only force we have is trust and a vision of the future that is far greater if we work collectively than the future we face if we work alone.

So there has been tremendous power in having people's behavior public. It certainly causes people to act in the best interests of the community.

The second thing is that we have had, I think, two non-unanimous votes in the 7-years because we work hard to work through the issues. We do not force anybody to vote a certain way but we work on it until the issue is resolved and we can all live with the path that we are proposing.

As far as the resource goes, yes, I am the President and CEO. But for the first five or 6 years of organization I was the only employee. And it was a little disappointing because obviously I could say—go get me a cup of coffee. Yes, ma'am—it was a little unsatisfying. But we have a VP right after that and so I am happy to say that under my leadership the Institute doubled in size.

We now have an assistant, so we have tripled in size in the last 18 months. I am very proud of that.

But the initial thought about the organization was that what we did not want to create yet another organization in the middle of all of the silos. So we did not to build it out, staff it, and then have somebody say oh, the safety thing? Yes, that is going to be taken care of by group over there. What we wanted to say is we have a safety problem collectively in Rhode Island. What are we going to do about it?

So what that has resulted in is probably about $5.5 million in local contributions to support these efforts that we are putting together. And I can tell you there is probably another $2.5 million in in-kind contributions coming from people. So a large number has skin in the game.

But still the resources leave us wanting. We have so much yet to accomplish. We are unable to take on the payment reform that we need to address. We are unable to expand our health information exchange in the way we want to until we come up with further resources.

Senator WHITEHOUSE. About $2 million a year has been your average resource, and a lot of that is dedicated by the funding source to specific task?

Ms. ADAMS. Exactly. We have had $1.7 million dedicated to our ICU effort. That returned, by the way, about $5.5 million on that $1.7 million. So the return on investment here is significant, as far as we are concerned. And that one is very well-established in terms of the data we have on that. We have been working with Johns Hopkins as our clinical lead on that for the first 2 years of that project and so those data, are incontrovertible.

Ms. ADAMS. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator GREGG.

Senator GREGG. Thank you. A lot of intriguing issues raised here.

We are now, as a Senate, we have a health technology bill that has been passed by the HELP Committee under the leadership of Senator Kennedy and Senator Enzi, in which portions of the Medicare Quality Enhancement Act, which I mentioned earlier, are involved.

I was wondering, Director Melvin, have you looked at that bill?

Ms. MELVIN. We have not looked specifically at that bill. We have tried to peruse some of the legislation that is out there to get a sense of where areas of emphasis have been placed.

Senator GREGG. This bill is about to pass, hopefully. I understand there are holds left on it and we are trying to clear them. But essentially this bill will hopefully create a capacity of the Federal Government to begin to fund interoperability in the area of technology.

The problem, as I see it, is that we all say we want interoperability but it is really a huge issue to get it. I know, I had a hospital in New Hampshire which was not a very big hospital—big by New Hampshire standards but not big by national standards. And they came to me and asked if I could earmark a grant so that they could get their hospital to be interoperable. I mean, basically their radiology department could not talk to the emergency room. The emergency room could not talk to pediatrics. Pediatrics could not talk to maternity.

And just getting within the hospital interoperability was a huge issue.

So I am interested, Ms. Adams, because I am impressed with the initiative you have started in Rhode Island and New Hampshire does not have such an initiative—I think it is a great initiative. How successful are you in just doing the local hospital interoperability efforts? Or is that not the focus of your effort? Is your focus more on quality?

Ms. ADAMS. No, the focus of our effort is making sure that this entire State is connected because that undergirds any quality effort we are going to be successful at doing.

Senator GREGG. And is it possible to do that? I mean I do not honestly know if it is possible for Southern New Hampshire to be able to communicate with Catholic Medical Center in Manchester. I just do not know. Is that possible in Rhode Island? Do you have Warwick communicating with Providence?

Ms. ADAMS. What we are doing right now is establishing a statewide health information exchange based on the best current standards that we have. I have to say that up to this point—I would say the last 18 months to 2 years—vendors have not been focused on standards. There was more a value in keeping your system proprietary and unable to communicate with anyone else. Then if you added on to the lab, you needed to buy their system. If you added on to the ED, you want to talk to it, you buy their system.

Now we understand that any vendor that pursues that avenue is going to be out of business shortly because we all recognize now the destructive force that that has been in trying to communicate with each other.

So in Rhode Island, we are fortunate to have one of our largest IDNs, integrated delivery networks, Lifespan, has achieved almost full interoperability between all of their entities.

There is a discussion of a merger with them and Care New England, which would cause about 70 percent of our health care system to be merged and connected. Now we have the Westerly Hospital that received an earmark to get the very thing going that you are talking about, some interoperability and additions.

But we also see that as something that falls under that health information exchange financial nut that we have to find the money for it.

In Rhode Island, we are looking at a model of whoever benefits pays. So we do know that if you look at the pie diagram of who benefits from health information exchange and the value that comes from that, nobody's piece of the pie is any bigger than 27 percent and that is the problem.

Senator GREGG. Actually, the IT bill which is hung up right now, that is the focus of it. We are basically going to say Federal funds only go to interoperable systems.

And you are right what happens is that people want to predict their proprietary interests so there is an actual disincentive to be interoperable or has been historically.

Ms. ADAMS. Not anymore.

Senator GREGG. I guess my second question is are you also going to the issue of quality amongst hospitals? In other words, if there is a hospital in Rhode Island that does an appendectomy at half the cost of another hospital, are you looking at whether that appendectomy—the outcomes are as good and the difference in cost is disclosed?

Ms. ADAMS. This is one of the things that we see as, once again, the high leverage value of something like a regional health information organization. When the State needs that kind of money to begin to pair cost and quality, there is no sense in creating yet another data base besides the exchange. You can leverage that exchange to do it.

In Rhode Island, we will look to have the introduction of a patient safety organization bill this year in the legislature which will create an opportunity for us to share information.

We had two suicides in hospitals in Rhode Island this year. The second suicide followed exactly the same pattern as the first suicide. Yet that first hospital had put good procedures in place to stop it. We did not have a mechanism for communicating it to our second hospital.

Senator GREGG. So your patient safety bill is not going to limit information as some patient safety bills have. It is actually going to attempt to expand the availability and yet protect the patients?

Ms. ADAMS. Yes. We introduced our privacy bill on Tuesday of this week. That privacy bill we put together with people like the Domestic Violence Coalition, ACLU, and others that we knew would hold our feet to the fire until they blistered on the issues of privacy and security. And we are very proud of that bill. It extends the protections far beyond HIPAA and we expect that bill pass.

Senator GREGG. Sometimes that becomes a bigger problem than a plus.

Ms. ADAMS. We very carefully looked at the architecture and spent 18 months figuring out how we can do this Rhode Island. At the same time, consumers have to trust this system or they simply will not opt-in. And if they do not opt-in, we have nothing. We have done a good job, we think, of developing a system that will allow us to operate the system at a price we can afford and still protect their privacy.

Senator GREGG. Does anybody else on the panel have a thought on this issue of disclosure of quality in different provider groups? And how we make that quality more visible, transparent, and therefore more available to purchasers, quality and cost?

Ms. GREALY. Senator Gregg, I think that really is one of the goals, information sharing and how we can improve the quality and safety of the care that is being provided. So we know that we have CMS driving toward value-based purchasing. We have private plans that are driving toward value-based purchasing.

Senator GREGG. But you need specific information on the actual on the ground delivery. You have to know if hospital A or provider group A is delivering a service that has a quality issue or it does not have a quality issue but is less expensive than somebody else who is the same quality or maybe less. You have to know the specifics; right?

Ms. GREALY. Right, I think that is——

Senator GREGG. You have to have that available.

Ms. GREALY. I think that is why this is such an important tool in making that information available in a way that you can do this comparative analysis, which I think is your point. How do we compare providers? We have guidelines. We have a whole host of organizations that are developing what are the appropriate practice guidelines, what is the best use of evidence-based medicine. And then I think the next step is how do we do this comparative analysis so that payers for health care as well as consumers of health care have that information available to them so that they can make that choice.

Senator GREGG. And how do we do that?

Ms. GREALY. I think by implementing health information technology. I think what you are hearing from this panel is that this is a tool that is so important in so many ways in terms of improving quality and safety but also in increasing the efficiency of health care. And so we need the funding to get these systems in place.

We have organizations that are currently doing it. I think what you are hearing Rhode Island, light-years ahead of many other providers and systems. But we are seeing this throughout the country but they are still in their silos.

And I have been impressed with my members like the Mayo Clinic, the Cleveland Clinic. When you talk to them, what do they want out of the system? We are doing it. They have made the investment. What they would like to see is how can we help smaller community hospitals? How can we help small group practices of physicians? How can we help rural providers do what we are doing?

They made the investment, they did not expect to see a return on their investment, and they have been very pleasantly surprised that they actually have seen cost savings as a result of doing this. They now want to make sure that others can access the system so that we can share this information nationwide.

And I think really achieve the goal that Senator Whitehouse was mentioning. If we do not do system reform to get control over making the system more efficient, then I think the only alternative we have is imposing across-the-board cuts, price controls, things that will not work.

Senator GREGG. Have you looked at the IT bill?

Ms. GREALY. Yes, and we are very supportive of that legislation and have worked very hard with Senators Kennedy and Enzi to try and get that legislation passed.

Senator GREGG. Thank you.

Chairman CONRAD. Thank you, Senator. I am going to defer again to Senator Stabenow because she has played such a lead role on this Committee on this subject. We will turn to Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman, very much for this important hearing. This has been a passion of mine. I think one of the very first conversations Senator Whitehouse and I had in his coming to the Senate was on this topic? And so it has been wonderful to work with you and to see the energy that you bring to this.

I would say to my friend, Senator Gregg, that the answer is yes, in terms of being able to demonstrate quality and comparisons and so on, using health IT because we are actually doing that in Michigan.

Mr. Chairman, we may even want at some point to have another hearing that relates more to the specifics on the quality pieces of sort of what has been demonstrated. There is something called the Keystone Initiative that was started by the Michigan Hospital Association, that has received national attention. Senator Whitehouse and I have also talked about that extensively, but where they are focused on certain benchmarks of quality, eliminating infections, now surgical procedures and so on. And they have had terrific results.

But again, they go back to the ability to cut data and health information technology and it all goes back to the same thing that we are talking about now and issues around privacy, which are also something I would like to ask you about which are very important.

We, though, in Michigan—and just to brag about Michigan because we have had a number of areas of leadership on this—and frankly because we have the largest employers that provide employer-based health insurance in the country. And so there has been a real incentive, the auto industry and others to really focus on this.

But we have had one area specifically where we have seen just tremendous results in just a couple of years. And that is around e-prescribing. We had the auto industry and BlueCross BlueShield and physicians and others that came together in 2005. And since that time, they have had over 6 million prescriptions that were written electronically in Southeastern Michigan, the Detroit region. They have 2,500 physicians that are actively involved in this now, providing more than 282,000 electronic scripts each month. What they have found, when they evaluated this after 2 years, is that it substantially improved patient safety. It was not just an issue of cost, as all of you know. It is an issue of safety.

And they found that doctors were alerted about incorrect drug prescriptions, incompatibility with prescriptions that people were already on. They found that 423,000 prescriptions were actually changed or canceled by the doctor when they had better information by using e-prescribing, and that there were 100,000 medication allergy alerts that went out that caused the doctor to be alerted and to be able to change the medicine. And they also found that 38 percent of the time the doctor changed the prescription to a lower-cost generic once they were given information about other medicines that were available that would address the same issue of concern.

Plus you can read their handwriting better.

So I say that only to say there is a tremendous amount of effort happening here and also among individual hospitals.

But what I am leading up to is what I hear over and over again, I hear from major hospital systems in Detroit that are doing health information technology. I hear it as it relates to the e-prescribing effort, is that the most difficult part is physicians participating. So you have a hospital doing this and yet it is dependent upon the physician sharing information and being a part of this.

And I am not being critical of them. They face Medicare cuts, Medicaid cuts every year. Then we say to them by the way, we want you to go out and buy this equipment, we want you to train your people, we want you to spend these resources, do these new systems. And the folks that will benefit the most are the Federal Government or others.

And so I wondered if you might speak to the importance of incentivizing physicians and others to participate? And I would say, on that note, that there are two initiatives happening. Senator Snowe and I have had legislation for some time to provide incentives through Medicare for physicians that use health information technology to be able to help them be able to address the costs and be incentivized.

And Senator Kerry and I, in the last Medicare legislation we were working on concerning physician payments, worked with colleagues on an e-prescribing effort that would provide an incentive payment to physicians as well as one-time grants to help them be able to get the equipment.

So I wonder if you might speak to sort of—the saving comes to the providers and the Government and yet we are asking the providers, the physicians, to go through a tremendous amount to be able to make it happen.

Ms. ADAMS. We see that problem as likely one of the most significant root causes of why we are stuck in the status quo. When you really think about the fact that a physician may put something in place that prevents a medication error, what that means for that physician is that patient will not be returning to the office numerous times for followup visits.

They get paid by the visit, not for the continuous healing relationship that the IOM described, not for treating the patient at home and making sure that if they see their A1c hemoglobin is going up, their blood sugar is going up, that they intervene at home and keep them out of the office or hospital. For every patient they do not harm, that patient is not hospitalized, that money goes back to somebody else.

I think it was Jim Reinertsen that was so eloquent when he said every step we take toward this collective vision of nirvana is one step physicians take toward insolvency. And then we wonder why they will not participate as actively.

So in Rhode Island we have addressed it in a couple of ways. First of all, our major insurer, BlueCross BlueShield, stepped up huge. They put in a significant reimbursement rate increase but they split it in half. They said you get 50 percent of it because you need it. And the other 50 percent you get if you go electronic, certified electronic. And if you do not, you do not get it. Because it is safer, better care, it is cheaper care. So we had a big incentive program there.

They also put in a program called Quality Counts, which means that the first year is a pay for adoption. Not pay for performance yet, pay for adoption. So that system went into place also.

We also have a group that we have assembled under the Quality Institute umbrella of the senior-most thought leaders physicians. We recognized that the pharmaceutical companies were just ingenious at figuring out how to identify thought leaders in communities, talk to them about prescribing certain medications, and those would sweep across that social system and any population they were trying to change.

Now the physicians chafe at that idea but we should not throw the baby out with the bath water. That is a brilliant idea. So we are conducting a study right now with the same group that formulated that capacity for finding those opinion leaders, finding their communities of practice and making sure we understand those thought leaders in HIT Rhode Island, physicians. What are they saying? Are they saying yes, adopt or no, do not adopt? It helps us develop our strategies if we can find those physician thought leaders because really the tipping point and diffusion of innovations theory tells us that if you can convert 20 percent of the thought leaders, that innovation will continue through the population and you cannot stop it even if you wanted to.

So we are doing a couple of different approaches—and we are also working on things like low-cost loans, whatever we can do, supports because we know that the biggest challenge for them after they get past the OK, I am going to buy it is they need their hand held every step of the way during the early part of the transformation. That is where the failure occurs most of the time.

Ms. GREALY. Senator, I think there is another area and we have seen some progress in this. We have many hospitals that are willing to help physicians that are affiliated with them or even not affiliated with them. Under the Stark self-referral and the anti-kickback statute they can do that with their employed physicians and not be concerned about the penalties.

But for those physicians that are not employed by the hospital it is a little more vague. And the penalties for violating these laws are quite severe. So I know that hospitals tread very cautiously there.

There has been some new regulations that have helped clarify that. We probably could use more clarification in that area.

But I think what you are hearing, and I think Rhode Island, you know, if we could just expand that model nationwide, it really is a shared responsibility. Providing incentives, and I think that absolutely is the way to go, provide that carrot. Having physician leadership. For every hospital leadership that has done this and done it well, it has been with great physician leadership and leadership at the top. So it is that cultural change, as well.

And the low-cost loans. There is a variety of tools that we can use. Something that we can do on the regulatory side as well as the financial side.

Senator STABENOW. Mr. Chairman, I hope we are going to be able to really address these things as we move forward, whether it is Budget or whether it is Finance, to really address those incentives that will allow this to move forward, through Medicare payments, through other things that will really make the difference.

Chairman CONRAD. You know, this is a situation where two committees have cross-jurisdiction. We have a responsibility as the authorizing committee. Finance has a responsibility in two areas, provide the money and as an authorizing committee, as well. And so we are going to have to work hand in glove in order to provide resources necessary to actually accomplish an outcome.

Senator WHITEHOUSE. Mr. Chairman, can I offer an observation to you?

Chairman CONRAD. Yes, absolutely.

Senator WHITEHOUSE. I would like to followup on what Ms. Grealy just said, that Rhode Island could be a model if you would expand it nationally. I think it is, obviously for our purposes, a very flatting point but also one that is worth considering is how you might do that.

I think if you look at what identifying characteristics are that made Rhode Island successful, the key one was this question of having a place, a forum, a location, an organization where local leadership could get together and step outside of their siloed roles and start to think collectively about the direction of the system they were, until then, trapped in.

I think that if you are going to try to take the Rhode Island system national, the best first step would not be to take what you do in Rhode Island and go to Michigan or to the Dakotas or to California or to Texas some place and say here, do this. It would be to try to facilitate that same process where the local leadership has the opportunity to get together and start making these decisions.

Because there are other ways to do this and we know so little about what we are doing at this point that experimentation, health care federalism would really be, I think, valuable.

So I just wanted to followup on Ms. Grealy's point because I think is a valuable one. But I really think it is important that we try to drill down to how you would make that happen. And I think counting on local leadership, where people trust each other, they see each other at the market. They go to the same church. They see each other at the football games when their kids are playing.

Chairman CONRAD. So we call it the grocery store.

Senator WHITEHOUSE. The grocery store.

Senator STABENOW. I am sorry, we keep going back and forth here. But I would just echo that because on e-prescribing in Michigan, that is exactly what happened. Employers, BlueCross, hospitals, physicians, everybody came together to do something that was across lines. And so I think that is an important point.

Chairman CONRAD. Can I just make this observation, that the crisis is now. The crisis is now.

I just tell you Senator Whitehouse described very aptly what is going to happen at some point. We are there.

The next administration is going to walk into this town and they are going to have seen the Federal Government's debt go up $800 billion in the previous year. Not the $400 billion that all of the news media writes about. Wrong. That is not the problem. The deficit, that is all they can write about is the deficit.

I do not know why the news media cannot write a four letter word, debt. They do not want to deal with that.

I had one very prominent reporter tell me we do not write about the debt. It is too complicated. We do not know whether to write about the gross debt or the publicly held debt.

Well, guess what? The gross debt is what the country owes. It is what is going to have to get paid back. And the gross debt of the United States, now $9 trillion, is going to go up $700 billion this year. It is going to go up $800 billion the next year. Nobody talks about it. Nobody mentions it. It is like the crazy cousin in the closet or what did Ross Perot talk about, the crazy aunt in the basement.

It is unbelievable what is going on in this country, just a collective kind of hide the ball from the American public.

The next administration is going to walk in here. At some point this will precipitate a crisis because we are borrowing this money, increasingly from the Chinese and the Japanese. And it is just a matter of time before the roof caves in.

I had another senior colleague tell me well, that is what has to happen, we have to wait for the crisis. I love that. That is a great plan, let us wait for the crisis. But that apparently is what is happening.

None of us knows when the crisis is going to occur, but you can just write it down. It is going to occur because there has never been a country ever that has been able to sustain itself by borrowing from abroad. And over half of our debt now is financed abroad.

And guess what? The dollar is going down in value, which is exactly what you would predict. And at some point, those of us who are loaning the money and they are going to look at their holdings and they are going to say gee, we are holding all of these dollars, and the dollar is going down dramatically in value. Maybe this is not such a good idea. And then we have a big problem.

Because if they make that decision, singly, collectively—we have already heard warnings from Chinese finance ministers, Japanese parliamentary members, that they might have started diversifying out of dollar-denominated securities? Then what happens?

To get the money you have to raise interest rates. And I will tell you, that is when it is going to get really ugly in this town because we are just in a financial dream world. We are just running up the charge card and hoping the bill never comes due.

But it will. Absolutely, without question, it will come due.

So that is why this subject is critically important and your observation, Senator Whitehouse, that you have to build to prepare, that is exactly right. Unfortunately, we are going to get caught in an unbelievable crunch.

I sometimes think of it and I wonder what this town is going to be like when this realization hits.

Senator NELSON. Mr. Chairman, did I not see a story recently where some stores in New York were only dealing with euros instead of dollars?

Chairman CONRAD. You have some European super model that will only take a contract in euros now because the dollar is going down in value and so she wants to get paid only in euros. Who would ever have believed we would be in a circumstance like that?

I want to go to a question that was raised by something that you said, Ms. Adams, on infection that really caught my attention. An initiative through the use of information-technology, as I took it—and correct me if I am wrong—that helped bring down the rate of infection I heard you say 57 percent. Could you tell the Committee a little more about that? I would be very interested.

By all accounts the infection rate in hospitals has always been a serious concern. But now it is a growing concern. We have infections in hospitals not seen before. What was done to so dramatically reduce the rate of infection?

Ms. ADAMS. We took our inspiration from the Keystone project in Michigan. That is the project that originated this, and we replicated because we know that there is no sense in starting from scratch when somebody has done something dramatic. They have achieved results beyond what we have achieved. They have been going on I think 2 years longer than we have.

What it entails is we have almost no feedback loops in health care. We do not know how often we are infecting people. We do not know how often we are harming people. We do not know what it costs. We have so little information to operate on, yet we keep imploring people to do better. They have no metric.

So one of the most important cornerstones of our initiative was to get them a metric. How often are we infecting people? Let us standardize our definitions so we know it across the State.

Then we know that there are certain interventions based on science. To keep people from getting a ventilator associated pneumonia, you have to keep their head of the bed elevated 30 degrees. We have to find some way to measure to make sure that it is happening. And if it is not, then we have to find ways locally to make sure that that head of the bed says 30 degrees, even if it is making sure that the daughter knows that that head of the bed ought to stay 30 degrees. And anybody that leaves the room, nail them and tell them that mom needs to have her head of the bed up 30 degrees.

But if we do not have those metrics that come back and tell us about our performance, we have no way of knowing how we are doing. And it is incredibly demotivating to staff to be—sometimes we will devolve to such things as like the hand washing police and we will count how many times people have washed their hands. But we will not put up on the wall how many people have been infected by the fact that we are not washing our hands.

Now when we put up there that it has been 66 days since the last infection, 67 days since the last infection, 68 days since the last infection, they wash their hands because they have a metric up there. But without information technology, we continue to try to deliver care in an information-free zone.

Chairman CONRAD. That is a very interesting point.

Let me ask you, when we are talking about information technology, we are talking about deploying it within an institution. We are talking about deploying it across institutions. And then there is the question of where does the product go.

Because I, as a consumer, if I have to make a decision what hospital I am going to take a loved one to—I just went through this with my daughter who had an emergency appendectomy over the Christmas holidays. You know, I went to the hospital where I went to school. I did not go to the medical school but I went to the school.

But I have no idea—actually I had a wonderful experience there, so I was fortunate.

Where would you find the basic information on something like infection rate that would be publicly available? Is there a place that a consumer could go and find out what is the consumer satisfaction? What is the infection rate? What is the survival rate of various surgical procedures? What is length of stay? What is cost?

Is there any public source where you could readily find that information as a consumer?

Ms. ADAMS. We have increasing opportunities for that now. In Rhode Island we have been doing public reporting on a certain set of outcomes. We have really been fortunate in having CMS advance that program of public reporting. We publicly report satisfaction in California, for example.

There been a number of places that attempted to publicly report the outcomes of cardiac surgeries. Pennsylvania has become a marvelous job in beginning to become very transparent about this.

It is a difficult science to do the measurement? And of course, the measurement also causes some interesting behavior. If you end up as the person with the highest mortality rate for cardiac surgery, we have seen physicians refuse——

Chairman CONRAD. Do they start to hide bodies?

Ms. ADAMS. They refuse to take on the difficult cases or operate on more healthy people to get their average up. So in some ways we have to be careful about the programs themselves. But increasingly we are seeing those. There is Health Grades on—the Internet is becoming a rich source of opportunity to look to see.

And also, hospitals that do not pay attention to bad outcomes, for example, and do not listen to the consumers and families that they have harmed will find their story being told on the Internet. I could give you five sites—I will not right now—where families have told their stories in aching excruciating detail about what happened to their loved one.

If we pave a way for that information to be known in a format that is acceptable to all of us, patients and families find a way to make it known. It is word-of-mouth on steroids.

Chairman CONRAD. Ms. Grealy?

Ms. GREALY. Senator, we are seeing great progress in this area. I think we have moved beyond providers not being willing to share this information. And I think they see that we now have an opportunity really to get in front of this. So you have the National Quality Forum. You have various projects going on where medical societies and other health care providers are getting together and determining what are the appropriate measures. And I think that is the important point.

We want to make sure that we are measuring and reporting the right thing, that we are not penalizing providers that are taking the tough cases.

But this movement is well underway. We are seeing great progress. CMS is helping to drive it. Private health plans are driving it. Consumers are now demanding this information. Providers get it. And now we are just trying to find what is the best format both for the provider as well as for the consumer.

Chairman CONRAD. And is this something you would anticipate would be available in a certain timeframe?

Ms. GREALY. I think much of it is available already. What we need to do is get it more unified. So you can go to Leapfrog, you can go to the CMS website. There are a variety—as Laura just said—of different websites that are available now. But I think everyone is trying to do this in a much more unified, uniform way. CMS is driving it to a great extent, as well as the private health plans.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE. I have a question and I would like each of you to answer it. President Eisenhower, not exactly a major league liberal lefty, decided that it was very important to build a national highway system. Now pretty much every American drives out of their driveway onto a publicly maintained road and we all accept that the roads should be publicly maintained. We are very comfortable with the idea of a huge Federal transportation budget that maintains that infrastructure. We all recognize that collectively, when we get together to build that infrastructure, we do ourselves a great common good because goods travel more cheaply and they travel more efficiently and the prices of goods go down and it is easier to visit grandma on the holidays. And for all of those reasons we get together and do it.

And if somebody came to us and said well, the way we are going to do this now is we are going to make everybody responsible for the care of the roads and highways in front of their houses individually, you would end up with a nightmare. You would end up in potholes. You would end up with mud. You would end up with everybody trying to deflect from their responsibilities.

What is it about the health information infrastructure that is different from say the highway infrastructure? We had a bridge fall in Minnesota. It was a terrible tragedy. We leapt, as a Senate, to go and build that new bridge and put that infrastructure back together.

What is it about health information infrastructure that makes it so hard for us to see it as infrastructure like the highway system? Why don't we have a more prominent Federal role in it? The wave of debt that Chairman Conrad talked about, I use my eight pennies example because I keep hearing from our colleagues across the aisle about how bad earmarks are and how there is 8 billion too many of them.

If a penny is $1 billion, that is the pile of what we save if we cut the earmarks in half, $8 billion. There is eight pennies.

If you look at our long-term unfunded health care liabilities, it is a pile of pennies, my staff has calculated, that is 221 feet high. And what we spend on it through ONCHIT is $66 million in the president's budget. That is one-fourteenth of this piece of penny. You would need a little clipper to clip one-fourteenth off.

And when you put that against that, I do not get why do we do not see this as infrastructure, particularly with the savings available.

Ms. MELVIN. Senator Whitehouse, in the work that we have been doing at GAO, one of the things that we have recognized is that there are a number of initiatives that HHS is undertaking. There are initiatives related, I think in the same sense, to some of the discussion that we have had earlier relative to e-prescribing, Rhode Island's experience so far. So there are ongoing efforts——

Senator WHITEHOUSE. But is it not fair to describe the HHS efforts as regulatory?

Ms. MELVIN. I think they are more from the position of trying to determine solutions and how they can move forward.

The concern that we have had, and I think it goes to part of the reason that have not been able to perhaps come to some more definite statements or positions relative to infrastructure, is that what we have seen is that there has not been a national strategy, if you will, to really carry the initiatives forward. While there have been important progress made in a number of areas, even from the standpoint of what you have spoken of today, there are national trial implementations going on that do address some of the issues that, for example, Chairman Conrad mentioned relative to trying to get a handle or a better understanding of interoperability.

The concern that we have is that there is no defined strategy that identifies the plan in terms of overall what it is that they are trying to accomplish that addresses all of the nuances that I think have been mentioned here today through the experiments of Rhode Island and other places, that there are not specific milestones for how to reach the objectives.

And then ultimately, as was mentioned earlier, having outcome-oriented results measures that, in effect, allow them to look back at what it is that they set out to achieve, knowing definitely where they want to go to, making informed decisions based on the various activities that are being undertaken—and there are good projects in the works from what we can see. It is a matter of trying to utilize those projects in an effective way to get information that allows them to make informed decisions, whether it is on a public level——

Senator WHITEHOUSE. If you do not mind, the time is running out.

Ms. MELVIN [continuing]. Or a private level.

Senator WHITEHOUSE. I want to give the other witnesses a chance to answer, as well. Laura, Ms. Grealy, is this infrastructure?

Ms. GREALY. I would agree it is infrastructure. It is a very complex, challenging problem. As I said in my testimony, we recognize the fiscal difficulty of doing this in a huge way, which is why we are really looking for what I would call seed money. There are a whole host of organizations, entities, out there that really could do this. They just need help with the initial investment.

So we are not saying that the Federal Government has to finance this 100 percent, or that the private sector has to finance it 100 percent. But we think through a partnership—and some of the legislation that is out there, I think, really provides that.

It would be nice to have the overall framework, kind of the map, so we know where we are headed and get this coordinated. But the movement is underway. And people are doing it and they are willing to make the investment. They just need the helping hand.

Ms. ADAMS. My take on this is that it is a failure of market forces and people are putting way too much stock in the idea that market forces are going to fix it. Whenever I am speaking to employers and other people who look at health care as another industry, they will say nobody paid for my IT infrastructure, why should I pay for yours? They fail to understand that the benefits accrue to everybody else but the person who puts it in.

And then I think the other concern that I have is things like competition does not work in health care. You get another MRI on the corner, you have another MRI on the corner. Having more does not drive down costs. It does not drive down the number of MRIs. It drives both of those up.

When you look at things like our payment structure, the worst cardiac surgeon is paid the same as the best cardiac surgeon. We have no set of market forces and people rely on that.

I think one of my greatest concerns, I would like to sound an alarm a little bit, on the issue of the relaxation of the Stark. Because what I think that that is going to do, in the absence of the group that you talked about, the community governance structure coming together, then what the relaxation of Stark allows us to do is say I am going to connect. But I am going to connect just with that orthopedic hospital that sends me referrals and just that one that sends me the referrals over here.

The rest of you, patient-centeredness? That is your problem. And to get your little doctor on the corner linked, really not financially in my best interest.

So we are going to see what John Glaser of Partners has described as RHIO 2.0, the default to the market structure. And we will once again have more duplication and it will fail again.

So my concern is if we do not see it as the public good then we are headed toward—talk about the next festival of waste.

Chairman CONRAD. I think we should go to Senator Wyden because he has not had a round, if we can do that.

Senator Wyden, welcome. Senator Wyden, of course, has been legendary in terms of leadership on health care. He has spent years trying to put together an alternative structure that we could look to for reform.

Senator WYDEN.

Senator WYDEN. Thank you, Mr. Chairman. And I would probably characterize it more as infamous rather than famous, but I thank all of you. I apologize, we have had a huge hearing for Oregon today in terms of forestry, and Senator Stabenow and Senator Whitehouse, of course, have had a tremendous interest in this, as well.

I am so glad that you are here and that we are having this hearing because the history of this debate, of course, is that what gets most of the attention is cost. And if you look at the 1993 discussion about the Clinton plan, there was oceans of debate about the costs of health care and virtually no discussion about what we are talking about here today which is quality and people, in particular being able to find affordable services and providers that are good quality.

And what we do in the Healthy Americans Act is to try to take some steps in that direction, certainly not anywhere near as bold as Senator Whitehouse has been advocating in his good work. But we secure a way to pay for electronic medical records. A number of insurers have indicated that they would be supportive of that under the approach that we advocate.

We use the Agency for Healthcare Research and Quality to publish nationwide by ZIP code information about the kinds of providers and services you are talking about.

I want to talk about the role of the individual to start with in this because I think it is something that we have missed. And it is, to a great extent, a transparency issue. Right now in America, if you got an employer buying you $12,000, $14,000 of health care, and it is part of your compensation, you are basically in the dark about whether that purchase of health care for you really addresses the kinds of quality concerns that you all are talking about.

So I think I would like to start, and maybe we can start with you Ms. Grealy, and go right on down the line. How important is it to you, in this effort to drive quality, that we show the individual how that money is being spent today?

Because I think if individuals see, for example, that $14,000 or $16,000 is being spent on their health care benefits, I think the first thing they are going to say is darn it, I want to get more value for my money. I want to do some of these things Senator Whitehouse and Senator Stabenow are talking about, the e-prescribing and the sensible suggestions Senator Whitehouse is talking about.

I think they are going to say I want to see that done so that my $14,000 is going to get more for me and my family.

So starting with you, Ms. Grealy, how important is it that the individual see what the health care dollar that is being used in their name goes to?

Ms. GREALY. We strongly support a patient-centered or consumer-centered health care system. In just talking with my members, who not only are health care providers and manufacturers of health care products and health plans, but they are also, in many instances, large employers. And more and more they are telling their employees: here is how much is being spent on your health benefits. And for every dollar that is being spent on your health benefits is a dollar that is probably not being spent on wages.

So I think consumers are very interested not only in what is being spent on their health care, but I think we are trying to create more of that market force that is missing by getting consumers closer to the cost as well as the quality of their health care.

That is why I think the whole discussion about transparency is so critical. We have to make sure that we are providing them good information. But we need to get the consumers much more involved, both in managing the costs of their health care as well as the quality. And of course, what can they do to make a difference in health care costs, which is managing their health better, as well, the whole disease prevention movement.

I think this is a very exciting time. I feel like we are just on the precipice of making true health system reform, not just talking about costs but really talking about the system and how we can improve it. And the consumer just absolutely has to be part of that.

We have not really spent much time today talking about what I think is the real critical problem here. Why do we need a unified electronic health record? It is so that parents like mine, who are in their 80's, that are seeing on average 10 health care providers, that each of those providers know what is going on with them and that they have a better sense of what is the health care that they are getting.

So again, I think there is a very critical role for the individual consumer and patient to play in this, and it is all about having useful information.

Senator WYDEN. Let us give your colleagues a chance at this. The question of transparency with respect to where their health care dollar goes today and how it might be better utilized.

Ms. ADAMS. I would say that I think we ought to keep in mind the notion of the connection between quality and cost and be sure that if they get the cost information, they get the quality information.

I was fortunate enough to learn and travel with W. Edwards Deming, a theorist who essentially brought Japan's economy back from World War II. And one of the things that Deming taught me about was the notion of price tag versus total cost.

He was wearing a pair of shoes 1 day and an old engineer friend walked up and said hey, those are a great pair of shoes. How much did they cost you? And he said I have no idea, I am not done wearing them yet.

His point was that there is a total cost and there is a price tag. My concern is if we show people price tag—we have a good study that just came out from Brown recently, in the last month, that showed even a small copay and the showing of the cost of a mammogram will cause some women not to go get that mammogram.

Now we will understand that there is a price tag there and they may reduce the price tag but they will not increase the overall cost. So I think it is a very difficult conundrum.

Senator WYDEN. Just so we are clear, under the Healthy Americans Act all of those essential preventive services would not get a copay. What we are talking about here is just access to information so that you would be in a position to say boy, they are spending all this money in my name. Gosh, I would like to look around a little bit and see if we might get more for my money.

Ms. ADAMS. Yes, and all I am saying is if we can tie that to quality, because I would like to know what my money is buying. Few of us would want to put our health care out for bid to the cheapest provider.

Senator WYDEN. That is for sure.

Let's hear from the folks from GAO. You are from GAO, aren't you?

Ms. MELVIN. Yes, I am.

From the work that we have been doing, it has been focused on the technology aspects. And certainly, driven by patient-centric emphasis on having quality care to the patient. In the work that we are doing, we have seen that with the electronic health records the key is in being able to have information readily available regardless of the provider that the patient chooses to use.

Hopefully, in terms of that intent, you would see that through the availability of that information, that hopefully that would translate into better care which ultimately makes the bottom line for the actual patient, makes it clear in terms of quality improvement.

Senator WYDEN. My time has expired and let me just ask one question that perhaps you could respond in writing. In the past we have really looked to the Agency for Healthcare Research and Quality to take the lead in terms of getting this kind of information out. I think there is certainly going to be a debate about whether we ought to reconfigure their role and have them take on additional assignments.

If you could get back to us for the record what kinds of suggestions you could give us for the best way to use that premier agency with respect to information and data as it relates to quality, that would be very helpful.

We may get another round and if so I will get a chance to get into it. But again I want to thank also my colleagues, Senator Whitehouse and Senator Stabenow. They have been the champs on this issue and have been educating me and I look forward very much to working with them.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Wyden. And thank you for your contribution to this committee.

Senator STABENOW.

Senator STABENOW. Thank you, Mr. Chairman.

Just for a moment on the issue of quality again in the Keystone project, just to followup. And I appreciate Rhode Island's work in working with what has really been a phenomenal initiative by the Medical Society in Michigan. Within an 18 month period, they first focused on intensive care units, as you know, the intensive care unit and diseases? And within an 18 month period actually saved 1,500 lives and $165 million. It was just extraordinary.

So it is very exciting what can be done. It is very exciting what you are doing, as well. It is very exciting what the possibilities are.

But if we are going to get ahead of this curve that the Chairman talked about and Senator Whitehouse talked about, it takes time to do this. So we have to start doing it so we have time to develop it and really see those results.

I wanted to turn a little bit to the issue of privacy. We hear a lot of concerns. I find it interesting when I can go to the ATM. I bank online. I can go anywhere in the world to an ATM and be able to get cash, assuming I have some in the account. So we have security systems. We do this for financial services all the time.

But there is a legitimate concern about health privacy and how we manage that, who owns that information and how do we do that and so on.

It was interesting, I had a psychiatrist who was in the office for a meeting this week, a woman in psychiatry, talking about the fact that she was very concerned about health IT because there were medicines and physical ailments that she needed to know in treating her patients, whether they were on heart medicine, other kinds of things, that even though it did not directly relate to what she was doing, she needed that information from a safety standpoint in working with the person.

And she talked about how her records are private, from a privacy standpoint, from a mental health or psychiatric standpoint, and that they have a firewall to protect information in her system, in the hospital that she works in.

So I wondered if you might speak, I mean I personally think that having a password and some kind of an electronic system is actually much more secure than a file in somebody's filing cabinet that anyone could open up.

But I wonder if you might speak to the security issues and the progress in dealing with these issues around privacy and security and how we tackle that. Because I personally believe that is one of the barriers publicly in moving forward, that is an initial comment that people have in terms of who will have my information? How will it be used? Will an insurance company use it in some way against me if I am looking for coverage? And all of those kinds of things.

Ms. GREALY. Senator, I would like to respond. We have done a lot of work on the privacy issue. We head up a confidentiality coalition of over 100 groups and have been working on this for over 10 years. I think we have not done a very good job of educating the public about what protections are currently in place.

As we began working on health information technology legislation, I felt like we were starting all over again, that the HIPAA privacy rule that we worked on did not exist.

So I think we need to make sure we inform the public. Protections are in place. Your information cannot be disclosed to your neighbor, to your employer, to a reporter. And if it is disclosed without your permission, there are penalties. So we need to educate.

We also need to educate people that, as you pointed out, your information is much more secure in an electronic health record and system because there is an audit trail, there are passwords, there are protections that you do not have if your record is just sitting in a file cabinet on a piece of paper.

As I said in my statement, we would like to see more uniformity just to make it easier, as you are going from state to state, and not having to spend much time and much money trying to figure out those rules and regulations.

But I think more importantly is just coming back, looking at this from the patient's point of view and assuring them one, your information is protected.

But I think more importantly, why is it important that health care providers have access to your information? Why is it good for you? Why is it good for your children? Why is it good for future generations? And that is the case that we have to make.

It is important that we have the information. We will de-identify it when we are using it for research. We will not disclose it inappropriately. But we have to make them feel comfortable with how it is being used and, more importantly, how it is being protected.

Ms. ADAMS. In the traditional Rhode Island way, we started with this about 2 years ago and got everybody and their brother together in the community to talk about it. We were educated quickly by people like the Domestic Violence coalition who said you talk about HIV and mental health as sensitive information. Well, for an abused woman who does not want her abuser to know she sought treatment, a cracked rib is sensitive information.

So what we got those groups that felt most vulnerable by the idea of having their information on the Internet. And the legislation that we introduced in Rhode Island this week includes a couple of things such as it is voluntary. You can opt in or not.

The second level of opt-in is you can OK, for this physician and that group and that group but not this one, that one, and that one. So there is the opportunity to direct your care.

The ACLU was somewhat concerned because we did not allow yes, this lab test, no, not that lab test, that level of granularity. But our concern was for our providers that if they go into that information exchange and they do not know whether 5 percent of the information on the patient is there or 95 percent, it renders it worthless and we can stop now.

So we did go with the you are all or you are all out.

We did also set up a regulatory body because these groups like the Quality Institute, we are freestanding. We are not for profit. And I think their concern is wait a minute, you have a sustainability issue. So how do we know some pharmaceutical is not going to swoop in and offer you a bunch of money for our sensitive information and you sell our soul.

Chairman CONRAD. Can I interrupt for just a moment? Can I interrupt for just a moment?

Could I ask Senator Stabenow to take over direction of the Committee? I have been called out for a moment.

Senator STABENOW [presiding]. Absolutely.

Ms. ADAMS. I think it was the concern that there be a regulatory body. And then obviously authentication and penalties because there is the situation and we do feel the need to communicate it to the community that—the situation like Mary Jones, the young girl that was beaten to death in New York and 34 providers in the New York hospital looked in her record. Well, there was an electronic fingerprint of that and those people were fired.

We have not had that kind of protection before of who can peruse your record. And short of getting a dusting for fingerprints, we do not know who has been in your paper record. So we would agree that that notion of informing the public is critical.

Ms. MELVIN. In our oversight role, our work has also identified challenges associated with protecting personal health information as it relates to, for example understanding and resolving legal and policy issues on variations in State laws that relate to privacy. Also on ensuring, for example, the amounts of information necessary to be disclosed and giving patients the right to really decide whether there should be amendments to their information.

What we have noted overall, which again goes back to the overall strategy that we have talked about, is there has been a need for an overall privacy approach in looking at this from a national perspective to make sure that there are plans and there are milestones and, again, measures for being able to really assess the extent to which privacy is being addressed in an effective manner.

Ms. ADAMS. Could I correct my testimony? I said those people were fired in New York. They were disciplined.

Senator STABENOW. Thank you. I think at this point, unless there are further questions, we will bring the hearing to an end. But we want to thank you very much for your testimony. This is an extremely important topic and I appreciate both the Chairman's commitment and Senator Whitehouse and others on the Committee. I hope that together we can move this and begin to move this.

We have an opportunity under Medicare, with the effort that is going on that could very well happen this year in terms of incentives around e-prescribing. And then hopefully we can take that next step and as quickly as possible begin the incentives to be able to support what you are doing.

So thank you very much.

[Whereupon, at 11:33 a.m., the Committee was adjourned.]

Mike B. Enzi

Statement of Michael B. Enzi

Health Care and the Budget: Information Technology and Health Care Reform

February 14, 2008

I would like to thank Chairman Conrad for calling this hearing today, as well as thank the witnesses for taking time to give us the benefit of their expertise today.

I think we can all agree that health care spending is not on a sustainable track. It is spiraling out of control. I think we can also agree that mistakes and medical errors in our hospitals, and our out-patient facilities are far too high, with sometimes deadly results. Ongoing increases in health care costs, along with the aging of the population, are expected to put substantial pressure on the budget in coming decades. And we can't count on economic growth alone to alleviate that pressure, because Medicare, Medicaid and Social Security costs continue to increase under current law.

As an accountant, I think this is a dangerous situation that must be addressed. And as a former business owner, I know it would be hard for a company to manage its books in a situation like this.

The time has come for Congress to stop just talking about health care reform and start doing something. Last year, I introduced "Ten Steps to Transform Health Care in America", a bold and comprehensive solution that addresses our health care crisis by building on market based ideas to expand access to health insurance for all Americans. If this bill were to become law, the end result would be an insurance card for everyone.

The plan is affordable. It's not free, but it is affordable. If it were free, people would wonder if it really did anything. The plan equalizes the tax treatment of health insurance for ALL Americans, not just the ones that get their health insurance at work.

The Ten Steps plan will reduce the cost of health care. Right now, a lot of rules are in place that prohibit groups of businesses from getting together and pooling their purchasing power so they can negotiate better deals for health insurance. This doesn't make sense. If a group of shoe store owners in Wyoming wants to get together with shoe store owners in Montana and Colorado and band together so they can get greater discounts on health insurance, they should be allowed to do so. This bill allows that.

We have no choice but to stabilize this system and provide more options for businesses so they can continue to provide health care for their employees. We must also provide real options for those without employer-based health care.

Along these lines, the bill recognizes the changing workforce. It provides real options for people to take their insurance card with them when they change jobs. No one should be trapped in a job just because their loved one needs particular health insurance.

One of the other main focuses of the Ten Steps plan is on health information technology. If more folks start using electronic medical records, lives will be saved. Not only will fewer mistakes happen, but a trip to the doctor's office won't start off with a clip board and a pencil. I'm so tired of filling in my personal information every time I go to the doctor. I should be able to carry around a key or a token that I can hand over to my doctor that allows her to access all of my health information. On a good day, I can't remember all there is to remember about my health history, what drugs I'm allergic to and what surgeries I had when. If I had a token or a key that could provide access to this information, my doctor could always have the most accurate information about me and she wouldn't need to reorder tests another doctor ordered.

Most folks know how passionate I am about health IT and they know I worked to get a bill through the Senate during the last Congress. Last year I worked closely with Senator Kennedy on that same bill and with Senator Gregg's help, we made the bill even better and reported it out of the HELP Committee last summer. Unfortunately, the bill is being held because some folks don't think it does enough to protect patient privacy. I disagree.

Protecting privacy is a very high priority of mine and nearly every section of the bill demonstrates that. It is very important that we find the right balance between protecting privacy and ensuring that health information is available to the appropriate people when it is need. The Health IT bill does a lot to build upon the privacy protections we already have in place.

The bill establishes the American Health Information Community (the Community), which is made up of experts representing a complete cross-section of the health care, consumer, and technology communities. The Community is charged with providing the Secretary of Health and Human Services recommendations concerning national privacy policies for adoption by the Federal Government. All of the bill's authors thought about privacy very carefully, and we wrote the bill this way because technology is always changing and privacy policies will need to change as technology changes. Once something becomes cemented in law it can be nearly impossible to get the law changed and updated, even if the policy is flawed and outdated.

I hope we can work across party lines to enact health IT legislation this year, as one way to address the fiscal challenges associated with spiraling costs, and unacceptable levels of medical errors. My hope is that this is a year of new beginnings, and that my colleagues will reach across the aisle and work together on meaningful health care and entitlement reform. We all know that 2008 is an

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March 21, 2008

The Honorable Kent Conrad
Chairman, Committee on the Budget
United States Senate

The Honorable Judd Gregg
Ranking Member, Committee on the Budget
United States Senate

Subject: *Post-Hearing Questions Concerning the Department of Health and Human Services' Efforts to Advance the Use of Health Information Technology*

This letter responds to your request of February 25, 2008, that we provide answers to your questions related to our February 14, 2008, testimony.[1] In our testimony, we discussed the Department of Health and Human Services' (HHS) efforts to advance the nationwide use of health information technology and to complete a national strategy for health information technology. Your questions and our responses follow.

Senator Bill Nelson asked the following three questions:

1. *Your recent report recommends that HHS establish a national health IT strategy that defines plans, milestones, and performance measures for reaching the President's goal of interoperable electronic health records by 2014. Do you believe that the President's goal to have interoperable electronic health records by 2014 is achievable?*

Without a comprehensive national strategy for health information technology, there is a substantial risk that the President's goal to have interoperable electronic health records by 2014 will not be achievable. HHS has reported that ensuring that electronic health records are interoperable is a key component for encouraging the adoption of electronic health records among health care providers. To this end, HHS and its Office of the National Coordinator for Health Information Technology have recognized the need to accelerate the use of information technology in the health care industry and have taken action on numerous initiatives to promote its use. These actions include the development of a nationwide health information network, the definition of data standards, the certification of electronic health records, and the assessment of privacy and security standards, policies, and practices associated with

[1]GAO, *Health Information Technology: HHS Is Pursuing Efforts to Advance Nationwide Implementation, But Has Not Yet Completed a National Strategy*, GAO-08-499T (Washington, D.C.: Feb. 14, 2008).

the nationwide exchange of health information. Moreover, it is anticipated that, beyond these initiatives, much additional work could be required to fully transform the use of information technology in the health care industry.

Nevertheless, as our report and testimonies have noted, HHS and the National Coordinator's Office have not yet defined a national strategy that includes detailed plans and milestones for completing and integrating the outcomes of the various initiatives, nor have they developed performance measures for tracking progress toward the President's goal. Thus, it remains unclear specifically how the President's goal is to be met and what the interim expectations are for achieving widespread adoption of interoperable electronic health records by 2014. This was the basis for our recommendation that HHS complete a national strategy that establishes performance goals for achieving interoperability and accelerating the adoption of electronic health records and that actively measures performance against these goals. Without such goals and measures, it is difficult to gauge the amount of progress that is actually being made and to have assurance that HHS is effectively positioning itself to achieve the President's goal.

2. *How much progress do you believe the administration is capable of making toward this goal without Congressional assistance?*

If HHS defines a comprehensive national strategy for health information technology, as we have recommended, it could help ensure that the administration proceeds on a positive course toward achieving the goal of interoperable electronic health records. However, in the absence of such a strategy, it is unclear to what extent progress could continue to be made without Congressional assistance. As noted in the previous response, a comprehensive strategy is necessary to guide the various initiatives involved in promoting and accelerating the use of health information technology. In this regard, a complete national strategy that defines HHS's milestones and timelines for meeting interim goals and that identifies initiatives and approaches most critical to achieving the end goal of interoperable electronic health records could more effectively highlight what has been accomplished and better inform Congress of what additional actions and related assistance are needed to achieve the intended results.

3. *What legislative initiatives do you think would be most helpful to move further toward this goal?*

In light of the concerns that we have highlighted in our reviews of the health information technology initiative, progress toward the goal of achieving interoperable electronic health records could be facilitated by legislative initiatives that would, among other actions, require the Office of the National Coordinator for Health Information Technology to develop a national health information technology strategy, including an approach for protecting the privacy of personal health information. As has already been discussed, we have recommended that HHS develop a national strategy for integrating the outcomes of its various health information technology initiatives. In addition, we have recommended that, as part of this strategy, HHS define an overall privacy approach for protecting electronic health information exchanged within a nationwide health information network. These two actions are essential to ensuring that HHS and the National Coordinator's Office have a defined approach to guide their efforts in developing and integrating health information technology, and that the initiatives undertaken include appropriate measures to protect the privacy of individuals' personal health information.

Legislation that members of your committee and others have proposed, such as S. 1693 (Wired for Health Care Quality Act), includes provisions related to the development of a strategic plan for implementing a nationwide interoperable health information technology infrastructure; this and other proposed legislation, such as S. 1455 (National Health Information Technology and Privacy Advancement Act of 2007) and S. 1814 (Health Information Privacy and Security Act) emphasize privacy protections for health information. Our work has not examined any of these specific legislative proposals in detail; however, if implemented, they could potentially help ensure that HHS addresses important deficiencies in its approach to advancing the use of electronic health information.

Senator Michael B. Enzi asked the following question:

4. *Ms. Melvin, I noticed in the GAO report you coauthored, GAO identified key challenges associated with protecting electronic health information. One of the challenges listed pertains to ensuring that individuals understand that they have rights to request access and amendment to their own health information.*

   I agree with GAO's conclusion that this is a problem. Very few people understand these rights. I am curious if you can explain in more detail these rights under the HIPPA Privacy Rule? Additionally, I would like to note that my health IT bill (which is being held up because of privacy concerns) reiterates these rights in Title IV— Privacy and Security.

The HIPAA Privacy Rule establishes individuals' right to access—i.e., to review and obtain a copy of— their protected health information maintained in a designated record set. A designated record set includes (1) medical records and billing records about individuals maintained by or for a covered health care provider; (2) the enrollment, payment, claims adjudication, and case or medical management record systems maintained by or for a health plan; and (3) records used by or for a covered entity to make decisions about individuals. The rule also gives individuals the right to request from covered entities changes to inaccurate or incomplete protected health information.

HHS provides information about consumers' privacy rights through the department's Office for Civil Rights Web site. This information explains that health care consumers can ask to see and obtain copies of their medical records and other health information from covered entities, except in a few special cases. It also explains that consumers can ask to have changes made to wrong information in their records or to add information if they believe their file is incomplete. If a provider disagrees with the changes, the change will not be made, but the consumer's disagreement will be noted in the record or file. This and other information can be found at www.hhs.gov/ocr/hipaa/consumer_rights.pdf.

Senator Wyden asked the following question (as reflected in the transcript of the February 14, 2007 hearing):

5. *In the past we have really looked to the Agency for Healthcare Research and Quality to take the lead in terms of getting this kind of information [about quality of health care] out. I think there is certainly going to be a debate about whether we ought to reconfigure their role and have them take on additional assignments. If you could get back to us for the record what kinds of suggestions you could give us for the best way to use that premier agency with respect to information and data as it relates to quality, that would be very helpful.*

The Agency for Healthcare Research and Quality (AHRQ) could potentially facilitate HHS's efforts to establish standards to promote nationwide use of health information technology, specifically health information technology standards for health care quality reporting. GAO reported in 2007[2] on HHS's efforts to increase the use of health information technology by hospitals for submitting quality data to the Centers for Medicare and Medicaid Services (CMS).[3] We noted the recommendations of the American Health Information Community Quality Workgroup[4] that an expert panel be formed to work to identify and prioritize quality measures for standardization to enable automation of the collection and submission of quality data using electronic health records and health information exchange. The workgroup also recommended that the expert panel take actions to (1) guide efforts by the Health Information Technology Standards Panel[5] to fill in identified gaps in related data standards for quality indicators and (2) guide efforts by the Certification Commission for Health Information Technology[6] to develop criteria for certifying electronic health record products that incorporate standardized data elements for quality measures. The

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[2] GAO, Hospital Quality Data: HHS Should Specify Steps and Time Frame for Using Information Technology to Collect and Submit Data, GAO-07-320 (Washington, D.C.: April 25, 2007.)

[3] The agency maintains quality indicators that are, among other things, used to measure the performance of hospitals' quality of care. Currently, AHRQ maintains four sets of quality indicators: 1) inpatient quality indicators, which reflect the quality of care provided in hospitals; 2) patient safety indicators, which reflect potentially avoidable complications or other adverse events during hospital care; 3) prevention quality indicators, which consist of hospital admission rates for 14 ambulatory care-sensitive conditions; and 4) pediatric quality indicators, which combine components of the other three indicators, as applied to the pediatric population. These indicators are publicly distributed and regularly updated by AHRQ.

[4] In 2005, HHS established the American Health Information Community, a federal advisory committee, to help define the future direction of a national strategy for health information technology and to make recommendations to the Secretary of Health and Human Services for implementing interoperable health information technology. The community is made up of several workgroups. The Quality Workgroup is charged with determining how health information technology can be used for the development of quality measures helpful to patients and others in the health care industry.

[5] The Health Information Technology Standards Panel is a public- private partnership made up of more than 300 health related organizations participating together to identify and harmonize data and technical standards for health care information technology. It was established by HHS's Office of the National Coordinator for Health Information Technology in 2005.

[6] The Certification Commission for Health Information Technology is a private sector task force that was established in 2005 by the Office of the National Coordinator for Health Information Technology to develop certification requirements for electronic health records and health information technology products.

workgroup also recommended that AHRQ and CMS work to bring together the developers of health quality measures and health information technology vendors, so that development of future information technology systems would take greater account of the data requirements of emerging quality measures. In this regard, AHRQ can play an important role in supporting HHS's efforts to establish the standards needed to ensure that health care quality measures can be collected and submitted automatically using health information exchange and that they are interoperable within a nationwide health information network.

In responding to your questions, we relied on past work related to our reviews of HHS's efforts to advance the use of health information technology and develop a national health information technology strategy. We reviewed our prior reports and testimonies on the department's efforts to define a national strategy for health information technology and to ensure the privacy of personal health information. We conducted this performance audit from February 2008 to March 2008. All work on which this correspondence is based was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Should you or your offices have any questions on matters discussed in this letter, please contact me at (202) 512-6304 or by e-mail at melvinv@gao.gov. Key contributors to this letter were Barbara S. Collier, Amanda Gill, Nancy E. Glover, Saad Khan, and Teresa Tucker.

Sincerely yours,

Valerie C. Melvin

Valerie C. Melvin
Director, Human Capital and
Management Information Systems Issues

(310920)

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Director, Human Capital and
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(310920)

Senate Budget Committee Hearing:
"Health Care and the Budget: Information Technology and Health Care Reform"
Thursday, February 14, 2008
Written Responses for the Official Record, Mary R. Grealy, President, Healthcare Leadership Council

Question: I firmly believe that HIT can help increase health care quality and reduce costs. I have been working very hard to advance S. 1693, the Wired for Health Care Quality Act, through the Senate since the HELP Committee discharged the bill back in June. Some Members of the Senate have tried to block this process by insisting on adding new and cumbersome privacy regulations on top of what exists in current law. For instance, one proposal seeks to allow patients to hide pieces of their medical record from their own doctors; information like prescriptions or diagnosis of a particular disease. If a patient was able to shield clinical information from their doctors, what kind of impact would that have on patient care?

Response, Mary Grealy: Senator Enzi, on behalf of the Healthcare Leadership Council, I want to thank you for your hard work to advance HIT legislation. We share your support of the "Wired for Health Care Quality Act" (S. 1693) and commend you for your commitment to improving the health care system through the adoption of HIT.

Unfortunately, supporters of increased privacy requirements are attempting to attach provisions to the HIT legislation to revise and dramatically expand the HIPAA Privacy Rule. Many of these provisions aim to tackle issues that were previously discussed and rejected during the rulemaking process which spanned both a Democratic and Republican Administration.

Senator, for more than ten years, HLC has chaired the Confidentiality Coalition, a broad-based group of hospitals, health plans, pharmaceutical companies, medical device manufacturers, biotech firms, employers, health product distributors, pharmacy benefit manufacturers, pharmacies and academic health centers. The Coalition was formed to advance effective patient confidentiality protections.

The Confidentiality Coalition is very concerned about the proposals you mentioned to allow patients to shield clinical information from their doctors, among other requirements. Patient safety would be in grave danger under these kinds of privacy-related proposals. Under these proposals, patients would be able to segregate or mask any type or amount of protected health information and limit the use and disclosure of segregated information. This will increase the administrative cost and complexity of administering patient records systems.

Of much greater concern, heavily redacted records could potentially destroy the reliability and integrity of patient records for use in treatment decision making and could increase the probability of medical errors, as well as duplicative testing and other services.

This could result in negative quality outcomes in both the ongoing delivery of care and medical research. In addition, providers are very concerned about potential liability in a system predicated on reliance on incomplete information.

We urge your continued opposition to these proposals that we believe are incompatible with the aims of HIT legislation.

Question (paraphrased from Senator Wyden, transcript page 66, lines 22 to page 67, lines 17): My time has expired and let me just ask one question that perhaps you could respond [to] in writing. In the past we have really looked to the Agency for Healthcare Research and Quality to take the lead in terms of getting this kind of information out. I think there is certainly going to be a debate about whether we ought to reconfigure their role and have them take on additional assignments. If you could get back to us for the record what kinds of suggestions you could give us for the best way to use that premier agency with respect to information and data as it relates to quality, that would be very helpful.

Response, Mary Grealy: Senator Wyden, the HLC recognizes the important work that AHRQ has conducted over the years related to studying and assessing the quality of healthcare in this country. As we continue to work towards widespread adoption of HIT as a tool towards improving the quality and efficient of health care, undoubtedly AHRQ must play a key role in quality research and the more rapid dissemination of information on best clinical practices through the use of HIT.

As an organization that strongly supports a patient-centered health care system, HLC recognizes that one of the most important benefits of HIT is the promise of a unified electronic health record to give patients and providers a complete look at all the information related to that specific individual's health. As a component of that, HLC agrees that the patient as a consumer will play a critical role in creating a health system that pays for value.

AHRQ has already devoted significant resources towards President Bush's goal of adoption of interoperable electronic health records within 10 years for most Americans. They have already commissioned more than $166 million grants and contracts throughout 41 states to spur investment in HIT, including in rural areas, that I highlighted in my testimony as in particular need of assistance to encourage adoption. In return, AHRQ and others will identify the solutions, challenges, and best practices for HIT. The AHRQ National Resource Center for Health Information Technology has already been established to disseminate their findings and assist the health care community as they work to bring the benefits of HIT to their patients.

However, as key stakeholders work with AHRQ and other key entities, such as the American Health Information Community (AHIC), to set HIT policy that represents demonstrated best practices and lessons learned, it may be premature to envision what specific activities AHRQ is best suited to conduct related to HIT and quality improvement. We look forward to working with members of Congress, AHRQ and other stakeholders to develop a specific and fitting role for AHRQ that builds on their extensive experience and expertise in critical health policy initiatives and improving the quality of care.

Responses for the Record

Question from Senator Michael Enzi to Laura Adams, President and CEO, Rhode Island Quality Institute:

How can health information technology assist in not only measuring quality data but using that data to improve the quality of care?

Senator Enzi,

Thank you very much for your question—it is central to the debate on the value of health information technology. As I'm sure you're aware, health IT can greatly assist in measuring quality data when designed as not only a means for documentation and communication at the point of care, but as a tool to collect data for quality measurement and assessment of performance at every step of the care process.

A hallmark of world class companies known for their superior quality is the availability of data on the performance of processes. These data are automatically generated as part of the manufacturing or service processes. Front-line employees use these date to anticipate, prevent and correct defects in real time and management and staff view the data over time and/or in aggregate to continually improve quality.

Health care providers on the other hand have very little access to data on the quality of their work. As a case in point, about a month ago, I met with a prominent physician who is the Director of Surgery for a Boston-area medical center. I asked him if the operating-room staff knew their post-operative wound infection rates. The answer was no and, sadly, this isn't unusual. This is one of the most critical and basic of outcome measures in an operating room and yet the staff has no knowledge of how well they are performing. Instead, because of the difficulty of generating the data, weeks or months-old infection reports are distributed to managers in formats that make analysis difficult and at levels of detail that make evaluation of improvement efforts almost impossible.

This is characteristic of the majority of health care processes in the U.S. We have precious little data to guide decision-making and to employ in real-time to assure and improve the quality of care. In the absence of automated systems to generate data, providers must engage in laborious and resource-intensive processes of manual extraction of data from paper records. This limits the types of data that can be gathered as well as the amount, the granularity, the frequency and the timeliness.

Properly designed, health IT systems could be a one of the more significant advances in the history of health care quality improvement science and practice. As an example in the hospital setting , IT systems can prompt ICU practitioners to make sure patients on ventilators are also on protocols to prevent blood clots from forming, which is a best-practice standard of care. It can repeat this reminder during the course of care if the protocol is not initiated. It can also generate real-time reports of how many patients and which ones never received the appropriate care. That same system can identify those patients who developed blood clots and provide much more timely measures of outcome. It can trend all of the aforementioned data over time in aggregate to shed light on how well quality improvement initiatives are succeeding at ensuring that all patients who need this care are getting it.

As an example of the value of health IT in the physician's office, when blood sugar levels are documented in the records of patients with diabetes, an advanced EHR can generate reports of the blood sugar levels of all patients with diabetes in an individual physician's panel or at the practice level. When aggregated and reviewed at regular intervals, these data can show such things as:

-How many and which patients with diabetes have blood sugar readings above the desired level (a proxy measure for the quality of care)

-How many and which patients have not been seen in at the appropriate intervals to adequately manage their diabetes and follow-up contact can be made with these patients to bring them in for the care that is essential in managing their illness

-How many and which patients with diabetes are improving as evidenced by their blood sugar readings and the physician/practice can expand and reinforce those approaches and processes that are succeeding with a high number of patients

-How many and which patients are benefitting from quality improvement initiatives. When the physician or practice implements new processes and programs to help patients manage their chronic illness, measuring the aggregate data over time can reveal how well these improvements are working. Basic graphs of data over time can document when improvements were initiated and the effect following the implementation.

These are just two examples of how health IT could be applied in virtually every process of care to generate data to prompt adherence to evidence-based medicine/best practices and to track key process and outcome measures without the costly and inefficient manual chart review that is the prevailing practice.

It follows that if the majority of patient records were electronic, data could be gathered on a region or state-wide basis to assess the effect of more far-reaching policy initiatives designed to produce improvement in the outcomes of care.

Clearly, I believe strongly in the contribution of health IT to improving quality. My background is in quality improvement –not technology--and the only reason I'm spending almost all of my life moments advancing health IT is precisely because of its potential to save lives and prevent suffering.

I hope this response was helpful. I'd be happy to expand on these concepts, provide further detail or respond to additional questions.

Laura Adams

Responses for the Record

Question from Senator Bill Nelson to Laura Adams, President and CEO, Rhode Island Quality Institute:

What potential do health IT reforms have to slow the growth in health care spending?

Senator Nelson,

Thank you very much for your questions. They're important to address in a national discussion of the value of health IT. I appreciate this opportunity to make additional contributions to the discussion and my responses are below:

What potential do health IT reforms have to slow the growth in health care spending?

Health IT reforms have significant potential to slow the growth in health care spending when coupled with reform of payment/incentive systems and redesign of care delivery systems, such as instituting the Medical Home model and broadening quality improvement efforts.

One study that examined the potential of health IT when coupled with optimal processes of care for managing such conditions as chronic illness came out of the RAND Corporation. It was published in 2005 by Richard Hillestad, et. al, and is entitled, "Can Electronic Medical Records Systems Transform Health Care? Potential Health Benefits, Savings and Costs." The conclusion of this research team was that the adoption of interoperable EMR systems could produce efficiency and safety savings worth \$142–\$371 billion. Their abstract embedded within their article reads, "To broadly examine the potential health and financial benefits of health information technology (HIT), this paper compares health care with the use of IT in other industries. It estimates potential savings and costs of widespread adoption of electronic medical record (EMR) systems, models important health and safety benefits, and concludes that effective EMR implementation and networking could eventually save more than \$81 billion annually—by improving health care efficiency and safety—and that HIT-enabled prevention and management of chronic disease could eventually double those savings while increasing health and other social benefits. However, this is unlikely to be realized without related changes to the health care system."

Regarding these "related changes to the health care system" they write, "For example adoption of EMR systems and valid comparative performance reporting, which would enable the development of value-based competition and quality improvement to drive transformation. Health IT also should facilitate system integration for broader optimization, and comparative benchmarking should encourage development of market-leading examples of ways to better organize, pay for, and deliver care."

However, there have been studies done that project significant savings from health IT adoption and use alone, such as the Johnston, Douglas, et al. study entitled, "The Value of CPOE in Ambulatory Settings" (2004) and the Pan, Eric, et al. study out of the Center for Information Technology Leadership's study entitled "The Value of Health Information Exchange and Interoperability" (2005). These studies report that the net estimated savings from a National Health Information Infrastructure are \$132 billion ***annually***.

While I recognize that there is significant value in just the adoption of health IT to reduce costly errors and contribute to better coordination of care, the true potential for health IT to slow the rate of spending depends upon whether it is coupled with the other key reforms. If only one other reform were to be undertaken, it must be reform of the payment/incentive system.

Our current payment/incentive systems basically reward piecework and we're getting exactly what we pay for. Sandeep Jauhar, MD, a Long Island cardiologist, offers an extremely compelling insight into the effect of the current system in a New York Times essay published March 11, 2008. Dr. Jauhar writes, "Doctors are usually reimbursed for whatever they bill. As reimbursement rates have declined in recent years, most doctors have adapted by increasing the quantity of services. If you cut the amount of air you take in per breath, the only way to maintain ventilation is to breathe faster. Overconsultation and overtesting have now become facts of the medical profession. The culture in practice is to grab patients and generate volume. "

It is my belief that the coupling health IT reforms with payment/incentive reforms to reward the care we want will drive other elements of the transformation and do so rather quickly.

How long do you think it will take to begin seeing savings?

The timeline for seeing any of the potential savings from health IT is correlated with the pace of adoption and use, which at this point is plodding along. This is especially true of the savings from electronic health information exchange, as this a type of innovation that is characterized by a "network effect". Network effects show relatively little value in the beginning when only a few people are "on the network", but the value increases as the network grows. A good example of this is fax machines—they're not worth much when only 10 people in town have one, but as the network grows, they become more and more valuable.

Uncertainty about the savings and to whom they accrue is one of the biggest barriers to investment in health IT. This underscores the need to fully fund a few comprehensive demonstration projects in the nation as soon as possible to shed light on these unknowns and establish evidence of the savings generated. The models, improved based on the lessons learned, could be replicated across the nation.

To answer your question directly, without any reforms to speed health IT adoption and use, it could easily be 10-15 years before we see significant savings from health IT. If there are no payment/incentive reforms adopted concurrently, the savings from health IT could be offset by having enabled the system to produce more piecework faster.

Do you have samples of savings from initiatives that your organization has implemented in the state of Rhode Island?

We do not have samples of savings from the implementation of health IT in Rhode Island at this point. We are just now getting our electronic health record adoption above 25% and our health information exchange is scheduled to being exchanging a limited amount of data with 4 large data submitting partners this fall. Essentially, we don't have enough of the" network effect" at this point and it is a bit early to assess value.

With this level of adoption and maturity of the implementation, we haven't invested dollars in evaluation of the financial results. Like many other Regional Health Information Organizations (RHIOs), we have very limited funds and direct nearly everything we have toward getting health IT adopted and used.

Probably the best examples of evaluation of the savings of health IT adoption alone will come out of Massachusetts later this fall or early in 2009. They plan to release the results of an e-prescribing initiative than has demonstrated significant savings. Also, the Massachusetts eHealth Collaborative, funded at the level of $50 million by Blue Cross and Blue Shield of Massachusetts, will produce a comprehensive analysis of the effect of completely connecting all of the providers in three communities through a linked EMR system. Their project ends in December of 2008 and my understanding is that we can expect the analysis to follow.

Thank you again for the opportunity to provide this testimony.

Laura Adams